BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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July 18, 2019 | www.btnresearch.com

Contents

LyondellBasell (LYB) Update- Maintain BUY p. 1
Ocean Yield (OCY NO, OYIEF) Update- Maintain NEUTRAL p. 3
Campbell Soup (CPB)- EQ Update p. 5
Eaton (ETN)- EQ Update p. 6
Zimmer Biomet (ZBH)- EQ Update p. 8

LyondellBasell (LYB) – Update
Maintain BUY

LYB does not report earnings until August 2, but last week it did complete a purchase of 35.1 million shares of its common stock at $88. This reduced the share count by 9.5% At most companies we favor cash dividends over repurchases because dividends reward shareholders who stay rather than giving the cash to shareholders who leave. Moreover, we see too many companies who are atrocious at the timing of buying back their shares – buying high and selling low. Plus, it is often used to limit dilution of stock options paid to management and the net share-count does not decline much.

- At LYB, we praise their repurchase because first and foremost, they are buying a cheap stock. EBITDA runs between $6-$8 billion and the company is buying stock for 5-6x EBITDA. The P/E is about 7-8x and EPS has a 12% growth rate baked in from the share count at the end of 2018 due to the repurchase.

- After purchases, LYB's share count actually does decline by the number of shares bought. They do not have a history of issuing massive amounts of new stock as they do the repurchases:

LYB in mm's	2018	2017	2016
Shares issued	0.3	0.4	0.4
Shares bought	19.2	10.0	36.6
Ending Shares	375.7	394.5	404.0

By seeing the share count actually fall by the amount of the repurchases, LYB has built-in even more EPS growth. It just retired 9.5% more of the stock in one deal and the outstanding share count should be about 335 million.

- They pay a dividend of almost 5% also and just raised it by 5% in 2Q19. They are not ignoring cash payments to people who remain investors.

- The repurchase is a net positive for cash flow. Even if $3.1 billion used to buy stock was fully borrowed and ultimately financed at 5% interest – the cost would be $150 million in interest expense. Net of the tax shield, the cash impact would be about $120 million. But, 35.1 million shares with a quarterly dividend of $1.05 is essentially $150 million of cash flow saved.

- The debt at LYB after this deal would remain under 2x EBITDA and cash flow remains very strong to push that ratio to 1.5x. Free cash flow has been $3.0-$3.5 billion the last 3-years. The dividend is currently $1.4 billion per year, so coverage is over 2x with considerable cash left to retire debt or buy more shares.

Ocean Yield (OCY NO, OYIEF)
Maintain NEUTRAL

We are maintaining our NEUTRAL rating on Ocean Yield. Two events seem to indicate that the company will reduce its dividend in 2020 in our opinion. The first is the extension deferring charter fees to Solstad Offshore on two vessels to October 31. Solstad is looking to restructure debt and boost liquidity as the speed of recovery for offshore oil drilling and support has been slower than expected. Given the seasonal nature of that industry in the North Sea, where much of Solstad's potential work is located (one of the Ocean Yield vessels is working in Indonesia), we doubt that payments would resume in the final two months of 2019. While we believe a plan that defers debt payments for a longer period of time will be reached, we believe Solstad may look for a grace period that covers all of 2019 and perhaps even the first half of 2020. There is more offshore work starting and there are agreements in place that as cash levels rise at Solstad – it will be paid out to deferred creditors. That makes it more likely that some cash will come back to Ocean Yield, but we think that will be in 2020 at this point.

Second, the FPSO appears ruled out of working the largest part of the Ghana project for Aker Energy at this point. Aker and Ocean Yield are looking to still use the FPSO on smaller parts of the project, but that sounds like shorter-term work to us. Aker extended its option for the vessel until September 1. As Aker owns almost 62% of Ocean Yield it has every incentive to find employment for Ocean Yield's largest asset. Ocean Yield is also pursuing a contract with another oil company at the same time. Per the CEO on the call, "We are working very closely with Aker Energy and we've put together a joint organization for basically the FPSO. The main Pecan field, they are looking at another development solution than our FPSO. We are focusing on one particular field and we are performing now a concept study which will then go to more field study and approval processes. So you are quickly going to 2020 before any decision can be made."

The company made it clearer that this issue of employment will be resolved one way or another by 1Q 2020. It expects to either have a contract in place or it is open to selling the vessel. If it does not have a contract in place, it will likely reduce the dividend from $0.191 per quarter to $0.15.

The market appears to be more than pricing in the dividend cut with the current yield at 12.7% and the lower dividend would still yield about 9.5%. The company's liquidity remains

solid and it has covered all of its remaining capital spending for vessels that are being delivered. The balloon payment on the SBM Installer is in the process of being refinanced now and the bond due in 2020 is also planning to be refinanced as well. If the FPSO is sold, it will bring additional cash into the company to retire debt or reinvest in new assets. Having that situation resolved will likely help the stock bounce too as having that large of a debt-free asset produce only minimal cash flow on a series of short-term options is far from the best use of that capital.

The issue remains that there may be three more quarters to go before this is fully resolved and we remain Neutral.

Campbell Soup (CPB) EQ Update

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 are maintaining our earnings quality rating of 3+ (Minor Concern).

- Cash earnings in the quarter declined, but the company was able to report rising cash from operations due to working capital improvements from stretching payables and cutting receivables and inventory.

- Restructuring costs were $20 million in the 4/19 quarter versus $75 million a year ago. However, the company has extended its restructuring program multiple times over the years and we would not be surprised to see the scope of the current program expanded in the future.

- Note that results in fiscal 2019 reflect the adoption of new revenue recognition standards resulting in a 1 cps boost to EPS and a boost to reported sales growth of 30 bps due to a reduction in promotional spending. The sales impact was more concentrated in Meals and Beverages where the accounting change added 1% to sales growth.

Eaton (ETN) EQ Update

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 are maintaining our earnings quality rating of 3+ (Minor Concern).

ETN's adjusted EPS of $1.26 beat the consensus estimate by a penny.

- Other income rose by $8 million which would have provided a 1.6 cps boost to EPS, more than the reported beat. The company did not discuss the move in the 10-Q or on the call. We do know that about $3 million of the change was a result of lower pension and post-retirement benefits expense (other than service charge) which is included in other income. We also note that foreign currency derivatives not designated as hedges posted a $40 million gain in other income although the year-ago 10-Q does not disclose the income statement impact of such amounts.

- The service component of pension and postretirement (not included in other income) benefits expense declined another $3 million, or about a half a penny.

- Inventory days of sales jumped by almost 4 days over the year-ago quarter. While the company did not specifically address inventory levels on the call, there were comments made that seemed to indicate that slower orders in the Hydraulics segment could have been at least partially to blame:

  "And I would say that our orders were certainly weak in Q1. If you take a look at some of our customers, all the names that you know well, I would say their sales are holding up better than our orders are. And so there could be a better outlook as we look forward. We are not sure to what extent. There is some inventory repositioning taking place in this segment. But right now, it's really more a function of weaker volumes."

- We note that the detail of the company's deferred revenue disclosure indicates that customers made $208 million in deposits in the 3/19 quarter versus $232 million in the year-ago quarter and $271 million in the 12/18 quarter. This is likely a reflection

of the lower order activity cited above. Deferred revenue recognized during the quarter also declined so we are not concerned about aggressive revenue recognition.

- R&D expense was flat despite a rise in sales. The decline as a percentage of sales added less than a half a cent to EPS in the period, but the company stated at the end of 2018 that R&D investment in eMobility is expected to pressure margins in 2019.

- ETN's $671 million in buybacks in the 12/18 quarter followed by the $180 million in the 3/19 quarter led to an almost 3.5% reduction in the average number of shares in the quarter compared to last year. While the buyback and dividend consumed more than free cash flow in the last two quarters, the company has not been a long-term dependent on an unaffordable buyback to drive growth. However, next year we will see what the company does when this significant year-over-year EPS tailwind dries up.

Zimmer Biomet (ZBH) EQ Update

Current EQ Rating*	Previous EQ Rating
3-	4+

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

We are lowering our earnings quality rating to 3- (Minor Concern).

ZBH is in a turnaround mode and it is benefitting from certain costs a year ago not repeating this year. Most of these items are being adjusted out in the non-GAAP presentation. In our minds, this affords the company some grace patience when assessing the quality of its earnings. However, the company is barely beating the consensus targets as it topped 3/19 forecasts by only a penny, and we can't ignore that there are multiple small items without which it would have missed. Thus, we lower our rating back to 3- (Minor Concern.)

- On-balance sheet receivable DSOs fell by 7.6 days while outstanding factored receivable DSOs (not on balance sheet) rose by 3.4 days. Overall receivables DSOs continue to decline. While ZBH is still expanding its factoring, the year-over-year pace has slowed significantly. It sold $799.4 million of receivables during the 3/19 quarter compared to $617 million in the 3/18 quarter While still a meaningful increase, consider that the company only sold $208.7 million in the 3/17 quarter. The artificial boost to operating cash flow is disappearing as receivables generated $50.7 million in cash in the 3/19 quarter versus $146.2 million in last year's first quarter.

- ZBH noted in its 10-Q that gross margin improved due to hedging gains of $7.2 million in the current quarter versus losses of $11.1 a year ago. However, these are related to derivatives qualified as hedging instruments, meaning these amounts were reclassified from other comprehensive income and were presumably offset by gains/losses of roughly equal amounts in the hedged transaction. Therefore we do not view these as non-operational benefits.

- However, the company also has foreign exchange forward contracts not designated as hedging instruments which are marked to fair value at the end of each reporting period with gains and losses recognized in other income. The net impact was a $7.8 million beneficial swing in the quarter or about 3 cps.

- The company reversed a reserve related to its Durom Cup claims resulting in a $2.5 million gain, or a little less than a penny per share. This may have been included in its "other charges" segment of non-GAAP adjustments although it is not specifically cited.

- Gross margin also benefitted from lower obsolete inventory charges. These amounts are taken out of adjusted EPS. ZBH has reworked its product line since the turnaround began in 2017, so the charges last year are not unusual. However, investors should remember that the boost to unadjusted margin growth will not repeat next year. Other one-time items included in the quarter included adjustments to uncertain tax positions and a $23.5 million gain from litigation gain. However, these were also removed from the adjusted non-GAAP EPS numbers.

Explanation of EQ Rating Scale

Rating	Explanation
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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