BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Starwood Property Trust (STWD) Update
Maintain BUY

We are maintaining our BUY recommendation on STWD. Given some of the moves in the bond market, we thought clients may want to remember a few key points about STWD:

1. Interest rate movements will not hurt the company. In general, STWD benefits from rising LIBOR because the bulk of its investment portfolio is tied to LIBOR. We have noted many times that STWD picks up about 6-7 cents in EPS from every 100bp increase in LIBOR.

   It is also worth noting that if interest rates are cut, STWD has many investments with LIBOR floors. Thus, if rates decline noticeably, the company's EPS will rise that way also. The sensitivity analysis STWD has done shows it gains 8-cents in EPS from a 200bp decline in LIBOR.

2. The company's LTV (Loan to Value) ratio of 64%-66% depending on the sector is really a collection of 64%-66% LTVs. It is not a barbell approach where some 90% and 95% loans are averaged down with a pool of 50% loans. In the event of stress, a barbell would likely see more problems in the 90%-95% LTV area. Conversely, very little of STWD's book will have issues with underwater investments.

   In 4Q18, the company stress tested its full portfolio for a 20% drop in real estate values across the board and spreads on loans widening by 250bp both within a single day. They looked for impacts on liquidity, book value, and debt/bank lines. STWD found it could not only endure that type of an event – it would still have liquidity to take advantage of bargains caused by other players being in trouble and could be a buyer.

3. In times when the market is looking at falling interest rates instead of rising rates, being in the ETF funds with residential mortgage REITs may be beneficial. When we first wrote about STWD, we noted that it is being misclassified and grouped into ETFs where the bulk of other players deal solely with buying residential agency fixed-rate mortgage bonds financed at 5:1 – 9:1 leverage with a large difference in funding maturities vs. those of assets. STWD instead has floating rate loans and funding and focuses much more on commercial property. It can own property directly and has diversified in several areas. It also carries considerably less leverage.

   When investors believe interest rates are unlikely to rise and may in fact decline, the traditional mortgage REITs like Annaly Capital (NLY) and AGNC Investment (AGNC) which make up 20%-27% of the two largest ETFs for the group look more attractive. STWD at 6%-8% of those ETFs could benefit from more investors eyeing the ETF portfolios yielding over 8%.

Ocean Yield (OCY NO, OYIEF) Update on FPSO Maintain NEUTRAL

We are maintaining a NEUTRAL Rating as the company announced an extension of the option for the FPSO vessel with Aker Energy until September 1st. That does ensure the FPSO will generate some income and cash flow in 2Q19 and 3Q19. If terms remain the same ($50,000 per day), it adds about 3-cents to 2Q in EPS and 2 cents for 3Q.

Aker Energy has submitted a revised plan to Ghana for development of a multi-year deepwater drilling project. It expects to get feedback from the government and expects to receive final approval in the 3Q19. Also, in the news, Aker is exploring the use of an FPSO from SBM Offshore or Yinson on the project, which may be bad news for Ocean Yield.

There are multiple reasons to still expect Ocean Yield's ship to be used. Aker owns 49% of Aker Energy and 61.7% of Ocean Yield. Also, the project expects to be producing oil within 35 months of final approval. That gives ample time to modify the Ocean Yield FPSO. It is debt free as well, so it is not costing anything during this time. It should also help Ocean Yield stock and bolster the dividend coverage for the largest investor.

Ocean Yield is also marketing the ship to other projects that are starting up as well. It believes it should be able to resolve the matter by 1Q20, which is essentially the time-frame we have been targeting. We actually think by then; a new deal will be in place or the ship will be sold.

We have believed that 2019 would be the transition year and there is enough cash and liquidity to sustain the dividend until the FPSO situation is concluded. However, if there is no deal or sale of the vessel, the dividend would likely need to be reduced. The company indicated that if neither solution is in place by then, it may adjust the dividend down to 15-cents per quarter from 19.1 cents. That would save the company about $6.5 million per quarter ($26 million annually) in dividends and create a sustainable situation with an idle FPSO. The dividend yield would be 9.1% vs. the current 11.5%.

Longer term, we still believe the FPSO situation will reach an end and not remain an idle vessel for Ocean Yield in 2020 and beyond. It's on the books for $232 million and is debt free. It has already had an impairment charge in late 2018 when Reliance did not exercise the purchase option. Even if it is sold for $100-$150 million, we believe Ocean Yield can leverage that capital 4-1 and invest in new ships worth $500-$750 million. It has been earning double-digit rates of returns these deals and should be able to produce more than $26 million annually to cover the potential dividend reduction. For example, the company's 49.9% equity investment in 6 containerships cost $162 million and is producing equity income of $5.7-$6.0 million per quarter.

If Aker signs a long-term deal on the FPSO it is expected to be a double-digit rate of return on $232 million plus $200-$300 million of modifications made and financed by Ocean Yield. That again should be a figure higher than the $26 million discussed above.

Kellogg (K) EQ Update 3/19 Qtr.

Current EQ Rating*	Previous EQ Rating
2+	2-

*For an explanation of the EQ Review Rating scale, please refer to the end of this report

We raise our rating to 2+ (Weak) from 2- (Weak)

While the company will still be dealing with the negative impact of its receivables factoring and payables reverse factoring arrangements unwinding, we consider the overall earnings quality picture for the company to be slightly improving. The company plans to sell off part of the Keebler business which will generate proceeds of $1 billion which the company will use for debt reduction. It remains to be seen if the company can reignite any lasting organic growth from its brand revitalizing efforts.

- Accounts receivable days of sales at the end of the 3/19 quarter based on receivables remaining on the balance sheet fell 0.7 days versus the 3/18 quarter. Sold but outstanding receivable days of sales also fell by a similar amount. The boost to cash flow growth from increasing the pace of selling receivables has played itself out. We do not see how cash flow growth can benefit from working capital management going forward without growth in the rate of factoring.

- Accounts payable days fell by 5 days compared to the year-ago first quarter. This marks two quarters of year-over-year declines, taking away a key source of cash flow growth. Payables in the tracking system rose to 35.8% of total payables from 32.5% a year ago but remained below the peak of 37.6% set in the 9/18 quarter. Payables sold by suppliers under the tracking system were 25.0% of total payables which was slightly above a year ago but well below the 28.9% in the 12/18 quarter. The cash flow boost from this program appears to have run its course.

- Accrued advertising and promotion expense showed a year-over-year decline again despite an increase in revenue. The company experienced exceptionally strong promotional activity in the year-ago quarter, but given its push to revitalize its brands, we would not expect any benefit from lower promotional and advertising spending to last.

Clorox (CLX) EQ Update- 3/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3-	3-

*For an explanation of the EQ Review Rating scale, please refer to the end of this report

We maintain our rating of 3- (Minor Concern).

- We remain concerned by the buildup in inventories which we pointed out in our review of the 12/18 quarter. In the conference call, management continues to blame the increase on its 4/2/18 acquisition of Nutranext:

  "Yes, no real change there. It's pretty consistent to what I mentioned last quarter, we were up about $48 million year-over-year at the end of Q3, $46 million was Nutranext, so the base business was essentially flat year-over-year and that was my commitment. Last quarter, we'd worked down the higher inventory as we launched our innovation. We had pre-built some innovation.

  And as I also mentioned, if you think about Nutranext, it's a relatively small business we've acquired, it was not particularly efficient when we bought it. Their days on hand probably operate in the 120 to 130 days. Clorox generally operates in the 50 to 60 days inventory on hand. So, there are some good work and some good opportunity for us to go through there and make that business more efficient.

  It will not be our first priority. We're focused on innovation. We're focused on extending distribution, but we will improve the overall turns of that business, but the other comment I'd say is I never expected to be consistent with other parts of our portfolio. They tend to be very high turn items. I think the VMS space in general will be a little bit higher in inventory levels and days on hand because of the complexity, but certainly expect it to be lower than where it is right now."

  We remain puzzled by management's explanation of the increase. Remember that inventory days (DSI) of sales jumped over 7 days in the 12/18 quarter. However, the increases in DSIs in the 6/18 and 9/18 quarters (both post-Nutranext acquisition) were only about 2 days. DSIs rose by 4.4 days in the 3/19 quarter, which was still notably higher than the increases seen in the first two quarters after the acquisition.

Management's admission that Nutranext had inefficient inventory management prior to the acquisition implies that improving the inventory situation should be relatively easy. Also. remember that sales fell short of expectations in the 3/19 quarter and the company lowered guidance partly due to increased competition in Glad bags and lower demand for sanitizing wipes. All of these factors continue to give us cause for concern that the increased inventory balances could have a negative impact on margins in upcoming quarters.

- CLX's buyback is now consuming more than free cash flow and adding about 1.2% to reported EPS growth. Organic growth is essentially non-existent. Debt to EBITDA is approximately 2x so this is not an immediate problem but warrants observation going forward.

Baxter (BAX) EQ Update- 3/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3-	3-

*For an explanation of the EQ Review Rating scale, please refer to the end of this report

We maintain our rating of 3- (Minor Concern).

BAX reported adjusted EPS of $0.76 in the 3/19 quarter which was 8 cps ahead of the consensus expectation. We estimate that about 3 cps came from timing of R&D spending, about 4 cps from a lower than expected tax rate, and another penny from lower pension expense. As such, we do not view the earnings outperformance as a high-quality beat. Management upped its full-year guidance by 5 cps reflecting the outperformance for the first quarter offset by the anticipation of the R&D benefit reversing during the remainder of the year.

- R&D expense fell precipitously in the quarter due to the timing of projects. After adjustment for one-time items in both periods, R&D as a percentage of revenue fell to 4.3% from 5.1% in the year-ago period. We estimate this provided an approximate 3 cps tailwind to results. Management indicated that the spending will shift into the remainder of the year so this tailwind should disappear going forward.

- We noted in past reviews that year-over-year pension expense was falling significantly after the company froze its US pension plans at the beginning of 2018. However, pension expense continued to decline, falling by $6 million in the 3/19 quarter courtesy of lower amortization of net losses and prior service cost. This added about a penny per share to EPS growth.

- The adjusted tax rate for the quarter was 12.7%, well below the forecast 18% effective rate for 2019 which the company forecast in the fourth quarter. Management stated in the conference call that "The adjusted tax rate was 12.7% for the quarter, favorable to our expectations, primarily driven by a benefit of $34 million related to stock compensation deduction as compared to $13 million in deductions to previous year…" We estimate that the lower tax rate added about 4 cps to EPS in the quarter.

- Management accelerated the buyback in the last two quarters, spending \$1.4 billion in the fourth quarter and another \$597 million in the first quarter of 2019. This had the effect of lowering the share count by 5.2% in the 3/19 quarter versus the 3/18 quarter, providing more than half of the 9% adjusted EPS growth in the period. Cash spent on the buyback more than consumed free cash flow after the dividend on a trailing 12-month basis. With debt to EBITDA below 2x, so this is not an immediate problem. In addition, the timing of the purchases appears to make this buyback more of a capital allocation decision than and a way to boost EPS though an ongoing buyback program the company can't afford which we have been critical of with other companies. Still, investors should realize the extent to which recent adjusted growth is coming from a non-operational source.

- Inventory DSIs continued to rise, climbing by almost 11 days versus the year-ago quarter. Management attributed this to unanticipated sales mix shift but indicated in the conference call that there will be improvement in upcoming quarters:

  "Where we expect to see a significant improvement in working capital relates to inventory. This is an area that has disappointed us over the last year. The inventory build up as a result of different sales mix than we anticipated has been a real problem and something that we focused on correcting but it's not something that corrects overnight.

  And in the first quarter of the year, the days inventory on hand will end at roughly at 107 days. By year end, we will expect to see roughly a 10-day improvement in that particular area. And frankly, that will drive the lion share of performance in our cash flow – free cash flow for the year. We've got a new leader in supply chain, Philippe Reale comes to us and we are excited to have him on board."

Becton Dickinson & Co. (BDX) EQ Update- 3/19 Qtr.

Current EQ Rating*	Previous EQ Rating
4-	4-

*For an explanation of the EQ Review Rating scale, please refer to the end of this report

We maintain our rating of 4- (Acceptable).

- Pension expense fell by $4 million due to a higher expected return on plan assets and the absence of a $2 million settlement charge. This only added about a penny to EPS in the quarter.

- Inventory days of sale jumped by 19 days over the year-ago level. However, this represented a normalization as year-ago inventory levels were artificially depressed from the release of back ordered stock to satisfy last year's spike in demand driven by hospitals stocking up on supplies ahead of Hurricane Maria. Therefore, we are not concerned with current inventory levels.

- The main overhang we see with the stock is the myriad of legal and regulatory issues facing the company. During the quarter, BDX took a $331 million charge to increase its legal reserves as well as accruing $65 million in remediation expenses related to its *Alaris* pump recall.

- BDX is currently not buying back shares and remains in deleveraging mode a year after the Bard acquisition. It recently increased the size of its tender offers for its long-term notes by roughly $175 million.

Stanley Black & Decker (SWK) EQ Update- 3/19 Qtr.

Current EQ Rating*	Previous EQ Rating
4-	4-

*For an explanation of the EQ Review Rating scale, please refer to the end of this report

We maintain our rating of 4- (Acceptable).

- SWK's inventory days continued to climb in the quarter, rising by almost 9 days over the year-ago period. Management continues to attribute this to preparation for new product launches, stating in the conference call that "*Tools & Storage continues to carry high levels of inventory to support the ongoing Craftsman rollout and other brand transitions that we are currently executing across the channels.*" We are still not concerned by higher inventory given the nature of the Craftsman launch and management has indicated we will see a moderation in working capital during the remainder of the year.

- After discontinuing its sales of accounts receivable at the end of 2017, the company restarted its receivables sales program in October of 2018. Trade receivables are transferred to a wholly-owned bankruptcy remote subsidiary which in turn sells receivables to a third-party financial institution. Receivables sold are derecognized from the balance sheet and all related cash flows are reported in the operating section of the cash flow statement. Derecognized receivables only amounted to $25 million at the end of the 3/19 quarter and DSOs adjusted for those amounts still showed a decline versus last year. We are therefore not currently concerned at this point the factoring program is being used to mask a buildup in receivables.

- Provision expense for doubtful accounts jumped to $18.3 million in the 3/19 quarter from $6.8 million in the 3/18 quarter. This helped drive the allowance for bad debts to 6% of gross receivables compared to 4% a year ago. We saw no mention of what drove the increase, but the spike in provision expense would have provided an approximate 6 cps headwind to EPS growth in the quarter.

Explanation of EQ Rating Scale

6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

Disclosure

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