BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Patterson Companies (PDCO) EQ Update- 9/20 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 an explanation of the EQ Review Rating scale, please refer to the end of this report

We are maintaining our earnings quality rating of 3- (Minor Concern)

Patterson beat forecasts by 24-cents with an adjusted EPS of $0.69. A great deal of this can be explained by dentists going back to work for the bulk of the quarter vs. 4Q, and 1Q and having a sizeable backlog of elective procedures to complete. Dental consumable sales grew at 17.7% y/y in 2Q after a -15.4% 1Q. However, selling PPE like gloves and sanitizer was about 12% of the growth. Actual consumables grew only about 6% despite the very easy sequential comp. **We estimate the $36.5 incremental PPE sales in Dental consumables added 2-3 cents to EPS. A lower tax rate added another 1-cent.** The biggest driver was reduced operating expenses as PDCO's gross margin fell 60bp. **Operating expenses fell by 220bp ($34 million), which was 27-cents of EPS.** Within that total of expense cuts are several items we do not regard as sustainable such as:

- Salary cuts and furloughs which ended in August
- Hours were reduced for other employees
- No travel/entertainment spending or in-person sales calls

PDCO did not consider these types of cuts to be sustainable. **In the 1Q21, PDCO said these types of cost savings were about $20 million or 15-cents per share. In 2Q21, there was 2-cents from lower stock compensation too.** We will grant PDCO that there is some operating leverage happening due to higher sales but the company is saying it expects marketing efforts to return, its PPE sales to moderate, and it has tough revenue comps for 3Q and 4Q.

What improved?

- PDCO only added back amortization of acquired intangibles as an adjustment to EPS. This was 7-cents for 2Q20 and 2Q21. That is down considerably from prior quarters when restructuring, integration, write-offs, and legal costs were common adjustments.

- Cash flow benefitted from payables increasing with higher sales and higher repayment of existing deferred receivables net of new DPP.

What deteriorated?

- The animal business grew sales as more people adopted animals and spent more on their pets. However, the margins continue to fall because PDCO is not hitting rebate levels from suppliers.

- The animal business wrote off all its goodwill in 4Q, but still is not taking impairments on other intangibles, which are being amortized over very long periods.

What to watch

- Working capital still appears likely to grow as sales recover and become a headwind on cash flow of about $150 million.

- PDCO is essentially maxed out on how many receivables it can sell, which may cause the surge in 2Q cash flow from repayment of DPP to weaken.

- The company warned that it expects tough comps in 3Q and 4Q to hurt growth rates and that PPE sales may moderate.

- PPE sales were a big topic on the call. It is important to remember that PDCO always sold some protective equipment. 12% growth in dental consumables due to higher PPE sales is $36.5 million in incremental sales or just over 2% of total sales. We're not sure this is the game-changing sales item for a long period. Also, many other companies have jumped into this market too so pricing may be pressured. It also should eventually move closer to sales growth of normal dental supplies.

- We warned that the PDCO's margins are dependent on reaching goals to achieve rebates. If it still cannot do it in animal health with sales rebounding – this may be an area to watch for more asset impairments.

Increase in Cash Flow Due to Weak COVID Sales in Prior Quarters

As we discussed in the original report, PDCO sells finance contracts for equipment purchases to banks. It collected cash upfront in these deals and has additional receivables posted as collateral. These are called Deferred Purchase Price receivables or DPP. The DPP is paid last and generates cash to the company as well after the banks are paid on other sets of receivables. PDCO also sells regular receivables from its consumable unit. These are shorter-term and operate similarly with a DPP as back-up collateral for the banks.

PDCO reports the collection of DPP in the investing section of the cash flow statement. It also defines its free cash flow as Cash from Operations less Capital Spending plus the collection of DPP. The company cheered the cash flow produced in 2Q20:

	2Q20	2Q19	1Q20	1Q19
Cash from Ops	-$193.2	$30.6	-$229.8	-$45.2

Capital Exp.	$8.0	$14.0	$6.4	$8.9
Collection DPP	$269.4	$106.6	$139.5	$105.7
Adj. FCF	$68.2	$123.2	-$96.7	$51.6

Dental equipment sales plummeted by 36% in 4Q20 and 10% in 1Q21. There were simply fewer new sales being made against collections from higher prior sales levels. We think that resulted in collections exceeding new contracts sold in the 2Q21. To the extent there were dentists given some payment deferrals or who simply paid late during 4Q and 1Q – they also caught up in the 2Q. Also, as we have noted, PDCO has been essentially maxed out on these receivable programs – they needed prior receivables to be paid in order to sell new ones:

- Collections on DPP in 2Q were $269 million vs. $139 million in 1Q.
- That helped the company create new DPP of $235 million in 2Q vs. $202 million in 1Q.
- The net swing in 2Q was a positive $34 million vs. -$62 million in 1Q – a sequential change of $106 million.

We also noted in the original EQ report that PDCO booked some abnormally large gains on selling receivables in fiscal 2020 of $44 million vs. the customary $15-$20 million. We thought that source of income would decline and it has. In 1Q21, PDCO booked a $2.7 million loss and in 2Q21, it booked a gain of only $1.3 million.

Working Capital Ratios May Be Too Low

Given how much sales have moved up and down with COVID – we are not concerned about one or two days change.

- Receivables are at 52.0 days after 2Q. We add in the $200 million from the latest round of sales of non-financing contract receivable sales. Historically, DSOs are 55-59 days. PDCO is maxed on selling more receivables at this point at $200 million of $200 million available on one plan and $612 million used on the other plans allowing for a $625 million limit.

- Receivables could become a headwind of about $70 million on cash flow.

- Inventories are at 56 days after 2Q. Inventories dropped by $111 million in 1Q and regrew $148 million in 2Q. They are typically 65-70 days. Ten more days would be a headwind of about $135 million more.

- Payables are at 51 days after 2Q. They are normally about 52-56 days. PDCO paid down $312 million in 1Q and added $148 million in 2Q. This would produce cash flow but getting back to normal would only produce about $50 million in cash flow.

- Total working capital may consume about $150 more in cash to return to normal levels.

Ball Corp. (BLL) EQ Update- 9/20 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

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We are lowering our earnings quality rating to 3- (Minor Concern)

BLL's 9/20 non-GAAP earnings of $0.89 beat the consensus estimates by 12 cps. We identified about 4 cps in one-time benefits in the quarter, so the earnings beat remains well intact. Our reduction in rating reflects the continuing increase in factored receivables.

What deteriorated?

- The growth in factored receivables continues. Factored receivables balances rose sequentially in the quarter by approximately $240 million versus about $53 million growth in the year-ago quarter. This could have added almost $200 million to cash flow growth in the first nine months of 2020. Outstanding factored receivables balances are larger than trade receivables left on the balance sheet. Factored receivables days of sales stood at 39 days at the end of the quarter compared to the mid-20 range two years ago. How much longer can this disproportionate growth continue to drive cash flow growth?
(Concern level: MEDIUM)

- Depreciation expense fell to $115 million in the quarter from a recent trend in the $125 million range seen over the last several quarters. This was despite an increase in net property, plant, and equipment from the August acquisition of Tubex. The absolute decline in depreciation from the 6/20 quarter added about 2 cps to EPS in

the 9/20 quarter. This should reverse soon as new production facilities are brought online and capex remains elevated over the next two years.
(Concern level: LOW)

- We estimate that the adjusted effective tax rate used in the calculation of adjusted EPS fell by 200 bps to 17.7%. This would have added about 2 cps to EPS in the period.
(Concern level: LOW)

What to watch

- BLL plans to add 25 billion units of capacity by the end of 2023 with as much as 45 billion units by 2025. This is expected to keep capex spending above $1 billion in the next two years. Also, investment in working capital is expected to remain a drain on cash flow growth. Over the long-term, however, management declared that it has a "path to doubling cash from operations by 2025." In the meantime, free cash flow growth may be limited.

- Debt to adjusted EBITDA was 3.6 at the end of the 9/20 quarter. Management noted in the call that it is in "growth mode" in terms of capital allocation. It does not plan to deleverage over the next year and it will limit the buyback in 2021. In the last few quarters, the lower share count from previous buyback activity has been adding about 2.5-3.0% to EPS growth so that source or earnings growth could fade in the next year.

- BLL's contracts contain pass-through provisions where pricing moves to compensate for the rise and fall of aluminum prices to protect it from rising costs of aluminum While this helps protect BLL's bottom line, changes in the rate of pass-throughs can materially impact reported revenue growth. Currently, declining aluminum prices are a drain on reported revenue growth.

- In the short-run, BLL has seen volume growth boosted by COVID driving an increase in packaged beverages for at-home consumption. Longer-term the bull story centers around an expected switch from plastic cups and beverage containers to new lightweight, recyclable aluminum cups and bottles. In the last conference call, the company forecast 6% volume growth in North America over the next 3-5 years with "mid-single-digit" growth in EMEA. An evaluation of this forecast is beyond the

scope of this report and aluminum packaging will certainly help with the buildup of plastic waste which is a current source of public concern. However, we note some onlookers worry that aluminum production gives off substantially more greenhouse gases than paper or plastic and increases the problem of pollution from bauxite mining.

Factoring Continues to Climb

(Concern level: Medium)

The accounts receivables number on BLL's balance sheet includes trade receivables, unbilled receivables, and other receivables. Other receivables contains items such as tax receivables and other items not related to revenue. Therefore, we define base balance sheet receivables as trade receivables plus unbilled receivables net of allowances for bad debts.

Also, the company maintains a receivables factoring program whereby it sells receivables to third parties to accelerate the receipt of cash which results in these receivables being removed from BLL's balance sheet. BLL discloses the limit of the factoring facility and the amount currently available. We estimate the amount of receivables sold but still outstanding at the end of the period by taking the difference between the limit and the amount still available under the facility. Note that the limit is disclosed rounded to the nearest $100 million so our factored receivables number is not exact. We estimate rounding could potentially impact the days sales calculation around 1-1.5 days of sales.

The following table shows the calculation of DSOs based on base receivables, factored receivables, and the total of both:

	9/30/2020	6/30/2020	3/31/2020	12/31/2019
Sales	$3,093	$2,801	$2,785	$2,719
Net Trade + Unbilled	$1,418	$1,447	$1,417	$1,186
Base DSO	42.2	47.0	46.3	40.1
Outstanding Sold Receivables	$1,316	$1,073	$1,098	$1,170
Factored DSO	39.1	34.9	35.9	39.6
Adjusted Receivables	$2,734	$2,520	$2,515	$2,356
Adjusted DSO	81.3	81.9	82.2	79.7

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Sales	$2,953	$3,017	$2,785	$2,803
Net Trade + Unbilled	$1,405	$1,511	$1,426	$1,280
Base DSO	43.8	45.6	46.1	42.0
Outstanding Sold Receivables	$1,145	$1,092	$1,008	$1,022
Factored DSO	35.7	32.9	32.6	33.5
Adjusted Receivables	$2,550	$2,603	$2,434	$2,302
Adjusted DSO	79.4	78.5	78.7	75.6

As we have observed in previous reviews, factored receivable DSOs have been steadily rising YOY for the last several quarters. A large sequential and YOY jump in factored balances again drove a 3.4-day increase in factored DSOs. Base receivables on the balance sheet were essentially flat YOY with DSOs down 1.6 days. Adjusted DSOs which take into account the factored balances, rose by 1.9 days, continuing a trend in YOY increases seen for several quarters.

Our most immediate concern regarding receivables is the impact that rising factoring has on cash flow growth. We see in the table above that factored receivables rose to $1.316 billion at the end of the 9/20 quarter versus $1.073 billion at the end of the 6/20 quarter- a $243 million increase. If the company had not factored those receivables, cash generated in the quarter would have been lower by roughly that amount. Looking at last year's third quarter, the increase in factored balances was only $53 million. If we take the impact of factoring out of both periods, it appears as if the increase in factoring in the quarter could have boosted cash flow growth in the first nine months of 2020 by around $190 million, a period in which reported cash from operations actually fell from $656 million last year to $345 million this year. This decline was driven partly by the timing of metal payments in the first quarter of this year along with inventory rebuilding. We have nothing against a company working to collect cash faster- that's good cash management. However, if the growth in receivables factored flattens or reverses, receivables will revert to being a headwind to cash flow growth. Trade receivables (excluding unbilled) on the balance sheet

amounted to $925 million at the end of the quarter compared to the $1.3 billion that has been removed but still outstanding. With the balance of sold trade receivables already exceeding those left on the balance sheet, how much longer can the outpaced growth in factored balances continue?

Total DSOs Adjusted for Factoring Rose by 2 Days YOY

Another concern regarding receivables is the growth in adjusted DSOs. The company acquired Tubex Industries in August for $80 million which could have contributed to the increase in DSO although the impact was likely minimal. It is worth noting that the current level of adjusted DSOs in the low 80s compares to the mid-to-low 70s two years ago. We have been watchful of the increase in unbilled receivables which have been partly driven by the growth in Aerospace sales which are recognized under long-term contracts. The following table shows the increase in unbilled receivable DSOs compared to the increase in total adjusted receivable DSO which includes trade receivables, unbilled receivables, and factored receivables.

	9/30/2020	6/30/2020	3/31/2020	12/31/2019	9/30/2019	6/30/2019
Increase in Unbilled DSOs	-0.4	2.4	2.8	3.1	4.1	3.7
Increase in Adjusted DSOs	1.9	3.4	3.5	4.2	6.3	5.8

We can see that the increase in unbilled receivables has accounted for some, but not all of the increase in adjusted DSOs over the last couple of years and they *declined* in the 9/20 quarter. Note that acquisitions and divestitures can impact all these periods, but over time there is a definite increase in rising DSOs.

While the increase in adjusted DSOs over time has not been especially dramatic, it deserves attention as it could be an indication of the company offering better terms to customers to drive sales growth.

Depreciation Expense Declined Sharply in the Quarter

We noticed that depreciation expense declined materially in the 9/20 quarter as seen in the following table:

	9/30/2020	6/30/2020	3/31/2020	12/31/2019
Quarterly Depreciation Expense	$115	$126	$124	$123
Net PPE	$4,895	$4,662	$4,499	$4,470

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Quarterly Depreciation Expense	$123	$123	$122	$123
Net PPE	$4,320	$4,385	$4,360	$4,542

BLL acquired Tubex Industria in the 9/20 quarter for $80 million which resulted in net property, plant, and equipment (PPE) increasing. There were no other significant acquisitions or divestitures made in the last three quarters that would have resulted in the sudden decline in depreciation expense seen in the period. The absolute decline in depreciation expense from the 6/20 quarter added about 2 cps to EPS in the 9/20 quarter.

BLL has been investing heavily in new production facilities for several quarters and expects capex to remain elevated for the next couple of years. Depreciation expense can be expected to begin increasing as these new facilities come online.

PerkinElmer (PKI) EQ Update- 9/20 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

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We are raising our earnings quality rating to 3+ (Minor Concern) from 3- (Minor Concern).

PKI reported adjusted EPS of $2.09 in the 9/20 quarter which was 60 cps ahead of the consensus. The increase in our rating reflects the decline in DSOs although we want to see more improvement before upgrading to a 4 (Acceptable).

What improved?

- Accounts receivables days of sales fell to 75 in the 9/20 quarter from 83 in the year-ago period. Our main concern in our original review was an ongoing buildup of receivables through the 3/20 quarter that the company attributed partially to extending more beneficial payment terms to customers. Our upgrade is a reflection of that improvement...

- …however, we are reluctant to move the rating above a 3 at this point as receivables are still notably higher than some industry peers with DSOs between 50-60. Revenue growth has skyrocketed from COVID-driven demand for the company's diagnostic tests. Ordinarily, we would expect to see a rise in DSOs from such an acceleration in revenue growth, but we suspect the increased demand is allowing the company to tighten its credit terms and improve collections. We will hold off upgrading the rating further until DSOs fall further and hold in a normal environment.

DSOs Declined- But Are Still Relatively High

The main factor in our original 3- (Minor Concern) rating was a steady YOY increase in DSOs through the 4/20 quarter which the company attributed at least in part to better terms extended to customers. The following table shows that DSOs have declined in the last two quarters.

	10/04/2020	7/05/2020	4/05/2020	12/29/2019
Sales	$964.025	$811.718	$652.396	$805.496
Trade Receivables	$797.911	$708.799	$626.150	$725.184
Trade Receivables Days of Sales	75.3	79.5	94.1	81.9

	9/29/2019	6/30/2019	3/31/2019	12/30/2018
Sales	$706.923	$722.517	$648.737	$756.349
Trade Receivables	$646.286	$654.454	$623.927	$632.669
Trade Receivables Days of Sales	83.2	82.4	87.5	76.1

	9/30/2018	7/01/2018	4/01/2018	12/31/2017
Sales	$674.313	$703.362	$643.972	$641.630
Trade Receivables	$551.385	$564.041	$575.740	$552.304
Trade Receivables Days of Sales	74.4	73.0	81.4	78.3

In the conference call, management attributed the decline in DSOs to "improved monthly linearity, process improvements, and COVID-related demand." However, revenue rose by 36% in the 9/20 quarter and 12% in the 6/20 quarter in the COVID-driven rush to the company's diagnostics solutions. In such a sudden acceleration in revenue growth, we would ordinarily expect to see receivables outrun revenue growth and drive an increase in DSOs. This makes us wonder if the increased demand for the company's products allowed it to tighten its credit terms. We also note that the company's current DSO level is still material higher than the 50-60 range reported by peers Mettler-Toledo (MTD) and Bruker (BRKR). Therefore, we will hold off upgrading to a 4 (Acceptable) until we see DSOs improve further and hold in a more normal market environment.

Behind the Numbers Focus List
Top Longs, Biggest Concerns, and Themes for 1Q'21

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Starwood Property Trust (STWD)- Long

STWD is a commercial mortgage REIT. However, unlike typical mortgage REITs, its structure allows it to benefit from both rising and falling rates. In addition to commercial lending, the company also operates in infrastructure lending, the acquisition of ownership interest in commercial real estate and multi-family properties, and the servicing of troubled assets. We see STWD as a longer-term value play worth approximately $27 (currently selling for

$18.50.) The stock will likely be volatile, fluctuating with the market's views on the economy and interest rates.

Growth drivers:

- STWD has been holding more cash than normal to preserve liquidity but that is now reversing. It put $400 million back to work in 3Q which will contribute 3 cps in a full quarter of deployment.

- LNR specialty service business helps troubled borrowers restructure/refinance loans. This segment should provide a solid source of earnings over the next two years. The value of active cases rose by 60% from 1Q to 3Q. Fees are earned on a lagging basis and can take up to 18-24 months to be realized in some cases. Every $3 million in servicing fees represents 1 cps in earnings. These earnings can be lumpy, but we see this segment as having the potential to boost growth for many quarters.

- Non-QM Residential has the potential to expand returns. These are loans with high FICO scores over 700 and low LTV (loan-to-value) ratios in the 60s. STWD has been buying these loans at a discount and securitizing them at par and booking gains. The market is now over par for these loans, but it is at the stage where the early securitization trusts are refinancing. The loans are paid down to even lower LTV, and the trust has financing at 3%. STWD will roll the loans to a new trust at a lower rate with more loans. They will not have the same gains on sale with new loans, but the lower financing will push up the rate of return. Also, in a trust with some more seasoned loans with even lower LTVs, STWD may hold more of the junior tranche.

- STWD has diversified into owning property with a focus on medical buildings and apartments where rent is government-backed. Occupancies are near 100% and rent cannot decline. This creates depreciation expense which reduces EPS and the required distributions to maintain REIT status which allows more flexibility for self-funding

- Commercial mortgages are to high-grade tenants. Payments on 99% of the loan book were received during COVID while 1% paid slightly late. The company is limiting its exposure to NYC hotels and areas with high pre-COVID valuations.

- The company is financed with term debt, fixed bonds, and securitizations, and its size allows it to obtain cheaper financing than peers. It is positioned to take advantage of a crisis and it grows in times like these.

- STWD continues to be well-positioned for rising or falling interest rates. Of the $9.8 billion on the loan book, $7.1 billion has 145bp LIBOR floors. That is helping earnings and STWD still gets the upside if rates increase. The company should still be able to add 1-cent in quarterly EPS from a 100 bp move up in rates and close to 3-cents on a 200 bp move up. That book is not seeing many loan problems either. The company experienced three interest deferrals in 2Q, all hotels, and all have been repaid. STWD continues to collect about 97%-98% of interest as scheduled. They have only 0.5% exposure to San Francisco and < 4% exposure to NYC. It de-risked the only NYC hotel loan by selling the mezzanine loan and buying parts of the first mortgage.

- Liquidity is good shape with $8.1 billion available and unencumbered assets of $2.9 billion. STWD has already raised the money to repay its February debt too. Its property book continues to appreciate, and it has boosted the return by refinancing the property multiple times at lower rates. The longer duration of the portfolio also solidifies core EPS as well.

- STWD's accounting is more conservative than GAAP. It values securities below GAAP's CECL rules. The company has stress-tested for both a 20% drop in real estate values and the spread widening by 250 bp. STWD trades for 0.9x book versus the historical norm of 1.5x book and book is understated as depreciation depresses property which is booked sub FMV.

Main risks to thesis:

- STWD is weighted heavily by mortgage ETFs. Investors flee ETFs when rates rise because that hurts constituents NLY and AGNC even though STWD benefits from higher rates. We believe the stock returns to the mid-$20s as its 14% yield draws investors independent from the ETFs.

Mowi (MOWI.OL)- Long

Mowi is the world's largest salmon farmer. We see this as a secular growth story, but short-term results can be choppy. In our view, the market focuses too much on short-term setbacks such as demand/supply imbalances or sea lice outbreaks and misses the value in the company's long-term growth potential. Our initial price target is NOK 230.

Growth drivers:

- We expect rising demand for salmon as more people enter the middle class and the demand for protein rises. Seafood is taking an increasing share of the protein market.

- Farmed salmon can be grown more quickly than other forms of protein and is arguably healthier than beef or chicken. It also consumes less to produce as it takes 1.1 kg of feed to produce 1 kg of salmon whereas beef requires 4.7 kgs and chicken requires 1.9 kgs.

- Mowi's salmon is not a pure commodity play as it breeds higher quality salmon, uses less antibiotics, and half its sales are from value-added products demanding higher margins.

- COVID has hurt demand, but 3Q saw demand and supply equalize. Supply growth forecasts for 2021 call for -1% to +3% growth. Demand was up almost 5% in the quarter with Europe and the US posting 7.2% and 14.3% gains, respectively. This bodes well for pricing strength going forward and there is room to run. Salmon from Norway is normally €6-7/kg and is currently in the €3's but is starting to bounce up. Salmon in the Americas is normally about $5/lb and it is about $3.50 now. Recovery in pricing should drive EPS growth in 2021.

- Closed restaurants have been a 5-10% headwind which has offset the rise in home preparation demand. History in Europe supports the possibility of the company maintaining much of the strong home preparation demand when foodservice reverses.

- FX is a key component of the story. Costs and revenues are in euros which gave them a short-term cost disadvantage against other salmon players using the NOK for costs. Going forward, competitors using NOK are seeing cost inflation from the FX which means pricing for revenues will get upward pressure. MOWI should get higher pricing and flat costs now

- FX also impacts the MOWI ADS which trades in USD but the underlying security is priced in NOK. The NOK/USD historically is 5-6 to 1. Recently it has been as high as 15-1 and over 10-1 much of the time. The ADS could appreciate with the ratio normalizing

- There are no debt maturities for two years and ample cash and credit on hand should enable the company to weather the storm. Cash flow was still positive in 2Q despite unusually weak pricing. Cost reductions and a marketing push should help margins in recovery.

- Mowi's dividend policy is to pay 75% of free cash flow. It was suspended with markets closed and weak pricing. The dividend should return as pricing recovers for salmon. 2021 is shaping up for demand growth to exceed supply growth.

Main risks to thesis:

- Sea lice can hurt harvests, but multiple pens in multiple regions help diversify exposure.

Ares Capital (ARCC)- Long

ARCC is the largest business development company (BDC) specializing in various forms of financing to middle-market companies with a focus on the manufacturing, business services, IT, and healthcare industries.

Growth drivers:

- Portfolio value is now recovering. The number of companies rising in its ranking scale outnumbered decliners by 3 to 1 in 3Q. 99% of contractual interest payments were received in the quarter and the number of new amendments fell by 60% compared to 2Q. The larger companies in its book are already switching to growth mode from risk management.

- ARCC is reducing leverage as more investments are being repaid than new ones originated. This is both positive and negative as more investments will need to be made with increasing leverage to drive growth. This appears to be reversing as the first 21 days of 4Q saw $409 million of new loans versus $706 million for all of 3Q.

- New deals are picking up which will boost fees collected from new loan origination. This will help offset losses from the reversal of the recent uptick in capital restructuring fees which the company collects when it amends existing loans.

- The company has a diversified balance sheet with multiple fixed-rate medium-term notes rather than relying on short-term variable rate financing.

- Management has all but guaranteed the dividend. Core EPS is 1 cent below the dividend per quarter. That should improve as more money is put to work - backlog and new deals are improving. Pricing on deals is not as tight which improves profits too. LIBOR floors are kicking in and preserving spread too. Also, ARCC needs to pay out all its long-term gains as dividends over time. It has over 90-cents in this type of income that it uses as a cushion to maintain the dividend if the quarterly core EPS does not cover the 40-cent payout.

Main risks to thesis:

- The largest risk is holding variable-rate investments in a declining LIBOR environment. 84% of investments float but 79% of those have floors of 1.1% so decline should be contained at this point.

Air Lease (AL)- Long

The company leases passenger aircraft to airlines around the world. It buys new planes from Boeing and Airbus at reduced prices by purchasing the parts to finish out the interiors directly from suppliers at lower costs. Those planes are then leased out to airlines for the first third of the aircraft's 25-year useful life. The company frequently sells planes still on lease and recycles the proceeds into more new planes. This keeps the portfolio young and highly sought after – especially considering frequent delays from the manufacturers in delivering planes. We think the stock should return to the mid $40s as travel continues to rebound.

Growth drivers:

- Air Lease seems to be past the worst of its COVID headwind. It offered 58% of its customers some deferred rent last spring and early summer. Those deferred amounts are now being paid back. The level of repayment is exceeding new deferrals by about 3 to 1. Because of delays in aircraft production from both Boeing and Airbus, the capital needed to purchase planes in the next two years should be lower. This led AL to start its first share repurchase and boost its dividend earlier this year.

- There have been no write-downs of planes. AL focuses on buying new planes and sells them as they reach 7-years of age. The lack of new supply is helping hold up values. Airlines are seeking to cut costs as well which means they ground older planes and keep their younger, more efficient planes flying more. So, demand for AL's planes increasing.

- 73% of customers are the flag carriers for countries. The governments have infused more money into the airlines. AL expects that more airlines will restructure going forward, but so far everyone wants to keep their AL equipment. AL is also helping in these deals by purchasing young planes and leasing them back to the airline which expands the business.

- Liquidity is very strong at over $7 billion. It has only had to offer about $200 million in deferred rent. Debt maturities are light for the rest of 2020 and 2021. Spending

on new planes was expected to be $6 billion in 2020 but this has been cut to about $2.5 billion. A large percentage of 2021 planes on order are likely to be delayed too. It has enough liquidity, in our view, to endure any future rent deferrals needed. The company recently increased the dividend and announced a $100 million share repurchase.

- The area of the business that is down is selling aircraft. The company works to sell its own planes and planes owned by other parties. There simply have not been many transactions in 2020. This is a minor part of the business, but it produces a few cents in EPS and this contributed to AL missing estimates in 3Q. As more airlines restructure their fleets, this business may have some pent-up demand for AL's services.

- AL's accounting is getting more conservative as it began delaying revenue recognition on certain leases until the cash is collected. This amounted to 17 cps of the earnings miss in 3Q.

Main risks to thesis:

- If an unexpectedly high number of airlines restructure their balance sheets it could result in additional delays in AL getting paid.

- This risk is compounded by the high degree of leverage in the business. For reference, debt covenants are as follows:

    - Equity must be > $2b – it is $6.0b and has risen this year.
    - Total Debt/Equity must be less than 3x and is at 2.3x.
    - Aircraft/unsecured debt > 125% - it is 140%
    - BBB- or greater debt rating. It is BBB, but is on negative watch

Macquarie Infrastructure (MIC)- Long

Infrastructure company comprised of storage tank business, Atlantic Aviation services business, and Hawaii Gas utility. This is a special situation where the sum of the parts appears to exceed the current value.

- MIC – the sum of the parts is probably worth $42-$48, currently at $30.
    - Mgt has a financial incentive to unlock value by end of 2021
    - Deal in place to sell their petroleum tank storage business – will retire all corporate debt and pay $10.75 dividend.
    - Should be able to sell Hawaiian Natural Gas utility for about $600 million – worth about $4-$5 per share
    - The remaining aviation support business operates fueling, catering, cleaning, and hangers for planes at airports. Long-term concessions to operate – tough to duplicate. Long-term organic growth is about 3%-4% and it produces strong cash flow.
    - Business is improving now as COVID ends. Having it decoupled from a utility and tank business should result in a higher multiple.

We see a similar situation with **Signature Aviation (SIG.L)- Long**

- Two years spent trying to unload its Engine Repair unit. The main business is aircraft support like MIC – via long-term concessions with airports. It also has some foreign locations. L-T 3%-4% organic growth

- Trading for 16x EBITDA before it had 2-year albatross of selling Engine Repair unit and COVID.

- Also, the unit operates in US dollars but the stock trades in GBP – it gets discounted there too.

- Selling for about 8x pre-COVID EBITDA if we value the Engine unit at zero.

- At some point, they sell/spin-off engine unit and eliminate that concern. Proceeds or spin-off reduces debt and/or repurchases stock.

Macro Themes for Potential Long Ideas in 1H'21

Recovery in Auto Production Helping Adjacent Industries

Auto production has been down in 2020 with COVID which led to sales declines for other industries key to supplying the automakers. Auto production should see a rebound as conditions normalize and may receive a sustainable boost as COVID has opened the eyes of millennials to the downside of relying too heavily on public transportation. Industries and companies to consider:

- Plastics: DOW, LYB – auto-related sales down > 20%
- Semiconductors: NATI, TXN, TSM – auto-related sales down considerably
- Refiners still hurt by less jet fuel – but gasoline starting to recover – LYB, VLO

Recovery in Movies

- Few films were released in 2020 leaving a big backlog of films for 2021

- Studios committed to theaters for release – they make money back quickly going that route.

    - Studios collect 90% of ticket revenue for the first 2-3 weeks
    - Four people going to the movies is $60 vs $7 for a pay-per-view
    - They also need theater business in Asia and Europe after US

- Movie studios have much product to put out and should have a double year – T, VIAC, DIS

- Movie Theaters have been closed and should rebound – lots of debt here though – AMC, CNNWF, CNK – rents have been reduced too.

- Landlords for theaters have reworked deals and should see deferred rent start to come in plus scheduled rent – EPR, STOR, O

Keurig DrPepper (KDP)- Concern

KDP is a leading producer of beverages and soft drink concentrates as well as coffee systems. The company sells at a discount to industry leaders Coke and PepsiCo largely due to higher leverage. However, we believe the accounting is of weak quality and the high leverage is understated by multiple accounting tricks. A minor hiccup in earnings could unwind the leverage. We see a potential 30%+ downside from the current price.

Problems with the bull story:

- KDP is a classic growth-through-acquisition story. Organic growth is weak and recently has been artificially boosted by adjusting out large FX losses while growth benefits from inflation-driven price increases. Pantry stocking is a headwind.

- Debt is not actually going down as the headline numbers would indicate. KDP has shifted debt to working capital by stretching payables (now 239 days). This equals approximately $2B in debt that would unwind if the debt rating is cut- it is currently on negative watch. "The "structured payables" account amounts to another $250M. Adjusting for the $2.5 billion in factored and structured payables, debt/EBITDA is 4.5x vs. the reported 3.8x.

- Sale leasebacks have also been used to retire debt with future obligations up to $1.1B from $300M. The dollar amount of new leases nearly doubles prior lease obligations which should become a headwind for EPS. For the first three quarters of the year, the company has projected that the increase in lease expense would begin in the next quarter. However, lease expense is still flat, indicating it is being delayed and could be a material headwind in upcoming quarters.

- Debt is largely backed by Dr. Pepper assets which account for only half of the cash flow. So $13B in debt is supported by cash flow of $900M which is being boosted by payables stretching.

- Dr. Pepper is the bulk of intangibles. KDP is using a low 7.5% hurdle rate to value these assets. Dr. Pepper cash flows discounted at 8% amounts to $20B supporting $30B in intangibles. This is highlighted as a critical audit matter.

- KDP regularly adds back amortization expense and stock compensation expense to non-GAAP earnings. It has also failed to adjust out material one-time gains in the past.

- A minor hiccup in earnings could unwind leverage. Artificial FX boost, dependence on price increases, rising cash lease expense, increasing depreciation lives, rising capex, and a reversal of pantry stocking are all potential reversing tailwinds that could pressure earnings. It is also reliant on synergies for forecasts.

Main risks to thesis:

- KDP could benefit in the short run from lockdowns continuing to fuel pantry-stuffing.

RealPage (RP)- Concern

RP provides software to the property management industry which helps with such tasks as documentation, managing service requests and maintenance, procurement, and the management of senior communities. We believe RPs accounting is of poor quality and materially overstates the company's returns and profit growth. We see the potential for a 50%+ downside from the current price.

Problems with the bull story:

- There have been long periods where RP has not added new customers with organic revenue growth weak to non-existent. Reported growth has come from adding acquired services to existing customers. However, acquisition spending has not been covered by free cash flow.

- Many of the new services seem like "nickel and diming" tenants. For example, RP wants property managers to charge for parking and using trash bins, or installing soda machines. Managers have to wait until lease renewal to add many of these items. There are also legal limits on how much rents can be raised on renewal and these new items count towards the limit. If parking is free in the current lease, charging for it adds to the total cost and can butt up against the limit. More importantly, it may drive tenants away.

- RP's accounting eliminates most of the cost of its acquisitions. Acquired assets are mostly booked in goodwill where they are not amortized. For intangibles that are amortized, RP uses estimated lives that are longer than comparable assets developed in-house. The company adds back amortization to non-GAAP earnings anyway, so none of the costs of these deals is being reflected in adjusted results.

- Acquisitions allow RP to keep product development spending low by picking up technology from acquired companies. This makes ignoring the costs of acquisitions more misleading. However, RP noted in the 3Q call that it will be less active on the acquisition front in 2021. This may improve earnings quality, but it will eat into growth and likely result in materially higher product development costs which it will not be able to add back to non-GAAP results.

- Deferred revenue is declining. Deferred days have fallen from the 60s to the 40s over the last two years. Deposits received from customers' tenants were down in 3Q but there was no drop in residential services revenue. This could be a risk for 4Q.

- Restructuring charges are getting larger and are added back to non-GAAP results.

- RP appears to have under-invested in equipment for years. Capex is now rising, and depreciation may become a headwind.

Main risks to thesis:

- RP is considered a tech stock and it can run when that sector is climbing.

- COVID has driven demand for online leasing and rent collection. More lockdowns could be a short-term boost to the stock.

Mondelez International (MDLZ)- Concern

MDLZ is a major packaged food company with key brands including *Oreo, Cadbury, Trident*, and *Tang*. We have been skeptical of the quality of MDLZ's reported results since it was spun-off during the Kraft Foods perpetual restructuring fiasco years ago. Difficult comps in the packaged food industry is one of our macro short themes for 2021 and MDLZ is a key target given one-time boosts, reliance on price increases, tight cash flows after dividend and buyback, and artificial FX benefits boosting non-GAAP organic growth figures.

Problems with the bull story:

- MDLZ is pushing price hikes well ahead of cost inflation. Large retailer customers are likely taking notice and it may become more difficult to push future hikes through. We estimate this could have added 2 cps to earnings in 3Q.

- Meanwhile, cost inflation is rising again, and management is indicating possible lower gross margin growth in 4Q.

- Marketing is about $300 million per quarter. MDLZ benefitted from cutting spending in 2Q and 3Q and stocking the channel. Now it is increasing spending again. Every 6% change of the $300 million quarterly marketing spend is worth about 1 cps in EPS.

- Sales growth slowed in 3Q despite a 1% boost from channel stocking. Comps get tougher going forward and the COVID boost is losing steam.

- Cash flow remains tight and barely covers the dividend plus share repurchases. This is despite the company stretching payable to nearly 130 days of sales and factoring receivables.

- For some time MDLZ's organic sales growth figures have received an artificial boost from adjusting out the negative impact of currency devaluation in Latin America while the associated inflation-induced price increases remain. In 3Q, Latin America registered 3.1% organic growth as volume *declines* of 5.1% were offset by 8.1% price

increases. After adjusting for this impact, total company reported organic sales growth of 4.4% falls to 3.0%. Management is even beginning to call this out as being an artificial source of growth.

Main risks to thesis:

- The company lowered guidance for 4Q, so an earnings beat is possible. However, risks for 2021 remain.

- While most of the company's sales face tough comps as COVID pantry stuffing laps, this could be offset some by a recovery in travel driving gum sales.

Sealed Air (SEE)- Concern

SEE provides food and product packaging solutions. In our view, the company has produced less than impressive growth over the last few years which featured an environment of growing online shipping. We have several concerns we expect to impact the near future.

Problems with the bull story:

- SEE has benefitted from taking pricing greater than cost inflation. Under its deals with customers, SEE is allowed to recover cost inflation, but the net of price and costs end up at zero over time. SEE has given guidance for several quarters in a row that this price/cost metric would be a sizeable headwind to EPS and then beat forecasts when it was instead a tailwind. This is a rubber-band that has been stretched over and over now and we expect it to reverse going forward.

- The IRS has a dispute over a $1.49 billion tax deduction SEE took several years ago. The disclosure in the filings has changes in recent quarters that it may be resolved within 12 months.

- SEE's organic growth is inflated because of hyperinflation in South America. They are taking sizeable pricing there to boost organic growth against negative volume. However, the FX loss normally exceeds the pricing gain and the FX is the only reason pricing was taken in the first place. South America is only 5% of sales and removing its price hikes from the mix – SEE is not reporting much growth at all. Yet this is supposed to be a huge beneficiary of people buying products online and having them shipped and people eating more fresh protein as it makes the packaging for those items.

Iron Mountain (IRM)- Concern

IRM is a REIT focusing on document storage, information management, digital transformation, and document destruction. In our view, the quality of IRM's reported results are weak as many recurring cash costs are added back to arrive at AFFO (adjusted funds from operation). Traditional free cash flow does not cover the dividend, implying more borrowing to sustain it while a realistic debt/EBITDA is closing in on 7x. We see a potential 30%+ downside from the current price.

Problems with the bull story:

- Reported AFFO covers the dividend at 120%, but traditional free cash flow did not cover the dividend in 2020 due to add-backs of cash costs.

- Intake costs and withdrawal fees are capitalized and amortized over 3 years and 7 years, respectively. These costs are all added back to AFFO and together amount to more than 2%.

- Finance leases inflate income and AFFO as only interest expense is reflected. Depreciation and is added back and amounted to 2% of AFFO and the principal payment is ignored which was 7% of AFFO. This nets to 5.5% of AFFO (if principal payment was made, there wouldn't be depreciation).

- Stock compensation is ignored which is 5% of AFFO.

- Maintenance capex is running $20-$40 million below guidance.

- Acquisition costs, restructuring expenses, and commissions are cash costs and are being added back as "one-time". This spending runs $60-$100 million every year and every $10 million is worth 1% of AFFO.

- All our adjustments to AFFO reduce YTD AFFO by 26%.

Main risks to the thesis:

- IRM has a reputation as a defensive stock and could outperform in a downturn until the debt load catches up with them.

Macro Themes for Stocks to Avoid in 1H’21

Consumer Food Companies already losing tailwinds – MDLZ, KDP, GIS, CAG

- COVID meant they did not have to advertise which saved money. This will reverse.

- They had enormous channel-stocking after panic buying which resulted in them outselling consumer sell-through in 3Q.

- Grocery stores are emphasizing lower pricing for customers and private-label brands.

- Branded companies require price hikes to grow. They were seeing more disappointments than beats before COVID. They are already seeing growth stall now.

- COVID helped them retire some debt, but balance sheets are still not great.

Negative Impact of Graphic Packaging and Menthol Bans on Cigarettes – MO, PM, BAT

- 2021 is when the new graphic packages for cigarettes are expected to start

- Graphic packaging was mandated by the courts 10-years ago and it was the courts that required the FDA to create the plans going into effect soon.

- Sales have gapped down everywhere after the graphic packaging began.

- Menthol has been the one bright spot for tobacco sales in recent years. However, Europe has banned menthol and several US cities have as well plus Canada. California just did too.

- FDA is also studying cutting the nicotine levels in cigarettes – which they project would cut smoking rates by 40% in a few years.

- Despite vaping, IQOS, and other devices – the tobacco companies still rely almost solely on cigarettes for their actual cash flow.

- Companies have squandered billions of borrowed dollars on acquisitions.

- If gasoline prices recover more – that's a headwind for cigarette purchases too

- States are raising cigarette taxes too – and that hurts volumes

Ali Baba (BABA) – Unusual Structure

- The Chinese do not allow foreigners to own telecom/tech businesses in China

- BABA has a structure that several Chinese nationals own the actual shares of BABA who borrowed the money to buy the shares from wholly-owned entities of BABA. These notes can be called at any time.

- The shares in the US actually own holding companies in the Caribbean who have ties back to the Chinese entities. It effectively skirts the Chinese law, which has not been tested in court.

- China could easily see that the company is effectively more than 50% controlled by foreign investors and change the rules.

- Most of the transactions are in Chinese currency, but it has US dollar debt and shares. The FX could be a problem and China limits dividends out of the country.

Earnings Quality Will Matter Again

Companies posing results 40% or more ahead of guidance have been commonplace as COVID led to companies withdrawing guidance and Wall Street conservatively baking worst-case scenarios into their models. In such an environment, finding companies that are meeting expectations by leaning on accounting games to squeeze out another 5-6 cps has

become less relevant. However, as conditions normalize in 2021, quality will begin to matter again. Examples of situations to watch for include:

- Many companies have maintained higher-than-normal bad debt allowances to reflect concerns with customers struggling with COVID. We will be watching for signs of reversing those reserves in 4Q'20 and 1Q'21.

- Many consumer products and packaged food companies that were seeing inventories build to concerning levels before COVID received a reprieve as they were able to "clean house" in the rush for pantry stocking. Examples include CAG, CL, KMB. Lower-than-expected demand or poor management will become more visible as the year wears on.

Explanation of EQ Rating Scale

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

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

Key Points to Understand About the EQ Score

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

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

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