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BTN Research

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

June 13, 2019 | www.btnresearch.com

Aggressive Non-GAAP Latin FX Adjustments Padding Results and Bonuses (SEE, MDLZ, CL, KO, PEP)

One of the things we look for in our work is small tidbits in company financials that should be immaterial but are in fact major drivers of reported results. Many of these would be difficult to find by using computer screens, but anecdotally they pop-up and simply don't pass a common sense test. Several years ago, Newell (NWL) (a company we could write a book on) was suddenly reporting massive growth in its writing division in South America. On the surface, there was massive inflation and horrible economies in Venezuela, Brazil, and Argentina. Other companies were leaving and even writing off cash because the value was plummeting. At the same time, Newell was making a fortune selling pens in South America with growth rates of over 30%. Somehow, it had a sprinter with a broken leg that was winning gold medals in the Olympics.

What we found was Venezuela's official exchange rate was essentially 6 to 1 for the US Dollar, but the black market exchange was 30 to 1 and on its way to 200 to 1. To make this illustration simple, let's say Newell sold pens for $1 and they cost $0.50 to make. Everywhere in the world, it was seeing at best low single-digit growth except in South America. What was happening was they could sell a pen in Venezuela for $0.50 – which should have produced no profit, but they actually were showing enormous gains in revenue and earnings. The $0.50 in revenue achieved at the black market value of 30 to 1, became 15 Bolivars, which the company translated at 6 to 1, and suddenly the $0.50 in revenue became $2.50 in revenue under GAAP. No longer was selling a 50-cent pen for 50-cents an unprofitable deal. Suddenly the margin was 80% with $2.00 in gross profit – that was 4x as profitable as selling in the US. The next year, with the black market at 60 to 1, the same pen could be sold for $0.50 as 30 Bolivars which became $5.00 in revenue. The growth in revenue was 100% y/y and income was rising too - all built on a collapsing economy.

Newell was not realizing cash income from this and it even took valuation reserve charges against some of this income as it could not repatriate the earnings. However, as just one of many charges that Newell was routinely taking, it was commonly added back to adjusted earnings. The important point is this one small collapsing country was driving a huge amount of revenue growth and allowing Newell management to hit targets to collect bonuses. We saw several periods where they would not have reached their goals if they used the real market exchange rates to translate foreign revenues. It also allowed the company to report to the analyst community that its organic revenue growth was often stronger than expected, which helped the stock price. A few years ago, Newell had to finally write-off the bulk of its assets and past earnings from Venezuela.

We believe we've found a similar situation at several companies from their results in Argentina in particular. Hyperinflation is driving huge revenue gains from a market that may be 1%-2% of total sales and that is carrying the "non-GAAP organic sales growth" figure up for these companies and helping them reach guidance. In reality, the size of the FX loss is also ballooning and actually creating net negative growth to match often negative volume growth. We believe investors are missing this problem and are not asking questions about how one of the weakest economies in the world is showing accelerating growth for results.

- **Non-GAAP revenue and income without Foreign Exchange can be helpful measures when the spread between GAAP and non-GAAP results is minor. As the spread widens, we believe investors need to ask more questions.**

- **With Argentina now classified as a hyperinflationary country, there is little reason to expect positive news from there. Yet, many multinational companies are reporting outsized growth in their Latin America divisions when they omit FX.**

- **Typically, organic or constant-currency results adjust for acquisitions, divestitures, and FX. It is expected to only focus on price and volume changes. With hyperinflation, it is common to see huge increases in price drive up these non-GAAP growth figures.** GAAP results are simultaneously being punished by exploding FX losses that offset those price increases and the spread between reported and adjusted results widens.

- **We found that many large companies are seeing revenue growth from their Latin American units that is considerably faster than the rest of the company. Looking deeper, that division is often showing negative volume growth and negative total growth due to heavy FX losses – hardly evidence that the unit is in great health.**

- **If we adjust for Latin American swings, the reported growth in revenues declines in a material way. Many of these companies are forecasting minimal sales growth, modest EPS growth or even declines – yet have P/E ratios over 20 based on the adjusted non-GAAP guidance. If this non-GAAP tailwind provided by higher Latin American pricing does not persist – guidance may need to be reduced further.**

- **Management performance pay is often tied to these non-GAAP metrics growing. It looks likely that many of them would be missing some of these internal growth targets without this Latin American situation too.**

- **Sealed Air saw South America at less than 5% of total sales – produce more than 100% of sales growth last quarter.** Before that, the unit was bringing in 4x its weight in sales growth and adjusted sales growth would have been cut in half without Latin America.

- **The spread for Mondelez reported vs. adjusted sales growth was only 100bp two years ago, now it's over 700bp. Its Latin American unit has posted negative volumes and very high FX losses for some time now – yet it is still regularly producing 20%-30% of MDLZ's adjusted sales growth.**

- **Colgate-Palmolive's Latin American unit is much larger at almost one-quarter of sales**. It actually is not posting absurd pricing gains but is still showing sizeable FX losses vs. gains only 2 years ago. **Their unit is much more of a wild card as it has periods when even volume is positive and being much larger, can dilute Argentina better.** It is a wild card because results have shown some large swings both good and bad.

- **Coca-Cola may already be missing on both adjusted sales and income growth targets without Latin America.** The spread between reported and adjusted results has increased from 100bp to 600bp. Latin America at 11%-12% of sales is often 20%-25% of total KO sales growth all due to rapid price increases. The FX-adjusted income growth rate of 11% last year would have been much lower without Latin America's 17% growth figure. No other major unit grows at more than 7%, and North America was negative.

- **Pepsico has the Latin America boost and still missed some growth targets last year.** The company is actually forecasting -3% negative growth for adjusted EPS this year on only 4% adjusted revenue growth. Latin America is becoming a smaller percentage of sales too so that may cut the impact.

Backdrop – Non-GAAP Measures Are Being Skewed in Our View

The current issue involves companies trying to report revenues and earnings with non-GAAP adjusted figures that exclude FX impacts. (Most will adjust for acquisitions and divestitures too). Many believe over time FX swings even-out and the modest swings in pluses or minuses for any given year are often immaterial. Plus, it is something the company does not have much control over so when FX is a larger impact on revenues and income – they want to isolate that from GAAP results to illustrate what the underlying company's true organic growth is before the masking or boosting impacts of FX changes. We understand why companies do this and, in many cases, it is valuable information.

Typically, this is called Constant Currency growth or Adjusted Organic growth and is supposed to represent largely changes in volume and changes in price mix to show revenue growth. When the results are modest, this often has minimal impact. A company may report 2% volume growth with 2% pricing gains and say Constant Currency revenue grew at 4%. There may be a +/- 1% for FX too, so GAAP would be reporting actual growth at 3% or 5%.

However, when a country becomes hyperinflationary, this presentation blows up into a non-realistic picture of what organic growth is. The difference between adjusted growth and GAAP growth can become absurd. A country in hyperinflation may report a -4% volume figure and a 26% increase in price. The FX may be a -35% figure. Suddenly, under Constant Currency growth – it appears the results are growing at 22% vs. GAAP reporting -13%. This is when this presentation – designed to provide a clearer picture of organic growth, clouds it tremendously. In this situation, one would have to believe that a country whose currency is in free fall with massive inflation is the hottest growth area in the world.

Even for a large multi-national company, the net impact on total sales may still seem very small. Argentina or the country in question may be only 1% of sales and considered immaterial. However, as a percentage of the total growth – it may be 30%-60% of the adjusted growth reported by the full company.

Management is often getting paid bonuses based on achieving sales and earnings targets and those targets are based on the adjusted figures, not GAAP. If adjusting out some of the impact of high-inflation removes 30%-60% of the growth, they may not be hitting those targets. Moreover, this is also how a company will report that it has had 7%-8% growth for several years but looking back at actual GAAP figures over that same period shows results are flat. Thus, the attempt to remove the FX impacts and show an adjusted organic growth figure is presenting an inflated view of the company. That could impact its P/E and P/EBITDA multiples as a result.

We looked at several S&P 500 companies for signs that constant currency growth in Latin America was becoming a significant source of total growth. We also looked at how actual growth compares to the touted adjusted figures over time and if management is paid based on the adjusted figures. We started looking at this problem when we were working on Sealed Air (SEE) but believe many others have a similar issue of their adjustments actually creating an unrealistic view of actual results less FX.

Sealed Air - Sales Growth is Negative Adjusting for South America

Let's look at what Sealed air touted for sales growth recently:

	1Q19	4Q18	2018	2017
Reported Sales Growth	-2%	3%	6%	6%
Constant Currency Sales Growth	3%	7%	7%	5%
FX Impact	-5%	-4%	-1%	1%
Acquisitions	2%	2%	3%	0%

On the surface, we would already note that constant currency sales growth is overstated if looked at as organic gains if it includes acquisition impacts. That would reduce it by 2%-3% right there. Then, the FX impact is becoming larger and the discrepancy between reported sales growth and adjusted constant currency growth is becoming wider.

Let's look deeper at results for the growth, where is it coming from?

	1Q19	4Q18	2018	2017
Constant Currency Sales Growth pre-acquisition	$8.8	$53.7	$200.7	$196.8
C.C growth From Latin Am.	$14.7	$20.1	$69.0	$9.9
Latin Am % of change	167.0%	37.4%	34.4%	5.0%
Latin Am % total sales	4.9%	8.7%	8.8%	9.2%

In 2019, Latin America was split up with South America becoming its own unit at under 5% of total sales while Mexico and Central America were added to the North American unit. The company has seen South America become over 100% of its constant currency growth. Moreover, the components of Latin America show it is largely the result of higher pricing due to inflation that is then more than wiped out by the FX losses:

	1Q19	4Q18	2018	2017
Latin Am Pricing	$14.8	$21.9	$45.6	$4.0
Latin Am Vol	-$0.1	-$1.8	$23.4	$5.9
Latin Am FX	-$18.9	-$25.8	-$62.6	$2.6
Net impact	-$4.2	-$5.7	$6.4	$12.5

The recent results are being carried by a unit that is posting such big FX losses that it is actually a drag on GAAP sales. Yet, SEE is reporting a much higher constant currency growth rate before FX in Latin/South America. If Latin/South America was removed from the mix entirely, look at how much reported sales growth would fall:

	1Q19	4Q18	2018	2017
Reported Constant Currency Growth	3.0%	7.0%	7.0%	5.0%
CC Growth w/o Lat. Am.	-0.6%	3.0%	3.3%	4.9%

Non-FX impacted sales growth would fall significantly under this scenario. Look at how the spread is widening too. Removing Latin America only had a 10bp impact in 2017, now it's running about 400bp. Plus, this isn't a high-growth company making an adjustment from 25% growth to 22% - the growth rate is being cut by more than half.

To its credit, SEE's management earns the bulk of its bonuses based on Adjusted EBITDA levels for 50% and the change in EBITDA margins against actual sales for 30%. The Adjusted EBITDA adds back gains and losses from divestments, restructuring charges, stock-based compensation – fairly common adjustments. They did not adjust for Latin America other than a $2.5 million charge for FX losses due to highly inflationary currencies in 2018. That is against the reported Adjusted EBITDA of $890 million. We are going to consider that immaterial and the EBITDA does reflect the problems with South America.

There are some Performance Share Units (PSUs) that are weighted to sales growth also. Those also appear to only adjust for internal sales, not FX making that a reasonable approach too.

However, we believe SEE already has growth problems and those look even worse if hyperinflationary pricing is factored out.

Mondelez International – Spread between Organic and Reported Sales Growth Increasing

MDLZ does not grow very fast either and reported sales growth has been negative the last two quarters. However, its non-GAAP measure for Organic Sales growth which excludes acquisitions, divestitures, and FX moves is rising. The spread has grown significantly in the last year:

	1Q19	4Q18	2018	2017
Reported Sales Growth	-3.4%	-2.8%	0.2%	-0.1%
Organic non-FX Growth	3.7%	2.5%	2.4%	0.9%
FX Impact	-7.1%	-5.3%	-2.2%	-1.0%

Again, we see a company seeing accelerating decay and it does a fair amount of business with emerging markets. It lists Argentina as only 1.5% of total sales and it also adopted hyperinflationary status in 3Q18. While not as pronounced as Sealed Air, Mondelez results are still getting an outsized benefit to growth from Latin America:

	1Q19	4Q18	2018	2017
Constant Currency Sales Growth pre-acquisition	$251	$174	$603	$220
C.C growth From Latin Am.	$75	$35	$129	$120
Latin Am % of change	29.9%	20.1%	21.4%	54.5%
Latin Am % total sales	13.8%	11.3%	12.3%	13.8%

At 11%-13% of sales, Latin America before FX consistently reporting at least double that impact on the non-GAAP Organic Sales growth figure. So while Latin America inflates organic growth, its actual sales results are in decay as FX and volume losses overwhelm the huge prices increases:

	1Q19	4Q18	2018	2017
Latin Am Pricing	$88	$65	$221	$260
Latin Am Vol	-$13	-$28	-$93	-$142
Latin Am FX	-$166	-$172	-$493	-$62
Net impact	-$91	-$135	-$179	$57

Management bonuses are 40% tied to their Organic Revenue Growth rate. On the surface, it already looks inflated as FX loses increase the divergence between Organic and GAAP sales growth. However, the company has a very low target to reach even on Organic Growth to pay bonuses. The minimum amount is -0.5%, the target is 1.5% and the maximum payment is reached at 4.0%. Thus a few basis points make a difference. If Latin America is taken out of the mix, Organic Growth falls 40-70bp in recent periods:

	1Q19	4Q18	2018	2017
Reported Organic Sales Growth	3.7%	2.5%	2.4%	0.9%
Organic Growth w/o Lat. Am.	3.0%	2.3%	2.1%	0.5%

Colgate-Palmolive Weak Sales Growth Even with a Larger Latin American Unit

CL has a much larger exposure to Latin America at 22%-25% of sales. That also helps dilute the impact of Argentina. In 2007, the company had positive figures for price, volume, and FX in Latin America. We may not have included this one as an example based on 2018 figures, but 1Q19 showed more signs of the organic growth without FX issues.

Again, CL is a company not reporting much growth at all and the spread between reported sales before acquisitions/divestitures and organic sales is widening.

	1Q19	4Q18	2018	2017
Reported Sales Growth	-3%	-3%	-0.5%	1.5%
Organic non-FX Growth	3%	2%	0.5%	1.0%
FX Impact	-6%	-5%	-1.0%	0.5%

In 2017, FX was actually a slight positive. In both 2017 and 2018; CL showed what the organic growth calculations are supposed to do. Basically, remove the impact of minor amounts of FX to help establish what is the underlying rate of growth. But does anyone really believe the organic growth rate suddenly rose 300-600%? It's still mediocre at 3% last quarter, but Latin America was a big help after being a drag in 2018:

	1Q19	4Q18	2018	2017
Constant Currency Sales Growth pre-acquisition	$120	$78	$77	$152
C.C growth From Latin Am.	$56	$10	-$39	$201
Latin Am % of change	46.4%	12.6%	n/a	132%
Latin Am % total sales	22.9%	23.3%	23.2%	25.2%

While 1Q19 showed what we expected – an outsized gain in sales growth that is more than double what Latin America is as a percentage of sales – CL actually saw some volume growth. Also of interest, the pricing gains in Latin America have not been nearly the level posted by others:

	1Q19	4Q18	2018	2017
Latin Am Pricing	$33	$44	$58	$110
Latin Am Vol	$23	-$34	-$97	$91
Latin Am FX	-$98	-$98	-$253	$36
Net impact	-$42	-$88	-$179	$237

The pricing gains have been only 1.5%-4.5% and volume was positive in 2017 and early 2019. The decay in volume in 4Q18 and 2018 actually makes removing Latin America from the organic sales mix a positive for CL.

	1Q19	4Q18	2018	2017
Reported Organic Sales Growth	3%	2%	0.5%	1.0%
Organic Growth w/o Lat. Am.	2.1%	2.3%	1.0%	0.0%

Management does have bonuses determined by organic sales growth – however, they have not been hitting their targets there. The target is 3% and that was not reached in 2018 or 2017. The 1Q19 they did reach it, helped considerably by Latin America.

Just looking at the results, we see Latin America as a bigger wildcard for CL than most of the other companies we looked at. It can point to periods where Latin America was a drag and when it was a boost. The lower than normal pick-up in pricing is also a positive sign overall for better quality behind the Organic Sales Growth figure here. We would be more concerned that CL still cannot make targets with this potential push and has not been coming close.

We also want to note that CL also has bonuses calculated on currency neutral EPS that is adjusted for restructuring charges, divestments, and acquisitions too. The company is not hitting these targets either for 2017 or 2018 that are looking for 10% growth. In 2017, adjusted EPS growth was 0.7% followed by 4.5% in 2018. The FX impact by division is given for sales but not net earnings. Thus, at this point all we can point to is of the total FX impact in 1Q19 of 6% and 4Q18 of 5% - the weighted averaged impact of Latin America was 2.4% and 2.3% respectively. The spread between organic and reported sales growth is getting wider as well. So, adding back FX losses to EPS may become a larger source of this adjusted figure.

Coca-Cola May Miss on Adjusted Sales and Income Growth without Latin America

KO has some issues with bottler transactions in recent years and those acquisitions and divestitures can cloud the results a bit. We adjusted the reported sales growth for those items. The company is seeing the same widening of the spread between reported sales growth and organic sales growth that excludes FX:

	1Q19	4Q18	2018	2017
Reported Sales Growth	0%	0%	4%	2%
Organic non-FX Growth	6%	5%	5%	3%
FX Impact	-6%	-5%	-1%	-1%

Latin America is providing a boost to organic sales beyond its actual weighting to overall sales and it is all coming from pricing gains:

	1Q19	4Q18	2018	2017
Constant Currency Sales Growth pre-acquisition	$458	$376	$1771	$1032
C.C growth From Latin Am.	$60	$78	$443	$191
Latin Am % of change	13.1%	20.7%	25.0%	18.5%
Latin Am % total sales	11.2%	13.9%	12.6%	11.4%

The company calls out Argentina for strong pricing and collapsing volumes – "[In 1Q19] Unit case volume declined 1% as growth in Brazil, Peru and Chile was more than offset by a double-digit decline in Argentina. Price/mix grew 9% for the quarter, largely driven by strong performance in Brazil and pricing in Argentina."

	1Q19	4Q18	2018	2017
Latin Am Pricing	$90	$145	$403	$306
Latin Am Vol	-$30	-$67	$40	-$115
Latin Am FX	-$160	-$190	-$363	$0
Net impact	-$100	-$112	$80	$191

In 1Q19, Latin America's impact was closer to its actual percentage of total sales and it did not create a bump in growth. But, in prior periods, Latin American organic growth without the FX impact was producing about twice the positive impact on overall company growth as it should:

	1Q19	4Q18	2018	2017
Reported Organic Sales Growth	6%	5%	5%	3%
Organic Growth w/o Lat. Am.	6.0%	4.7%	4.2%	2.8%

Coke management has an organic revenue growth test for 50% of bonuses. Again, there is a low target of only 4% on it and the company beat it in 2018 with a 5% figure. However, adjusting for Latin America, the beat would have been less impressive.

The other issue with Coke is it also pays 50% of bonuses based on hitting/exceeding targets for adjusted currency neutral operating income growth. The target here is 8%. Latin America is having a larger impact here than on sales:

	1Q19	4Q18	2018
Reported Op Inc. Growth	5%	-4%	6%
Organic non FX Growth	16%	8%	11%
FX Impact	-11%	-12%	-5%

Coke exceeded the target in 2018 with an 11% currency adjusted organic growth rate for operating income against the target of 8%. However, at nearly one-quarter of sales, Latin America was 36% of the income growth. With Europe/Middle East/Africa at 7% growth, North American at -5%, and Asia Pacific at 6% - it's likely Coke does not reach this target without Latin America's 17% growth rate in FX adjusted operating income.

	1Q19	4Q18	2018
Constant Currency Op Inc. Growth pre-acquisition	$374	$156	$1049
C.C growth From Latin Am.	$40	$66	$378
Latin Am % of change	10.7%	42.1%	36.0%
Latin Am % total sales	21.2%	28.1%	23.7%

For all the growth being picked up by Latin America by ignoring the currency situation – here's what Latin America was actually contributing to reported operating income growth rather than the adjusted figure:

	1Q19	4Q18	2018
Actual Op. Inc. growth from Latin Am.	-$75	-$79	$100
C.C growth From Latin Am.	$40	$66	$378

Pepsico Grows Slower than KO and is Already Missing Some Targets with a Latin America Boost

We again adjusted PEP's reported sales for acquisitions and used the organic currency neutral growth rates to compute some of these figures. Because they tend to round fairly large dollar figures to 1% or 2% rather than 0.8% or 2.2% - we had to estimate some figures in our tables to match the formats of the other company tables. This may make some of the ratios off by a couple of basis points. However, the results look very similar:

	1Q19	4Q18	2018	2017
Reported Sales Growth	2.2%	0.4%	2.8%	1.2%
Organic non-FX Growth	5.2%	4.6%	3.7%	2.3%
FX Impact	-3%	-4%	-1%	0%

Even with some rougher figures, the results are still clear. The impact of Latin America before FX considerations on growth is routinely over 2x its sales weight.

	1Q19	4Q18	2018	2017
Constant Currency Sales Growth pre-acquisition	$653	$898	$2350	$1444
C.C growth From Latin Am.	$117	$232	$579	$375
Latin Am % of change	18%	26%	25%	26%
Latin Am % total sales	9.6%	12.4%	11.4%	11.3%

It's also almost entirely pricing driven too:

	1Q19	4Q18	2018	2017
Latin Am Pricing	$117	$216	$403	$306
Latin Am Vol	$0	$16	$40	-$115
Latin Am FX	-$100	-$248	-$363	$0
Net impact	-$17	-$16	$80	$191

Reported Organic Sales growth declines by 50-70bp quickly without the hyperinflationary benefits of non-FX growth in Latin America:

	1Q19	4Q18	2018	2017
Reported Organic Sales Growth	5.2%	4.6%	3.7%	2.3%
Organic Growth w/o Lat. Am.	4.7%	3.9%	3.1%	1.9%

Again, bonuses are tied to organic sales growth before FX. The target was only 3.6% last year and PEP hit 3.8% with the calculation given in the proxy. It would have missed it without hyperinflation in Argentina in our view by about 50bp.

Bonuses are also tied to constant currency adjusted operating income growth with a target of 8.3% in 2018 and PEP missed with an 8.0% result. We are going to argue again that these results would have looked even worse without the inflation on pricing before FX. Only two divisions posted growth over 8% - Latin America at 11% and Asia Pacific at 12%. The rest were 4%, 0%, and -14%.

Conclusions:

We discussed five companies here and only focused on their reporting for the Latin American unit. There are others that likely have this problem. Johnson and Johnson, for example, has sales in South America. However, it only breaks sales down as Domestic and all of International. 3M has some exposure too. We passed on looking at it too closely as management pay is tied to actual volume growth given what we've seen of hyperinflation – volume is often negative so that sounds very conservative on first glance. Other consumer companies may have this issue too. Nike operates in Argentina as well as making sales.

The issue here is not GAAP results. It's that companies with poor growth under GAAP are presenting a picture that real growth is actually doing much better and that only minor short-term blips in FX is changing that picture. **<u>While this is a not an accounting problem it is a presentation problem</u>** and we believe investors are being led to expect faster growth because of hyperinflation in Argentina carrying the day. If it was presented in that manner, (management expects to achieve double-digit price increases in Argentina to drive growth) we believe most investors would laugh rather than cheer the widening spread between GAAP and non-GAAP adjusted results. This is how a company touts that it grows at 8% every year and when you look back – reported results are essentially flat – they didn't compound to become 47% higher after 5-years because GAAP is recording the full definition of sales which includes FX.

We are also surprised that these stocks are fairly expensive given that growth is weak already and targets that most have outlined are rather low. If they lose some of this adjusted growth from Latin America and growth falls does the P/E stay above 20?

Guidance	Sales	EPS	EPS chg	P/E
Sealed Air	5%	$2.70	6-10%	16.5
Mondelez	2-3%	$2.50	2-5%	21.8
Colgate-Palmolive	2-4%	$2.82	-5%	25.9
Coca Cola	4%	$2.08	flat	24.6
Pepsico	4%	$5.50	-3%	24.2

Only Sealed Air is expecting EPS to rise much and it has seen a bigger bump from South America.

Disclosure

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