BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Macy's (M) 3Q19 Update
Maintain BUY

We are maintaining our BUY recommendation on Macy's after a disappointing 3Q. The company had guided to a negative sales comp for the quarter from continued weakness in International shoppers and a strong comp in 3Q18 of 3.3%. The company definitely came in below their forecast, posting a -3.5% same-store sales figure. It also lowered sales guidance for the full year to -2% from flat. That would mean sales down $500 million and YTD, they are already down $293 million.

There are several positives still seen in the 3Q such as gross margin bouncing back considerably after the mark-downs in 2Q. New store remodels are complete going into 4Q where the comp is easy and colder weather has already given a pop to sales in early November. Overall, we think too much positive work is in place here for the company's results to languish and expect the longer-term trends of higher customer traffic, better margin control, and completing the refurbishment of many stores to reemerge in results going forward:

- Weaker consumer spending hurt the number of transactions. This was not expected after several quarters of transactions growing above 5% y/y. International shoppers remain weak and tend to generate higher per capita sales and margins.

- We see multiple factors that could lead to Macy's outperforming guidance in 4Q19. It already starts with a 70bp head-start on comp sales by not repeating limitations on its loyalty members' holiday promotions of 2018 or a fire in a key distribution center.

- Work on the e-commerce systems disrupted sales in that area in 3Q – it is now back to normal rates of growth and mobile is accelerating. Physical work on Growth 150 stores is now complete and those stores produce half of Macy's total sales and comp more strongly. Last year there were 50 locations, now there are 150.

- Already, sales have started to improve in 4Q vs 3Q with colder weather and new Ready To Wear offerings that are well-received, plus the roll-out of same-day delivery in some markets and higher SKUs from Vendor Direct should help too.

- Margin guidance is actually pointing to the blood-letting ending. Gross Profit is already down $268 million YTD, guidance points to it ending the year down $285-$310 million. In 3Q19, shipping was a 40bp headwind and total gross margin declined by only 30bp. Macy's is also guiding to zero impact on tariffs now too.

- Other new margin saving programs are in place now that weren't here in 2018 as well. These include more Backstage stores which are seeing faster inventory turn, higher sales and higher margin; productivity gains are expected to add nearly 200bp to margin and are starting to make impacts in 2019 – earlier than expected; preventing mark-downs is also a stronger suit of Macy's now with Hold and Flow that has rolled out.

- More of the lower-tier stores may close in 2020. These are playing a larger role in fulfillment operations and have been losing selling space. Eliminating some more from the retail side may allow Macy's to better leverage the costs in those locations and not lose much in overall sales if their fulfillment operations expand.

Weak Transactions Were the Bad News in 3Q

The biggest factor according to management was weaker consumer spending. In particular, international shopping remains weak down about 6.3% in the 3Q. We have noted in the past that international is a key metric because they pay full price, don't return much merchandise, and buy more per visit.

Sales Comps	3Q19	2Q19	1Q19	4Q18	3Q18
Store Comps	-3.5%	0.3%	0.7%	2.0%	3.3%
Transactions	-0.4%	5.3%	5.7%	6.2%	3.8%
Units/Transaction	-1.8%	-1.8%	-2.2%	-4.9%	-3.1%
Rev/Transaction	-1.8%	-3.0%	-2.7%	-0.3%	2.6%

There is no doubt 3Q18 was a tough comp to match against and Macy's was guiding to a negative same-store sales figure. Spending per transaction actually improved sequentially. That is actually a bigger improvement than it appears given that Backstage has become a larger part of the business. That lowers revenue/transaction but helps boost total volume.

The big disappointment was in transactions. The 5% growth in that area dropped off and that is what Macy's called out as the reason for lowering guidance. It believes the macro environment remains tough for the 4Q and is effectively guiding to a negative comp of about -1.5% for 4Q19.

We believe they may be overly conservative, and sales could bounce back more quickly.

Specific Items Impacting 3Q19 and 4Q18 Sales Have Improved for 4Q

- In 4Q18, the company suffered a fire at a key distribution center that impaired the ability to get full inventory at key points of the holiday season. That's unlikely to repeat.

- In 4Q18, Macy's tried to make its loyalty program more exclusive and only offered some specific holiday promotions to the top tier of the loyalty customers. The offers will return to all loyalty program members in 2019 and the number of people in the program has increased.

- Those two issues cost about 70bp of sales comps in 4Q18.

- In 3Q19, the company disrupted its e-commerce platforms with upgrades, new apps, better navigation, and functions. That hurt e-commerce sales and they did not rise by double-digits in 3Q19. With those changes now complete, e-commerce sales have returned to the normal pace. Mobile growth is running 4x the rate of e-commerce and that is still accelerating. Vendor Direct expansion is also expanding online sales.

- 3Q19 suffered from a late start to winter weather which hurt apparel sales in the period. With a cold spell in early November to start 4Q, Macy's noted that sales have seen a good pop to start the quarter.

- Ready To Wear underperformed in 3Q19. So far in 4Q19, there are signs of improved sales. New merchandise has been well received and sales are up.

- 3Q19 saw the end of the construction disruption to refurbish the Growth 150 stores – 100 new ones in 2019 and it has Backstage up to 215 stores. Both situations are driving comp sales higher than stores without these changes. Backstage is comping at low single-digit rates still. Growth 150 stores produce about 50% of total company sales.

- The tariff issues were expected to hurt sales/margins for an estimated 7-cent impact in 2019. Macy's has worked with vendors to mitigate that entire issue.

- Bloomingdale's posted a -2.9% comp in 3Q19 which is getting better and the trends for more improvement have continued.

Margin Gains Also Appear to be Building

The company has definitely seen gross margin/pricing start to hold better. YTD, gross margin is down 100bp, but it was only down 30bp in 3Q19 despite the weaker sales. Macy's will continue to face pressure from shipping costs and even rolled out same-day delivery in

some markets in 3Q. They stated that delivery was a 40bp headwind for gross margin in 3Q, so the rest of the cost savings and pricing efforts have offset part of that already.

Keep in mind the productivity gains and improvement in logistics is expected to produce $400-$550 million in cost savings. The company expected the bulk of that to start flowing through in 2020 but noted that some of that is appearing now in late 2019. They are actually seeing the speed increase and the number of initiatives also increase giving them more confidence in reaching the higher part of that goal.

The productivity gains will produce about 160-225bp of incremental margin. Some of that will recycle back to defray shipping and fund other new operating investments. Other parts should flow to the bottom line as more profitable sales.

The company also called out Backstage as an area where sales are not only building, but margins are improving too, and inventory is turning faster. This is a positive change that was not in last year's margins.

Another program that has rolled out to help sales and margins is Hold and Flow. This allows Macy's to buy less inventory overall and rapidly move inventory to stores where something is selling well. The trite example would be that if it's 60 degrees in Virginia during December, winter coats may not sell as well. But, if It's 10 degrees in Chicago, they can't keep winter coats in stock. In the past, both areas would have had similar seasonal allocations and where sales were weak, merchandise would be marked down. Under the new system, less initial inventory goes to each store with follow-up shipments to those stores selling the most. Plus, inventory in other stores can be moved more rapidly. This is designed to help sales and prevent discounting. Results have been very favorable. This wasn't in place last year and should help margins in 2019.

Macy's is guiding to a modest decline in gross margin for 2019 now, greater than the 30bp of 3Q19 by not anything like earlier in 2019. Gross margin is down 100bp YTD. Given the sales guidance of down about $500 million in sales or 2% and flat credit card revenue, if gross margin falls 40bp for the year – it implies gross profit down $285 million. It's already down $268 million YTD based on the mark-down issue in 2Q. If it falls 50bp, the decline for the years it would fall about $310 million. vs. the $268 million. Either way, we think 4Q at worst shows the blood-letting is stopping and if sales outperform – gross margin could too.

There Is the Potential for More Store Closings Among Smaller Stores

Macy's has been investing in stores located in malls where the mall owners are investing too. The result has been stronger sales in those locations. One of the reasons we never considered Macy's to be like Sears is it operates predominantly in A-class space with more than 75% of stores located in such areas.

It does have smaller stores in C and D-class malls too. Those survived the cut a couple of years ago because they were either owned, had very low rent, and offered potential to be fulfillment centers for online sales, delivery, and pick-up. These stores were a drag on same-store sales in 3Q19 of about 30bp.

Two things are happening in those locations. First, they are not getting the make-overs of other stores in the area and traffic may be switching more toward the other Macy's stores. Second, because these stores are being used to a greater degree for fulfillment – they are losing selling square footage. So, last year some of these stores may have had 40,000 sq. feet of selling space and a larger assortment of inventory vs. today the selling space may be 25,000 sq. feet with less inventory on display. That would certainly have a negative impact on sales comps – but the store is helping boost total online sales still.

Macy's is planning to announce plans for each of these stores on its Investor Day on February 5, 2020. We believe some may cease being retail stores altogether and become fully devoted to fulfillment in particular cities and further boost things like same-day delivery, faster Hold and Flow inventory movement to remaining stores, and lowering delivery costs by having bulk orders sorted at these new fulfillment centers.

It is very possible that closing more of these stores will reduce total expenses and not impact total sales to the same degree. We say that since there are 680 total stores and 150 produce about half the total sales. Closing more of the weaker and smaller stores are unlikely to have a significant impact on sales and wages and operating costs in those stores are probably not leveraging as well as other locations.

RealPage (RP) 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)

The company just met guidance for 3Q, which has been the case for all 2019 quarters thus far. It did reduce guidance slightly for 2019 from adjusted EPS of $1.73-$1.77 to $1.74-$1.76 with lower revenue of $987-$995 million falling to $983-985 million and adjusted EBITDA forecasts falling slightly also to $280-$282 million from $278-$283 million.

Virtually every issue we had with accounting quality in the initial report is still a potential problem with some already causing problems. We still believe income is inflated with a combination of not amortizing goodwill and writing off acquired assets at a slower speed than internally developed assets. Plus RP's Non-GAAP EPS adds back all amortization of intangibles and stock compensation – even though both activities are consuming cash.

- Is RP really meeting forecasts? Or, is it cutting R&D to make quarterly results? The bad debt reserve as a percentage of sales is also falling this year.

- Is Depreciation and Amortization of software and equipment running too slow for a fast-growth company indicating it is using older equipment? The depreciation/amortization life for PP&E and software is 3-5 years. We believe this expense should be higher too and this may be another source of unsustainable EPS being tapped.

- Capital Spending may also be too low to sustain PP&E and software given the useful lives. Gross PP&E is $300 million, indicating $60-$100 million in annual capital

spending based on 3-5 year useful lives. Capital spending is $38.5 million through 9 months of 2019 instead of $45-75 million. It's also basically flat y/y.

- Deferred revenue growth is running slower than sales and making the company more dependent on current quarter sales to meet revenue targets. Since 4Q17, quarterly revenue is up 36% and deferred revenue is up 5%.

- The adjustments to earnings continue to add back recurring items in non-GAAP EPS. The company guides to this, but when isn't employee pay via stock compensation going to happen? The company's business model relies on making acquisitions, but the cost of these deals is added back too.

- When we adjust reported EPS for simply the reported cash spent to purchase stock used for stock compensation and the amortization of intangibles acquired with cash – the EPS figures fall more than 50%. Cash flow becomes negative quickly when considering cash spent on acquisitions and cash spent buying shares to cover stock-based compensation too.

Cuts to Product Development Are Helping RP Meet EPS Forecasts

RealPage uses its Non-GAAP EPS in setting guidance and judging success. This includes using a 26% tax rate and adding back numerous recurring items such as stock compensation, amortization of its convertible debt, and amortization of intangibles related to acquisitions. In the last three quarters, RP has met forecasts on Non-GAAP EPS. We believe this was largely the result of cutting R&D expense in absolute dollars and as a percentage of sales:

Cuts to R&D	3Q19	3Q18	2Q19	2Q18	1Q19	1Q18
Met Non-GAAP EPS	$0.45		$0.43		$0.40	
Product Dev w/o Stock Comp.	$25,602	$26,422	$26,135	$28,126	$27,417	$26,877
Non-GAAP sales	$255,202	$225,371	$244,018	$216,355	$234,530	$201,614
Prod Dev % Sales	10.03%	11.72%	10.71%	13.00%	11.69%	13.33%
EPS from $ Cut	$0.01		$0.02		$0.00	
EPS from % Cut	$0.03		$0.04		$0.03	

The company is just hitting non-GAAP forecasts, but without cutting R&D investments in both dollar terms and as a percentage of sales – it would be missing. And this is largely a software company! It's also not as though sales growth is leveraging the costs either. Sales growth is only running about 13% and that is padded with acquisitions producing about half that growth.

We also removed the stock compensation from the product development costs above. It is interesting to see that the last two quarters have seen a big drop in stock compensation already, which tempered some of the drop in total R&D:

Cuts to R&D	3Q19	3Q18	2Q19	2Q18	1Q19	1Q18
Product Dev. GAAP	$27,866	$28,942	$28,151	$30,771	$29,891	$29,040
Stock Comp	$1,948	$2,520	$2,016	$2,645	$2,480	$2,163
Non-GAAP Prod Dev.	$25,602	$26,422	$26,135	$28,126	$27,417	$26,877

If the stock compensation had been figured into the mix, (and BTW – try not paying it and see how long the engineers stay) – GAAP EPS benefited another $0.01 in 3Q19 and 2Q19 from lower stock compensation. The company says that the drop in product development expense is due to an effort to reprioritize its R&D toward major new projects. If that is true, we would expect it to rise again in the near future.

Bad debt reserves have also fallen in 2019. The decline in absolute dollars from $8.85 million to $8.55 million on a 6% increase in receivables. Reserves should be $9.35 million, but they are light $800,000. That added another 1-cent to EPS during the first nine months of 2019.

Depreciation and Amortization of Software May Also Be Helping Non-GAAP EPS

Essentially all assets purchased via capital spending or developed in-house are depreciated over 3-5 years at RealPage: Data processing and communications equipment, furniture and fixtures, and software. The depreciation and amortization of these items do remain in the reported Non-GAAP EPS.

Here is the current PP&E for Real Page:

PP&E	3Q19	4Q18
Leasehold Improvements	$66,697	$63,391
Data Proc/Communications	$78,549	$68,015
Furniture/Fixtures	$35,057	$33,840
Software	$149,912	$131,437
Gross PP&E	$330,215	$296,683
Accum. Dep/Amt	$170,610	$143,155
Net PP&E	$159,605	$153,528

Over half the gross PP&E has already been depreciated at this point. That would indicate to us that some assets are likely fully depreciated already and the remaining net figures may have 1.5-3.0 years of expensing left. Just taking an average of $155 million net PP&E and dividing by 12 quarters, the depreciation and amortization should be about $13 million per quarter. RealPage is not hitting that figure and in fact, depreciation fell sequentially last quarter:

	3Q19	2Q19	1Q19
Depreciation	$7.5	$7.7	$7.5
Amort. Software	$3.9	$3.8	$3.2
Total	$11.4	$11.5	$10.7

It is very possible that the software is being amortized over 4-years. The unamortized amount was $63 million, which divided by $3.9 million equals 16-quarters. So, 58% of the software has been depreciated, while only 47% of the other equipment has been. Furniture and leasehold improvements are probably largely depreciated at this point. The recent growth has been in computers for PP&E. Yet, the depreciation figure indicates that the remaining PP&E still has 3-years of life. We disagree there. RP is not spending that much on new equipment. Much of the undepreciated equipment may have only 1.5-2.0 years of expense left. Every $1 million additional depreciation is worth about 1-cent in EPS per quarter. We think RP is picking up at least 1-cent here by using older equipment.

Low Capital Spending Also Points to Older Equipment and Reduced Depreciation Expense

Looking at the Gross PP&E figure above with software, it has been essentially $300 million for some time. Replacing those assets over a 3-5 year timeframe would require $60-$100

million in capital spending per year. RealPage is running below that figure and capital spending has been flat for nearly three years now:

	YTD 19	YTD 18	2018	2017	2016
Depreciation	$22.7	$21.3	$28.5	$27.2	$24.5
Amort. Software	$10.9	$8.7	$11.9	$8.0	$5.8
Total	$33.6	$30.0	$40.4	$35.2	$30.3
Capital Spending	$38.5	$37.3	$50.9	$49.8	$75.2

Looking at the Gross PP&E figures also shows a sizeable drop in computer equipment in 2018:

PP&E	3Q19	2018	2017	2016
Leasehold Improvements	$66,697	$63,391	$59,179	$51,242
Data Proc/Communications	$78,549	**$68,015**	**$83,922**	$76,773
Furniture/Fixtures	$35,057	$33,840	$28,752	$26,513
Software	$149,912	$131,437	$107,924	$86,983
Gross PP&E	$330,215	$296,683	$279,777	$241,511
Accum. Dep/Amt	$170,610	$143,155	$131,349	$111,083
Net PP&E	$159,605	$153,528	$148,428	$130,428

Again, this is a software company, so when computer equipment gets old that's a problem for long term competitiveness in our view. In 2018, it appears that RP disposed of a higher percentage of older equipment to lower the gross figure. However, we are concerned about two things. First, the gross amount of computer equipment is still below 2017's levels near the end of 2019. Second, if the company eliminated older equipment that was likely full depreciated and replaced it with newer stuff – then the depreciation should be rising and it's not. Depreciation has been flat for 2019 with a small sequential decline in 3Q19 from $7.7 million to $7.5 million.

In our view, RP may be picking up 1-2 cents in EPS per quarter from using older equipment that is fully depreciated, seeing lower depreciation, having flat capital spending against 30% sales growth in 2018 and 14% in 2019 YTD. The company may need to ramp up capital spending considerably going forward or risk losing competitiveness.

Deferred Revenue Growth Is Not Keeping Pace with Sales

We talked about this in the initial EQ report and it has continued to worsen. Days Sales for Deferred Revenue was well above 60 days in 2017. Now it's well below 50 days in 2019. It has also fallen sequentially for 3-straight quarters:

	3Q19	2Q19	1Q19	4Q18
On Demand Rev	$245.6	$235.2	$226.5	$218.1
Def. Rev	$127.9	$128.7	$125.7	$125.6
Days Sales	47.5	49.9	50.6	52.6

	3Q18	2Q18	1Q18	4Q17
On Demand Rev	$215.4	$206.9	$193.3	$180.1
Def. Rev	$115.6	$116.4	$115.4	$122.2
Days Sales	49.0	51.3	54.5	61.9

This will make the company more dependent on signing up new business in the current quarter to make forecasts. It also has a negative impact on cash flow because rising deferred revenues brings in cash. The ASC 606 rule adoption lowered deferred revenues in 2018 by $3.7 million that is only about 1.5 days. Compare that to the drop from 61.5 days from 3Q17 to 47.5 days in 3Q19.

The Adjustments to Earnings and Cash Flow Are Inflating Results in Our View

We are going to highlight three major areas where the non-GAAP results may be overstating the results here.

Acquisitions are a key part of RP's growth model. It has made several in prior years and has added two more in 2019 with a third announced this month. RP wants to view this as discretionary spending and therefore it is free cash flow positive without acquisitions. We would argue that the company is addicted to doing more deals to jumpstart growth. Organic growth is about half the rate of reported growth with acquisitions.

Even though the bulk of the acquisitions' purchase price is being allocated to goodwill and therefore is not amortized at all, remaining assets such as developed technology is being amortized over 5-7 years and client relationships are being amortized over 10 years. If these assets were built in house, sales commissions are paid as they occur or are amortized over

3-years. That's much faster than 10-year amortization. The acquired technology would be amortized over 3-5 years if built in house. Plus, that amortization would not be added back to reported Non-GAAP earnings. These are some sizeable figures looking at the two most recent deals in 2019:

	Goodwill	Client Rel.	Dev. Tech	Total paid
Simple Bills	$9.5	$5.2	$4.0	$18.1
Hipercept	$23.1	$3.0	$1.7	$28.2

The goodwill isn't being amortized at all – even if it only half what they paid for goodwill would have been necessary to build it in-house, that figure would be depreciated over 3-5 years into income or expensed immediately into income. The other assets are being amortized – but RP adds it back to both non-GAAP earnings and to cash flow. The most recent deal that was announced was Buildum for $580 million. The company has negative EBITDA and revenues of $50 million so they paid over 11x revenue for it. Per *Zoom Info*, Simple Bills had revenue of under $6 million so they paid more than 3x sales for that. *Owler* showed revenue for Hipercept of about $10 million, so RP paid nearly 3x sales for that deal.

Total assets at RP are $2.3 billion and 48%, or $1.1 billion, is goodwill. Another $261 million are acquired intangibles or 11% of the total. The size of acquisitions dwarfs capital spending, R&D, and even sales and marketing combined. To us, that makes this an on-going activity not a one-time event:

	2019YTD	2018	2017	2016
Cash Acq.	$38.5	$278.6	$649.9	$66.4
Other Acq Payments	$26.3	$28.4	$8.5	$5.7
Capital Spending	$49.0	$50.9	$49.8	$75.2
Prod. Dev.	$85.9	$118.5	$89.5	$73.6
Sales & Marketing	$145.9	$166.6	$140.5	$122.5
C+P+S&M	$280.8	$336.0	$279.7	$271.3

This assumes all of product development costs and sales & marketing are cash. **Also, in 2019, RP has already announced another $580 million deal for Buildum. That alone will outdo everything spent on internal business building items.** In 2018, acquisitions were basically equal to spending on internal items. In 2017, acquisitions were more than twice the level of internal spending.

Thus, we are not going to treat the acquisitions are one-time in nature for cash flow, nor are we going to view the amortization of acquired assets as non-ongoing costs. If they didn't buy this stuff, it would have been required that they built it and expensed it.

Share compensation is another item that continually recurs and often increases. Employees consider it pay. Try not paying it and see what employees demand in cash wages. We talked about some of this in the section on cutting product development costs. RP tries to minimize the dilution of shares issued in this manner by repurchasing shares and that consumes cash too.

	2019YTD	2018	2017	2016
Share Compensation	$47.3	$50.6	$45.8	$36.9
Share Repos for comp.	-$16.8	-$29.0	-$30.9	-$6.0

At a minimum, we believe the cash spent buying back shares should be expensed.

Reported Earnings and Adjustments

	2019YTD	2018	2017	2016
Non-GAAP EPS	$1.28	$1.51	$0.93	$0.76
Non-GAAP pretax inc.	$162.4	$183.1	$127.1	$98.8
Less Cash spent on Stk Comp.	$16.8	$29.0	$30.9	$6.0
Less Amort of Intangibles	$60.4	$71.7	$39.9	$30.3
Adj. Non-GAAP pretax inc.	$85.2	$82.3	$56.3	$62.5
26%/40% tax rate	$22.1	$21.4	$22.5	$25.0
Net Adj. Non-GAAP	$63.0	$60.9	$33.8	$37.5
Adj. Non-GAAP EPS	$0.67	$0.68	$0.43	$0.48

If we only deduct the cash spent on share repurchases related to stock compensation and do not accelerate the amortization of acquisition intangibles to conform with RP's actual depreciation schedule of 3-5 years, that is already enough of a change to cut reported EPS in half.

Remember, the acquisitions consumed cash too, we are simply putting some of that cost into the income statement. Also, the other areas of EPS that may have inflated recent results such as cuts to product development for 3-4 cents per quarter in 2019, the cuts to bad debt expense and the reduced depreciation would still be inflating these adjusted figures.

Reported Cash Flow and Adjustments

	2019YTD	2018	2017	2016
CFO Reported	$186.1	$244.8	$140.3	$129.4
Cap-Ex	$38.5	$50.9	$49.8	$75.2
FCF Reported	$147.6	$193.9	$90.5	$54.2

Here is what RP is reporting for cash flow. It looks like solid results. We are going to adjust this for three things:

- We believe capital spending is too low and are going to boost it to $60 million annualized where necessary
- We are moving the cash spent buying stock to offset stock compensation from the financing section to the operating section
- While we will let the amortization of intangibles be added back, we are going to consider acquisitions an ongoing cash outflow as well as move additional consideration paid on prior acquisitions listed in the financing section to the investing section

	2019YTD	2018	2017	2016
CFO Reported	$186.1	$244.8	$140.3	$129.4
less cash Stock Comp	-$16.8	-$29.0	-$30.9	-$6.0
Adj CFO	$169.3	$215.8	$109.4	$123.4
Cap-Ex	$38.5	$50.9	$49.8	$75.2
Additional Cap-Ex	$6.5	$9.1	$10.2	$0.0
FCF before Acq	$124.3	$155.8	$49.4	$48.2
Acquisitions	$50.1	$278.6	$649.9	$66.4
Add Acq consideration	$26.3	$28.4	$8.5	$5.7
Adj. FCF	$47.9	-$151.2	-$609.0	-$23.9

Again, remember that there is another $580 million acquisition coming in 2019. The company's cash flow drops noticeably when low capital spending, cash spent on stock for compensation, and the acquisition payments are taken into account.

Boston Scientific (BSX) EQ Update 9/19 Qtr.

Current EQ Rating*	Previous EQ Rating
4-	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 maintaining our earnings quality rating of 4- (Acceptable).

- BSX closed on its $3.6 billion (net of cash) acquisition of BTG. The company warned that it expected to take a longer than normal time to finalize the allocation of the acquisition price, up to a year. During this time, adjustments to the carrying value of intangibles could result in non-operating gains and losses that investors should be watchful of, but we note that the company has been good about adjusting these items out of non-GAAP results in the past.

- However, we will take this opportunity to once again criticize the company's practice of excluding amortization of acquired intangibles from non-GAAP earnings. In the case of BTG, $1.9 billion of the $3.6 billion purchase price was allocated to intangible assets with $1.5 billion allocated to goodwill. BTG's main asset was its portfolio of pharmaceutical products which the company would have had to incurred substantial amounts to develop on its own had it now acquired them from BTG. However, the money spent on the acquisition for those assets is being totally disregarded in the non-GAAP results. Also, while the add-back of amortization makes this less relevant, we note that the company assigned an amortization period of 10-17 years for its technology-related intangibles from the BTG deal with the high end of that range seeming unusually long for a pharmaceutical asset.

- The recent acquisitions have left the company with a leverage ratio of 4.27 as defined by its debt covenants with the maximum allowable ratio of 4.75. The maximum allowance amounts steps down in 25 bps increments in each quarter after the

acquisition. With the company currently not paying a dividend or buying back shares, there should be no problem with keeping debt below the covenant level.

- On-balance sheet receivable DSOs were essentially flat versus the year-ago quarter, as were DSOs based on sold but outstanding receivables. Therefore, we remain unconcerned regarding any artificial benefits to cash flow or sales.

- Deferred revenue days fell by one day versus the year-ago quarter. However, deferred revenue balances arise primarily from sales of the *LATTITUDE* Patient Management System, the absolute amount of deferred revenue increased both year-over-year and sequentially, and revenues were inflated by sales of recently acquired products. These factors erase concern regarding the decline in deferred revenue days.

Kellogg (K) EQ Update 9/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3+	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 raising our earnings quality rating to 3+ (Minor Concern) from 2+ (Weak)

K reported adjusted EPS of $1.03 topped consensus estimates by 12 cps. We note below that a lower than expected tax rate likely added more than 2 cps to EPS in the period. The upgrade in our rating largely reflects the normalization of both the receivables balances and the structured payables program. However, we caution that cash flow remains under pressure from the absence of those items as well as the divestiture, restructuring spending and investment, and higher capex.

- Trade receivable DSOs rose by 1.2 days over the year-ago quarter to 37.9 while sold but outstanding receivables were essentially flat at 25.5 days. As we have discussed in previous reviews, the huge boost to cash flow from receivables factoring and the boost to sales from extending more generous payment terms to customers has been over for the last few quarters. While we are not overly concerned with the 1.2-day increase in receivables in the quarter, this metric should be monitored going forward for evidence of increasing payment terms.

- The multi-year Project K restructuring program is winding down and expected to be completed in 2019. However, the company announced in the 6/19 quarter that it was launching a reorganization plan for Europe that will result in $40 million in charges mostly related to severance and termination benefits, relocation costs, and third-arty legal and consulting fees. Likewise, a similar reorganization plan for North America was announced with a $30 million price tag and similar expense categories. We are

not overall concerned about the earnings quality impact of these initiatives given there relatively small scope, focus and time frame.

- The company's effective tax rate fell to 17.9% in the 9/19 quarter from an unexpected reversal of a tax accrual. The effective tax rate for the six months ended 6/19 was 20.5% with the company guiding for a full-year rate of 21% at the time. We estimate that analysts would have likely been expecting an approximate 20% effective rate in the quarter, implying the lower rate could have provided an approximate 2.5 cps boost to earnings above expectations.

- The company used proceeds from the sale of the cookie business to reduce net debt to around 3 times EBITDA. However, cash flow growth remains under pressure from the divestiture, restructuring spending and investments, the absence of the receivables factoring and a continuing decline in payable days as the structured payable program is no longer expanding.

- We note that accrued advertising jumped to 4.7% of trailing 12-month sales in the quarter, up from 4.4% in the previous quarter and 4.4% in the year-ago quarter. This was a sizeable jump and implies an 11 cps drag on earnings if we assume a similar percentage of sales to the 9/18 quarter. There was no mention made in the 10-Q or conference call regarding the overall level of promotional and advertising spending. While management cited a new campaign on *Special K* and *Mini Wheats* in North America, most of the discussion centered around delays in advertising spending in cereal : "Our promotional activity as measured by the percentage of units sold on promotion in a scanner data didn't climb all the way back to year-ago levels yet and we also delayed some advertising activity in part to enable us to activate additional capacity for certain products. Where we have most return to normal brand activity is in the taste fund segment which underwent its pack harmonization back in Q1. This quarter, our taste fund segments brands collectively grew consumption and share." We suspect the company has already accrued for future advertising spending to the detriment of the 9/19 quarter which may provide an artificial tailwind to future quarters.

Sysco (SYY) 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) reflecting non-operating benefits to earnings in the quarter.

SYY reported adjusted EPS of $0.98 in the 9/19 quarter, a penny ahead of Street estimates. However, the beat looks very low quality when considering:

- Lower share-based compensation expense added 1.2 cps. Management noted higher spending on employee compensation during the quarter yet lower stock compensation expense appeared to offset some of that increase.

- Management noted in the conference call that the effective tax rate of 22% was lower than the guidance going into the quarter of 24% due to tax benefits from share-based compensation. This would have provided an approximate 2.5 cps boost to EPS above expectations in the period.

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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