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The Scotts Miracle-Gro Company (SMG)
Earnings Quality Review

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are initiating earnings quality coverage of SMG with a 4- (Acceptable) rating.

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

Summary

SMG is a leading provider of lawn and gardening products. In addition, approximately 30% of revenue is generated by the company's Hawthorne division that provides supplies for hydroponic farming which is currently benefitting from the trend towards legalized cannabis.

Overall, the company's earnings quality is acceptable. It does not engage in excessive non-GAAP adjusting of results. However, we do have some concerns regarding a buildup in finished goods inventory and note that recent results have received a material boost from unusual items.

What is weak?

- Finished goods inventory has spiked in the last two quarters. The company utilizes FIFO inventory accounting which matches older, lower-cost inventory against current sales. SMG took price increases in August which it admitted were behind the curve in matching rising costs. More price increases are in effect in January. It is possible that March quarter results may benefit from expensing older inventories against revenue driven by the price increases. However, this could wane quickly as the company begins expensing the inventory with higher costs.

- Payables have been rising for two years driven not only by rising inventories but also by extending payment terms on suppliers. Days payable stood at 89 days at the end of the 9/21 quarter, up from 49 days two years ago. Any unwinding of payment terms could derail cash flow forecasts next year.

- The inventory reserve jumped noticeably in the 9/20 quarter indicating an unusually high charge which we estimate could have added 23 cps to growth in the 9/21 quarter.

- Lower share-based compensation added about 8 cps to earnings growth in the 9/20 quarter.

What to watch

- The allowance for doubtful accounts jumped in the 9/21 quarter which we estimate could have cost the company about 13 cps in growth. The reserve now stands at 3.4% of receivables which is well above its historical norm of closer to 1.5%. Investors should be watching for an artificial benefit to future quarters from a takedown of that reserve.

- About 3% of revenue and over 10% of profits are generated by the company's licensing deal with Monsanto for the marketing and sale of Bayer/Monsanto's *Roundup* weed control products. Bayer announced last summer it will remove the key ingredient in *Roundup* in the consumer versions of its products in 2023 after well-publicized lawsuits alleging it is a carcinogen. It remains to be seen how this will impact sales of the product in the years ahead. The company accounts for the value of the agreement as an indefinite-lived asset which we do not consider realistic in the current environment. However, even if it was amortized over 10 years, the amortization would be immaterial to earnings.

- About 25% of revenue comes from the company's Hawthorne segment which has been providing a disproportionate share of growth driven by the growing cannabis market. While there is a trend towards legalization, this market is also subject to extreme volatility with oversupply, falling prices, and unpredictable regulation posing problems.

- SMG maintains a receivables financing facility. Receivables are kept on the balance sheet and we see no problems with distortion of cash flow at the moment although this should be regularly monitored.

- Minor business risks include significant customer concentration, with Home Depot and Lowes accounting for more than 40% of revenue. Likewise, investors should be aware that the Hagedorn family owns 26% of the outstanding shares.

Drivers of Recent Results

SMG's US Consumer segment, which comprises about 65% of revenue, has benefitted from the pandemic and to a lesser degree, the booming housing market as homeowners became more interested in landscaping and gardening. Another key driver of recent revenue growth is the trend towards legalization of cannabis which has boosted revenue at the company's Hawthorne segment (30% of revenue) which sells products for hydroponic (indoor) gardening. However, comps in the last two quarters have turned more difficult as seen in the following table showing revenue growth for the last twelve quarters.

	9/30/2021	7/03/2021	4/03/2021	1/02/2021
Revenues	$737.8	$1,609.7	$1,828.8	$748.6
growth rate	-17.1%	7.8%	32.3%	104.6%

	9/30/2020	6/27/2020	3/28/2020	12/28/2019
Revenues	$890.3	$1,492.7	$1,382.8	$365.8
growth rate	78.9%	27.5%	16.2%	22.7%

	9/30/2019	6/29/2019	3/30/2019	12/29/2018
Revenues	$497.7	$1,170.3	$1,189.9	$298.1
growth rate	14.7%	17.7%	17.4%	34.6%

Before the pandemic, growth was disproportionately coming from Hawthorne. For example, for the fiscal year ended 9/19, the company's total sales growth of 18% came from 8% sales growth at the core US Consumer segment (then 73% of sales) boosted by the 95% growth in the Hawthorne segment (then 20% of sales). Sales growth weakened in the last two quarters as conditions have begun to normalize in the consumer market post-pandemic. In addition, growth at Hawthorne turned negative in the 9/21 quarter both from difficult comps and the impact of reported oversupply of cannabis in California. This led management to guide for flat revenue growth in 2022, calling for negative volume growth to be offset by pricing growth. However, management all but admitted that it expects growth to exceed this level given trends seen in the early months of the fourth quarter.

With regards to profitability, rising costs, lower revenue growth cutting expense leverage versus a year ago, and a shift in sales to the lower-margin Hawthorne segment have all taken their toll on margins. The following table shows a common size statement for the last twelve quarters:

	9/30/2021	7/03/2021	4/03/2021	1/02/2021
Adjusted Gross Profit Margin	17.4%	30.8%	36.6%	26.7%
SG&A Expenses %	21.8%	12.1%	12.7%	20.9%
Adjusted Operating Margin	-4.6%	18.8%	24.0%	5.9%

	9/30/2020	6/27/2020	3/28/2020	12/28/2019
Adjusted Gross Profit Margin	24.3%	36.1%	40.0%	14.9%
SG&A Expenses %	23.0%	15.9%	14.1%	32.8%
Adjusted Operating Margin	1.0%	20.1%	25.8%	-17.7%

	9/30/2019	6/29/2019	3/30/2019	12/29/2018
Adjusted Gross Profit Margin	18.5%	36.2%	39.8%	12.4%
SG&A Expenses %	27.9%	14.2%	15.1%	39.0%
Adjusted Operating Margin	-9.7%	22.1%	24.5%	-26.5%

The huge YOY decline in gross margin in the 9/21 quarter is accentuated by the unusually strong revenue growth in the 9/20 quarter which improved fixed cost absorption in the year-ago period. When viewed next to the more normal 9/19 period, gross margin, while still down, does not look as out of place. Still, the impact of higher costs and lower sales can clearly be seen in the decline in profitability. Management initiated a price increase in August but admitted it was behind the curve in matching cost increases. Another “high single-digit” price increase is set to take effect in January which is expected to help mute the impact of higher costs in 2022.

As a result of the above factors, the company is guiding to 2022 EPS of $8.59-$8.90, down from the non-GAAP 2021 actual EPS of $9.19.

Buildup in Inventory and Payables

SMG’s inventory skyrocketed last quarter. The following table shows inventory DSIs for the last twelve quarters:

	9/30/2021	7/03/2021	4/03/2021	1/02/2021
Total Inventory	$1,126.6	$962.8	$1,019.2	$1,068.3
DSI	163.9	78.6	79.2	180.0

	9/30/2020	6/27/2020	3/28/2020	12/28/2019
Total Inventory	$621.9	$493.1	$743.3	$866.1
DSI	87.6	46.5	81.2	247.4

	9/30/2019	6/29/2019	3/30/2019	12/29/2018
Total Inventory	$540.3	$533.7	$675.3	$745.4
DSI	123.1	65.0	85.6	254.5

During 2020, the company struggled with keeping inventory as high as it needed due to outsized pandemic demand. Therefore, we believe it is more meaningful to compare current numbers to the 2019 time frame. Also keep in mind that the large degree of seasonality in the company's operating model leads to volatile sequential movements in inventory, with DSI notably higher in the September and December off-season quarters. With that in mind, we see that DSI jumped to 78.6 in the 6/21 quarter versus 65.0 in the 6/19 quarter. However, the YOY increase was much more pronounced in the 9/21 quarter which jumped 40 days over the 9/19 quarter to 163.9. We can also see in the table below that the bulk of the increase in DSI came from a buildup in finished goods:

	9/30/2021	7/03/2021	4/03/2021	1/02/2021
Finished Goods DSI	115.5	54.3	55.1	129.5
Raw Materials DSI	35.3	18.0	18.5	36.4
Work in Process DSI	13.1	6.3	5.6	14.2
DSI	163.9	78.6	79.2	180.0

	9/30/2020	6/27/2020	3/28/2020	12/28/2019
Finished Goods DSI	55.0	29.0	56.8	174.0
Raw Materials	23.2	11.9	17.0	50.8
Work in Process	9.4	5.5	7.4	22.6
DSI	87.6	46.5	81.2	247.4

	9/30/2019	6/29/2019	3/30/2019	12/29/2018
Finished Goods DSI	78.6	43.7	59.6	179.0
Raw Materials	30.0	14.5	18.0	50.3
Work in Process	14.5	6.8	8.1	25.2
DSI	123.1	65.0	85.6	254.5

The buildup in finished goods inventory could be a result of slower than expected sales in either the Consumer segment, the Hawthorne segment, or a combination of the two. Remember that

Consumer sales will be negligible in the December quarter due to seasonality while Hawthorne should not seasonally weaken as much. If Hawthorne sales are strong in December and finished goods come down, it would indicate that the finished goods were more skewed towards Hawthorne. However, if finished goods remain elevated in December, it would be a strong indication that the finished goods are skewed towards the Consumer segment. SMG utilizes the FIFO (first in, first out) method of inventory accounting which matches older, lower-cost inventory against current sales. With the company increasing prices in January, margins could benefit in the March quarter as these higher revenues match against the older inventory. This benefit would quickly fade by summer as inventory was rebuilt at higher cost.

The huge jump in inventory has taken its toll on cash flow. Cash from operations fell to $271.2 million in the year ended 9/21, down from $558 million the year before. This was partly due to the payment of variable compensation earned in 2020 being deferred until 2021. However, the main culprit was a $496 million drain from inventory which was softened by a $202 million jump in payables. Management noted that the jump in payables was accentuated by lengthening payment terms with suppliers. However, payables have been increasing for two years as seen in the following table showing days payable for the last twelve quarters:

	9/30/2021	7/03/2021	4/03/2021	1/02/2021
Trade Accounts Payable	$609.4	$467.9	$549.9	$498.9
Trade Accounts Payable Days	88.7	38.2	42.7	84.1

	9/30/2020	6/27/2020	3/28/2020	12/28/2019
Trade Accounts Payable	$391.0	$310.5	$324.7	$309.4
Trade Accounts Payable Days	55.1	29.3	35.5	88.4

	9/30/2019	6/29/2019	3/30/2019	12/29/2018
Trade Accounts Payable	$214.2	$222.6	$298.7	$237.0
Trade Accounts Payable Days	48.8	27.1	37.9	80.9

Days payable skyrocketed from 55.1 in the 9/20 quarter to 88.7 in the 9/21 period. However, the 55.1 figure from a year ago was already up 6 days from the 9/19 quarter. Management is looking for free cash flow in 2022 to rebound to $300 million from 2021’s $165 million. However, any unwinding of the company’s ability to stretch its suppliers could confound the company reaching that goal.

Earnings Quality Factors

We see SMG as having acceptable earnings quality overall. Management has admittedly given conservative guidance for FY22 and is focusing investor attention on big picture, longer-term growth objectives. Nevertheless, there are a couple of items worth taking into consideration when reviewing the results over the next couple of quarters.

Inventory Reserve Decline

SMG reports its reserve to adjust inventory to net realizable value which is shown below as a percentage of net inventory for the last twelve quarters:

	9/30/2021	7/03/2021	4/03/2021	1/02/2021
Total Inventory	$1,126.6	$962.8	$1,019.2	$1,068.3
Adjustments to Reflect Inv. at Net Realizable Value	$22.5	$21.3	$21.4	$23.9
% of Net Inventory	2.0%	2.2%	2.1%	2.2%

	9/30/2020	6/27/2020	3/28/2020	12/28/2019
Total Inventory	$621.9	$493.1	$743.3	$866.1
Adjustments to Reflect Inv. at Net Realizable Value	$31.3	$13.9	$12.5	$11.4
% of Net Inventory	5.0%	2.8%	1.7%	1.3%

	9/30/2019	6/29/2019	3/30/2019	12/29/2018
Total Inventory	$540.3	$533.7	$675.3	$745.4
Adjustments to Reflect Inv. at Net Realizable Value	$8.8	$9.4	$8.1	$8.3
% of Net Inventory	1.6%	1.8%	1.2%	1.1%

The company did cite higher inventory adjustments related to the consumer segment in its discussions of results during FY 2020 (ended September). However, it looks as if most of the increase was concentrated in the 9/20 quarter which saw the reserve more than double. The reserve normalized in FY 2021. Nevertheless, YOY profit growth in the 9/21 quarter appeared to benefit from a lower charge to inventories. If the reserve had remained a more normal 2.5% of inventory in the 9/20 quarter, then profits in that quarter would have been almost $16 million (23 cps) higher than reported and taken away a meaningful tailwind to reported growth in the 9/21 quarter.

Lower Share-Based Compensation

A decline in share-based compensation added almost 8 cps to earnings in the 9/21 quarter. The trend in share-based compensation for the last eight quarters can be seen in the following table:

	9/30/2021	7/03/2021	4/03/2021	1/02/2021
Share Based Compensation	$6.6	$8.2	$17.6	$8.2

	9/30/2020	6/27/2020	3/28/2020	12/28/2019
Share Based Compensation	$16.1	$22.8	$12.0	$7.0

This is the second quarter of significantly lower YOY share-based compensation due to an increase in the expected payout percentage on long-term performance-based awards in the year-ago period. The tailwind from lower share-based compensation should fade in the 1/22 quarter but the 4/22 period should benefit from another easy comparison after which the benefit should disappear.

Increase in Bad Debt Allowances- Watch Future Quarters for Takedown

We noticed an unusual jump in the allowance for doubtful accounts in the 9/30 quarter. As shown in the following table the allowance for doubtful accounts jumped dramatically on both an absolute basis and as a percentage of gross receivables:

	9/30/2021	7/03/2021	4/03/2021	1/02/2021
Gross Receivables	$500.2	$1,068.9	$1,242.7	$353.4
Allowance for Doubtful Accounts	$16.8	$10.9	$12.4	$6.8
Allowance % of Gross Receivables	3.4%	1.0%	1.0%	1.9%

	9/30/2020	6/27/2020	3/28/2020	12/28/2019
Gross Receivables	$482.3	$983.4	$1,002.2	$196.9
Allowance for Doubtful Accounts	$7.5	$13.3	$7.5	$4.2
Allowance % of Gross Receivables	1.6%	1.4%	0.7%	2.1%

We estimate that the increase in the allowance percentage relative to the year ago September quarter cost the company about 13 cps in earnings in the quarter. We did not see an explanation for the jump, but we will be watching future quarters for signs of an artificial benefit from writing the reserve back into earnings.

Equity Income in Unconsolidated Affiliates

In 2021, SMG acquired a 50% interest in Bonnie Plants from the Alabama Farmers Cooperative (AFC) which it now accounts for as an equity investment. Before 2021, SMG earned commissions and reimbursement for certain marketing, R&D, and ancillary services performed for Bonnie which were recorded in sales and cost of sales. Also, before the acquisition, SMG made a term loan to Bonnie for $72 million.

The investment in Bonnie is now accounted for as an equity interest with SMG recording its proportionate share of the profits in “Equity Income of Unconsolidated Affiliates” on the income statement. For the nine months ended 9/21, equity income amounted to less than 5% of total adjusted net income. Nevertheless, this line should be monitored for unusual gains out of line with the company’s core business every quarter.

Exposure to Glyphosate via Monsanto Arrangement

SMG is the exclusive agent of Monsanto for the marketing and distribution of certain consumer *Roundup* products in the US and specified other countries. The two companies regularly restate the arrangement under which the deal operates and they are currently on the “Third Restated Agreement” which was struck in August of 2019. The key terms of the deal are as follows:

- SMG receives a commission of 50% of earnings before interest and taxes (EBIT) generated by Monsanto’s consumer Roundup business. Before the 2019 Agreement, SMG received a commission of 50% of EBIT *in excess of $40 million*.

- SMG must also make annual payments to Monsanto of $18 million to help cover program expenses. This payment is subject to a reduction in any year in which EBIT does not equal or exceed $36 million. These expenses are netted against commissions and reported in SMG’s revenue line.

- SMG performs other services related to the agreement which are reimbursed by Monsanto. These amounts are included in the calculation of net commissions and reported on SMG’s revenue line.

- SMG can terminate the deal with no termination fee upon the insolvency of Monsanto.

- If Monsanto (or its successor) terminates the deal as a result of selling the *Roundup* brand or a change of control of Monsanto, it must pay SMG the greater of $175 million or four times the average EBIT for the last three years less $186.4 million.

- Monsanto can terminate the deal with no termination fee if it decides to decommission the *Roundup* brand. In this case, Monsanto must pay a $375 million termination fee to SMG.

- Either party may terminate the deal without penalty if EBIT falls below $50 million.

- In connection with the Third Restated Agreement, SMG sold assets to Monsanto related to the development and sale of certain lawn and garden care products not related to *Roundup* for $115.5 million.

The following table shows the components of the net commission generated by the Monsanto agreement relative to total sales and operating profit.

fiscal year ended September:	2021	2020	2019	2018	2017	2016
Gross Commissions	$94.0	$90.4	$58.4	$80.5	$87.7	$97.9
Contribution Expenses	-$18.0	-$18.0	-$18.0	-$18.0	-$18.0	-$18.0
Amortization of Marketing Fee				-$0.8	-$0.8	-$0.8
Net Commission	$76.0	$72.4	$40.4	$61.7	$68.9	$79.1
Reimbursement Under Roundup Agreement	$70.8	$61.6	$73.4	$54.5	$56.1	$55.8
Total Net Sales Under Roundup Agreement	$146.8	$134.0	$113.8	$116.2	$125.0	$134.9
Total SMG Sales	$4,924.9	$4,131.6	$2,857.9	$2,663.4	$2,642.1	$2,506.2
Total Net Sales Under Agreement % of Revenue	3.0%	3.2%	4.0%	4.4%	4.7%	5.4%
Total Adjusted SMG Operating Profit	$752.2	$602.1	$422.8	$351.7	$438.3	$402.1
Net Commissions % of Operating Profit	10.1%	12.0%	9.6%	17.5%	15.7%	19.7%

Note that in 2019, Monsanto agreed to reimburse the company for $20 million of additional expenses. Also, note that the 2019 agreement included the divestiture of certain non-*Roundup* brands which drove the decline in net commissions in that year.

We note that SMG investors should be aware of ongoing developments with *Roundup*. The key ingredient in *Roundup* is glyphosate which has been the source of much controversy as an alleged carcinogen. Bayer/Monsanto have been the target of ongoing legislation for years as a result. While SMG is protected from direct exposure to litigation through indemnification arrangements, weakness in future sales of *Roundup* will obviously materially impact the company.

Last summer, Bayer announced that it will be phasing out the sale of products containing glyphosate into the consumer market by 2023. Bayer is apparently not looking to discontinue the brand, but likely reformulate the consumer version of the product. It is beyond the scope of an earnings quality review to assess the effectiveness or consumer uptake of a reformulated *Roundup*, although the skeptic in us wonders if taking out the key ingredient in a product can do anything but weaken the brand's appeal to consumers who have used it for years. It is worth noting that while SMG continues to proclaim the safety of glyphosate, it did remove it from its own brand of non-selective weed killer in 2018. In general, there are other non-glyphosate products on the market, but nothing we have seen matches the cost and effectiveness of glyphosate. It remains to be seen how well a reformulated *Roundup* will fare in those conditions.

SMG carries the value of the Monsanto agreement on the balance sheet as an indefinite-lived intangible valued at $155.7 million. Given the cancellable nature of the deal and the glyphosate overhang, we believe it is somewhat optimistic to declare the asset infinite. However, even if it was amortized over ten years, it would only amount to $0.22 per share in annual amortization expense for a company that earns well over $6.00 per share.

Cannabis Exposure

Over the last few years, SMG has become one of the leading "pick and shovel" plays for the legal cannabis industry. Through a series of acquisitions over the last several years, SMG's Hawthorne division has become a major player in the hydroponic gardening industry. Hydroponic gardening is the cultivation of plants indoors and requires special equipment and nutrients. The following table shows Hawthorne's contribution to total SMG sales and profits for the last three years:

fiscal year ended September:	2021	2020	2019
Sales			
US Consumer	$3,197.7	$2,883.5	$2,311.7
Hawthorne	$1,424.2	$1,023.1	$640.6
Other	$303.1	$225.0	$203.7
Total Sales	$4,925.0	$4,131.6	$3,156.0
Operating Profit			
US Consumer	$726.7	$694.3	$526.7
Hawthorne	$163.8	$111.9	$54.6
Other	$42.1	$11.7	$10.3
Total Operating Profit	$932.6	$817.9	$591.6
Operating Margin			
US Consumer	22.7%	24.1%	22.8%
Hawthorne	11.5%	10.9%	8.5%
Other	13.9%	5.2%	5.1%
Company Operating Margin	18.9%	19.8%	18.7%

US Consumer has enjoyed strong growth in the last two years as the pandemic and booming home prices prompted people to spend more time and money on their landscaping and gardening. This has set the stage for difficult comps, and the last two quarters have experienced negative YOY growth.

Despite strong growth in US Consumer, Hawthorne has been the real growth source in recent years, growing from 9% of operating profits in 2019 to almost 18% in 2021.

In addition to the Hawthorne segment, SMG has cannabis exposure through its new Hawthorne Collective subsidiary which makes minority non-equity investments in the cannabis industry. In August it made its first investment, a 6-year convertible note issue to RIV Capital. RIV is a Canadian cannabis investment firm listed on the Canadian Securities Exchange. The notes only yield 2% and will have an immaterial impact on the company's results. However, the conversion feature of the notes would give SMG a 42% interest in RIV. As part of the deal, RIV increased the size of its Board from four to seven with the three additional spots filled by nominees of SMG. SMG does not have day-to-day control of RIV. The Hawthorne Collective essentially gives SMG exposure to certain areas of the cannabis industry without being directly involved in the production of cannabis or taking an ownership investment in the industry in the US before cannabis is made legal at the federal level.

We do not have a strong opinion regarding the outlook of the cannabis industry. It is quite possible that more states will move to legalization and we would not rule out legalization at the federal level at some point. However, the industry has been very volatile. Legalization has led to huge growth spurts only to be followed by issues with regulation, taxation, and oversupply leading to lower prices. There is talk that the California market is currently oversupplied by a factor of 3 which had led to a fall in demand for hydroponic equipment. We also know that Altria's (MO) joint venture Cronos has regularly suffered from negative gross profits due to lower prices and inventory writedowns.

Receivables Facility

SMG maintains a receivables repurchase agreement under which it sells receivables generated by three specific customers to the related purchasers and agrees to buy them back weekly. This allows the company to accelerate the receipt of cash as a form of very short-term financing. As a result of the requirement to repurchase the receivables, the company accounts for them as short-term debt and keeps the receivables on its balance sheet. This does not allow it to hide the buildup of receivables by selling them and moving them out of the receivables balance. SMG has not been an aggressive user of the facility and the balance of borrowings on receivables pledged as collateral fell to 0 in the last two quarters as seen in the table below:

	9/30/2021	7/03/2021	4/03/2021	1/02/2021
Borrowings on Receivables Pledged as Collateral	$0	$0	$160	$136

	9/30/2020	6/27/2020	3/28/2020	12/28/2020
Borrowings on Receivables Pledged as Collateral	$20	$160	$160	$39

The facility should be monitored in future quarters for changes, but we are not as concerned with SMG's facility as we are with companies that remove material amounts of receivables from the balance sheet or accelerate the sale of receivables to third parties to boost cash flows.

Minor Business Risks

Customer Concentration

Home Depot and Lowe's account for about 40% of revenue with other big box retailers comprising much of the remainder. This could limit the company's ability to increase prices in the future.

Hagedorn Partnership, L.P

The Hagedorn family effectively owns 26% of outstanding shares. The late James Hagedorn was the inventor of the original *Miracle-Gro* fertilizer who merged the company with Scotts in 1995. James Hagedorn serves as CEO and Chairman of the Board while Chris Hagedorn serves as a Division President. We do not see this as a major risk although investors should be aware the high ownership effectively gives the family voting control which limits outside input.

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 Concern)- 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 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 upcoming quarters. 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.

Disclosure

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