BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

September 26, 2019 | www.btnresearch.com

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Contents

Alibaba Group Holdings (BABA) EQ Review

Current EQ Rating*	Previous EQ Rating
4-	na

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

We initiate earnings quality coverage with a rating of 4- (Acceptable)

We are initiating BABA with an EQ rating of 4- due largely to its complex corporate structure amid changing Chinese laws. Working capital is a minor part of the assets, the company invests in new assets, and many aspects of the accounting format are not aggressive in our view. With the sale of the old 9.4% Yahoo stake being liquidated via Altaba, which may have held the stock price flat, BABA may be catching more peoples' eyes after its investor day this week. Investors focusing on China trade and perhaps screening for growth and clean balance sheets may also drive people to look at BABA. Cash and investments equal to 37% of assets and income growth greater than 30%. Cash is $21 per ADS, and net cash is over $13.

The company routinely beats estimates handily and net of cash the stock is trading for about 24x EPS. The company's adjusted income is inflated by adding back stock compensation (about $2 in EPS) and not amortizing goodwill for companies where the other assets are being amortized rapidly (about another $2 in EPS) against forecasts of essentially $7. We would not consider either situation short-lived even though it is standard for companies to skip amortization of goodwill.

At this point, much of the accounting issues aren't problematic. For example, dilution is not material from stock compensation and cash flow is covering acquisitions and repurchases. However, the complexity of the corporate structure is an area where we think investors should have greater concerns and perhaps give some negative weight to their decision process.

- **20%-25% of cash flow is coming from adding back stock compensation. Also, Alibaba is spending considerably more on acquisitions than internal growth with capital spending.**

- **Adjusted reporting metrics add back several on-going expenses, which inflates margins and income.**

- **For adjusted earnings and EBITA – Alibaba is adding back wages paid in stock and amortization related to acquisitions. That is on top of not amortizing goodwill – it's as though the acquisition program has zero cost and only adds to revenue. Adjusted income is 16% higher than reported income and EBITDA margins are 10-13 percentage points higher than reported operating margin.**

- **Alibaba is conservative in that it does amortize non-goodwill acquired assets at basically the same rate as assets that arise via capital spending. Both have a short life assumption too- 2-5 years for acquired tech and 3-5 years for computers and software designed in-house.**

- **Alibaba is not conservative on acquisitions by often putting over 70% of the assets in goodwill and not expensing the cost.** It also acquires many of these over several years and generates gains on equity stakes already owned when the final deal is announced. Backing those gains out of adjusted results is conservative. Followed by little disclosure on revenue or operating results on the acquisitions - so what is organic growth, what was the price paid? These are questions that are unanswered.

- **There may be a risk for Alibaba's tax rate rising a material percentage. It paid 17% vs. the PRC's standard rate of 25%. Much of the difference is due to high-tech units** getting lower tax rates by China for periods of time. We would be concerned that the more tech-related enterprises are reporting net losses, while all the profits come from being a retailer. This seems like a potential target for the government.

- Alibaba's corporate structure is complex because it is considered a value-added telecommunications service provider. China restricts foreign investors from owning more than 50% of such a business. Alibaba is based in the Cayman Islands and its ADS is for shareholders on the NYSE and there is another large investor in Japan. That is 92% combined.

- Actual Alibaba assets are owned by Chinese citizens in a Variable Interest Entity who in turn borrow money to buy the equity in the VIE from a Chinese holding company. The Chinese holding company is paid via a service contract all the profits from the VIE but does not own the equity in the VIE.

- The Chinese holding companies are owned by offshore holding companies controlled by Alibaba. Thus, stockholders own 100% of several Chinese units that are creditors for the people who own the actual assets.

- The Chinese government is changing the laws on foreign ownership this January. Those new laws have not been tested in court. In prior drafts of laws, the Chinese Ministry of Commerce proposed deeming companies controlled by contracts held by foreign investors essentially owned by foreign investors. That could create a risk.

- We doubt the government shuts down Alibaba but they could start requiring more fees or changes to the structure that may negatively impact shareholders. It's not just China, the SEC also has questions about the Alibaba structure and is doing research.

- Alibaba has to move money around via dividends from one company to the next and pay taxes at several levels. That makes things cumbersome in our view and also means not all the cash flow may be available to service debt in US dollars whereas most revenues are in Renminbi. It also means stockholders to do have access to all cash or earnings either. For example, Chinese companies must keep their initial capital and a percentage of earnings as statutory capital – it cannot be paid as dividends. That restricted reserve is now 12% of Alibaba assets.

- **The complex structure allows the government to tax different units at different rates. It also allows them to examine transaction splitting where low tax areas earn more money and higher costs go to higher tax areas. China can impose fines, penalties and has just announced it will be installing government officials in Alibaba.** There are also currency controls in place to make it difficult to move money offshore where the bulk of Alibaba's stockholders are located.

- **The Founders' partnership has guarantees to always be in charge of the board and that can only be changed by a vote of 95% of shareholders – and the top two members of the partnership own over 8%.**

Cash Flow Overview:

Alibaba does not pay dividends to shareholders at this point. It produces growing cash flow and has been able to cover capital spending, acquisitions, and share repurchases with internally generated cash flow. We are going to highlight a few points of the cash flow statement to examine further for accounting quality and sustainability:

millions of RMB	2019	2018	2017
Net Income	80,234	61,412	41,226
Share Comp	37,491	20,075	15,995
prepaids, A/R	(10,185)	(14,765)	(8,237)
accruals, A/P	24,355	23,158	5,312
CFO *	150,975	125,805	82,854
Capital Exp	49,643	29,836	17,546
Acquisitions	35,434	515	33,448
Net Acq. of Equity Investees	11,578	61,184	35,611
FCF	54,320	34,270	(3,751)
Repurchases	10,872	-	13,182

- Many components of CFO are left out of this table so the column does not add up to the actual cash from operations.

What we see up front is 20%-25% of cash flow from operations is coming from employees taking stock compensation over cash. That works when the stock is rising, it doesn't always work if the stock is flat or falls – ask Twitter. The company also adjusts for this in non-GAAP income where it has become a sizable percentage.

Also, while the company does not have much in working capital relative to total assets, and we would expect working capital to growth with revenues, the accruals and payables have been producing much more cash than the assets are consuming.

We would expect capital spending to be rising and be higher than depreciation, which is the case. However, it also appears that Alibaba does much more acquiring than building. It lists both acquisitions and additions to equity investees where it does not own a majority but exercises substantial control. We listed both sets of purchases. When this is a way of life and not a one-time event – we are skeptical how much should be added back to adjusted income figures. We also wonder if that will have tax implications in determining just how cutting edge some of the technology is and whether all of Alibaba should expect to have a long run of favorable tax treatment from the Chinese government.

Alibaba Uses Several non-GAAP Measurements to Assess Results and Margins

There are no non-GAAP police that come to change presentation policies. One of the goals of financial statements is to have some comparability to other time-periods. As a result, we understand adding back truly one-time events to results such as the 2017 tax-law changes that impacted nearly every US company.

The bigger issue we have is when companies have a history of particular expenses and no plan for those expenses to disappear and they want to add them back to reported results. The bulk of expenses that Alibaba adds back fit this definition in our view. Is the company going to stop paying employees with stock? There is no plan to do that now. Is the company going to stop making numerous acquisitions? That seems unlikely too. Yet, amortization of acquisition costs is seen as something one-time in nature that should be added back.

The company touts performance via:

- Non-GAAP EPS – which adds back share compensation, amortization of intangibles, impairments of Goodwill, gains/losses and other restructuring or impairments. This essentially lowers the P/E ratios and boosts ROI figures.

millions of RMB	2019	2018	2017
Net Income	80,234	61,412	41,226
Share Comp	37,491	20,075	15,995
Amortization	10,727	7,120	5,192
Impairments	11,360	20,463	2,542
Gains	(47,525)	(25,945)	(7,346)
Non GAAP Income	93,407	83,214	57,871
Non GAAP/GAAP	116%	136%	140%

- Adjusted EBITDA and Adjusted EBITA – which add back the same figures as non-GAAP EPS + (depreciation in the case of EBITDA), along with tax expense, interest expense less interest income. These figures are used to look at operating margins in a more favorable light. Amortization of intangibles especially for acquired assets being added back essentially says that making acquisitions has no cost. Building assets in house results in depreciation at least. Adding back share compensation makes it appear employees are working for a steep discount compared to their total pay.

millions of RMB	2019	2018	2017
Net Income	80,234	61,412	41,226
Op. Income	57,084	69,314	48,055
Share Comp	37,491	20,075	15,995
Amortization	10,727	7,120	5,122
Impairments	-	494	-
Adj. EBITA	106,981	97,003	69,172
Depreciation	14,926	8,789	5,284
Adj. EBITDA	121,943	105,792	74,456
Op Margin	15.1%	27.7%	30.4%
EBITA Margin	28.4%	38.8%	43.7%
EBITDA Margin	32.4%	42.3%	47.0%

With regards to the share-based compensation – it is essentially 10% of sales and a key reason margins rise so sharply without it. At this point, Alibaba has not seen the level of dilution problems of other companies. The share count rose only 0.5% last year. The company is adding back 37 billion RMB to its income and it only spent 11 billion RMB buying shares last year. There is about 2% dilution potential from existing Restricted Stock Units that have been granted.

Our basic conclusion is to be skeptical that this is a one-time expense that should be added back. However, the negative cash impact or dilution are not at problem stages at this time.

Growth Through Acquisition Creates Some Issues

Alibaba spends much more on acquiring other companies than it does building assets in-house. In the last three years, 178 billion RMB went toward acquisitions vs. 97 billion for capital spending. In many companies, the first problem is they depreciate/amortize acquired assets over a longer period of time than built assets and that inflates income. In this area, Alibaba gets high marks for being conservative. They amortize over basically the same time frame:

- PP&E depreciation time for computers and software are 3-5 years
- Acquired Developed Tech and patents are amortized over 2-5 years
- PP&E depreciation time for office, transportation equipment is 3-10 years
- Acquired User base, customer relationships are amortized over 1-16 years and trade names/domain names over 3-20 years

The second problem is companies have to depreciate/amortize/expense all the assets they build in-house. However, when they make acquisitions, they can label part of the purchase price as goodwill which does not have to be amortized. In this situation, Alibaba is not conservative. Here are some recent deals:

millions of RMB	Goodwill	Other Intang	GW %	Other %
Alibaba Pictures	20,052	3,957	84%	16%
Rajax/Koubei	34,572	25,069	58%	42%
DSM	3,938	1,078	79%	21%
Kaiyuan	1,047	203	84%	16%
Cainaio	32,418	14,768	69%	31%
Intiuze	4,757	1,219	80%	20%
Youku	26,395	4,649	85%	15%
Lazada	5,216	3,265	62%	38%

Essentially, Alibaba is assigning much higher percentages of the assets to goodwill, which is not amortized and therefore does not go through the income statement. In our view, much of what is being acquired would have low life spans – just like what Alibaba is building.

Accounting procedures with goodwill may be allowing income to be inflated if the company is built via acquisitions instead of organic growth and expansion.

The next problem is the lack of disclosure on what these companies were posting for results before being purchased. That would further be complicated because several acquisitions take place over several years and start as acquisitions in equity investees – where Alibaba has significant control but not does not own the full company. It then finishes the full acquisition at a later date. So, we do not know multiples of EBITDA being paid and we do not know how much of revenue growth is the result of buying sales vs. growing organically.

Will the Acquisitions and PRC Review Lead to a Higher Tax Rate?

Alibaba is based in the Cayman Islands with no income taxes with some units in Hong Kong where the tax rate is 16.5%. However, the bulk of its operating companies are in China where the effective tax rate is 25%. Last year, Alibaba only paid 17%. How did this happen? China's 25% rate is modified for the following exemptions:

- Companies considered high and new technology enterprises only pay 15%
- Companies considered software enterprises pay 0% for the first two years of profitability, that becomes 12.5% for the next three years
- Companies considered key software enterprises get a 10% tax rate which is reviewed and renewed annually

It is unclear how many of these acquisitions may have been added after they passed various tax holidays or the 2-year clock was running on profits where the rate may rise from 0% to 12.5%.

Another risk we see is many of the areas of Alibaba's business that sound the highest-tech oriented, do not earn money. While the primary business is even called Core Commerce – generates all the income. We talk about the potential problems with the current operating structure below including transaction splitting scrutiny and the government's evolving rule book. The risk we see is does the PRC eventually see Alibaba's profitable division as a retailer and no longer eligible for a discount from a 25% tax rate?

millions of RMB	Core Commerce	Cloud Computing	Digital Media	Innovation Initiative
Revenue	323,400	24,702	24,077	4,665
Op. Income	109,312	(5,508)	(20,046)	(11,785)
Adj. EBITA	136,167	(1,158)	(15,796)	(5,971)
Margin	42%	-5%	-66%	-128%

Overview of Chinese Laws for Foreign Ownership

There is a maze of issues to deal with for the company and shareholders. Some of this stems from laws in China that restrict foreign investors from owning more than 50% of the equity in a value-added telecommunication service provider. In the case of Alibaba, the online and mobile commerce businesses and Youku are considered by the government to be value-added telecommunication services.

On top of that, for a foreign investor to own any percentage of the equity in a telecommunications business in China – it has to prove it has experience and a track record at running that type of business.

Foreign investment regulation is about to receive rules under the 2019 PRC Foreign Investment Law that goes into effect on January 1, 2020. This regulation includes "foreign investors obtaining shares, equity interests, property portions or other similar rights and interests of enterprises within the PRC." The new act has categories of industries that the government encourages foreign investment and a negative list of industries where foreign investment is either prohibited or heavily restricted. That list allows Alibaba's software and logistics businesses to have foreign investors but again not the value-added telecommunication services units.

In the case of Alibaba, 66.2% of shares are owned by foreigners via the ADS listed on the NYSE. Also, Softbank in Japan owns another 25.9% of the shares and would represent foreign investment. So, how does Alibaba deal with these restrictions?

Most of the Assets of Alibaba Are Owned by Chinese Citizens

The first step is to set up a Variable Interest Entity (VIE) that is 100% incorporated and 100% owned by Chinese citizens. These VIEs own all of the Chinese assets for Alibaba. In order for the Chinese citizens to buy the assets, they obtain a loan from a Chinese holding company. This holding company is called a Wholly Owned Entity (WOE). The WOE's are also incorporated in China.

So, the direct ownership of the assets belongs to Chinese citizens, who borrow money from the WOE to finance their ownership purchase. The WOE does not face the restrictions on foreign investment because it does not own the telecommunication assets/services – it is simply a creditor to investors who own the equity in the VIE with the restricted assets. The WOE in China is owned by offshore holding companies outside of China (in Alibaba's case mostly the Cayman Islands). So, Alibaba raises money, transfers it to its Cayman companies who in turn transfer it to the Chinese WOEs, who lend it to Chinese citizens who actually own the assets of the VIEs.

The WOE obtains control over the owners of the VIE in several ways:

- It is their creditor and directs that the loan can only be used to purchase the ownership in the VIE. The equity interest in the VIE secures the loan.
- The WOE can demand payment at any time.
- The WOE has control over who the owner of the VIE is and can direct a replacement should one repay the loan and want to leave.
- The WOE can dictate actions by the owner of the VIE to take or not take actions with the VIE or other investments so as not to interfere with rules governing the VIE.
- The VIE owner has given the WOE an exclusive call option to buy the equity interest in the VIE for paid-in capital plus a minimum purchase price.
- The VIE owner has given the WOE the power over his proxy to vote as the WOE demands.

The WOE also gets effectively gets paid all the economic output of the VIE:

- There is an exclusive technology service contract from the WOE to the VIE that results in the VIE paying the WOE essentially all net profits from the VIE.
- The call option also transfers any distributions or dividends from the VIE equity holder to the WOE.

Potential Problems with this Set-Up

Alibaba has been advised that by its legal counsel that this does not violate any laws and the agreements are all legally binding. Of course, that advice is quickly followed by:

> "***there are substantial uncertainties regarding the interpretation and application of current and future PRC laws, rules and regulations.*** *Accordingly, the possibility that the PRC regulatory authorities and PRC courts may in the future take a view that is contrary to the opinion of our PRC legal counsel cannot be ruled out. We have been further advised by our PRC legal counsel that if the* ***PRC government finds that the agreements that establish the structure for operating our Internet-based business do not comply with PRC government restrictions on foreign investment in the aforesaid business we engage in, we could be subject to severe penalties*** *including being prohibited from continuing operations.*"

The new laws on foreign ownership have not been tested in courts yet. In 2015, China's Ministry of Commerce proposed a draft of viewing VIEs that are controlled via contracts would be deemed foreign investors if they are ultimately controlled by foreign investors. The new law that takes effect in January does not examine the contractual control situation – and courts may be able to find that the 2015 draft shows what regulators were intending to prevent. We are not lawyers and have even less legal knowledge on China. But it doesn't take too much common-sense to poke a hole in this Goodfella defense, "Hey Jimmy don't worry about the fancy new car – it's in my mother-in-law's name!" by asking "OK where'd she get the money?" We do not think the government would ever put Alibaba out of business, but with the courts and new laws, it may be able to extract higher fees, penalties, and taxes out of the company for designing a structure with numerous holding companies, VIE's owned by people financed by the offshore entities… and saying this is designed to get around the 50% foreign ownership limit the government is trying to maintain.

What happens if a VIE owner gets divorced? Can the wife argue that she owns half the VIE even though she didn't sign the papers pledging to transfer all the income to Alibaba? It's probably not tough to buy out both the husband and wife and move the ownership to another PRC citizen. However, are there delays and lost transfers?

The government in China is also looking more closely at PRC citizens who have investments in offshore companies. The company notes this as a risk for Special Purpose Vehicles moving foreign exchange on and offshore. That would seem to have some impact for the members who are VIE owners but also own Alibaba stock and live offshore for part of the year.

A case in point is Alipay. In 2011, the payment processor of Alibaba ran into China changing the rules. New regulations required non-bank payment companies to get a license. If not obtained by 3Q11 – the company would need to cease business. Alibaba was prepared to get a license but the guidelines were not clear. Better safe than sorry – Alipay was divested to Jack Ma with operating agreements between the two companies. Alibaba agreed to acquire a 33% stake in Alipay over time starting in 2018 and announced the completion of that deal this week. This further changed the agreements between the two companies with Ant Financial (Alipay's holding company) no longer paying 37.5% of pretax income to Alibaba. Alipay remains the largest payment processor for Alibaba and offers it preferential treatment and the ability to offer free service to customers with payments from Alibaba to Alipay. This situation probably delayed the Alibaba IPO as Alipay was a significant asset that was removed from the mix and it may never be a 100% subsidiary of Alibaba again.

The first problem in our opinion is changing Chinese laws without little testing in the courts that can disrupt this structure with short notice and change how Alibaba operates.

It is not just the PRC; the SEC has also been investigating Alibaba's structure. There are not any allegations of wrongdoing at this time, but it is causing curious regulators to look:

> *"In early 2016, the SEC informed us that it had initiated an investigation into whether there have been any violations of the federal securities laws.* ***The SEC has requested that we voluntarily provide it with documents and information relating to, among other things, our consolidation policies and practices (including our prior practice of accounting for Cainiao Network as an equity method investee), our policies and practices applicable to related party transactions in general****, and our reporting of operating data from the 11.11 global shopping festival. We are voluntarily disclosing this SEC request for information and cooperating with the SEC and, through our legal counsel, have been providing the SEC with requested documents and information. The SEC advised us that the initiation of a request for information should not be construed as an indication by the SEC or its staff that any violation of the federal securities laws has occurred."*

Taxes and Dividends May Be Big Issues Too for This Structure – Moving Money Around May Be Inefficient and Costly

We are not concerned that the Chinese government would shut down Alibaba. The government can get paid via many forms of taxes and fines with vague laws and simply charging a fee every time Alibaba has to move money between entities. The result is all the cash flow and earnings may not be available to shareholders and the rules can change:

- Every Chinese subsidiary has to keep its initial capital and a percentage of net income each year as statutory reserves. These reserves cannot be distributed as dividends. Also, reserves in China, cannot be exported from China. The total of these reserves was $16.8 billion in March 2019 – that's 12% of assets.
- China has a 10% withholding tax on dividends paid by resident companies to non-resident companies. Right now, Alibaba does not have to pay this, but that could change.
- Alibaba is also not paying the 25% income tax on all global income that PRC companies do. That could change if as noted earlier it is viewed as being a Chinese company via that's where its VIEs operate and China is the bulk of sales.
- Transaction splitting is something else the Chinese government looks at. This is essentially claiming that the bulk of expenses occur in a high tax area and the bulk of revenues occur in a low tax region to minimize taxes.
- Preferential tax treatment for Chinese subsidiaries at 15% for being in the high-tech and software industries. Other entities get a 10% tax treatment and have those reviewed annually by the PRC. Is this whole company tech-related or is it largely a retailer? A reclassification could boost taxes by 10-15 percentage points.
- China restricts the outflow of currency exchange. **The bulk of sales are in Renminbi, the shares largely trade in US dollars, there is US dollar debt,** and it may not be possible to pull money out of China to make new investments or service requirement in foreign currencies.

The company also talks about facing fines and penalties for other actions that may occur regarding advertising, monitoring clients, meeting filing requirements, etc. It has been announced that China is putting government officials into larger private companies especially in the tech sector. This sounds like a way for the government to watch the money move around and make modifications to us as well as imposing fines.

We don't even want to try to model this much, but Alibaba has high margins now. Logistics are rising faster than sales and crimping margins a bit; gross margin has fallen from 62% to 45% in the last three years. Operating Income margins are now about 20% down from 30%. But revenue growth is still over 40%. Really rough figures – on March 2019 annual results, an extra 1% in taxes would have cost Alibaba about 5-cents in EPS. If revenue grows 40% this year, and even assuming some modest margin contraction – the EPS impact of 1% higher taxes would be about 7-8 cents. It is possible that if the tax rate rose it could move up more than 1%. However, offsetting that is the total growth in earnings. So, March 2019 results had EPS of $4.97, adding 40% revenue growth would get EPS over $7.00. That's the bigger picture, before making allowances that the cost of taxes and fines increases which could cost Alibaba 7-cents to 35-cents on a 1%-5% increase in tax rates.

The risk does not seem to be that this wipes out Alibaba, but it may hurt its ability to beat forecasts as handily as it has been doing and could boost the cost of doing business.

The Partnership led by Jack Ma and Associates Cannot Be Removed

Under the various holding company structures – it is debatable what investors in Alibaba actually own. The actual operating assets are not owned by Alibaba and even if a foreign investor wanted to change the structure and take control of the company – he could not unless he can prove he has a proven positive track record at running a value-added telecommunication business elsewhere.

The make-up of the board of directors is also out of reach for outside investors too. The company's founding documents are set up to allow the Alibaba Partnership to always have a majority of the board. In fact, if at any time they do not have a majority, they can simply appoint new board members until they reach a simple majority again.

If shareholders want to amend the documents to remove that power, good luck! That would require 95% of shareholders to do so, and Jack Ma and Joe Tsai own 8.4% of the stock. Also, Softbank of Japan owns 25.9% of the shares and can appoint one director. If it were to boost its stake in the company above 30% - it has granted Jack Ma and Joe Tsai a proxy to vote all shares over 30% it owns.

The company is also allowed to thwart take-over actions by issuing preferred shares with terms set by the board without shareholder approval.

General Mills (GIS) EQ Update-8/19 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 maintaining our earnings quality rating of 3- (Minor Concern)

GIS's adjusted EPS of $0.79 topped the Street consensus by 2 cps. Nevertheless, we continue to see red flags pertaining to the company's earnings quality.

- Cash from operations for the three months ended 8/19 fell by 6%, or $35 million. The change in current assets and liabilities was a $99 million drag on growth which the company blamed largely on an increase in inventory. However, we estimate about half this impact was offset by a rise in payables as the company continues to drive up payment terms on suppliers. Cash flow growth was further impeded by a $66 million change in deferred income taxes due to a net benefit related to the reorganization of wholly owned subsidiaries.

- Capital spending on a trailing 12-month basis fell by $124 million, or roughly 20%. As a percentage of sales, capex is now running at 2.9% versus the 4.0%-4.5% range seen in the 2017-2018 time period. This is providing a likely temporary boost to free cash flow growth.

- Inventories rose noticeably with DSIs jumping to 59.4 from 55.9 in the year-ago quarter. Remember that the company utilizes LIFO for its US inventories which limits the potential of rising costs being delayed from hitting the income statement. We are not overly concerned by the DSI increase but will be alarmed if it does not reverse in the next quarter.

- Also as noted above, payables have been rising. GIS began to push for longer payment times on suppliers a couple of years ago and in that time, days payable have steadily risen to over 97, up from 90, 81, and 71 in the 8/18, 8/17 and 8/16 quarters, respectively. That has not only been a boost to cash flow growth, but also more than offset the rise in DSOs from 34 to 39 during the same time frame. It appears that the company has essentially pressured its suppliers to help finance its customers. With the company taking more than three months to pay the average supplier, we are skeptical this can continue much longer. We note that the company offers certain suppliers access to third-party financing which allows them to monetize the balances owed to them by GIS. The balance of payables due to suppliers utilizing these arrangements has remained essentially flat over the last year.

- Total pension and postretirement benefit expense in the 8/19 quarter swung to a $2.5 million income from a $7.1 million expense in the year-ago period. This was largely due to a decline in interest cost which we suspect resulted from a decline in the rate used for the calculation. This added a little more than a penny per share to EPS growth.

- We note that gross profit growth received a $53 million boost from last year's first quarter purchase accounting charge related to the Blue Buffalo acquisition. To the company's credit, it did not add the purchase accounting adjustment back to non-GAAP earnings in the 8/18 quarter. However, it also did not remove this year's beneficial impact from its adjusted results either. The company pointed out in its MD&A section that margin improvement received a 130 bps boost due to last year's charge. Investors will simply have to be careful to not extrapolate the improvement going forward.

Explanation of EQ Rating Scale

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

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

Key Points to Understand About the EQ Score

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

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

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