BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Macy's (M) 2Q19 Update
Maintain BUY

We are maintaining our BUY recommendation on Macy's after 2Q19 results that literally saw one issue set off a wave of panic – marking down warm-weather seasonal inventory that was not selling in the first month of the 2nd quarter with temperatures below normal and rain nationwide. One thing Macy's has been rolling out is the ability to move slower-moving inventory within season to other stores where sell-through is better to reduce mark-downs and carry less inventory. Normally, it's warm somewhere when it's cold elsewhere – but that doesn't work as well when everywhere has the same issue. **The mark-down amounted to a 100bp hit to gross margin.** Because the cost of merchandise didn't change, it lowered the selling price. **That means, it also reduced the sales figure. We estimate that sales would have risen 1.2% without this mark-down and comp sales of 0.3% growth would likely have been up about 1.5%.**

Even with the mark-down of seasonal clothes, Macy's did in fact post it's 7th positive comp sales growth figure in a row. Transactions were up 5.3% in the quarter too, so traffic and purchases are not a glaring issue. **We estimate that the mark-down cost Macy's about 23-**

cents in EPS and the company reduced annual guidance by 20-cents. With the company increasing its customer totals, enjoying higher sales, reducing leverage and posting earnings and positive free cash flow – it's time to stop lumping this in with Sears as the press does hourly. At under 6x EPS, a 9% yield, with a growing on-line business that can produce same-day delivery, and cheap real estate to drive incremental sales – this business model is actually innovating and working.

Macy's was asked several times about the tariff issues. They pointed out the first two tranches had "no significant impact." The 10% third tranche had very limited impact. When tranche 3 went to 25%, they had to make adjustments with vendors. Tranche 4 for Macy's will not require price increases and in **total Macy's believes they may have no more than $0.05 of annual EPS at risk from tariffs – against essentially $3.00 in EPS.** This is another overblown issue in our view that probably cut $1.5 billion off the market cap before the 2Q results.

Guidance is for a very strong 4Q (against an easy comp) where Macy's does 35% of its revenues and routinely produces an incremental $1 billion in gross profit dollars vs the other quarters. Let's focus on the bad parts and the good parts of 2Q going into 3Q and 4Q:

- **Working through the miss in 2Q19, we see that markdowns coming in below forecast has been a more frequent positive or non-event at Macy's helping gross margin.** 2015 and now this quarter are the times this has been called out as a negative in 8-years. We do not view this as way-of-life for Macy's and many changes they have made to the business such as Vendor Direct and Hold and Flow are specifically designed to reduce markdowns going forward.

- **Basic retail stats all look positive. The company is seeing customers buy more frequently but spending less per transaction.** New store features are driving up comps and Vendor Direct should continue to add to digital sales with minimal investment. It also noted that international tourist shopping was down 9% in the quarter. This may be an area where Macy's outperforms in the next two quarters.

- **Guidance calls for flat 3Q and strong 4Q. Who wouldn't take that trade off?** A strong 4Q with several easy comp factors would produce much more sales and earnings leverage than if guidance called for the reverse.

- **Comps at smaller stores that are not getting all the new make-overs still struggle.** The market is focused on "maybe Macy's should just close every laggard store." What

is being missed is some of the lost sales at these stores is due to transforming their operations into a higher percentage of logistics, fulfillment, and warehouses for online sales and reducing their selling space footprint. Macy's real estate is largely in Class A malls with good locations and they either own the building or lease it for about $4-$6/sq. foot. We actually applaud the effort to use some of the existing cheap real estate in this manner. Macy's model reduces shipping costs, increases traffic to stores, and leads to incremental online and physical store sales. The result is total sales are rising and being allocated away from a store comp into the digital or vendor direct bucket. However, the store played a big role.

- **Cash flow and the balance sheet should continue to improve after 2019 completes another year of heavy investment.** Logistics build out, BackStage, Growth 150 stores will be largely completed this year. There will always be capital spending but it should start to decline from $1 billion to perhaps as low as $600 million. The new changes are boosting sales faster than the company as a whole as well. We expect free cash flow to increase and further support the capital goals of a reinvesting in the business, a low leverage situation, paying dividends, and repurchasing shares. The $465 million dividend consumes about 50% of free cash flow now, adding $300-$400 million via less capital spending should only enhance that picture.

Retail Stats Still Look Strong – the Markdown is Being Given too Much Weight:

Sales Comps	2Q19	1Q19	4Q18	3Q18	2Q18	1Q18
Store Comps	0.3%	0.7%	2.0%	3.3%	0.5%	4.2%
Transactions	5.3%	5.7%	6.2%	3.8%	0.5%	1.0%
Units/Trans	-1.8%	-2.2%	-4.9%	-3.1%	-2.6%	-2.0%
Rev/Trans	-3.0%	-2.7%	-0.3%	2.6%	4.6%	5.0%

First, let's look at the store comp of 0.3% for the 2Q19. The company reported sales of $5.55 billion vs. $5.57 billion in 2Q18 (down 0.5%). The market has focused on the mark-down of warm-weather apparel hurting gross margin by 100bp according to management. That's not really the place to start. We know that the cost of merchandise didn't change with the mark-down and we know the units were sold. The variable is the change in selling prices and the impact on sales and gross margin.

Cost of goods sold was $3.395 billion and the gross margin was 38.8%. First, let's take $236 million of depreciation and amortization of software out of COGS to get a merchandise cost figure. That gives COGS of $3.159 billion and dividing that by the $5.546 billion in sales is a margin of 43.0%. Without the mark-down, it should have been 44.0% which is 100bp higher. For $3.159 in COGS to make a 44% margin – sales would be $5.641 billion – which is $95 million higher. (Macy's mentioned nearly 100bp so if you want to make a range of 90-100bp – at 90bp, sales would have been $85 million higher).

First of all, $85-$95 million would have made total sales rise by 1.1-1.2%. Given that store comps rose 0.3%, that probably would roughly translate to a 1.4%-1.5% same-store sales comp for 2Q. Actually, we think the market would loudly cheer that. Also, a gross margin of 39.8% would not have looked out of the ordinary:

	2Q19	1Q19	4Q18	3Q18
Gross Margin	38.8%	38.2%	37.5%	40.3%

	2Q18	1Q18	4Q17	3Q17
Gross Margin	39.7%	39.0%	38.6%	40.3%

We already know that the ramp up of shipping costs for online sales, vendor direct, and promotions to ship to the store are pressuring margins and that happened again in 2Q19. Without the mark-down, gross margin would have been flat despite the other headwinds from changing the business model.

Let's not stop there. That $85-$95 million would have dropped to the pretax line – they already paid the staff, transport, and vendors. The company sees a 23% tax rate for the year – so they lost 21-23 cents in EPS here. The company cut guidance by only 20-cents. Also, mark-downs are a normal risk for a retailer. Is there evidence that Macy's gets hit with this often? No! We went back and saw that the company mentioned fewer mark-downs helped 2018 and 2016. In the years of 2017, 2014, 2013, 2012 – markdowns were not called out at all. Only in 2015 was there a year of markdowns and much of what Macy's has focused on with its new logistics systems within the company is targeted at preventing markdowns.

So, in our view, this company had an inventory problem that negatively impacted about 1.7% of inventory in one quarter. It's definitely a strike/foul ball/black eye – whatever term you want to use. The company probably should have pre-announced this issue. But it also

is a rare event historically and the transaction figures show that people are still coming. We're not as certain this $95 million one-time mistake is worth $1.4 billion in market cap disappearing and see the sell-off as a major over-reaction.

What Other Data is Helping/Hurting the Retail Stats?

We know that BackStage is a lower price point business and as that drives comps at mid-single digits for stores where it operates – it helps on transactions but reduces the revenue per transaction. That should cycle through in 2019 as the largest roll-outs of BackStage are now complete. Macy's has also seen strong numbers with its most frequent shoppers. They are buying more often – but are buying fewer units per sale. That figure is starting to improve too. Again, Macy's is being viewed as Sears or JCPenney but no one is looking to see that total sales are actually rising, comp sales are rising, people are visiting more often, and making more purchases. Those are big differences between Macy's and the others.

Macy's singled out International tourists as a problem area on revenues. This is likely more of a strong dollar issue than Macy's issue, but they did see a -9% y/y change in international tourism business and they shop at the larger stores. They are also very profitable as they don't return anything as well as paying full price. The company's guidance assumes the -9% figure continues in 3Q and 4Q. However, it is worth noting that they have now completed four straight negative comps for international. The -9% in 2Q came against a positive figure the year before. Thus, guidance may be too conservative in this area. Despite it occurring over the last four quarters, Macy's has had 7-straight quarters of positive comps.

More Backstage and Bluemercury.com continues to enter the comps going forward along with the $1 billion of spending this year to transform more stores to design into a Growth 150 model or add Backstage or more digital capabilities.

Also, the company is very comfortable with inventories which hurt the comp last quarter with the mark-downs. Vendor Direct where the vendors hold the inventory and Macy's does not have to deal with markdowns is becoming a larger part of total inventory. The investment is minimal so it is a higher ROI transaction. Also Hold and Flow is now rolling out on a bigger scale. This is where seasonal inventory is bought in smaller quantities and allocated to stores at the start of the season and then moved among stores during the season. Essentially this redesigns the older method of buying 200 units and giving each store 20, and at the end of the season – marking down the remaining 1-3 units per store. They

avoided fewer out of stocks that way, but still ended up with surplus merchandise. Hold and Flow would buy 100 units and give each store 10, some will sell out and others will sell few – the new system will rapidly take units from slower selling stores and move it to the others. Total mark-downs should decrease while minimizing out of stocks. Both situations should help on margin and sales going forward.

Macy's Has a Tough Comp for 3Q and an Easy Comp for 4Q

Last year Macy's had a strong 3Q with an early start for winter clothes. Comps were very strong as a result and the company is expecting weaker sales results than 2018 as result. It is even saying 3Q could come in below its full year forecast of flat sales. The positives for 3Q are that inventories are in better shape than the spring, more of the investments will be in place so overhead costs should be lower than in the spring, and there will more of their growth drivers in place – more Vendor Direct SKUs, more BackStage stores, more Growth 150 makeovers.

However, they are forecasting the comp for 4Q to be much stronger than 3Q. Last year they had missteps in releasing promotions to only platinum customers rather than all customers. They also had a warehouse fire that damaged inventory in 4Q and cost the company sales. More investment in growth areas will be in place as well.

The main issue to us is higher sales leverage quickly at Macy's against many fixed parts of SG&A. We'd much rather hear they are confident in a strong 4Q. Historically Qs 1-2 are 22%-23% of sales, Q3 is the weakest at 20%-21% with 35% in 4Q. That translates into about $1 billion in additional gross profit and leveraged overhead costs vs. the other periods.

2018 margins	4Q	3Q	2Q	1Q
Sales	$8,455	$5,404	$5,572	$5,541
Gross Margin	37.5%	40.3%	39.7%	39.0%
Gross Profit	$3,167	$2,178	$2,252	$2,159
SG&A	$2,538	$2,255	$2,164	$2,083
SG&A %	30.0%	41.7%	38.8%	37.6%

This leaves out credit card income and asset sale income. We actually took guidance on the call as very positive. If sales growth is going to be strongest in 4Q when the most operating leverage and operating profits are generated then that's a good situation.

Negative Comps on Some Stores Are Not Being Viewed in Full Context

There are articles out after the call focusing on whether Macy's needs to close hundreds of additional stores. On the call, the CEO noted that sales come from several segments: Online/digital, Flagship, Magnet, the Growth 150 (which are many of the Flagship/Magnet), BackStage stores all posting good comps while other neighborhood stores without the new makeovers do not see the same results and post negative comps.

Immediately analysts started talking about the death of brick and mortar again and just get rid of everything physical. The example that I always remember from years ago was an article about "Just think how profitable AMR would be with just Sabre and they got rid of this money losing American Airlines." Lost in the basic theme of "they should just run the accounting system as a profit center" was a huge flaw in the thought process – How would Sabre do all this profitable accounting without being able to bill the airline that generated 100% of its volume?

There are several points to make here. The first is Macy's does close stores. They closed five more this year so far which is after closing about 100 in recent years as part of the transformation that has been going on. Others have been transformed into outlet stores and BackStage. The company is not afraid to change its real estate footprint. Also, these smaller stores have lower sales totals to begin with. 50% of Macy's bricks and mortar sales come from its largest 150 stores. The smaller stores have a smaller impact on the total comp. The press makes this sound as though all stores are equal.

At the same time the company rolls out more digital/online sales, programs to move inventory between stores, have customers pick-up shipments at stores – including many direct from vendors where Macy's did not have inventory risk – Macy's needs a large amount of square footage devoted to logistics. The company essentially owns half its stores and leases the rest for about $4-$6 per square foot. So, if the company has real estate with poor sales that is cheap – why not transform to fit a growing logistical need? They can have units from Vendor Direct shipped in bulk to stores and reduce shipping costs. They have a location that is easy to find and people already visit the mall – why go out and lease more real estate for some of these logistical needs? When you think about total sales and costs vs. Amazon – Macy's is paying less for real estate, Macy's can get more bulk shipping from vendors and reduce delivery costs, with a physical store Macy's has proven people picking up an online sale come in and buy more stuff at the physical store – that offsets free shipping

cost – Amazon cannot do that, Macy's can also show that the physical store becomes a showroom and generates more online sales – Amazon cannot do that either.

The result is some of these stores becoming more focused on logistics and losing selling square footage which hurts their sales – and thus a negative comp. However, having the physical retail location does many things. People who pick up an on-line order at the store frequently make another purchase while at the store. Maybe free shipping at $50 of purchases, gets the first $50 in revenue and then they buy something for $10 at the store. In the past, the person not worrying about shipping deals may have bought $20 of things at the store. So, the store reports a drop in sales from $20 to $10. However, Macy's saw sales rise from $20 to $60. They pushed the total from $20 to $50 by giving away $6 in free shipping and the $6 in free shipping generated another $10 in sales at a physical store. Vendor Direct and Hold and Flow also allows Macy's to increase the total inventory available to the customer at any store – without increasing its inventory purchases. They can lower the sales staff in that store too.

Look at BackStage – which allows more orderly close-out sales and brings traffic into the store. Those are posting strong comps and its bricks and mortar! Maybe Macy's should close all the rest of the store and just operate the BackStage – that would be thinking being offered by many today. That would ignore that BackStage generates traffic and sales throughout the store. Also, people buy online in the store to match what they found in the store at the moment – have it shipped there and thus return the physical store again. It would also ignore that much of the BackStage inventory and sales process works in conjunction with the Macy's store. The BackStage sale generates a regular Macy's sale or the BackStage brings a person into the Macy's 10x per year instead of 3x and on those 10 visits, two additional online/mobile orders are made. Analysts are going to say the online is growing, the BackStage is growing and Macy's is not – but all the extra orders happened due to or with sizeable help from having a physical Macy's store.

Also, where did Macy's try and test all these new ideas? Did they tinker with pricing, shipping, BackStage, new product lines at their strongest Flagship stores and just accept that some things won't work? No – they test all this stuff in smaller stores on smaller scales, then roll it to a few more and ensure it works, the ROI is positive and then bring to the larger traffic stores. They then roll it back down to the lower stores. That's how the Flagships saw lots of transformation, then the Growth 50 stores, then that became the Growth 150. It's how BackStage went from a small number of stores to over 200 now.

Thus, when Jeff Gennette continued – he pointed some of this out too:

"So, we really have a line of sight on what growth looks like for Magnets and Flagships. The growth strategy really led by our Growth50 gave us all the confidence in getting growth out of those buildings. ***We talked about how those Growth50 stores had outperformed other stores in the Growth 100 by 3 full points.*** *Those stores are positive campaign, this -- customer engagement in those particular stores is much higher than our other store fleet.* ***So, what we've done is we've applied all of those learnings to the next 100 stores, which is what we call the Growth 100 and what you're quoting that Growth 150 which will be complete by the end of October touches about 50% of all of our brick and mortar sales.*** *Separate from that is what you have -- many of our flagships that are classified differently that add to that 50%, clear line of sight about what we need to do to make those better. So, we've got a lot of initiatives with what we're doing with new experiences like b8ta and Market and STORY, trying new concepts like thredUP that are all adding new opportunities in these stores, many of these stores are touched by Backstage.*

The neighborhood stores, I would expect those to continue to negatively comp, but they're becoming more profitable because we're operating them more efficiently with less square footage. The customers are really using them big for fulfillment, a higher percentage of their sales are moving through fulfillment. *So, we're handling their expectations in those particular stores. We're always looking at our portfolio to look at, does it make sense? We're never going to say, we're done, but we do believe this national footprint that we have, we're servicing a national customer. We know that when we close the store, we're firing customers, we lose their business online, we'll make all those decisions very carefully.* ***So, this segment's dictation strategy really serves a customer that shops between our stores satisfying her needs, it also satisfies how we're building the omnichannel business through Digital and Mobile****, and so we'll be very careful about any accidents that we do in -- in future store closures."*

Cash flow Should Improve after 2019

Based on Guidance for $3 in EPS with asset sales, there is about $1.9 billion of cash flow here assuming no working capital changes:

2019 guidance	4Q
EPS * 312	$936
Dep/Amt	$944
Cash Ops	$1,880
CapX	$1,000
FCF pre WC	$880
Dividend	$466
Dividend %	53%

Capital spending has been elevated for several years with the various store investments and new technologies. We believe those should drive earnings higher and push up cash from operations. Some of the inventory changes may free up working capital too. At the same time, the level of investment should decrease. They have been in this transformation for several years and still 2019 is expected to be one of the highest levels of investment at $1 billion. In 2017, it was $760 million. Having the investment level fall by $300-$400 million may be possible. That makes the dividend 35%-38% of the free cash flow without earnings growth.

Macy's also wants to reduce its debt ratio to 2.5-2.8x EBITDA The adjusted debt includes lease liabilities. Right now, the ratio is at 2.7x ($8045/$2962). However, that EBITDA includes gains on real estate sales and they would like the ratio in the 2.5-2.8x band without asset sales. Given some modest EBITDA gains and asset sales retiring more of the debt, Macy's would probably like to retire $500-$800 million in debt from internally generated cash flow over the next few years. That seems like an easy plan to accomplish given that free cash flow should increase.

Hanesbrands (HBI) – 2Q19 Update
Upgrade to NEUTRAL

We are boosting our EQ rating from 3- (Minor Concern) to 3+ (Minor Concern) but indicating some of our concerns have improved. We are also raising our recommendation on the stock from SELL to NEUTRAL with the stock down 30% from our initial SELL warning in February. We still have concerns that HBI has posted weak to negative sales growth adjusting for acquisitions and initial stocking. The weakness for Activewear should become more evident as the Target deal ends later this year too.

However, there is still very little expected of HBI. Sales growth before FX is expected to only be 3% in 2019 after posting 7.6% sales growth in the 1H19. FX is expected to be less of a headwind in 2H19 – only $35 million vs. $80 million in 1H. Adjusted operating profit growth and adjusted EPS growth are only supposed to come in at 2% and 3% higher y/y. In the 1H19, adjusted operating profit grew at 7.2% and EPS at 8.2%. These targets should not be tough to beat. Inventory trends may actually become a tailwind along with FX and the stock is only trading for just over 8x forecasted EPS. We recommend readers refer back to our EQ report from February 14, 2019 and fundamental report from February 21, 2019 for background information.

- We questioned the company's 4Q18 sudden 5-day drop in DSOs for receivables for its sustainability. The last two quarters have seen DSOs bounce back to normal and in fact, working capital was a sizeable consumer of cash in 1Q19.

- Inventories may be set up to help margins more going forward although a case can be made that inventory units are higher than the dollar terms truly reflect. Finished Goods inventory DSIs are rising over 10 days in 2019 so far.

- The company uses FIFO and is reporting that it is both taking price increases in recent quarters and suffering from higher raw material costs. We see no evidence of the latter as cotton prices have been falling all year and actually since summer of 2018. Natural gas has been falling all of 2019 and is less than half the level of 2018 – which is a key input to chemicals and plastics. Oil rose from December to April but falling ever since.

- We are seeing declining raw material and work-in-process DSIs to reflect falling input costs. Finished goods DSIs are over 6-months but they are being replaced with ever lower-cost merchandise. If HBI is taking price hikes on the basis of increasing costs, we think they are likely to see some gross margin increases in 2H19. Eventually, we expect customers to push back on HBI pricing as they can see cotton prices too – but this may be an area where HBI outperforms forecasts in the near-term.

- The FX headwind also sets up as something that will have minimal impact on margins in the 2H19. In the 1H19, HBI had comps where FX was a positive for results in 2018 and negative on results in 2019. For the 2H, FX may actually be a slight positive on y/y comps based on guidance. Negative FX swings have offset the impacts of higher pricing against lower raw materials in 1H19. If FX becomes neutral – the price hikes may become more pronounced and surprise on the upside.

- The International Division is Slowing. Much of the growth had come from stocking more stores overseas, which we did not see as sustainable. Growth has dropped to low single-digits rapidly from double-digit rates. Guidance calls for slowing down.

- Activewear growth of new products going to retailers and online sales has been strong too. This division is expected to come in flat for 3Q and only 4% growth for 2019 after strong double-digit rates of late.

- We still think marketing and R&D will continue to rise and HBI has reported that it continues to invest more than guidance in these areas. Investors should remember that against poor sales growth, this is likely a headwind on margins. Moreover, as we noted before, about 150bp of margin gain at HBI has come from this area in recent years.

Receivables Back to Normal Levels

As noted in the February 14 EQ report, HBI enjoyed a surprise drop in DSOs for receivables in 4Q18. We could not find any rationale behind this except perhaps a bad-debt charge in the prior quarter helping about 0.7 days. Management attributed this drop in DSOs due to its increased focus on working capital to improve cash flow – but it certainly didn't last:

	2Q19	1Q19	4Q18	3Q18
Sales	$1,761	$1,588	$1,766	$1,849
A/R	$1,012	$933	$871	$1,045
y/y Sales G	2.7%	7.9%	7.5%	2.7%
y/y A/R G	3.9%	6.6%	-3.6%	3.5%
A/R DSOs	52.4	53.6	44.9	51.6

	2Q18	1Q18	4Q17	3Q17
Sales	$1,715	$1,472	$1,645	$1,799
A/R	$974	$875	$903	$1,009
y/y Sales G	4.2%	6.6%	4.4%	2.2%
y/y A/R G	4.1%	9.3%	7.9%	4.9%
A/R DSOs	51.8	54.2	50.1	51.2

The company has picked up cash flow from the securitization facility until it became a slight headwind in 2Q19:

	2Q18	**1Q18**	**2018**	**2017**	**2016**
Borrowed on Securitization	$16.9	$106.9	$213.3	$373.6	$238.1
Repaid on Securitization	-$26.5	-$68.6	-$176.9	-$293.0	-$388.7

The securitized A/R remain on the balance sheet, but HBI has been raising cash by taking advances on the receivables. We also know that the company does sell receivables in factoring deals, which do remove them from the balance sheet. However, there is minimal information given on outstanding balances and essentially none in the 10-Qs.

We also want to point out that there is some seasonality to working capital changes on cash flow – with early quarters being negative and later quarters being positive. However, HBI does not have much of a recent track record of pulling cash out of working capital like it hinted at for 4Q18. Please note that the positive figure for 2017 was due to the tax changes and revaluing accounts. GAAP earnings in 2017 were $62 million rather than a normal $550 million. There were non-cash impacts added back to cash flow of $239 million for deferred income taxes and $179 million for accrued taxes. We would argue without the tax changes, working capital would have been a negative drag on cash flow in 2017 too:

	2Q19	2Q18	1Q19	1Q18	2018	2017	2016
W/C Impact	-$56.2	-$107.1	-$321.1	-$243.8	-$93.2	$165.0	-$103.6

Inventories DSIs are still Rising – Focused in Finished Goods

	2Q19	1Q19	4Q18	3Q18
Raw Materials DSI	9.0	11.2	9.2	10.8
Work in Process DSI	14.2	16.1	15.7	15.7
Finished Goods DSI	164.4	183.6	151.4	145.3
Total DSI	187.6	210.9	176.3	171.8

	2Q18	1Q18	4Q17	3Q17
Raw Materials DSI	11.9	13.8	11.6	10.6
Work in Process DSI	18.6	21.8	20.3	16.4
Finished Goods DSI	152.2	173.4	136.1	132.0
Total DSI	182.7	209.0	168.0	159.0

HBI uses FIFO accounting. Obviously, inventory does not turn that quickly – about 2x per year. At the same time, raw materials and work in-process have only been about 30 -31 days historically – yet it's now falling rapidly to 22-23 days. We do not think this is due to more efficiency and cash management. We think it is due to rapidly falling raw material costs:

These are cotton prices from Macrotrends.net. Cotton has been in a near freefall since the summer of 2018. During that time, inventory has likely turned over twice. With minor spikes of a couple of weeks during in the last year, Hanesbrands should be seeing ever-cheaper inventory entering raw materials, then work-in-process and finally finished goods. We are definitely seeing inventory levels drop in both the early forms of inventory. Raw materials are down y/y by 3 days, which is huge for what was an 11-12 day account. Work in process is down 4-6 days y/y, again that is huge for a 20-21 day account.

This is not just cotton going down, natural gas was $3 in the summer of 2018, spiked to $4.70 by November 2018 before falling continuously for 9 months to $2.00. Natural gas and NGLs make chemicals and plastics that HBI uses. All the expensive gas-related inventory is now gone and would have fallen throughout the 2Q19. Oil prices were $70 for the summer of 2018, fell to $46 in late 2018, rallied to $64 by April, and now are $55 – they are essentially lower for all of 2019 vs. 2018. These other commodities are down too. With rising DSIs on falling raw material costs, it could mean unit inventory is actually growing much faster.

Falling Raw Material Costs and FX Could Help Gross Margin in 3Q and 4Q

One of the reasons we are moving the rating on the stock from SELL to NEUTRAL is we expect a great deal of cheaper y/y inventory to be moving through the income statement for the rest of 2019. On top of that, the company has been touting that it has been taking price increases for several quarters as the future inventory costs were falling rapidly:

2Q19 commentary in 10-Q:

> *"Operating profit as a percentage of sales was 13.3%, an increase from prior year of approximately 50 basis points.* ***Increased operating profit from price increases taken in the first quarter of 2019 and higher margin product sales mix were partially offset by increased materials costs****, planned investments to support our brands and future growth initiatives as well as an unfavorable impact from foreign exchange rates. Included in operating profit in the second quarter of 2019 and 2018 were charges of $13 million and $25 million, respectively, related to acquisition, integration and other action-related costs."*

1Q19 commentary in the 10-Q:

> *"Operating profit as a percentage of sales was 9.3%, a decrease from prior year of approximately 60 basis points.* ***Improved sales mix and pricing taken in the first quarter of 2019 were offset by increased materials costs,*** *planned investments to support future growth initiatives, unfavorable impact from foreign exchange rates, higher variable compensation accruals and higher bad debt expense. Included in operating profit in the first quarter of 2019 and 2018 are charges of $21 million and $20 million, respectively, related to acquisition, integration and other action-related costs."*

Looking at the margins for the last three years we see the following:

Adj Gross Margin	4Q	3Q	2Q	1Q
2019	n/a	n/a	39.0%	40.2%
2018	40.1%	39.2%	39.1%	40.1%
2017	40.1%	37.8%	39.5%	40.2%
2016	39.6%	37.6%		

Adj Op. Margin	4Q	3Q	2Q	1Q
2019	n/a	n/a	14.0%	10.7%
2018	14.7%	15.8%	14.3%	11.3%
2017	14.3%	15.0%	15.8%	11.6%
2016	15.9%	15.4%		

These margins are adjusted to add back acquisition/integration/restructuring charges. FX is not added back. They are already taking price hikes based on prior raw material prices. By this time, all the higher cotton prices of 2018 and early 2019 have been expensed. All the higher natural gas prices have been expensed. There should be some considerable gross margin built in if HBI can hold pricing for a while longer. So far offsetting the gross margin gains have been FX losses and higher marketing/support investments. We'll talk about FX next, but the company is giving guidance for $7 million in higher marketing for the 2H of 2019, which is roughly 20bp – we will call it 10bp each quarter. If the raw material prices are as low as we think, HBI may be able to pick up 50bp of gross margin. Take away the 10bp for marketing – and that still adds up to 1.7 cents of EPS per quarter.

The company is giving guidance that FX will be less of a drag in the 2H19 than the 1H19. Guidance for the year is $115 million negative hit for the year on sales. $45.5 million hit in 1Q19 and $34.1 million in 2Q19. However, those were very tough comps on FX – look at what is coming for sales based on forecast vs. last year:

FX on Sales	4Q	3Q	2Q	1Q
2019	-$15.0	-$20.0	-$34.1	-$45.5
2018	-$25.8	-$22.0	$15.5	$44.9

So, in 1Q19 – the negative swing from FX was $90 million, it was $50 million in 2Q19. For 3Q19, the impact is expected to be the same or a small improvement and for 4Q19, it is forecast as an improvement of $11 million. That should be a positive change for margins if forecasts are correct. HBI gave a constant currency adjustment for Gross Profit and Operating Profit in 2Q19 results too. In the 1Q19, gross profit margin was hurt by 35bp by FX and operating profit margin by 11bp. For 2Q19, gross profit margin was hurt 29bp by

FX and operating profit margin was impacted by 1bp. It appears that HBI should have some tailwind here on margin simply by not having FX be the same type of y/y penalty to overcome in the 2H19.

Just looking at this from the big picture – FX was hurting on gross margin by about 30bp in 1H19 and gross margin was flat. Going forward, FX should be flat the next two quarters and the higher prices vs. lower raw material prices should be a more pronounced positive. 10bp is worth 0.4 cents in EPS per quarter. So, if FX and pricing combine for 50-70bp of gain – HBI could pick up 2-2.8 cents per quarter the market isn't expecting. And expectations are very low already.

Why Not Make this a BUY? Basically – There Are Still Other Problems We Have Highlighted

We are going to again point out that HBI has not been very successful in generating organic sales growth. In fact, more than 100% of sales growth over the last several years has been acquired. Given the guidance for 3Q19 and full year 2019 for the key divisions, we believe that our concerns that HBI was enjoying some initial stocking for some new customers and that would play out shortly – is becoming evident:

Sales Growth/Unit	2019e	3Q19e	2Q19	1Q19	4Q18	3Q18	2Q18
Innerwear	-2.0%	-2.0%	-2.3%	-3.1%	-0.1%	-6.9%	-3.4%
Activewear	4.0%	0.0%	10.5%	17.1%	13.5%	6.8%	6.9%
International	6.0%	3.5%	4.2%	13.4%	11.7%	11.3%	14.9%
International pre-FX	10.0%	7.0%	10.5%	18.3%	8.5%	9.5%	5.0%

We can infer the 4Q forecast looking at quarters 1, 2, and HBI's guidance for 3Q. Innerwear has had easy comps and continues to be a laggard. That is still the largest part of HBI at 35% of sales. Activewear has hit the wall and is losing Target sales in the 2H. And the easy comps are over. After strong double-digit gains for three quarters, forecasts are for 0% in 3Q? Only up 4% for the year? It's 25% of sales. International was opening new stores and getting growth, but FX has been taking a toll. We also doubt that a strong dollar makes it possible to push through and hold price hikes overseas. It's also about 35% of sales.

Second, remember that DSIs for finished goods are increasing by 10 days y/y despite lower raw material prices. That is a sign that inventory in unit terms are rising at the same time HBI is guiding to slower sales. On top of that, the guidance for sales has price hikes in

place, meaning they need fewer units sold to hit targets. That could add-up to inventory overhang and lead to discounting.

Third, people buying from HBI can see what the raw materials prices are doing too. And they have their own customers to deal with on pricing. It may be possible for HBI to hold higher pricing for another quarter or two, but its buyers are likely to begin pushing for lower prices sooner than later in our view. Tariff issues may pull that issue forward too as retailers look to offset some import tariffs.

We have also highlighted several times that much of the past margin gains came from cutting marketing and R&D. Now, HBI is having to rebuild those investments and every call seems to indicate that it will be spending more. The 2Q19 was no exception. Those continue to be headwinds for margins too.

Plus, HBI is trying to sell more online direct to the consumer as well as focus on higher brand awareness items. That's all good news, but its shipping and royalty expenses are rising faster than sales in many cases. The company only provides this information in the 10-K so we will refer investors back to the February 21, 2019 report.

Mohawk Industries (MHK) EQ Review-6/19 Qtr.

Current EQ Rating*	Previous EQ Rating
2-	3-

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

We are lowering our earnings quality rating on MHK to 2- (Weak) from 3- (Minor Concern).

MHK's stock dropped as much as 17% after reporting a 2 cps earnings beat but a sizeable revenue disappointment. The real catalyst for the stock price decline was the huge reduction in guidance as management called for third-quarter EPS to fall in the range of $2.58-$2.68 which was well below the pre-quarter Street estimate of $3.01. Management cited weaker demand, tough market conditions, and excess channel inventory as reasons for the bleak outlook.

We remind clients that our earnings quality scores are an assessment of the quality of the earnings reported in the quarter being examined. They are not an implicit buy or sell recommendation. Our stocks with a rating of 2 (Weak) going into a quarter have shown a number of earnings misses and pre-announcements. In the current case of MHK, the stock has been sold down to under 10 times forward earnings and guidance has been greatly reduced. However, we do not consider these factors when assigning a score to the quality of the second-quarter earnings. We have noted many of the concerns below over the last few quarters. However, given the moderate jump in DSOs, the acceleration in the inventory buildup, the easy comparison against contract amortization costs, and the unusual jump in other income, we are lowering our earnings quality rating to 2- (Weak) as we believe the operational growth in the quarter was weaker than the reported EPS figure implies.

- Accounts receivable days jumped by 2.5 over the year-ago second quarter. This is the largest YOY jump in over two years and could be an indication that the extension of more generous terms pulled sales forward into the second quarter at the expense of the third.

- In addition, allowance for doubtful accounts as a percentage of trade receivables continues to decline, falling to 4.1% from 4.6% a year ago. We estimate it would take a 10 cps charge to rebuild the allowance to the year-ago level.

- Inventory days climbed by 13 days versus the year-ago second quarter with 9 days coming from finished goods and the balance from raw materials. We have been highlighting the rising DSIs for the last few quarters and management has been attributing the increase to opening new plants, rising raw materials costs, and tariffs. However, management noted in the second-quarter conference call that it is carrying too much inventory and it would need to curtail production in upcoming quarters to bring its own inventories back in line. This will negatively impact per unit production costs and pressure profits.

- MHK's amortization of capitalized contract costs declined by approximately 5.2 cps in the 6/19 quarter due to an easy comparison against last year's second quarter. We view this as a non-operational benefit that will likely reverse in upcoming quarters.

- Other income took a favorable swing of $5.1 million (5.5 cps) due to the favorable foreign exchange transactions and an insurance settlement.

Receivables Days Up 2.5 Days While Allowances Decline

MHK breaks out the components of its accounts receivable in its footnotes which allows us to strip out tax receivables and other receivables. The below table shows that DSOs calculated from customer trade receivables at the end of the 6/19 quarter jumped by 2.5 days versus the year-ago second quarter:

	6/29/2019	3/30/2019	12/31/2018	9/29/2018
Customer Trade Receivables	$1,793.551	$1,716.927	$1,562.284	$1,726.925
Sales	$2,584.485	$2,442.490	$2,448.618	$2,545.800
DSO	63.3	64.1	58.2	61.9

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Customer Trade Receivables	$1,716.748	$1,674.518	$1,538.348	$1,660.987
Sales	$2,577.014	$2,412.202	$2,369.097	$2,448.510
DSO	60.8	63.3	59.3	61.9

MHK's DSOs have typically tracked very steadily over the last two years and the 2.5-day jump is the largest increase in that time frame. This leads us to question if the company could have offered more attractive terms late in the quarter to pull sales into the 6/19 period at the expense of the next quarter.

We have also highlighted how the company's allowance for bad debts as a percentage of gross trade receivables has been declining and that trend continued into the 6/19 quarter. (Note that we are assuming that all of the allowance is related to customer trade receivables rather than income tax or other receivables which we believe is a reasonable assumption.)

	6/29/2019	3/30/2019	12/31/2018	9/29/2018
Gross Customer Trade Receivables	$1,793.551	$1,716.927	$1,562.284	$1,726.925
Allowance	$72.782	$72.308	$74.718	$81.566
% of Gross Receivables	4.1%	4.2%	4.8%	4.7%

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Gross Customer Trade Receivables	$1,716.748	$1,674.518	$1,538.348	$1,660.987
Allowance	$78.141	$90.877	$86.103	$91.247
% of Gross Receivables	4.6%	5.4%	5.6%	5.5%

To put this in perspective, if the allowance percentage had remained constant, it would have taken almost 10 cps off of EPS in the quarter.

Inventory DSIs Spike

We have been following the ongoing climb in inventory at MHK the last several quarters and the year-over-year jump in DSIs actually worsened in the 6/19 quarter:

	6/29/2019	3/30/2019	12/31/2018	9/29/2018
COGS	$1,847.867	$1,817.563	$1,802.228	$1,825.367
Inventory	$2,367.631	$2,338.125	$2,287.615	$2,214.295
DSI	116.9	117.4	115.8	110.7

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
COGS	$1,810.459	$1,707.510	$1,615.473	$1,665.209
Inventory	$2,061.204	$2,044.962	$1,948.663	$1,911.029
DSI	103.9	109.3	110.1	104.7

In the past, management has attributed the rising inventory to new plants coming online, higher raw materials costs and the impact of tariffs. However, with the deterioration in

outlook, management seems to now be admitting that it has too much inventory on hand. Consider the following comments from the conference call:

> *"Given the uncertainties in our markets, we are taking actions to improve our business. We are streamlining our operations, consolidating facilities and taking out higher cost assets.* ***We are reducing production to control inventory levels,*** *introducing new product categories and increasing promotions to address changing markets."*

> *"The general conditions in our flooring markets around the world have become more challenging, and competition is more intense. We are taking actions to improve our sales, reduce our costs,* ***manage our inventory and adjust our offerings****."*

A breakdown of DSIs into inventory components gives us more insight into the situation:

	6/29/2019	3/30/2019	12/31/2018	9/29/2018
Finished Goods DSI	81.8	81.6	80.1	76.9
In-Process DSI	7.7	8.4	8.4	8.3
Raw Materials DSI	27.4	27.4	27.3	25.5

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Finished Goods DSI	72.9	75.0	74.9	71.8
In-Process DSI	7.9	9.0	9.0	8.3
Raw Materials DSI	23.1	25.3	26.1	24.6

We see that of the 13-day YOY increase in DSIs, almost 9 days came from finished goods with the remainder coming from a buildup in raw materials. As the company admitted on the call, it will have to cut production in the upcoming quarters for the inventory levels to reduce its inventories and "adjust" its offerings. We take that to mean that it has more of certain products than customers want. This will almost certainly result in higher production costs per unit as production is cut and quite possibly discounting or write-downs to eliminate obsolete inventory. Either way, margins suffer.

Amortization of Costs to Obtain Contracts Down by 5 cps

MHK capitalizes the cost to obtain certain contracts such as in-store advertising displays when the amortization period is expected to be more than one year. We noted in the 3/19

quarter that the quarterly amortization expense fell versus the year-ago first quarter. While amortization expense increased sequentially in the 6/19 quarter, it was still almost $4.8 million (5.2 cps) lower than the year-ago figure:

	6/29/2019	3/30/2019	12/31/2018	9/29/2018	6/30/2018	3/31/2018
Beginning Balance of Capitalized Cont. Costs	$59.034	$57.840	$57.051	$50.400	$46.224	$43.259
Amounts Capitalized (plug)	$25.228	$12.242	$12.879	$14.280	$25.331	$17.679
Qtrly Amortization of Costs to Obtain Contracts	**-$16.362**	-$11.048	-$12.090	-$7.629	**-$21.155**	-$14.714
Ending Capitalized Contracts	$67.900	$59.034	$57.840	$57.051	$50.400	$46.224
Amortization % of Avg. Capitalized Contracts	25.8%	18.9%	21.0%	14.2%	43.8%	32.9%

The company's amortization as a % of average capitalized contract balances has been very volatile, but we can see in the table above that the almost 44% from the 6/18 quarter was substantially above recent experience. Both the amortization percentage as well as the absolute amount capitalized should be monitored carefully going forward.

Procter & Gamble (PG) EQ Review-6/19 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 are raising our earnings quality rating to 3+ (Minor Concern).

PG's adjusted EPS of $1.10 beat the consensus target for its fourth fiscal quarter by 5 cps. The company also topped consensus top-line estimates. We saw little in the way of artificial benefits to earnings in the quarter, but view the almost $9 billion Shave Care writedown as an obvious negative. In addition, we consider the ongoing restructuring charges and the unfunded buyback to be long-term detriments to the quality of reported earnings.

- PG recorded an impairment charge of $6.8 billion to write down goodwill related to its Shave Care unit. After the charge, the carrying value of the remaining goodwill was $12.6 billion. As a result of the methodology used in the impairment test, the estimated fair value of the remaining goodwill is 20% above its carrying value. In addition, the company incurred impairment charges of $1.6 billion related to its Gillette indefinite-lived intangible asset which had a $14.1 billion remaining amount on the balance sheet. Shave Care accounts for about 8% of total company revenue. The writedown is a reflection on the price the company paid for Gillette back in 2005.

- As we have noted many times before, restructuring charges are a constant fixture in PG's results. The company has a somewhat unique procedure of adding back to adjusted earnings only the amount of restructuring charges it deems to be "incremental" to "normal" restructuring spending. We monitor the patterns of the company's labeling of its restructuring charges for unusual activity such as an unusual decline in the amount of total restructuring charges left in "core" earnings. We have seen no signs of manipulation in recent periods. Nevertheless, the sizeable amounts of "incremental charges" being excluded from adjusted earnings every quarter for years calls into question the quality of the adjusted earnings. The current program is set to run through 2020 and we will frankly be surprised if a new program is not announced before the current one is complete.

- Cash flow from operations for the fiscal year ended 6/19 increased by 2.5%. Inventory days jumped by approximately 3 over the year-ago quarter to support new products

and we are not especially concerned with the jump. Receivables days also increased slightly. Both items were an increased use of cash during the year, but this was more than offset by an 11-day YOY jump in accounts payables days due to the company stretching payment terms on suppliers. With payables at an astounding 115 days, we don't see how the company can squeeze much cash flow out of its suppliers. We also note that capex declined by $370 million, falling to 4.9% of sales from 5.6% a year ago and providing a huge tailwind to reported free cash flow growth and the free cash flow conversion ratio. Despite this boost, free cash flow still does not cover both the dividend and the buyback.

Explanation of EQ Rating Scale

Rating	Description
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.

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