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BTN Thursday Thoughts

Jeff Middleswart
Bill Whiteside, CFA
btnresearch.com

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"Open the pod bay doors, Hal…"
-from *2001: a Space Odyssey* (1968)

A Quick Note on Our Direction

Behind the Number's heritage is rooted in the analysis of earnings quality. It is, and will continue to be, the basis of both our sell and buy recommendations. Over the years, many clients have expressed a desire to see us expand our analysis to cover more of the companies they own. We are currently in the process of doing just that by publishing our *BTN Earnings Quality Reviews*. These reviews are not limited to companies where we find major problems in the accounting, but rather an overview of a company's results. We are building out a "watch list" of some of the most widely-held companies on which we will issue *Earnings Quality Reviews* every quarter after earnings are published. The below reports on TWTR, TMO, MDT and HD are examples of the scope of these future regular reviews. Next quarter, we will also introduce a scoring system that will make it easier for clients to

quickly gauge our level of concern on each these companies. At the same time, we will continue to monitor the universe of mid-cap and other large-cap names for companies and will bring problems to the attention of clients.

As the opening quote implies, we do not have tremendous faith in the ability of computers to totally replace human judgment anytime soon. As such, rest assured that our analysis will always be based on us reading the financial statements, conference call transcripts, talking to managements and searching for information in the pursuit of our goal of making sure the numbers match the story management is telling.

Twitter (TWTR)

When we heard Twitter was profitable for the first time and had a big free cash flow figure in 4Q17, we were skeptical of how sustainable that may be. We know it has been restructuring, but historically, Twitter was a cash-burning machine. This note is going to focus on accounting and sustainability of results. It won't comment on new Twitter features or apps and try to assess their popularity. We want to highlight three aspects of Twitter's business model.

First, it uses capital leases to finance much of its equipment. **Capital leases do not show up as capital spending** on the cash flow statement when they are initiated. This has the impact of boosting free cash flow (cash from operations less capital spending) when new equipment is financed with capital leases. Positive for Twitter – it does list the amount spent at the bottom of the cash flow statement and does subtract this form of capital spending from free cash flow when it provides adjusted cash flow statements.

When lease payments are made under a capital lease, only the interest expense is recorded on the income statement. The payment of principal is a scheduled and mandatory cash payment and is recorded in the financing section of the cash flow statement. Thus, earnings are inflated because the debt reduction under a capital lease is not recorded as an expense. Free Cash Flow is overstated because income is overstated and the cash payment is recorded neither in Cash from Operations or in Capital Spending. Negative for Twitter – it does not adjust free cash flow for this, although they do make it very easy to identify.

Second, the company makes acquisitions fairly consistently. The reason is it essentially helps them grow. The market demands changing content and capabilities and those items are not always something that Twitter can develop internally rapidly enough vs. buying a company that is already able to provide it. Twitter sees the risk of competitors taking over other companies and locking it out of a market, as well as losing business because it does not offer something in demand as key reasons why acquisitions play a big role in the business model. Twitter normally makes multiple acquisitions each year and historically paid the bulk of the purchase price in stock. Leaving out the risks of an acquisition not working as planned, or being too expensive – this is essentially a form of annual R&D spending for Twitter. Negative for Twitter – It made almost no acquisitions in 2017, which may hurt future results. Negative for Twitter – it does not account for even the cash portion of these recurring deals as a drag on free cash either.

Third, Twitter still relies heavily on using stock as a currency to pay for things such as wages and acquisitions. The stock has rallied but remains much lower than its high valuations. Paying with stock dilutes the current stockholders, which we will discuss later. It also poses a risk if people aren't willing to always take stock as currency – or even a risk if they take much less stock as currency. The difference needs to be made up in cash. Suddenly, much of the stock payments being added back as non-cash expense become cash payments and start to penalize cash flow.

Here is what Twitter Is Reporting for Cash Flow:

	2013	2014	2015	2016	2017
Cash from Operations	$1.40	$81.80	$383.10	$763.10	$831.20
Less Capital Spending	$75.70	$201.60	$347.30	$218.70	$160.70
Plus sales of Equipment	$0.00	$0.00	$0.00	$0.00	$2.80
Less Equipment purchased with Capital Leases	$155.70	$140.70	$31.20	$100.30	$123.20
Adjusted Free Cash Flow	-$230.00	-$260.50	$4.60	$444.10	$550.00

That's a big turnaround in a few years. The company was very proud of the $550 million figure on the conference call and were even asked about returning capital to shareholders. We think the real situation is not as rosy as what this table shows. We adjusted the table to include cash principal payments on capital leases and cash paid for acquisitions. We also looked at the total amount of expenses and capital purchases being paid for with common stock:

BTN Adjusted Cash Flow	2013	2014	2015	2016	2017
Cash from Operations	$1.4	$81.8	$383.1	$763.1	$831.2
Less Principal on Cap Leases	$70.4	$103.1	$117.5	$100.6	$102.8
Adj Cash from Operations	-$69.0	-$21.3	$265.6	$662.5	$728.4
Less Capital Spending	$75.7	$201.6	$347.3	$218.7	$160.7
Plus sales of Equipment	$0.0	$0.0	$0.0	$0.0	$2.8
Less Equipment purchased with Capital Leases	$155.7	$140.7	$31.2	$100.3	$123.2
Less Cash paid for Acquisitions	-$44.3 *	-$163.5	$62.1	$166.6	$0.8
BTN Adjusted Free Cash Flow	**-$344.7**	**-$527.1**	**-$175.0**	**$176.9**	**$446.4**
Wages paid in Stock	$600.4	$631.6	$682.1	$615.2	$433.8
Stock paid for Acquisitions	$331.8	$148.0	$516.5	$1.3	$0.0
Total paid with stock	**$932.2**	**$779.6**	**$1,198.6**	**$616.5**	**$433.8**

- Accounting titles were different on the cash flow statements of earlier 10-Ks, for 2013's cash acquisitions we added up the cash parts of each acquisitions from footnote 8.

In our view, the cash flow adjusted for the basic cash operating model shows free cash flow is more than $100 million below TWTR's adjusted figure. **Moreover, if the stock doesn't rise further, it becomes tougher to use as a currency – note that there were essentially no takers of TWTR stock for deals in 2016 and 2017**. At that point, paying all expenses in cash, a pro forma view of TWTR would have it essentially at zero for free cash flow in 2017 ($446.4 less $433.8) and most prior years, the company would have posted negative free cash flow of over $1 billion.

The other problem we see is even if you look at the $446.4 million number, it does not appear sustainable. The company reduced a number of expenses in 2017 and is already giving guidance for them to rise going forward:

Capital spending – "We anticipate making capital expenditures in 2018 of approximately $375 million to $450 million, a portion of which we may finance through capital leases, as we continue to expand our co-located data centers." That is the guidance in the 10-K. TWTR only spent $284 million in 2017, which was less than all years except 2013. That looks like a $100 million additional cash item for 2018.

Further evidence exists that this needs to rise considerably more. TWTR depreciates property and equipment very quickly: Computer hardware over 3-5 years, software up to 4 years, furniture is not as critical but up to 5 years. Only 4-years ago, hardware was being depreciated over 2-4 years and software 1-3 years, so **TWTR already**

extended the life of these assets. If this company is growing, it probably should not be seeing capital spending fall below depreciation. Essentially, it should be replacing 25%-33% of existing equipment and software and buying more to cover growth. However, **capital spending has already slipped below depreciation**:

	2015	2016	2017
Depreciation	$257.20	$332.80	$349.30
Capital Spending + Leases	$378.50	$319.00	$283.90

That would indicate that Twitter is already using much older equipment where life spans are being measured over only 1-5 years and competition is fierce. What also may point to this and the need for capital spending to rise considerably in the near future is **we think the reported depreciation expense figure is lower than it should be, indicating that Twitter is already using fully depreciated equipment.** We took the gross amount of the various PP&E items, used the prior year value to forecast a minimum depreciation figure – which is conservative as it assumes nothing purchased in the current year generates depreciation, and we used the maximum depreciable life for 100% of the assets. We believe depreciation should have been much higher in 2017:

	Gross PPE Amounts				*Estimated Min. Depreciation*		
$ in mm	2014	2015	2016	2017	2015	2016	2017
Equipment (5 yrs)	$584.50	$720.40	$909.80	$1,091.70	$116.90	$144.10	$182.00
Software (4 yrs)	$82.10	$211.20	$353.20	$472.10	$20.50	$52.80	$88.30
Furniture (5 yrs)	$131.90	$297.30	$304.60	$314.90	$26.40	$59.50	$60.90
Minimum Depreciation					$163.80	$256.40	$331.20
Actual Depreciation					$257.20	$332.80	$349.30

The company had a big cushion on this in 2015. If we depreciated equipment over 3 years and software over 2 years, the forecast essentially equaled the actual depreciation number of $262 million vs. actual $257 million. Using 5 years and 4 years for equipment and software, the 2017 forecast is equal to actual depreciation assuming only half the equipment bought in 2017 started to be depreciated over 5 years during 2017. The minimum figure surpasses actual $364 million vs. $349 million if deprecation on equipment is actually being run at 4.5 years and software at 3.5 years. We don't want to get too bogged down on minor number changes. If Twitter is due for a sizeable modernization effort – there is $1.56 billion in equipment and software here. There could be a sizeable catch-up outlay in 2018 or 2019 in addition to the scheduled capital spending.

Acquisitions – Can they go below zero? Twitter notes that its growth requires new products, new product features and new services developed by it and third parties be successful in retaining clients and adding new ones. We would expect a company that has spent $1.4 billion on deals from 2013-16 to add something going forward. This was one of the key growth paths laid out in the S-1 document. That is especially true after how little was spent in 2016 and 2017. Any spending above $800,000 will be a headwind in this area.

Research & Development – This has been cut significantly in recent years on top of fewer acquisitions, and that drove up income and cash from operations:

	2013	2014	2015	2016	2017
R&D Expense	$594.00	$691.50	$806.60	713.5	$542.00
R&D paid in stock	$379.90	$360.70	$401.50	$335.50	$240.80
R&D paid in cash	$214.10	$330.80	$405.10	$378.00	$301.20
Cash wage %	36%	48%	50%	53%	56%

Take note that just like acquisitions, people want more of their pay in cash from Twitter than in the past. Part of the restructuring efforts in 2016 and 2017 involved laying off research staff. R&D was 36% of sales in 2015 and was only 22% in 2017. We do not know what a sustainable level of investment here should be – 22% or 25% or 30% of sales? Twitter gave two comments about this on this subject – "really focused on investing to grow in 2018" and "expect expenses to more closely align with revenues in 2018." We would expect R&D to rise probably a bit faster than sales and be a higher percentage paid in cash. Assuming 5%-10% total R&D growth and 60% of it paid in cash – the cash costs would rise about $40-$55 million from 2017.

This view is supported by the company's guidance that wages will rise with revenues in 2018, but is guiding to stock compensation of $350-$450 million this year compared to $434 million in 2017 and $615 million in 2018. Overall, this is likely a good thing for shareholders and it does not impact earnings, but it would be a headwind for cash flow.

Advertising Cuts – Twitter advertises to gain new customers. Advertising has been falling for two years also in dollar terms and as a percentage of sales:

	2013	2014	2015	2016	2017
Advertising	$3.10	$46.60	$119.70	$114.30	$70.20
% of Sales	0.50%	3.30%	5.40%	4.50%	2.90%

On the surface, this looks like another $50 million headwind for TWTR on earnings and cash flow. It may actually be a little deeper than that. We noticed that accrued liabilities for publisher content and ad network costs declined from $44.4 million in 12/16 to $32.5 million in 12/17. Also, the company at times buys publishing and adverting relationships. It amortizes these purchases over 5-years. Twitter wrote off $43.8 million in gross carrying value of these assets last year as they were fully depreciated. The net carrying value of this area is now $2.5 million down from $19.9 million in 2016.

Bad Debt Reserves – Twitter has never had enormous bad debt expense, but the reserves are falling and driving expense down more:

	2013	2014	2015	2016	2017
Bad Debt Reserve %	0.80%	1.30%	1.30%	1.10%	0.80%
Bad Debt Reserve $	$2.00	$5.50	$8.10	$7.20	$5.40
Bad Debt Expense	$1.60	$4.60	$5.80	$4.00	$0.60

We won't call this very material, but this could be another $4-$5 million in headwind also looking at history.

Conclusion:

We think several areas point to cash flow being overstated – primarily capital lease payments. We also think many items point to rising cash outflows and rising expenses, making current cash flow and income levels unsustainable. Primarily we see the need for R&D and capital spending to rise faster going forward and the company may well need to make acquisitions. Moreover, the cash costs may be rising even faster as fewer people are showing that they want Twitter stock as currency. That could become a big problem as we estimate that actual free cash flow in 2017 was roughly equal to non-cash stock compensation and that's after a year of sizeable cuts to many other cash costs.

On the stock front, with people not wanting as much stock, dilution has been slowing considerably, so that is a positive:

	2013	2014	2015	2016	2017
Ending Shares Out	569.9	642.4	694.1	721.6	746.9
Y/Y growth	-	12.70%	8.00%	4.00%	3.50%

Twitter did file an S-8 in recent days for shares allocated for employee stock plans whereby employees can buy stock at a discount. We'll see if that becomes more popular. Only 1.7 million shares were purchased in 2017 down from 2.0 million in 2016.

Thermo Fisher Scientific (TMO)

What stands out immediately upon reviewing TMO's results is its long string of acquisitions over many years. We would not classify TMO as a true "roll up" in that it tends to do one or two good-sized deals a year rather than seeking to consolidate a stagnant industry by buying everything in sight. Nevertheless, regular acquisitions are a key part of the TMO story and any serial acquirer deserves attention. Typical red flags associated with serial acquirers include:

1) buying to mask lackluster growth in the core business
2) failure to integrate the acquisition profitably, leading to falling core returns
3) amassing excessive debt
4) taking huge charges to essentially write off huge parts of the acquired company, destroying value in the process

We evaluate TMO's acquisition history on each point below.

History of Deals for the Last Four Years

For reference, the below table shows the company's acquisitions since 2013 with prices paid and amounts allocated to goodwill and intangible assets broken up by customer relationships, product technology, tradenames and in-process research and development (IPR&D).

	Date	Price	Goodwill	Customer Relationships	Product Technology	Tradenames	IPR&D
2017 Acquisitions							
Pantheon	8/29/2017	$7,358.0	$3,255.0	$3,618.0		$112.0	
Core Informatics	3/2/2017	$94.0	$63.0	$6.0	$29.0	$3.0	
Finesse Solutions	2/14/2017	$221.0	$136.0	$68.0	$32.0	$2.0	$2.0
Other		$110.0	$64.0	$16.0	$35.0		
2016 Acquisitions							
FEI	9/19/2016	$4,082.1	$2,125.0	$1,051.0	$740.0	$42.0	$105.0
Affymetrix	3/31/2016	$1,341.8	$615.0	$501.0	$253.0	$46.0	$14.0
Other		$32.5	$16.0	$9.0	$7.0		
2015 Acquisitions							
Alfa Aesar	9/30/2015	$389.5	$125.1	$137.1		$15.6	
Advanced Scientific	2/15/2017	$288.8	$124.4	$90.0	$36.5	2.3.	
Other			$8.9	$7.9			
2014 Acquisitions							
Life Technologies	2/3/2014	$15,303.8	$7,167.0	$5,883.0	$2,626.9	$619.1	$58.4
Other		$35.8	$12.5	$7.0	$5.5		

Is TMO Buying Things Just to Boost Growth?

In short, this does not appear to be case at TMO. Reported revenue growth was 14% in 2017, but this was backed by a solid 5% organic growth with only a slight impact from currency. Likewise, 2016 saw 8% reported growth backed by 4% organic growth, and 2015 saw 5% organic growth being offset by a currency drag.

We are concerned when we see companies with no or even negative organic growth having to make acquisitions to post an increasing top line. TMO does not appear to fall into that category.

Is Value Being Created?

This is a little less clear for TMO. It is typical for serial acquirers to make promises of huge integration synergies leading to improving returns for shareholders. However, these promises are often never made good on, and shareholders instead experience eroding

returns on their capital. The following table calculates a simple pretax return on invested capital for TMO for the last four years:

	Year ended: 12/31/2017	12/31/2016	12/31/2015	12/31/2014
Adjusted Operating Income	$4,860	$4,222	$3,828	$3,695
Shareholders' Equity	$25,413	$21,539	$21,350	$20,548
Total Debt	$21,008	$16,628	$12,472	$14,564
Total Investment	$46,421	$38,167	$33,822	$35,112
Pretax ROI	**10.5%**	**11.1%**	**11.3%**	**10.5%**

We utilize the company's own adjusted operating income figure in the numerator which adjusts for one-time charges (more on that in the next section) and adds back amortization of intangible assets. While we do not necessarily agree with the concept of ignoring intangible amortization, it does serve to smooth out returns from period-to-period which is helpful in this exercise.

The first thing to note is that TMO's pretax ROI is being held down by both the numerator not including a full year's impact of the acquired businesses while the denominator is impacted by the full amount of new capital issued for the deals. Let's dig a little deeper and make some adjustments to the last three years to get an idea of the trajectory in returns.

In order to adjust for the partial contribution of acquisitions, we start with the pro-forma sales growth from the 2017 10-K which is adjusted to give the effect as if the Pantheon acquisitions had been made on January 1, 2016 and the FEI and Affymetrix acquisitions had been made on January 1, 2015. (referring to table 1 above shows these are the meaningful acquisitions made during those periods.)

	Year ended: 12/31/2017	12/31/2016	12/31/2015
Reported Sales	$20,918.0	$18,274.1	$16,965.4
Adjusted Operating Income	$4,860	$4,222	$3,828
TMO Reported Adj Op Margin	23.2%	23.1%	22.6%
Pro forma sales	$22,144.0	$20,807.0	$18,230.0
Estimated Adjusted Operating Income	$5,144.84	$4,806.97	$4,113.02
Shareholders' Equity	$25,413	$21,539	$21,350
Total Debt	$21,008	$16,628	$12,472
	$46,421	$38,167	$33,822
Pretax ROI on Pro Forma Sales	11.1%	12.6%	12.2%

We then apply the reported adjusted operating margins for those years to the pro-forma sales to come up with an estimate of a full year's impact of the acquired sales in each period. We realize this is not perfect, but we believe it is a reasonable estimate. What we see is that the estimated pro-forma reported pretax ROI has actually declined over the last three years. To be fair, both the Pantheon and FEI acquisitions were made late in the year which does not allow for any integration synergies to kick in. Nevertheless, the downward trajectory in pro-forma adjusted ROI casts some doubt on how much value the company is creating for shareholders with its acquisition strategy. We will continue to monitor this trend going forward.

What About the Debt?

A third concern with serial acquirers is if they accumulate an unmanageable amount of debt. Again, this is not a major problem for TMO. In the case of TMO, net debt-to-EBITDA is about 3.7x which is itself not too alarming given the relative defensiveness of the company's business. More importantly, TMO generates about $3.5 billion in free cash and the dividend consumes less than $250 million, so the company could easily throttle back on acquisition activity and reduce debt quickly. Incidentally, this would also result in an increase in the total company ROI.

Are Charges Excessive?

TMO takes charges every year related to integrating acquisitions. The following table shows these charges by income statement line item:

Charges reported in:	Year ended: 12/31/2017	12/31/2016	12/31/2015	12/31/2014
Cost of revenue	$123	$102	$9	$328
SG&A	$78	$104	$46	$131
Restructuring & Other	$97	$189	$115	$162
Total	$298	$395	$171	$620

The detailed disclosure on these charges indicate they are for items such as headcount reductions, facility closures, transaction costs, charges to conform acquired companies to TMO accounting policies, and the sales of inventories revalued at the date of acquisition. When viewed relative to pre-charge operating income and the size of the acquisitions they are related to, they are not especially alarming. Also, they do not appear to include write-offs relate to past acquisitions that are already going sour, as so many serial acquirers so often have. We will continue to monitor the frequency, size and content of future charges, but are not particularly concerned by what the company has done to date.

Summary

In summary, while ROI trends show signs that the company's acquisitions over the last few years have not produced improved returns for the company, TMO's acquisition program does not exhibit many of the red flags often associated with serial acquirers such as excessive charges and write offs, unmanageable debt build up, and no underlying growth of the core business.

Medtronic (MDT)

A review of MDT's 1/18 results turned up a few items that are not overly-alarming but do warrant tracking in upcoming quarters.

Cash Flow Growth Should Improve, but Continuing to Watch Receivables and Inventories

At first glance, MDT's operating cash flow declined significantly in the twelve-month period ended 1/18 to $4.3 billion from $5.2 billion in the year-ago period. During this same time frame, EBITDA increased. This would ordinarily be a point of concern, but the company provided the following explanation in its 10/17 10-Q:

> "The $1.4 billion decrease in net cash provided was primarily driven by an increase in cash paid for income taxes of $416 million, funding of our retirement benefit plans of $170 million, cash paid for divestiture-related expenses of approximately $100 million, an increase in certain litigation payments of $96 million, net cash outflows for collateral related to our currency exchange rate derivative instruments, a decrease in cash collected from customers, and an increase in cash paid for inventory. The increase in cash paid for income taxes was primarily a result of tax payments related to the intercompany sale of intellectual property and sale of the Patient Care, Deep Vein Thrombosis, and Nutritional Insufficiency businesses as well as settlement payments for U.S federal income taxes for fiscal years 2012 to 2014 and audit settlements outside of the U.S. during the six months ended October 27, 2017.
>
> The decrease in net cash provided by operating activities related to the funding of our retirement benefit plans is due to timing of contributions; we made a contribution of $170 million in the second quarter of fiscal year 2018 whereas the prior year contribution was made in the second half of fiscal year 2017. *The decrease in cash collected from customers is partially attributable to reduced sales due to the July 29, 2017 sale of the Patient Care, Deep Vein Thrombosis, and Nutritional Insufficiency businesses. The increase in cash paid for inventory is partially attributable to higher inventory in the Cardiac and Vascular Group and Minimally Invasive Therapies Group related to new product launches and in Diabetes due to sensor supply constraints."*

The company had already predicted in FY 2017 that timing issues would result in a spike in FY 2017 cash flow followed by a dip in FY 2018. Original guidance was for a high single-digit increase in free cash flow from FY 2016 to FY 2018, and the company is on target to deliver on this.

The main concerns raised by the explanation in the 10/17 10-Q was the lower cash collected from customers and the higher inventories. Both of these issues seem to have begun to resolve themselves in the recently-reported 1/18 quarter, although continued monitoring seems warranted. The following table shows accounts receivable days of sales for the last six quarters:

	1/31/2018	10/31/2017	7/31/2017	4/30/2017	1/31/2017	10/31/2016
Sales	$7,369	$7,050	$7,390	$7,916	$7,283	$7,345
Accounts Receivable	$5,775	$5,752	$5,784	$5,591	$5,453	$5,661
Sales YOY growth	1.2%	-4.0%	3.1%	4.6%	5.0%	4.1%
Accounts Receivable YOY growth	5.9%	1.6%	8.0%	0.5%	12.1%	12.2%
Sales Seq growth	4.5%	-4.6%	-6.6%	8.7%	-0.8%	2.5%
Accounts Receivable Seq growth	0.4%	-0.6%	3.5%	2.5%	-3.7%	5.7%
Accounts Receivable DSOs	**71.5**	**74.4**	**71.4**	**64.4**	**68.3**	**70.3**

MDT divested its Patient Care, Deep Vein Thrombosis and Nutritional Insufficiency Business on 7/29/2017, the first day of the 10/31 quarter. We can see the sequential decline in sales, but there is not a corresponding decline in receivables, which led to the observed increase in days of sales on both year-over-year and sequentially. Given that the divestiture took place on the first day of the quarter, we would not have expected a significant movement in DSOs unless the DSOs at the divested business were significantly different that the rest of the company, which appears to be the case. MDT disclosed in its 10/17 10-Q the assets and liabilities of the divested business as of 4/28/17, and while it showed $371 million for inventories, there is no amount disclosed for any other current asset account, implying no receivables at that time. This is somewhat puzzling given management's comment above that cash flow was hurt by the lack of collection of receivables related to that business. Regardless, if receivables at the divested business were unusually low relative to sales, it would have the impact of increasing DSOs in the 10/17 quarter. Therefore, observed reduction in year-over-year increase in DSOs in the 1/18 quarter of 3.2 days from the 4.1 days seen in the 10/17 quarter indicates that there is not a problem with receivables.

On the subject of inventory, the following tables shows the calculation of days of inventory for the last six quarters:

	1/31/2018	10/31/2017	7/31/2017	4/30/2017	1/31/2017	10/31/2016
COGS	$2,191	$2,120	$2,349	$2,436	$2,268	$2,326
Inventory	$3,751	$3,638	$3,538	$3,338	$3,720	$3,717
COGS YOY growth	-3.4%	-8.9%	3.9%	3.1%	5.9%	6.6%
Inventory YOY growth	0.8%	-2.1%	-1.2%	-3.9%	5.2%	5.7%
COGS Seq growth	3.3%	-9.7%	-3.6%	7.4%	-2.5%	2.9%
Inventory Seq growth	3.1%	2.8%	6.0%	-10.3%	0.1%	3.8%
Inventory DSIs	**156.2**	**156.6**	**137.4**	**125.0**	**149.7**	**145.8**

As with receivables, we can see the almost ten-day year-over-year increase in the 10/17 quarter brought on by the 2.8% sequential increase in inventory on a near-10% sequential decline in COGSs. In the case of inventories, we know that the divested business had $371 million in inventory as of 4/17 and can assume a similar amount at 7/17. Therefore, the 2.8% sequential increase in inventories in the 10/17 quarter, despite the exclusion of those inventories, does indicate something was out-of-line and corresponds with management's explanation that inventories were elevated from gearing up for new product launches in addition to sensor supply constraints. The increase in inventory relative to COGS seems to stabilize in the 1/18 quarter, plus management did mention in the call that inventories were pushed up some due to a currency impact towards the end of the quarter. Nevertheless, we would have intuitively expected a more pronounced decline as the new product associated with the inventory build in the 10/17 quarter began to sell in the 1/18 quarter and if the sensor supply issue had resolved. Given the possible impact from currency, we are not that concerned about the issue, but we will be tracking this going forward, starting with reviewing the inventory components when the 10-Q for the 1/18 quarter is released. If the buildup is focused in finished product, it will heighten our level of concern.

Restructuring Charges

During FY 2015, MDT acquired Covidien for $50 billion. This huge acquisition spurred a large restructuring/integration program that is just now winding down. The following table shows the one-time charges that MDT takes out of its adjusted profit numbers:

	9 mos 1/18	FY 2017	FY 2016	FY 2015	FY 2014
Inventory Step Up		$38	$226	$623	
Restructuring Charges	$62	$373	$299	$252	$88
Acquisition/Divestiture-Related Items	$216	$230	$283	$550	$117
Adjusted Operating Income	$5,893	$8,351	$8,126	$6,002	$5,177

These charges included such items as severance costs and headcount reductions, facility closures, charges for conforming to company accounting policies, and charges for the settlement of retirement plans. We are always skeptical of ongoing restructuring charges and their impact on earnings quality, but in the context of integrating a $50 billion acquisition, the size of the charges themselves are not that concerning.

However, management has now announced the beginning of a new plan called the *Enterprise Excellence Program* which is expected to cost another $1.6-$1.8 billion over the next several years and eventually cut $3 billion out of the company's cost structure. Most of the costs are expected to be incurred by the end of 2022. The company has yet to give much detail on the plan. We will be watching developments there closely as it is ongoing, open-ended restructurings that, in our opinion, carry much potential for abuse.

Prepaid Expenses and Other Current Assets

We noticed that the company's "other current assets" account on its 1/18 balance sheet increased out-of-line with both sales and with the recent trend:

	1/31/2018	10/31/2017	7/31/2017	4/30/2017	1/31/2017	10/31/2016
Sales	$7,369	$7,050	$7,390	$7,916	$7,283	$7,345
Other Current Assets	$2,645.00	$2,246.00	$2,000.00	$1,865.00	$1,792.00	$1,891.00
Other Current Assets Days of Sales	**32.8**	**29.1**	**24.7**	**21.5**	**22.5**	**23.5**

This account contains several unrelated items including the value of its derivative contracts. We were able to confirm from SEC filings that derivative contracts were not behind the increases seen through the 10/17 quarter, but the 10-Q is not yet available for the 1/18 quarter. We tried to contact management to get more color on the increase but did not hear back in time for publication. The concern with a rising other asset account is that expenses have been capitalized and therefore delayed in running through the income statement, thus overstating earnings. Given the lack of visibility into what is driving the

increase, this needs to be taken with a grain of salt until we get more information on the increase.

Home Depot (HD)

A review of Home Depot's (HD) 1/18 fourth quarter earnings turned up no significant items of concern. We do note that despite strong cash flow, the company has chosen to take on debt to buy back shares:

	Year ended: 1/31/2018	1/31/2017	1/31/2016	1/31/2015	1/31/2014
Operating Cash Flow	$12,031	$9,783	$9,373	$8,242	$7,628
Capex	$1,897	$1,621	$1,503	$1,442	$1,389
Free Cash Flow	$10,134	$8,162	$7,870	$6,800	$6,239
Dividends	$4,212	$3,404	$3,031	$2,530	$2,243
Net Stock Repurchases	$7,745	$6,662	$6,772	$6,748	$8,305
Cash After Buyback	-$1,823	-$1,904	-$1,933	-$2,478	-$4,309

While we could debate whether or not some of that extra cash would have better served shareholders by being spent on a larger dividend, the company's low leverage and excess cash flow does not make the large buyback a concern as it does for some companies. (See the 1/4/2018 *BTN Thursday Thoughts* for a more detailed discussion of share buybacks.)

What we found interesting in the conference call was management's forecast for $4 billion in buybacks in 2018. This is roughly half the recent level of spending. Management forecast $14.1 billion in cash flow (which includes about $1.8 billion related to tax reform) and capital spending of $2.5 billion, implying free cash flow of about $11.6 billion. The dividend (which was increased by 16%) will take up about $4.8 billion. Take out the $4 billion minimum commitments for the buyback and that leaves almost $3 billion unaccounted for. Consider management's comment on the call:

> "So, based on the cash flow guidance that we've given you and the use of cash, you're like, **wow, you're going to have some leftover cash, and that's right, we are. And we are exploring what to do with that cash. And it could be additional share repurchases, dividends, pay back debt, build cash for the future, so on and so forth.** We're going to take our time to think through this thoroughly and once we determine what we will do with the cash, we will let you know. The $4 billion specifically is

> what we had on our Investor Day. So, we just kept that for the year and then we'll update you as the year continues."

Too much cash is always a good problem to have.

Ocean Yield – updates on several fronts.

Ocean yield reported of February 27 that it is acquiring five drybulk ships on long-term charter. That comes on top of two other drybulk purchases, four VLCC tankers and three Suezmax tankers all announced in recent weeks. With 14 new ships scheduled for delivery soon, we believe Ocean Yield has shown that it will grow income and cash flow for the foreseeable future.

The company filed to sell 11 million shares of common shares. Ocean Yield's largest shareholder – Aker Capital, will purchase half of those. The proceeds will be used to offset debt incurred to finance the new vessel purchases as well as boost cash early in the acquisition cycle to ensure deals are closed on time. The company agreed with our forecast that future dividend growth will occur as new ships are added, but at a slower rate closer to the growth in new charter earnings. Past dividend growth was driven by expanding a small fleet, so a few new ships generated a significant increase in cash flow and a rising payout ratio. The current base of ships makes that level of growth more difficult to sustain now and the payout ratio is unlikely to rise much further.

The *Lewek Connector* has gone through a drydock period between contracts and received some maintenance. It started its latest charter on February 20 at a substantially higher charter rate than the last deal. The new charter lasts for 130 days with an option for another 130 days. Ocean Yield is seeing an increase in interest for new work for this vessel well into the summer of 2019 at which time the company hopes to find a longer-term charter and lock in higher rates. This vessel should report higher results in the coming two quarters.

The *Dhirubhai* FPSO appears to be nearing an outcome. The CEO believes that it will most likely stay in India under three possible outcomes: it's charter will be extended on the current field, it can be transferred to a new charter by the same parties who are opening a new field in India that will use an FPSO and that decision is expected in 1Q18 or 2Q18, or the customers can buy the FPSO for $255 million.

Of our three largest concerns, two appear to have been resolved favorably. Those are fleet growth and the *Lewek Connector*. The last one for the FPSO should have answers within months. The company also sees other opportunities in India and elsewhere without the current team of Reliance and BP as charter partners, but given that team is expanding, the most likely outcome for the *Dhirubhai* will involve them.

Starwood Property Trust (STWD) Review of 4Q

The company was included on a widely published list of REITs last week saying it would suffer from rising interest rates. That is completely untrue. Starwood has actually been punished over time for being in ETFs and funds that bought or sold on interest rate concerns even though it operates very differently.

Rising interest rates helps earnings at STWD because 93% of its lending book is floating rate and much of its funding costs are fixed. Core EPS for STWD was $2.23 for 2017 ($0.55 for the 4Q). If rates increase 100bp, EPS rises by $0.07, 200bp adds $0.17, and 300bp adds $0.26. That's the easy part to quantify.

Higher rates also mean the lending book does not refinance as quickly and return capital to STWD. This has been one of the operating issues the company faced when rates were low and falling – it was difficult to keep capital at work and idle money was earning almost nothing. Loans were prepaying through refinancing often faster than new loans could be originated. In the last two years, that trend has reversed and STWD reported the highest loan balance in its history. Plus, credit quality remained constant as the Loan-To-Value is 62% - it has held a range of essentially 62%-64% for years now.

To deal with the prepayment issue and finding ways to keep money at work, STWD has started to invest directly in some property deals looking at areas with growth such as medical related or housing that will benefit from population movement where they could invest for many years. They also wanted a rising cash flow stream from rent increases and financed it with fixed debt in nearly all cases. So again, rising rates do not hurt and can actually help.

STWD took this view before rates started to move, that rate increases would be driven by an improving economy. Thus, owning property in that environment should mean rising asset values and rents. Increasing inflation means replacement property becomes more expensive to build and helps boost asset values of existing property as well. The big change

here is depreciation pushes down book value and the property cannot be marked to market. It sets up a paper gain that will boost book value if/when something is sold. Depreciation is also a shield on taxable income that did not exist in the past at STWD. When it earns interest income on loans, income and cash flow are basically the same and the REIT structure says pay out 95% of income. Recording high ROIs owning property produces good cash flow, but the depreciation lowers income and the company can retain more of the cash flow to reinvest. That means STWD does not have to issue equity at 9% dividend rates to grow.

Barry Sternlicht at STWD gets the quote of the week as it captures our view that actual reading in much of investment analysis is never done any more:

> "[Looking for reasons to not like STWD] we all talked about that our book value is dropping [and is] another place sweeping computer program generated [a red flag] looking at our company with a misunderstanding what happened. It's actually asset [to be able to retain cash] because the assets are appreciating not depreciating but that takes more than a computer screen to figure out."

The company's coverage on the dividend remains strong for a REIT – with the $1.96 dividend covered by $2.23 of core EPS, which is cash. The leverage ratios employed at STWD on lending and within its balance sheet to leverage cap rates remains lower than peers. One of the only things holding back this company a bit is it is tough to grow faster without issuing debt and equity. But, STWD doesn't want to issue equity that has a 9% dividend cost. So, you can make a case that if the market begins to realize some of the earnings drivers in place at STWD and the stock moves up, growth could accelerate as it would become cheaper to issuer fewer shares at a lower cost of capital.

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