BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Altria (MO) 3Q'19 Update
Maintain SELL

We are keeping our SELL rating on MO after 3Q19 results. The company reduced its EPS forecasts from 2020-2022 to 5%-8% from 7%-9%. The claim is this will be driven by boosting promotion and investment spending to help brands and rollout of IQOS. Given that MO has been talking about IQOS for quite some time, we put less weight on the idea that new marketing plans suddenly are in the works for it vs. continued erosion of the cigarette market. MO just posted another 7% volume drop in cigarette volumes. They are continually losing more volume than the industry and these recent accelerating drops are coming against easy comps:

Cigarette Unit Growth	3Q19	2Q19	1Q19	4Q18
Industry	-5.5%	-6.0%	-5.0%	-5.0%
Altria	-7.0%	-7.0%	-7.0%	-5.5%

Those comps are coming against the prior 12 months where comps were -5% to -7%. Remember, decay used to be 2%. So, -7% on top of -7% is getting ugly. We think investors should also keep in mind:

- Promotional spending is netted against the price impacts. What really drives revenue and operating income are periods when the company reduces promotional spending. If we look at 2Q19 when promotion was increasing, revenue growth was considerably below periods where MO was cutting promotional spending. It's basically an additional $150 million of no-expense quarterly revenue hitting the operating income line. MO is almost promising more promotional investments.

- The rate of price increases is likely helping drive down volumes at this point. Volumes are down 13%-14% in the last two years and about 18% over three years. Yet, quarterly gains in y/y pricing are over $400 million now vs. about $250 million in recent years with lower promotional spending. Against quarters with higher promotional spending, quarterly y/y price hikes are $270-$290 million now vs. $160-$180 million in prior years with higher volumes. These accelerating rates of price hikes are helping cash flow, even though cash flow is still falling. What if the rate of price increases slows?

- Vaping is another headwind driving down volume growth according to the 3Q19 call. That is a different story than what MO said on the 2Q19 call where they downplayed the cannibalization risk. That is an odd change given all the negative attention vaping has received of late. As we talked after last quarter, IQOS is cigarette volume killer so far in every market PM has rolled it out.

- Here comes graphic packaging. The final FDA rule mandated by a federal judge must be completed by March 15, 2020. It would take effect 15-months later, but it should be receiving significant attention in the coming months, especially if the cigarette companies fight it. Numerous studies in multiple countries that have followed smoking rates after graphic packaging showing the health impacts of smoking can point to large decreases in smoking. It also keeps youth from starting. This could accelerate the decline.

- The new On! raises several questions. MO touted that it comes in seven flavors. Do we really need to go through this again? The FDA has been abundantly clear that it doesn't want flavors causing new people to become addicted to nicotine. Second, On! comes in five different strengths of nicotine. That may help people quit tobacco

altogether and adds credence to the FDA's current work on potentially lowering the nicotine content in cigarettes, which could really hurt the smoking market.

- Cash flow remains tight. Cash from operations after capital spending and the dividend is expected to be $1 billion this year. The problem is it was $2 billion in 2017 and $1.6 billion in 2018. The dividend continues to rise, working capital seems likely to rise with new product rollouts, interest expense for the JUUL investment is crimping cash flow. Plus, that $1 billion forecast comes with a big swing in lower promotional spending – which appears likely to reverse as could lower spending on strategic initiatives, which also may not continue or actually reverse. That $1 billion figure is also tied to the company's ability to boost prices at an ever-faster rate as volume decline accelerates.

Price Increases and Promotional Spending

It is widely known that MO's goal is to manage its decay in cigarettes by raising prices to offset volume loss. Another factor that is not as widely known is that promotional spending is netted against revenue. The result is pricing power looks even more explosive when MO cuts promotions and more subdued when it raises promotions. That is a big issue because in their outlook that lowered EPS growth for the coming 3-years, MO cited higher promotion as a likely cause. Here are some quarters where promotion was up and others where promotion was down:

Promotion Up	2Q19	3Q18	1Q18
Rev Growth from Price	$289	$272	$200
Rev Growth from Vol.	$20	-$221	-$252

Promotion Down	3Q19	1Q19	2Q18
Rev Growth from Price	$460	$399	$349
Rev Growth from Vol.	-$443	-$872	-$715

Two things to notice:

- In periods with lower promotion, MO is picking up about $150 million in higher revenue that flows at over 95% to operating income. In 3Q19 $460 million in pricing

became $447 million in operating income. IN 1Q19, $399 in revenue was $396 in income. That $150 million is 6-cents in EPS per quarter.

- During periods of lower promotion, MO frequently pushed volume up ahead of the price increases and volume tanks in the quarter. That's how they managed a positive $20 million in volume revenues in 2Q19 as it fallowed a quarter of -$872 million in volume.

We also looked back at past years when volume was higher for the rate of price increase. We believe MO is reaching the point where it is accelerating its own volume decay with large price increases and that is why it is not only seeing decay rates of 7% vs. 2%-3% only three years ago, but also losing volume faster than the market. As we will point out in the next section, the price gap between cigarettes and e-cigarettes is getting wider:

	3Q17	2Q17	1Q17	3Q16
Rev Growth from Price	$250	$252	$180	$163
Promotion trend	Down	up	up	up

We know that after a few years of 5%-7% declines, the market today is about 86%-87% the size it was in 2017 and about 82% of what is it was in 2016. Yet, now it is taking over $400 million in pricing on a smaller volume vs. $250 million on a larger volume when promotional spending is down. When promotions are up, the story is the same. They now take nearly $300 million in pricing vs. $160-$180 million. We think this really demonstrates how dependent MO has become not only on taking price – but also reducing promotional spending.

Let's look at one more step for operating income. In 2018, MO boosted spending on strategic initiatives to help preserve market share and look to grow. In 2018, the company was reporting these costs were a drag on operating income for the smokeable segment. **In 2019, these costs have been cut and it's become a big source of income y/y. Is this sustainable given the company announcing it may need to invest more and certainly JUUL has some issues to fix?**

In the first 9-months of 2018, MO had an increase in costs for smokeable products of $231 million. This was related to litigation and strategic initiatives. As a result, even with higher pricing offsetting volume decay, MO's smokeable segment reported flat earnings compared to 2017.

In the first 9-months of 2019, MO saw these costs decline by $247 million along with restructuring charges that were $82 million higher for a net positive of $165 million. **That is a positive swing of $396 million y/y. Operating income with higher pricing, lower promotion, and lower volume only rose $348 million.** Without cutting back on the various costs – the smoking unit may be unable to raise pricing fast enough to offset the decay. At the same time, they are paying interest costs on $14 billion in new debt.

Can MO cut costs again? They are telling us they need more promotional spending and investment going forward too.

So, Vaping Does Cannibalize Smoking?

We are going to reprint some of the 2Q19 call because when asked about JUUL and e-cigarette cannibalization, Altria was not concerned. Despite lowering its guidance after 2Q, it did not see a big impact from e-cigarettes:

Gaurav Jain – Analyst:

> *"So on cigarettes -- what we have seen this year is that pricing has gone up above expectations and volumes have come in below expectations and that substitute product which is e-cigarettes they aren't really taking any pricing and they haven't taken any pricing for two years. So, as we look out **does the e-cigarette cannibalization increase over time as price gaps keep widening**? And what has been your experience over the last two years?"*

Howard Willard – CEO:

> "*Yes. I'm not going to speculate on future pricing. **I think that consumers are moving into e-vapor because of significant benefits that those products have unrelated to price** and I'm not going to speculate on future pricing."*

Jennifer Maloney – Analyst

"*I wonder if you* ***can give us an update on direct mailings to your cigarette consumers and onserts or inserts in cigarette packs on behalf of Juul.*** *How many have you sent out? And what are the redemption rates looking like?*"

Howard Willard – CEO"

"*Yes. We don't share level of that detail.* ***Both direct mailings and onserts to date have occurred.*** *And I know that there is further activity that's planned between now and the end of the year communicating about the benefits of JUUL, but we haven't shared numbers or fine details on that.*"

Jennifer Maloney – Analyst:

"Broadly speaking, ***have the results of those changed your estimates for sort of what cannibalization you expect to see specifically on your brands from JUUL?***

Howard Willard – CEO

"*No it hasn't.* ***I don't think we've seen anything that caused us to change our views on JUUL's growth rate or the cannibalization of our products."***

Now, despite all the various issues at JUUL and new regulation that is causing the company to lay-off staff, and MO is revising its forecasts there downward:

Howard Willard

"Given the dramatic shifts in the current e-vapor regulatory and marketplace environments, we have revised our transaction assumptions. In preparing our financials this quarter, we performed a valuation analysis on our JUUL investment, which considered multiple regulatory and marketplace scenarios. In aggregate, ***we're now projecting lower e-vapor category volumes in the U.S.*** *versus our original estimates, which resulted in a third quarter non-cash impairment charge of $4.5 billion related to our JUUL investment. Also factoring into this determination where other changes to our original assumptions. For example, we expect it may take longer for JUUL to realize the strong margin performance that we previously communicated."*

However, also on the 3Q19 call – apparently, JUUL and e-cigarettes do cause cannibalization. As the company cut forecasts again for 3-year growth rates on EPS:

Howard Willard:

> *"We estimate that U.S. cigarette industry volumes declined by 5.5% in the third quarter and first nine months when adjusted for trade inventory movements, calendar differences and other factors.* ***We continue to believe that increased adult smoker movement to e-vapor and high levels of exclusive e-vapor category usage were the primary drivers of the accelerated decline rate over the past year.***
>
> *Based on our 12-month moving data,* ***we estimate there are now 12.6 million adult vapers 21-plus as of September 2019, up from 10.3 million at the end of 2018.*** *Importantly that growth trend coincides with the trend toward more exclusive usage in the category. According to our adult consumer tracking data,* ***we estimate that 6 million adults 21-plus vape and do not smoke*** *as of September 2019, which is the highest number of exclusive users since our study began in 2014."*

And later in the call, it is cannibalizing snuff too:

> "*USSTC's smokeless volumes decreased an estimated 3% in the first nine months of the year when adjusted for trade inventory movements and calendar differences. In the last six months smokeless industry volume decreased by an estimated 1.5%.* ***We believe these declines reflect increasing adult tobacco consumer interests in both e-vapor products and oral nicotine pouches."***

We've talked quite alot about JUUL and the accounting there. Our view is the JUUL does cannibalize cigarettes and for MO that is a problem because cigarettes represent cash flow and JUUL represents a 35% stake in non-cash earnings. It's the loss of cash that will hurt MO, along with paying the interest expense on the debt used to buy the stake in JUUL. That interest expense will need to be paid from cash out of the smoking division which is in decline.

We just thought it was interesting that in 2Q19, lower prices and advertising for JUUL in Marlboro packs were not going to hurt cigarette volumes but in 3Q19, cannibalization is now an issue.

Graphic Packaging Rules Are Coming and Have Negative Impacts on Cigarette Volume

Graphic packaging means cigarette packs will come with pictures of health impacts from smoking. They will cover a high percentage of the front and back of the package with people without teeth, advanced cancers, and larger warnings of other problems. There are two key things about cigarette packs. The first is that it is one of the few containers that people carry around all day and look at many times every day. Second, it is one of the few containers that non-smokers see very frequently as they are often near cash registers and smoking friends/parents have them in cars and on countertops.

The thinking is that the Surgeon General's text warning on the side of a pack is not very noticeable and is easy to ignore as more people look at the front of the pack. Also, the text has had only minor changes in decades. By having several different pictures and text warnings that rotate and having them cover the top 50% of the front and back of each pack – these warnings will much more difficult to ignore.

Congress ordered the FDA to adopt graphic packaging in 2009. The tobacco companies sued as a violation of free speech claiming the images were designed to cause fear or distress instead of educating smokers. The FDA sought to allay those legal concerns with new warnings but dropped the ball. In 2016, the FDA was sued by health groups over the delay and a federal judge ordered the FDA to issue a proposed rule by August 15, 2019, and a final rule by March 15, 2020.

That has happened and the FDA has a new rule, and the 60-day comment period is over. The FDA's first new batch of warnings don't go 100% for the gross-out factor of showing people with no lower jaw or smoking through a tracheotomy hole. Instead, the FDA has combined pictures of people with impaired health along with very large text that Smoking harms babies, harms children, can lead to blindness, cause several cancers, amputations… Therefore, it is believed that the text brings education to the mix and the photos will still draw attention. Also, by rotating and adding newer warnings more frequently, people will not become immune to the impact. The FDA sees this as addressing the free speech issues and "if we are sued after we issue the final rule, we strongly believe that this will hold up under any legal challenges under the First Amendment, under our statute or under administrative procedure, according to Mitch Zeller, the director of the FDA's Center for Tobacco Products."

There has also been more of a truce of late between the FDA and tobacco companies. Both are supporting allowing only people 21 and over to purchase nicotine products. Both are openly talking about cigarettes being harmful and focusing on reduced-risk products such as vaper, heated tobacco, gum… If there are legal challenges – the issue will get much more media attention and the proposed packages will appear often in various stories. Even if they work together, the new packages will also start appearing in public over the next 4-6 months long before the final rule goes into effect in 2021.

Numerous countries already have graphic packaging and their results show strong results for driving down smoking:

- *Social Science & Medicine* in 2016 published reviews of results of 20 countries that adopted graphic packaging and found that hotline calls increased from people asking for help to quit, smokers increased attempts to quit, there were more smokers who reduced the amount they smoke as well as taking breaks from smoking altogether.

- Canada found that graphic warnings reduced the number of new people taking up smoking and increased the number of smokers quitting.

- Studies from Singapore found that graphic warnings caused 28% of smokers saying they smoke fewer cigarettes, 14% decided to not smoke in front of children, and 8% said they smoked less at home.

- Brazil, Thailand, Australia, UK all reported that more smokers wanted to quit after seeing the new warnings.

- A small clinical study was published in JAMA in 2016 tracking 2,000 smokers over 4-weeks. Those exposed to graphic warnings were 50% more likely to have quit smoking at least a week by the end of 4-weeks and total quit attempts were up.

In our view, the threat to cigarette volume decay is that it continues to accelerate. Graphic packaging is coming at this point and simply showing the warnings and discussing them in public may start another source of volume decay in the near future. In 2021, the new packaging could be on the shelves of retailers and pockets of smokers. It is estimated that a pack-a-day smoker looks at the package over 7,000 times per year. All the evidence and studies point to graphic packaging hurting smoking demand.

Since kids see the labels too, we think this also along with the 21-and older laws again make it less likely that young smokers start. We have always held that when smoking volumes fall 5% that is a net number – meaning 8% quit and 3% growth from new smokers became the 5%. The efforts by FDA and tobacco companies are already pushing to hold down the new smoking entry market. Graphic packaging seems like another way this will happen and accelerate the negative volume growth.

While it is not being talked about – at least we haven't found much discussion on it – but do graphic warnings eventually spread to other forms of tobacco? Snuff is certainly a cause of many oral cancers.

Does the Roll-out of On! Bring Some Potentially Bad News Too?

On! is something MO invested in back in 2016. It is now planning to roll it out in larger volumes. This is essentially a tobacco-derived source of dissolving nicotine. People don't have spit to use it, so it more like nicotine gum than snuff. And the nicotine enters via the gums and mouth.

We don't have a great deal of information about this, but it received some attention on the last call that caught our eye:

Howard Willard, CEO:

> *"We expect to begin production of on! in our Richmond manufacturing center beginning first quarter next year.* ***In 2020, we are targeting annualized capacity of 50 million cans by mid-year and 75 million cans by year-end with additional capacity available if necessary****. In addition, our strong regulatory affairs team is preparing PMTAs for the on! portfolio for the May 2020 deadline.*
>
> *As a reminder, Altria owns 80% of the Helix Innovations joint venture that will commercialize on! globally.* ***On! has a product portfolio consisting of 35 unique SKUs; seven flavor varieties across five nicotine strengths.*** *We believe the breadth of nicotine strengths and flavors is a tremendous competitive advantage as both adult smokers and dippers can find satisfying options within the on! portfolio."*

Our first thought is: "Flavors? Really?" Has the FDA not been clear enough that it regards flavored nicotine as taboo and largely a way to make it appealing to under-age non-users? The FDA banned all flavors other than menthol many years ago. It became alarmed about vaping because kid usage was exploding upward because of the flavors and it is banning flavors there now. There is an open debate on-going to ban menthol because it makes it easier to start smoking as well as transition from vaping. So, at the same time, MO wants to rollout a tobacco/nicotine product that is offered in Berry, Cinnamon, Citrus, Coffee, Mint, Wintergreen, and Tobacco flavors? Do we really need to go through this again?

Second, the FDA has been abundantly clear. It does not view nicotine addiction as a good thing. What it has said is that the most hazardous way to obtain nicotine is through smoking. Therefore, for current addicts, it would prefer they use other methods like vaping, heated tobacco, gum, dissolving tobacco. However, it wants that transition to also lead to people quitting altogether. Moreover, the effort to regulate JUUL and the vaping/e-cigarette industry didn't start because people were using the device to smoke pot. It was tied to the FDA's goal of not having it become the gateway to getting more young people addicted to nicotine who may become smokers too. We think trying to roll out flavored tobacco pouches may have much of the same appeal to youth especially the flavors. Will the FDA allow the flavors and the product to continue to be widely available?

Third, the On! product comes in different levels of nicotine. That is likely a way to help people kick the nicotine habit altogether. However, the FDA is also doing a great deal of work on lowering the nicotine content in cigarettes. We have talked about these studies in the past and results show that the smoking market could lose 16% of its business in a year and 40% over five years. We do not think Altria could withstand that rate of decay. Yet, while the FDA debates that concept, Altria may be giving them additional cover by rolling out a product with five different levels of nicotine.

The Company's Cash Flow Situation Still Looks Very Tight to Us

On the 3Q19 call, MO touted that it generally has about $1 billion in excess cash flow after paying the dividend to use for strategic initiatives, pay down debt, and repurchase shares. We are still going to quibble with this quite a bit. First of all – in 2018 and 2017, free cash flow before working capital swings was $1.6-$2.0 billion after the dividend. We're now supposed to cheer that falling to $1 billion?

Cash Flow	2019ytd	2018ytd	2018	2017
CFO pre Wrk Cap	$5,567	$5,826	$7,291	$7,101
Wrk Cap	-$293	-$740	$1,100	-$2,200
CapX	$160	$132	$238	$199
FCF pre wrk Cap	$5,407	$5,694	$7,053	$6,902
Dividend	$4,498	$3,909	$5,415	$4,807
Repurchases	$346	$1,317	$1,673	$2,917

For the first nine-months of 2019, CFO before working capital changes is down $259 million y/y. That's with the company's efforts to reduce costs, the higher than normal price increases taken, and less promotional spending. Higher interest costs are taking a toll. Capital spending is up slightly and so are acquisition costs with Cronos. While they spent $4.5 billion on the dividend in the first nine months, the new annual rate is $4.7 billion ($6.3 billion annually) up $225 million for nine months.

The only thing that improved on cash flow was working capital was a smaller drag in 2019. Yet, now the company wants to roll out IQOS heated tobacco and On! That sounds like a larger working capital investment may be coming.

Investors should be scared by the basic numbers already. The higher interest costs and lower BUD dividend are already crimping cash flow. Then this company used to buy $3 billion in stock back in a year, now investors should cheer $1 billion over 2-years? The problem with that is the total dividend outlay is growing faster than in the past because the share count isn't falling as much. In 2017, the total paid on the dividend only rose 7%. In 2018, it rose 13%, so far in 2019, it's up 15%. The new run rate is only going to rise 5% because the dividend increases per share have slowed dramatically.

We think the change in cash flow after the dividend is likely to come in under $1 billion down from $2 billion only two years ago. That $1 billion already has a positive swing of strategic costs of $313 million net of taxes included in the first 9-months of 2019. MO has also been taking on about $150 million more per quarter in accelerating higher pricing on lower volumes than it was just a couple years ago. The decay in volumes is accelerating – that is evident. What if MO, can only take $100 million in higher pricing y/y going forward? That lost $50 million per quarter is $158 million in lower annual cash flow too. The pressures against that $1 billion cushion are getting larger in our view not smaller – especially if MO has to start paying down debt. And, investors will expect another dividend hike next year too.

Starwood Property Trust (STWD)– 3Q19 Update Maintain BUY

We are maintaining our BUY recommendation on STWD. In our view, it remains more diversified with lower risk than many similar types of mortgage REITs. There continue to be some sizeable unrealized gains in the portfolio, and it still sees a seasonally strong 4Q for new volumes. The core EPS continues to outpace the dividend at $0.52 vs. $0.48. The dilution from convertible securities had its last tough comp in 3Q19 as a drag of 3-cents on core EPS. 4Q the drag should be 1-cent and then neutral thereafter. There remain several other sources for EPS growth going forward:

- Sensitivity to LIBOR continues to positively expand if rates decline in the near future.

STWD EPS	Libor -200bp	Libor -100bp	Libor +100bp	Libor +200bp
4Q18	-$0.01	-$0.04	$0.07	$0.15
2Q19	$0.12	$0.03	$0.05	$0.11
3Q19	$0.17	$0.05	$0.03	$0.08

This is a combination of interest rate floors on floating-rate securities helping on the downside and fixing some of their borrowing costs at longer terms. The company noted that 84% of its loans have LIBOR floors and 25% of those floors are in the money now.

- In our view, should the company believe higher rates are more likely at some point in the future, it could move more of its financing back to take advantage of that situation. The turnover of loans in the portfolio and its efforts to match maturities should always allow for the portfolio to adapt to changing forward views. Where we think they deserve some credit now is pushing out maturities and reducing reliance on the repo market and short-term credit lines. As the CEO said last quarter, when ugly things are happening, banks have a habit of reducing short-term credit lines.

- STWD writes for credit quality not for spread. When spreads tighten, they maintain a lower cost of funds than competitors and can still earn higher returns. They can also be a seller into tight spread markets. When spreads widen, they have the liquidity and permanent capital to take advantage of others not being able to finance deals at when cheap. They have also focused on trophy or one-of-a-kind properties. In the past, they would do construction loans of 50-60 cents on the dollar, meaning

worst case, they take a building worth much more than the mortgage. They have taken some grief for lending to refurbish the Lord & Tailor building on Fifth Ave. However, they are paid in full if the value of the construction falls to only 50-cents on the dollar. There is strong demand for the space in the building and STWD has had offers to sell its loan.

- STWD's president, Jeff DiModica, does not see credit quality deteriorating on new loans. *"The good news is that volumes (of new loan activity) are fairly high, and we are seeing a decent amount of loan activity for everybody to choose from, and we're going to pick and choose where we want to be within that. The non-banks, people think that they're being more aggressive. I do we're getting pushed to tighter spreads today. Fortunately, we have tighter liabilities, so we're able to earn similar spreads…So, it's hard to say that standards are getting worse and that loans are deteriorating when everybody in our space seems to write more every year."* He also noted that many competitors specialize in particular areas and with high loan volume, they don't have to modify their approach.

- Barry Sternlicht, the CEO noted that they continue to see strong property markets in both the US and Europe with accelerating rent growth in their portfolio. He views office, industrial, and multifamily as being strong and challenges are retail and hotels. The hotel problem he characterized as overbuilding more than lack of demand. STWD has only 3% of its lending book in retail with half of that to The American Dream Theme Park/Retail Center which has strong leasing demand. Hotels are 23%. International is an area where the company continues to pursue more opportunities to expand and diversify the portfolio further.

- The Energy Infrastructure unit may now be ready to grow. Since the acquisition of this portfolio, STWD has been selling off lower margin loans and repaying/refinancing debt so loan maturities match the debt maturities. This has caused this unit to lag during 2019 as the portfolio shrunk nearly 50% and they prepaid debt. The unit has been profitable at 1-cent of core EPS in 3Q19 and 3-cents YTD. But by STWD's estimates, they have probably endured $0.10 lower EPS YTD via the restructuring. STWD has completed much of this and will start originating new loans in this unit. It may be more of a 2020 story, but if they have been restrained by 2-3 cents per quarter during 2019 in this area, that should drive EPS growth going forward.

- Settling some convertible securities in 2018 has diluted the share count of late. That was a 3-cent drag in 3Q19.

Share Count	3Q19	2Q19	1Q19	4Q18	3Q18
Basic Avg Shares	280.0	279.2	277.5	273.9	265.4
Unvested Stock Awards	2.3	2.3	2.4	2.5	2.4
Dilutive Woodstar II Op units	11.0	11.6	11.9	11.0	9.9
Other Dilutive items	-	-	-	0.5	0.1
Dilutive Avg Shares	293.3	293.1	291.9	288.0	277.8

By our calculation, this 3-cent drag on Core EPS will fall to 1-cent in 4Q19 and should have a minimal impact after that in 2020. There are $500 million in convertible notes due in February 2021 and another $700 million due in December 2021. Historically, STWD has settled its convertible notes in cash. In 2018-2019, it wanted to keep its liquidity and settled some with shares which accounts for the rise in basic average shares in the table above.

Zimmer Biomet Holdings (ZBH) 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 maintaining our earnings quality rating of 3- (Minor Concern)

- The pace of receivables securitization continued to slow in the 9/19 quarter, with the balance of sold but outstanding receivables rising by only 1 day on a days of sales basis versus the year-ago quarter. Total receivable DSOs including sold receivables declined by more than 6 days. (We note that the balance of sold receivables includes the US and Japan portion and not factored European receivables in which the company is not involved in collections and does not disclose data.) Cash from operations adjusted for a one-time lawsuit payment declined slightly in the nine-month period ended 9/19. The company noted the following in its explanation of the decline: *"Additionally, in the prior year period, we continued to expand our sale of accounts receivable in certain countries which provided additional cash inflows, compared to the 2019 period where our sales of accounts receivable have not expanded significantly and therefore the incremental benefits to the period are less."*

- ZBH's gross margin benefitted from a one-time refund of medical device excise taxes during the quarter which was not quantified. On one hand, the presence of the benefit was noted in the MD&A section of the 10-Q, the conference call, and the impact was forecast ahead of time in the outlook given in the second-quarter conference call. However, we have to question why the non-operating benefit was not excluded from adjusted non-GAAP earnings figures while items like obsolete inventory charges, termination of supply agreements, and costs to comply with legal agreements were.

- Inventory DSIs continue to rise with days of sales breaching the 400 mark in the quarter. DSIs are always relatively high for a medical device maker and ZBH is gearing up for new product launches. Nevertheless, 400 is an eye-popping number. Management made the following comment in the conference call regarding the inventory impact on upcoming gross margins: *"And as you know we have close to a year of an inventory which is another challenge and an opportunity we have in front of us. But those deferred or capitalized costs will flow through at a higher level into 2020, so that's a headwind."*

- At the beginning of the 6/19 quarter, the company paid $192.5 million to acquire the rights to certain intellectual property it had previously paid royalties to utilize. The purchase price was recorded as an intangible asset which is being amortized through 2029. However, given the company's policy of adding back the amortization of intangible assets to its non-GAAP earnings, the cost associated with utilizing these rights was effectively removed from adjusted results. We do not know the amount of the royalties previously paid, but we can estimate that the amount of quarterly amortization of the associated intangible is around $5 million or almost 2 cps. Management highlights the absence of the royalty payments in the MD&A section of the 10-Q although it is not quantified. As we have noted in past reviews, our opinion is that ZBH's policy of adding back amortization of intangibles to adjusted earnings overstates the company's true earnings power as it dismisses the cost associated to obtain these earnings-generating assets. For perspective, the non-GAAP EPS figure of $1.77 for the 9/19 quarter had $0.58 per share of intangible amortization added back.

- We remind investors of ZBH's history of impairment charges. The 9/19 10-Q echoed the previous warning issues after the 4Q 18 writedowns that the $732 million carrying value of its EMEA reporting unit remains susceptible to further write-downs should conditions deteriorate with the same true for the $387.2 million carrying value of its Dental unit.

Fortune Brands (FBHS) 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 maintaining our earnings quality rating of 3- (Minor Concern).

FBHS's adjusted EPS of $0.95 missed the consensus estimate by 2 cps. While the company has experienced rising costs from tariffs and a slowdown in activity in its end markets, it has promised that price increases and improving housing starts will reignite growth in upcoming quarters.

- Inventory days rose by 3.7 compared to the 9/19 quarter with the bulk of the growth coming from finished goods. While this is a moderation versus the DSI growth of the last three quarters, DSI of over 74 days is still elevated compared to the mid-60s level in the third quarter of 2017 and 2016. Note that the year-ago quarter DSI of 70 was inflated by the Fiberon deal. Management indicated in the conference call that inventory will continue to drain cash flow in upcoming quarters, noting that they "expect 2019 free cash flow of approximately $480 million to $500 million, which includes the accelerated investments in capacity and inventory to support new composite decking customers." The company has also cited lower retail and wholesale inventories as negatively impacting sales in the last few quarters and indicated filling that void will be a tailwind for upcoming results. If FBHS can move its inventory into those channels without significant discounting, the higher inventory may not be an issue for margins. However, the risk of discounting remains and the red flag will intensify if we don't see a decline in DSI after next quarter. Interestingly, raw materials DSI actually fell by 0.8 days verus the year-ago quarter which does not indicate management is gearing up to meet demand far beyond the next quarter.

- FBHS took a $29.5 million impairment charge to the carrying value of an indefinite-lived tradename in the Cabinet segment in the 9/19 quarter due to reduced revenue forecasts for the remainder of 2019 and 2020. Management stated that this was "primarily the result of a continuing shift in demand from semi-custom cabinetry products to value-priced cabinetry products, which led to consecutive downward adjustments of internal revenue forecasts associated with the tradename." This follows a $35.5 million charge in the 12/18 quarter for the same trade name. The remaining carrying value of this trade name as of 9/19 was $85 million. Also, in the 9/18 quarter, the company took a $27.1 million charge related to a second tradename in the Cabinet segment. The company further stated in the 10-Q that "a reduction in the estimated fair value of these two tradenames could trigger an additional impairment in future periods. In addition, future impairments could be triggered on a third tradename in the event of lower-than-expected sales in our custom cabinetry product line. As of September 30, 2019, the total carrying value of the three tradenames was approximately $174 million."

- Pension expense rose by 2.2 cps, but the company added the bulk of the increase back in its non-GAAP EPS presentation.

Thermo Fisher Scientific (TMO) EQ Update 9/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3-	4+

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 4+ (Acceptable).

TMO beat EPS estimates by 6 cps in the 9/19 quarter. Management indicated that earnings were 9 cps ahead of its midpoint outlook, attributing 6 cps to strong operational performance and 3 cps from less adverse FX. Taking out the lower FX impact from the 6 cps consensus beat still leaves a 3 cps upside. However, we note several one-time benefits in the quarter as well as some minor red flags. Our reduction in rating is a result of the increase in DSOs, the decline in allowance percentage, and the extension of restructuring charges announced.

- Accounts receivable DSOs rose by almost 4.5 days over the year-ago quarter which the company attributed to supporting sales growth. However, this is definitely out of line with the year-over-year increases in the 6/19 and 3/19 quarters of approximately 1 and -0.3. The sudden nature of the increase is a concern as it could be an indication that the company lured sales into the quarter with easier credit terms.

- The company also stated in the 10-Q that other assets consumed an additional $186 million in the nine months ended 9/19 due to the timing of customer billings. We assume this corresponds to the 1.7-day increase in contract asset days of sales versus the year-ago quarter. These contract assets relate to unbilled receivables where the company has recognized revenue under long-term contracts prior to billing the customer. This timing issue appears to have benefitted revenue growth in the current quarter. If contract assets had grown in line in sales, it would have taken over $100 million off of reported revenue in the 9/19 quarter.

- However, the company also stated in the 10-Q that cash flow was boosted by an increase in other liabilities due to increased customer deposits, which can be viewed as a type of deferred revenue. We assume this corresponds with the 1.4-day increase in contract liability days in the quarter. This is a positive for the quality of reported revenue as it represents cash received from customers which has yet to be recognized as revenue. This would offset most of the benefit of the increase in contract assets noted above.

- The allowance for doubtful accounts as a percentage of gross receivables fell to 2.4% from a peak of 2.9% hit in the year-ago quarter. While the company does not disclose quarterly provision expense, we estimate it would take almost 5 cps in provision charges to boost the reserve back the year-ago level.

- Warranty expense in the 9/19 quarter fell by almost a penny per share while the warranty allowance as a percentage of trailing 12-month sales fell to 0.34% from 0.38%. We estimate it would take about 2 cps in charges to boost the reserve to year-ago levels.

- The company identified an additional $80 million in restructuring charges it will take over 2019-2020. TMO features regular restructuring costs in its result which are added back to non-GAAP results. We again point out that the company adds back the amortization of acquired intangibles to adjusted earnings which amounted to $0.85 per share in the 9/19 quarter on total adjusted earnings of $2.94.

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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