BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Sealed Air (SEE) 3Q'19 Update
Upgrade to NEUTRAL

We are moving the recommendation on SEE back to NEUTRAL with the stock down 15% from our warning in August. We continue to see several problems – most notably volume growth is negative for its packaging division, which serves the rapidly growing e-commerce market. On top of that, it now sells automation equipment to help customers lower their e-commerce costs. We used to follow Pitney Bowes where the end market (mail delivery) was posting negative volume and yet still had growing demand from customers buying automation equipment to reduce their costs. SEE has a growing end market where customers are increasing their focus and it posts a negative volume figure? The company's goal is to grow faster than its end markets, we know the end markets are likely rising faster than 1.9% in food care and -5.0% in product care.

A low valuation is about the only thing causing us to change the rating to NEUTRAL from SELL. It is selling for under 14x 2019 EPS and 10x adjusted EBITDA. Should the stock rally at all, we will consider cutting the rating again. If we adjust for some margin compression issues – the stock would still be only 16x EPS and 11x EBITDA.

- We will need the 10-Q to see if there is a change in status to the SEC investigation and the subpoena from the US Attorney's Office. We will need the 10-Q to see if there has been any movement on the IRS dispute regarding disallowing a $1.49 billion settlement payment in 2014. The 10-Q is also necessary to see the full changes in working capital as the company securitizes and factors receivables.

- What growth is here? Sales rose 2.8% in the quarter and 0.6% YTD. Acquisitions were 5.2% and 3.4% of that growth. Volume was -0.8% and -0.6%.

- SEE continues to tout organic growth before FX as the standard to judge results. On top of negative volume, all of the pricing power came from South America where hyperinflation is skewing the numbers. FX continues to be a material drag too. We see across the board negative growth in pricing and volume serving markets that should be increasing.

- SEE is also taking more in pricing than costs justify. Guidance last quarter was for this windfall to get smaller and it rose further in 3Q. We believe that leads customers to opt for competitors with better pricing and we also think there will be push-back on SEE as well. Taking excess pricing out of the mix would strip about 200bp out of the EBITDA margins.

- Adjusted EPS and EBITDA look weaker with some low-quality items removed. SEE has also stopped buying back shares which removes a past source of EPS growth. Shares have been flat at 155 million all year. Working capital is also seeing payables decline and consume cash.

Once again – Hyperinflation in South America Is the Only Source of Growth

We have discussed this situation quite a bit with MDLZ and SEE. We consider the presentation of constant currency organic growth to be of very low quality at SEE because the FX hit is so large. In 3Q19, investors are again shown a picture that a division at less

than 5% of total sales and widely regarded as one of the weaker regions in the world economically is actually the engine driving SEE:

3Q19 Growth	North America	EMEA	South America	APAC	Total
Volume	-$12.7	$2.2	$1.5	-$0.4	-$9.4
Price	-$5.8	$0.0	$10.0	$0.3	$4.5
Org. Sales Growth	-$18.5	$2.2	$11.5	-$0.1	-$4.9
FX	-$1.3	-$9.6	-$9.1	-$4.7	-$24.7

Not only was South America all of the pricing growth – it almost the only positive place for organic growth at all. Only when FX is added does South American growth look remotely realistic. This $10 million in constant currency pricing gains in South America is poor quality earnings in our view. The company reported adjusted EPS of $0.64 in the quarter, we think $0.05 came from the hyperinflation of South America.

Acquisitions Provided Most of the Reported Growth

If South America shouldn't be viewed as real growth – then what about acquisitions? We do not consider those to be real growth either. Yet, look at the impact on 3Q and YTD:

Sources of Growth	Volume	Price	Acquisition	FX	Total
3Q19	-$9	$5	$62	-$25	$33
YTD19	-$20	$41	$117	-$118	$20

We also think the lack of volume growth in the product care unit should be alarming for many investors. As we noted after the 2Q19, more customers are trying to reduce the amount of material used in packing. That headwind looks to be continuing and taking a toll on SEE:

Volume	3Q19	2Q19	1Q19
Product Care	-5.1%	-2.5%	-4.4%
Food Care	1.9%	2.4%	0.4%
Total SEE	-0.8%	1.5%	-1.4%

We will need the 10-Q to review how much of the receivables are being securitized or factored. That was increasing in 2Q19. On the surface, trade receivables on the balance sheet declined from $485 million to $449 million in the 3Q. We feared that the higher

receivables balance after 2Q would hurt sales growth going forward. Payables also fell from $753 million to $713 million in the 3Q consuming $40 million of cash flow.

We Question How Long SEE Can Boost Prices More than Cost Inflation

One of the other trends in the industry for SEE is customers looking for more recycled product, and other forms of packaging that are more durable. That is effectively boosting some of the raw material costs for SEE and it is passing them through to customers. We don't have a problem with that. However, SEE is also taking pricing in excess of the cost increases and that is a key part of the recent margin expansion:

EBITDA Changes	3Q19	2Q19	1Q19
Price/Cost	$24	$19	$22
Restructuring	$21	$17	$13
Oper. Costs	-$14	-$12	-$10
Sales	$1,219	$1,161	$1,113
EBITDA Margin Gain	130bp	160bp	130bp

This is becoming a tailwind even larger than the saving from the restructuring plans. The problem we see is EBITDA margins are rising about 130bp y/y. The excess pricing SEE is taking is basically 200bp of the improvement ($24/$1219).

Again, in the 3Q19, adjusted EPS was $0.64 per share with $0.05 coming from hyperinflation in South America. This excess pricing amounted to $0.12. Some of South America's impact is part of that $0.12 so we won't add them together. But that is a sizeable part of EPS that may be tough to maintain let alone expand further.

Remember – here is what the CFO said in the 2Q19 on price/cost spread, "*However, **keep in mind our formula pricing and Food Care is expected to be more aligned with raw material cost**. So, we are assuming less contribution from price cost spread in the third and fourth quarters."*

So pricing is expected to follow more closely the changes in costs, and they were forecasting Price Cost spread to decline. Yet it expanded further in 3Q. Taking SEE's guidance this source of profitability does not look sustainable at all.

Ares Capital Corp. (ARCC) 3Q19 Update
Maintain BUY

We are maintaining our BUY recommendation on ARCC. There are several positives and some negatives that are coming out of 3Q19. Overall, we still believe this company has ample room to both pay the current dividend and expand it. The underlying companies that ARCC is financing continue to grow and ARCC believes it can continue to put more money to work without stretching its credit quality. In the 3Q19, the underlying businesses in the portfolio grew EBITDA at 3% y/y. That comes against a tough comp of 6% growth the year before. We believe the 3% still represents a solid growth figure, where historic growth has been about 4%.

- Core EPS of $0.48 easily outpaces the dividend of $0.40 plus the additional $0.02 per quarter of additional earnings being distributed in 2019. That should set the company up for additional dividend growth.

- The $0.02 per share in additional quarterly dividends in 2019 may increase in 2020. The $0.02 amounts to $34 million of additional distributions. After the 2018 tax return, ARCC determined that spillover income from 2018 that has not been distributed is $343 million or $0.80 per share.

- The leverage ratio is rising and is now at 0.89x – which is the low-end of what ARCC wants to achieve of 0.9x-1.25x on a debt to equity basis.

- Lower LIBOR plus a push toward more first-lien senior-secured financing combined to lower yield by about 50bp in the quarter. Financing costs did not fall as rapidly due to some fixed-rate debt. Overall, rising rates help more than falling rates. However, there are interest rate floors on many of the loans where the yield will not decline as much while most of the floating rate financing has no floors for ARCC. Thus, falling rates may have less of an impact going forward.

- The 10-quarters of waiving $10 million in quarterly management fees (about 2-cents per quarter) have ended. This was set up when ACAS was purchased in 2017 and had a large percentage of non-yielding investments. ARCC has transitioned the bulk of that acquired portfolio into yield during the period of lower management fees and that process is now complete.

- Spreads on loans in the market have increased off the lows. The St. Louis Fed shows the spread at just over 4% vs. the low 3% range a year ago for high-yield debt. Also, spreads in retail and energy have risen much higher – where ARCC has very little exposure. The company is seeing signs that better terms and documentation are returning to the market.

- ARCC and the BDC market is now petitioning the SEC to gain relief from investors having to report double management fees in the expense line if they own ARCC. Essentially, this would treat ownership in ARCC more like a regular stock instead of a portfolio. This would be another catalyst for the stock as it could open up ownership of BDCs to index funds and other large mutual funds. As the largest BDC, we think ARCC would benefit the most from opening the size of the potential ownership pool and could push the stock price higher if this change is successful.

Current Situation with Changes in the Quarter

ARCC continues to grow its portfolio without raising equity, which is pushing up the debt/equity ratio as planned. 3Q19 saw it increase to 0.89x. Core income has exceeded the dividend even with the additional $0.02 per quarter for 2019.

	3Q19	2Q19	1Q19	4Q18
Core EPS	$0.48	$0.49	$0.48	$0.45
Distribution	$0.42	$0.42	$0.42	$0.39
Debt/Equity	0.89	0.77	0.79	0.69
Yield on Portfolio	9.8%	10.4%	10.4%	10.2%
Inv. Income	$387	$382	$373	$345
Financing Cost	$76	$69	$67	$60
Base Mgt Fee	$52	$50	$49	$45

If there is an issue, it is that the company is seeing falling LIBOR push down yield on the portfolio. This was very noticeable in 3Q. The company attributes this coming from both falling LIBOR for about 20bp and boosting quality in loans in the quarter for about 30bp. In the quarter 90% of new loans funded were first-lien senior-secured. We are not going to question that effort to boost credit quality. Since quarter end, 90% of loans in October have also been first-lien senior-secured.

The emphasis on floating rate loans clearly took a toll in the quarter. Even with the portfolio growing, interest income rose only $5 million sequentially while the financing costs rose $7 million. Also, the larger portfolio led to higher base management fees as well.

ARCC may not see the movement continue at the same level. First, most of the loans have interest rate floors on them and will not see much more downward movement. At the same time, the variable-rate financing does not have floors and could fall more than rate on loans. The company is still set up nicely should rates increase to see faster growth in income. ARCC reported the following sensitivity analysis:

	Interest Income	Interest Expense
300bp +	$365	$55
200bp +	$243	$37
100bp +	$122	$19
100bp -	-$117	-$18
200bp -	-$141	-$37
300bp -	-$142	-$37

The squeeze of falling rates has an end to it, while higher income from rising rates continues to have upside increase.

On top of that, there is a spread where loans trade vs. treasury bonds. This has widened from multi-year lows of about 3.5% in 2018 to about 4.1% now according to the St. Louis Fed's High-yield bond tracking figures. There have been periods of late where the spread has reached 4.5% too. Problems with debt in the energy and retail sector have been the primary culprits for this spread widening.

Historically, the warning sign has come when the spread is over 8% so we do not consider 4% a red-flag. The market is simply viewing 4% vs. 3.5% as a negative trend, but it is hardly out of line with history. ARCC's focus on boosting credit quality is something we view as a positive especially given there remains room to still boost the dividend.

ARCC noted that as the spread has widened and hurt some of the more leveraged players in the field, it is causing some funds to pull back. That is good for ARCC as it can be pickier about loans it makes. At the same time, it is starting to see more discipline on loan terms which also boosts safety.

Other Changes to Watch

3Q19 was the last quarter where the management fee will be reduced by $10 million. This was part of the deal when ARCC bought American Capital – which had a large equity portfolio. The goal was to transition out of non-income producing securities into ARCC's style of producing yield. During that transition, the management fees were cut by $10 million for 10-quarters.

This is a 2-cent expense that will rise and lower GAAP EPS going forward. This was an expected change and over the 10-quarters, ARCC has seen core EPS rise noticeably above the distribution. Core EPS was $0.32 in the 1Q17 following the acquisition and is now $0.48.

A BDC must distribute a minimum of 90% of its income to shareholders to remain a tax-free vehicle. It can also avoid a 4% excise tax if it distributes 98% of ordinary income and 98% of capital gains. GAAP earnings have been exceeding the regular $0.40 dividend in most periods by more than 90%. ARCC noted on the call:

> *"Following the filing of our 2018 tax return, we determined that our final taxable income spillover from 2018 going into 2019 was $343 million or $0.80 per share, which provides us with a significant amount of undistributed earnings. Given the amount of spillover coming into 2019 combined with our year-to-date 2019 core earnings in excess of dividends paid, we believe we will continue to be in a strong undistributed taxable income position at the end of this year."*

We believe this is a good sign that the dividends will continue to rise from ARCC.

When we first wrote ARCC it was based on the catalyst of the government changing the rules around BDC leverage and boosting the cap from 100% of equity to 200%. We believed this would create growth without raising equity and the larger portfolio would result in higher EPS and higher dividends.

Another change is being pushed in 2019 too. This one would modify the rules of funds who buy BDCs to report their share of the BDC's management fees as an expense item on their own fund. The proposed change would eliminate that separate expense item and make BDC's more attractive to own. It is also believed it would effectively reduce the cost of equity capital for BDCs by raising their stock prices if the pool of potential owners could be increased. As the largest publicly traded BDC – ARCC would stand to benefit if it was

allowed to be included in index funds and other large funds could more easily add BDC exposure to their portfolios.

There is no timeframe on when something could happen here if it does at all – but valuing the dividend at ARCC at even 6% or 7% would move the stock into the mid-$20s.

Ocean Yield (OCY NO, OYIEF)– 3Q'19 Update
Maintain NEUTRAL

We are maintaining a Neutral rating on Ocean Yield. It was a fairly busy 3Q. As the company promised, if it did not appear to have the FPSO contract situation resolved by the end of 2019, they would reduce the dividend in 1Q20. The cut will be from 19.1 cents to 15.0 cents per quarter. On the current price, that would still be an 11% yield and save the company approximately $26 million in cash flow per year.

Also, in the current 4Q, the seasonality of offshore oil projects tends to slow down. That makes it tough to sign new contracts for the Connector vessel and the two supply vessels operated by Solstad. The Connector has been on short term deals and Solstad has deferred payments on the two supply vessels for 2019 and that that deferral is now extended until the end of 1Q20.

There remain several reasons to be positive as well. However, it may be three more quarters until it is clear how some of the variables will play out regarding the FPSO, the Connector, and Solstad. Ocean Yield did raise $125 million in a hybrid perpetual bond at the end of the quarter that brings the total cash balance to $176 million. The issues to still focus upon remain:

- The FPSO has several options for future employment. The most promising remains with Aker, which is developing a field in Ghana and owns 61.7% of Ocean Yield. However, nothing may be decided before 3Q20. The FPSO will be producing minimal if any cash flow in 2020. But keep in mind, it remains debt-free and the rapid paydown of debt in 2017 and 2018 effectively made it a zero for net cash flow during those years too.

- The Solstad restructuring is continuing to focus on deferring interest and debt payments until the business cycle strengthens for offshore oil work. There is evidence of improvement from several companies. This could see cash flow rise at Ocean Yield from the two Solstad vessels and the Connector in 2020 and 2021.

- EBITDA is growing with new vessels coming online. The smaller dividend adds some cushion, but interest expense and debt payments are rising. The company already

operated without oil-related vessels discussed generating much EBITDA in 2019. Cash inflow/outflow will still be tight going forward.

- Aker is a key player here as it owns 61.7% of Ocean Yield, 20.1% of Solstad, and developing the field in Ghana. Also, Okeanis which has a lease on the four VLCC oil tankers from Ocean Yield has given notice to reacquire them. That is in dispute but could result in Ocean Yield receiving about $64 million in cash.

We Still See the FPSO, Connector, and Solstad Vessels as Call Options for the Stock

The delays in getting a new FPSO contract and short-term nature of work for the connector have hurt the stock price. At the same time, the Solstad revenue deferral that has been extended is not a positive either. The issue at this point is, what is the downside?

These vessels have contributed only modestly to EBITDA in recent quarters versus past results:

FPSO	3Q19	2Q19	3Q18	2Q19	2018	2017	2016
EBITDA	$0.6	$1.5	$26.3	$29.7	$63.6	$115.9	$114.5

We have talked about talked about the FPSO situation in prior reports. In the years when its contract was finishing, the company aggressively retired the vessel's debt and thus the EBITDA of $115 million resulted in essentially no cash flow to the company overall. The contract ended in 3Q18 and the drop-off has been severe. An option with Aker is the current source of quarterly EBITDA that may well disappear in December. However, the FPSO is debt-free and on the books for $150 million after a write-down of $68.4 million in 3Q19 based on the projected delay into 2H20 for a resolution to the next contract situation.

The FPSO could still produce above $20 million in EBITDA plus a return on any capital on improvements/modifications that may be required.

The Other Oil Service vessels contain the Wayfarer on a long-term contract, the SBM Installer on a long-term contract, and two platform supply vessels on contract that are all paying and producing EBITDA. The Connector has been on a series of short-term charters or idle since early 2017. The two Solstad vessels have not produced EBITDA since December 2018.

When all the vessels were working under contract and being paid in 2016 – the EBITDA from these ships was $90 million per year or about $23 million per quarter. In mid-2017, the two platform supply ships were added on a 15-year charter paying $12.6 million per year. When everything is working and getting paid, this division should have EBITDA of over $100 million. Before the Solstad standstill, EBITDA was about $90 million with the Connector on short term deals. After the standstill, EBITDA is running about $60 million per year.

Even if Ocean Yield takes a haircut on the Solstad charters – EBITDA will still increase going forward. Based on how similar companies such as Seadrill restructured and what Solstad's goal has been – the primary part of the deal is to delay debt payments until the market turns up again. That seems to be the blueprint at work here now. The potential may be for a return of $20-$30 million of EBITDA in this division.

Total EBITDA is running about $320 million per year now plus the addition of a few new ships. In our view, simply resolving the FPSO, the Connector, and Solstad charters could add 10%-15% to EBITDA.

Offshore Market Is Showing Some Improvement

The fact that Ghana is working with Aker to develop an offshore field is evidence that the offshore business is improving. Looking at conference calls from the various offshore rig companies shows universal gains too.

- Transocean reported that it signed new contracts in 3Q19. Day rates are increasing from the lows. It is seeing customer interest at a 5-year high and is starting to reactivate rigs that have been stacked.

- Diamond Offshore said rates are rising off the bottom. Each new contract is showing a higher rate than the last one. It is also starting to reactivate rigs.

- Noble has reactivations starting. It is reporting new contracts and contract extensions on existing deals.

- Varalis (formerly Ensco and Rowan) said rates have been rising steadily since early 2018. It believes that as rates increase, customer interest will also increase as they want to avoid booking rigs at peak prices like in 2008.

- Seadrill has not reported 3Q results yet. It has listed new contracts in Brazil for 3Q. In its 2Q results, it saw day rates recovering in all segments. Longer-term contracts are also starting to see higher rates and the market is seeing forward pricing increase.

- ExxonMobil announced five significant deepwater discoveries in 3Q19 and Petrobras is focusing on deepwater and ultra-deepwater exploration on its 3Q19 call.

This is the market that is important for Ocean Yield's major idled vessels. It's also why we believe the Solstad issues will be worked out. That company is even signing new contracts in Brazil and Mexico. It saw EBITDA rise y/y in 2Q19 and reported an increase in activity. Solstad's goal is to now build cash and let business demand grow as it reaches the spring of 2020.

Where Does This Stand?

EBITDA is $320 million a good estimate without the FPSO, Connector, or Solstad ships. The new dividend is $96 million and interest expense will be about $128 million with the new bond. That's $224 in cash outflow. This company operates like a triple net lease REIT with bare boat charters and financing leases. It has roughly $100 million in cash flow after interest expense and the dividend.

There is $176 million in cash. Capital spending is essentially for growth and at this point is fully covered with financing. Debt is high at just under $2 billion. Much of that is related to assets on lease with customers where the debt retirement is built into the payment. The remaining vessels have Loan-to-Value ratios of under 80% of depreciated value. The company retires debt with the remaining free cash flow and refinances any balloon payments due. The recent bond offering covers much of those scheduled payments as the EBITDA is depressed with several of the oil-related assets not producing steady cash flow. We believe there is the potential for an additional $30 million+ per year in cash flow to return in 2020. At the moment, that missing cash flow is the difference from being able to retire 6% of vessel debt per year and nearly 10%.

There is also a contract on some recently placed VLCC oil tankers with Okeanis. That company is trying to exercise a purchase option to reacquire those ships. Ocean Yield is disputing that at the moment, but the two outcomes are the company continues to receive payments or it will receive $64 million in cash and remove the debt from the balance sheet.

Ghana, where Aker is working to develop a new field and could employ the FPSO, has asked for more accelerated development from Aker. Those plans are in the works and will need approval from the government, but it appears that could result something positive in 2020 for Ocean Yield. Also, we anticipate the Solstad vessels will resume generating positive cash flow in early 2020 as well. Aker as the largest holder of Ocean Yield and a large player in Solstad has incentives to clarify that situation.

Illinois Tool Works (ITW) EQ Update 9/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3-	3+

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

*For a more detailed 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) from 3+ (Minor Concern).

ITW reported EPS of $2.04 which beat the consensus estimate by 10 cps. 7 cps of the upside was driven by a positive tax liability adjustment. Management maintained the full-year guidance as the lower tax rate is expected to offset a like amount of higher than previously forecast FX headwinds. While inventory levels improved during the quarter, an unusual boost from other income added about 5 cps to EPS in the quarter which is larger than the earnings beat after adjustment for the tax benefit which calls into question the quality of the beat.

- Other income rose to $26 million in the 9/19 quarter from $10 million in the year-ago period. There was no mention of this move in the 10-Q nor was it discussed on the conference call. We know that the non-service components of pension costs are included in this account, but those amounts were roughly flat with the 9/19 quarter. This decline added about 5 cps to earnings growth in the quarter.

- We note that amortization of intangible assets declined by 2.2 cps in the 9/19 quarter versus a 1.7 cps decline and 1.2 cps decline in the 6/19 and 3/19 quarters, respectively. There were no unusual impairments cited and this is likely related to the businesses reclassified as held for sale in the 6/19 quarter. If so, the reduced level of amortization expense will continue to provide a mild tailwind to results for another three quarters.

- Inventory management improved in the quarter with inventory days down over 3 days versus the year-ago third quarter. This marks the end of a string of increases and reduces our concern in this area.

- Management warned that margins in the fourth quarter will be negatively impacted by higher restructuring spending as it has accelerated its restructuring activities. We have noted in past reviews that the company does not quantify its restructuring spending and does not add it back to adjusted EPS. Rather, it cites the basis point impact on margins in its MD&A sections and mentions it in its conference calls. On one hand, we like the lack of tampering with reported EPS. However, management still appears to have leeway to blame higher than expected costs on restructuring spending with less visibility into the duration and ultimate restructuring spending levels.

Eaton (ETN) EQ Update 9/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3+	3-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

*For a more detailed 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) from 3- (Minor Concern).

ETN's adjusted EPS of $1.52 in the 9/19 quarter was a penny ahead of expectations.

- The buyback continues to add a significant boost to EPS growth with the numbers of shares declining by 4.1% in the 9/19 quarter. Free cash flow after the dividend fell $102 million short of covering the buyback in the 12 months ended 9/19 with acquisition requiring over $275 million more in cash. However, as we have pointed out in past reviews, the company's relatively light leverage has made this less alarming. In addition, more cash will be coming in with the expected sale of the Lighting business projected to bring in an additional $1.4 billion in cash in the first quarter of 2020. Management indicated in the call that this would enable it to continue with aggressive share repurchases: *"Rick, I would think of it this way. Our expectation would be take down 1% to 2% float and then the proceeds from Lighting on top of that, so you'll end up with considerably more than 1% to 2%."*

- Other income jumped to $2 million in the 9/19 quarter from an expense of $7 million a year ago. The company does not discuss what drove this. We know that this account includes non-service pension costs which increased by about $5 million, as well as a portion of the charges related to the planned lighting divestiture. We are uncertain of what drove the positive offset, but the observed change on the income statement would have added about 1.5 cps in EPS improvement.

- Accounts receivable from customers fell by 2 on a days of sales basis. Days payable also increased by 4.6 days. However, this was partially offset by an increase in inventory DSIs of 3.5 days. Management stated on the call that it anticipates an improvement in inventory which will provide a continued tailwind to cash flow growth in 4Q ’19 and into 2020. The increase in inventory was spread fairly evenly over raw materials, work in-process, and finished goods. This makes us less concerned that the company will have to discount to unload excess inventory in the fourth quarter.

Ball Corp. (BLL) EQ Update 9/19 Qtr.

Current EQ Rating*	Previous EQ Rating
2-	2-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

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

We are maintaining our earnings quality rating of 2- (Weak).

BLL once again missed its EPS targets in the 9/19 quarter with the adjusted figure of $0.70 falling 2 cps below the consensus target.

- Reported trade receivables DSOs fell by 4 days in the 9/19 quarter versus the 9/18 quarter. However, after adjustment for factored receivables that were outstanding at the end of the period, DSOs jumped by over 2 days. Analysis of receivables is complicated by past divestitures and moving assets to held for sale, but the company noted in its 10-Q that after adjustment for the sale of the US steel packaging business in 2018, the China beverage packaging business, and the transfer of the Argentina steel aerosol business assets to held for sale status, DSOs increased "from 42 days in 2018 to 49 days in 2019."

- A 2-3 days increase in DSOs would be less concerning for a company that is growing its sales base. However, BLL's total sales are flat. Aluminum can volume was up about 4%, but this was largely offset by lower pass-through of aluminum costs. The company continues to report it is struggling with lower inventory and production issues to meet demand for its aluminum packaging products. In such an environment, an increase in DSO calls into question the quality of reported revenues. We also note that the 9/19 quarter ended on a Monday versus a Sunday in the year-ago period which should have improved collections.

- Unbilled receivable days also climbed by 4 days in the 9/19 quarter versus the year-ago period. As we have noted in past reviews, this may be driven by the increase in Aerospace sales recognized under long-term contracts in the mix. However, we are skeptical that that is driving the entire increase in unbilled receivables as the growth in unbilled receivables outran the growth in Aerospace sales in the 9/19 quarter. This may be an indication of more aggressive revenue recognition of non-Aerospace revenues and this trend should be monitored going forward.

Receivables Sales and Adjusted DSOs Continue to Rise

One of our key concerns with BLL has been its increased use of receivables factoring. The table below shows the calculation of trade receivable days of sales adjusted for outstanding sold receivables that have been removed from the balance sheet as well as unbilled receivable days:

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Sales	$2,953	$3,017	$2,785	$2,803
Gross Trade Receivables	$922	$1,017	$958	$812
Gross Unbilled Receivables	$491	$503	$477	$478
Outstanding Sold Receivables	$1,145	$1,092	$1,008	$1,022
Gross Trade Receivable DSO	28.5	30.8	31.4	26.4
Factored Receivable DSO	35.4	33.0	33.0	33.3
Gross Trade +Factored DSO	63.9	63.8	64.4	59.7
Unbilled DSO	15.2	15.2	15.6	15.6

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Sales	$2,946	$3,101	$2,785	$2,747
Gross Trade Receivables	$1,052	$1,259	$1,332	$1,206
Gross Unbilled Receivables	$359	$390	$429	$147
Outstanding Sold Receivables	$942	$838	$589	$561
Gross Trade Receivable DSO	32.6	37.0	43.6	40.1
Factored Receivable DSO	29.2	24.7	19.3	18.6
Gross Trade +Factored DSO	61.8	61.7	62.9	58.7
Unbilled DSO	11.1	11.5	14.1	4.9

Trade receivables declined year-over-year from 32.6 to 28.5. However, the increase in factored but still outstanding receivables more than offset this, resulting in a 2-days increase in adjusted DSOs. Note that our figures above do not take into consideration the impact of the sale of the US steel food and aerosol business in 2018, the sale of the China beverage packaging business, or the transfer of the Argentina steel aerosol business assets to held for sale as of the end of the 9/19 quarter. However, the company noted in its liquidity section of its 10-Q that taking these items into consideration, DSO jumped from "42 days in 2018 to 49 days in 2019" indicating a definite increasing trend in receivables.

Meanwhile, unbilled DSOs increased by more than 4 days over the year-ago quarter. Some of this increase may be due to rising aerospace sales which involve long-term contracts that result in more unbilled receivables being generated relative to sales. However, we are skeptical that this accounts for all of the increase. The following table shows a DSO calculation using Aerospace sales and the total unbilled receivables balance:

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Aerospace sales	$374	$379	$328	$359
Unbilled Receivables DSOs on Aerospace Sales	119.8	121.1	132.7	121.5

	9/30/2018	6/30/2018	3/31/2018
Aerospace sales	$283	$290	$264
Unbilled Receivables DSOs on Aerospace Sales	115.8	122.7	148.3

We want to point out that the above DSO number is relatively meaningless on an absolute basis since the unbilled receivables balance contains amounts relating to non-Aerospace sales. Also, we would point out that the timing of recognition of a non-Aerospace contract will have a magnified impact on a DSO figure utilizing the smaller Aerospace sales base. Regardless, we do believe the relative trend in our unbilled aerospace DSO is informative and a large year-over-year increase like the one observed in the 9/19 quarter may indicate more aggressive revenue recognition in non-Aerospace sales. This metric should be monitored going forward looking for signs of a trend.

Mohawk Industries (MHK) EQ Update 9/19 Qtr.

Current EQ Rating*	Previous EQ Rating
2-	2-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

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

We are maintaining our earnings quality rating on MHK of 2- (Weak).

MHK's 9/19 quarter EPS of $2.75 trounced the consensus target by 11 cps. However, we remind investors the consensus target for the 9/19 quarter was $3.01 prior to management's huge reduction in its outlook after the 6/19 quarterly results. Nevertheless, the stock is higher now than prior to the downgraded outlook. We continue to see a number of red flags and one-time benefits to the company's EPS.

- We noted in the last review that management stated in the 6/19 quarter that inventories were too high and it would have to cut production in the second half to bring them back in-line. DSIs in the 9/19 were flat sequentially and still higher by 6 days versus the year-ago period. The company is continuing efforts to reduce its inventory levels which could represent a headwind to margins in the next quarter.

- Other expenses rose to $52.7 million versus just $706,000 a year ago. Management noted in the 10-Q that the change in other expense was *"primarily attributable to an impairment charge of $65.2 million related to the Company's net investment in a manufacturer and distributor of ceramic tile in China, partially offset by foreign exchange rates on transactions in the current year."* However, the $65 million charge was taken out of adjusted non-GAAP earnings. This leaves a $13 million (14.3 cps) swing in other income which would have benefitted adjusted earnings. While the company indicates that the non-China portion of the other expense account was due to foreign currency change, the detailed line items in the footnotes indicates that only $3.6 million of the swing came from "foreign currency losses (gains)" while $8.9

million of the swing was labeled as "all other." We are uncertain of the source of the movement in the "all other" category, but we are inclined to view it as non-operational in nature.

- Accounts receivable allowances for doubtful accounts once again declined, falling over $11 million from the year-ago level despite a rise in receivables. This drove the allowance percentage down to 3.8% from 4.5% a year ago and 3.9% in the 6/19 quarter. We estimate it would now take more than 13 cps in provision charges to bring the allowance back in line with the year-ago level.

- Amortization of costs to acquire contracts rose by almost $7 million (7.5 cps) in the 6/19 quarter. In addition, our estimated capitalization of costs to acquired new contracts fell to $1.5 million from $14.3 million a year ago, implying lower spending on setting up in-store fixtures at new customers.

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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