BEHIND THE NUMBERS
Quality of Earnings Analysis
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BTN Thursday Thoughts

Updates and New Developments on Active BTN Ideas

Companies covered in this issue:

Lancaster Colony Corporation (LANC)

Update on 3/22 results and 10-Q review

We are maintaining our earnings quality rating of LANC of 4+ (Acceptable)

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

Summary

While LANC's 3/22 quarter revenue slightly topped estimates, EPS came in at 71 cps after adjustments for 63 cps in impairment charges related to Bantam Bagels, 29 cps in Project Ascent charges, and a 4 cps benefit from contingent consideration adjustments. This was well short of analysts' expectations and the stock is down about 20% since reporting.

From a pure earnings quality standpoint, we see LANC as still being reasonable. The write-down of the Bantam Bagels' goodwill was certainly not a positive, but the company does not carry as large an intangibles balance as many food companies. This is not the first time Bantam has incurred a write-down but given the impairment test was triggered by the company's plan to explore selling the business, we do not expect further material charges from this source.

Nevertheless, LANC does face several headwinds in the next few quarters in the area of rising costs.

- Volume growth was a negative 2% in both segments while total revenue growth was 13% with dramatic price increases driving the difference. The company has taken sizeable price increases in the last two quarters with more on the way. We are concerned about how long demand will remain elastic. Inflation may be denting demand for dining out and we believe yesterday's sell-off in staples was at least partly due to TGT's results reminding investors that when push comes to shove, the big box retailers and grocers are the 800-pound gorilla.

- Gross margins fell by 840 basis points as the higher prices could not offset 30% raw materials inflation, higher costs from packaging, freight, warehousing, and labor, as well as higher costs from the increased use of co-manufacturers. We do note that the MD&A in the year-ago 10-Q contained the following statement regarding costs in the 3/21 quarter: *"Manufacturing costs in the current-year quarter continue to reflect the impacts of COVID-19, including hero pay for our front-line employees, increased expenditures for personal protective equipment and lower operating efficiencies.* The absence of these items in the 3/22 quarter would seem to have been a material, unusual benefit but this was not mentioned in the 3/22 10-Q's MD&A.

- While management expects conditions to remain very difficult, we do see one bright spot: inventories rose in the quarter faster than raw materials inflation and now stand at a historically high level on a DSI basis. We believe the company's inventory accounting method may mean that the 3/22 quarter absorbed more of the brunt of higher costs than many of its peers.

How Far Can LANC Push Pricing?

This is the key question facing most companies today, including the consumer staples names. Even LANC's revenue growth was entirely dependent on pricing growth in the quarter. Total revenue rose by 13% in the period, yet volume *declined* with the balance coming from pricing. The volume growth was weak in both segments with Retail posing a 2% decline compared to 12% volume growth in the year-ago quarter. Retail volumes would have grown 5% after adjustment for discontinuing non-core product lines. Pricing added about 9% to Retail growth.

Meanwhile, Foodservice sales volume also declined by 2% versus flat volume growth last year. However, pricing/mix of 22% resulted in net growth of 20%.

The company said that it is experiencing inflation of about 30% for raw materials as well as higher fuel, freight, and packaging costs which were all ahead of expectation going into the quarter. Unfortunately, management does not see this getting better soon and stated that pricing is its primary tool for fighting higher costs. The company increased prices by 6% in Retail in both the 12/21 and 3/22 quarters and anticipates another 8% in the 6/22 quarter. Foodservice prices increased by 13.3% in the 12/21 quarter, 20% in the 3/22 quarter, and will increase in the mid-20% range in the 6/22 quarter. Management said so far that it was not seeing a significant rejection of the price increases although it admitted it was seeing some trade down in certain categories.

We are most concerned with the Foodservice segment. Management saw a falloff in demand in the Foodservice segment in the latter half of the quarter which it attributed more to restaurants having trouble staffing than a reflection of declining consumer demand. Still, inflation takes its toll in other areas and gas prices are topping $5 a gallon. Stimulus checks are gone and increasing talk of recession can't be doing consumer sentiment any good. We are concerned about how long the demand for dining out will last in these conditions. The potential offset is consumers eating at home could shift sales to the higher-margin Retail segment.

We also believe that TGT's profit disappointment yesterday serves as a reminder that the company's retail customers are facing their own cost pressures and decades of retail consolidation have left the staples companies with much less bargaining power when it comes time to get serious about pricing.

Inventory Is a Possible Bright Spot

We have highlighted how lower inventories have put some consumer products companies in a tough spot going forward as they have had trouble rebuilding inventories. This may have artificially delayed the impact of higher costs from hitting the income statement depending on the accounting method they employ which could result in the impact of higher costs being magnified in upcoming quarters. However, it appears that in LANC's case, the most recent quarter may have absorbed a bigger portion of the blow from higher costs. The following table shows LANC's inventory components and their year-over-year growth rates for the last few quarters:

	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020
Raw Materials	$61.17	$56.29	$48.08	$48.90	$40.60	$41.73
Finished Goods	$104.86	$98.87	$110.29	$72.98	$62.44	$67.32
Total Inventory	$166.02	$155.17	$158.37	$121.88	$103.05	$109.05
Raw Materials YOY Growth	50.6%	34.9%	16.4%	42.2%		
Finished Goods YOY Growth	67.9%	46.9%	59.2%	44.0%		
Total Inventory YOY Growth	61.1%	42.3%	43.2%	43.3%		

We can see that in the last two quarters, LANC's inventory growth has exceeded inflation which implies a buildup in inventory units. Take a look at components on a DSI basis:

	3/31/2022	12/31/2021	9/30/2021	6/30/2021
Raw Materials DSI	16.4	15.6	14.8	15.4
Finished Goods DSI	28.2	27.4	33.9	23.0
Total DSI	44.6	43.0	48.6	38.4

	3/31/2021	12/31/2020	9/30/2020	6/30/2020
Raw Materials DSI	13.7	14.3	14.8	13.5
Finished Goods DSI	21.1	23.1	24.8	19.9
Total DSI	34.8	37.4	39.6	33.4

	3/31/2020	12/31/2019	9/30/2019	6/30/2019
Raw Materials DSI	14.9	14.1	14.1	11.4
Finished Goods DSI	20.9	18.5	21.4	20.5
Total DSI	35.8	32.6	35.5	31.9

Both raw materials and finished goods inventories are now at historical highs. You will not catch us applauding historically high inventories very often, but in this case, we believe it is potentially a positive. Admittedly, some of this increase may be due to higher labor costs and costs from contracting with third parties to help with production being capitalized in inventory in addition to raw materials inflation. However, the company specifically cited building out inventories to be prepared to meet demand as having a negative impact on cash flow in the quarter.

LANC states in its 10-K that it accounts for inventories under *"various methods that approximate actual cost on a first-in, first-out basis."* The average cost method is often referred to as approximating FIFO which makes us believe that LANC utilizes average cost or similar methods for much of its inventory. While average cost may approximate FIFO, the difference is that the cost of inventory purchased in the period will immediately impact cost of sales regardless of whether it is sold in the period or not. In times of rampant inflation, this can meaningfully impact results. While we have criticized several companies whose results appear to have benefitted from delaying raw materials purchases, LANC may have shifted more of the impact of higher costs into its 3/22 quarter and lessened the blow in the next couple of quarters which will allow it to keep more of the benefit of its price increases. We are not predicting a huge improvement in gross margin in the 6/22 quarter by any means, but simply note that the company appears to have less risk than some of its peers that have more inventory to purchase over the next couple of quarters.

LyondellBasell Industries NV (LYB)

We primarily look for accounting issues that may be problematic. We do come across companies where the accounting looks clean, there is good growth potential via selling more volumes, there are barriers to entry, shareholders are receiving growing dividends, and the businesses are self-funding with sizeable cash flow. The market is often caught up with minor issues such as next week's pricing levels and often mislabeling the company as a cyclical. We plan to write a series of short Thursday Thoughts summaries on these companies that we believe offer real volume growth potential with large cash flow to investors. We would urge readers to review our past work on these companies for more information.

Summary

At $107, LYB is paying a 4.2% dividend yield that grew 8% last year. The company routinely buys back its stock. It began repurchasing shares in 2013 and has retired 44.9% of shares outstanding since that time. More importantly, it is not overpaying for shares. Most purchases occur at prices of $80-$100 with the company only paying about 6-7x EBITDA and 6-9x EPS.

- Today, Free Cash Flow Yield net of sustaining capital spending is 23% on its market cap for 1Q22. With net debt at only 1.05x EBITDA, it does not see the need to deleverage more. That should mean more cash flow returned to shareholders.

- Share repurchases lead to dividend growth per share, with total outlay remaining almost flat while cash flow rises. The dividend coverage is improving.

- Current Valuation at $107 is 4.9x EBITDA of $9.1 billion and 5.6x EPS of $19.01

Accounting Issues Are Minor in Our View

There are only two issues that both impact inventory. The first also impacts earnings. LYB is dealing with several petrochemicals in its inventory and it marks them every quarter to the Lower of Cost or Market. When costs are rising, this is seldom much of an issue. However, when they are falling, they lower GAAP earnings and that in turn lowers reported EBITDA. LYB will report earnings and EBITDA with and without the LCM adjustment. In some years, it will result in a charge one quarter that will reverse out in future quarters. In 2016, 1Q saw a $68 million LCM charge and in 2Q it reversed. Overall, these have been very minor adjustments, except when oil fell in 2014:

- In 2014, the LCM was $760 million and 2015, $548 million

- Since then, it was zero in 2017, 2018, and 2021 with only $29 million in 2016, $33 million in 2019, and $16 million in 2020.

- There is some incremental inflation in oil and gas from the Russian/Ukraine situation, which if resolved could see prices decline $10-$20 a barrel. That would likely lead to an LCM markdown in a future quarter.

The bigger issue is inventory looks too low and it could consume some cash flow to rebuild it. Historically, LYB has carried about 55 days of inventory. Demand has been so strong since late 2021 that LYB has seen inventories drawn down:

	1Q22	4Q21	3Q21	2Q21	1Q21
DSIs	40.8	40.9	45.0	50.9	55.1

Inventory in dollar terms is up to $5.0 billion from about $4.5 billion pre-Covid, so inflation is already evident. Adding 5 days of inventory would consume about $600 million in cash at this point. LYB could probably get by with $600 million - $1 billion in higher cash outlay and the rate of inflation in petroleum slowing would curb some of this cost. But, that is still a material figure and it would be cash.

Free Cash Flow – Growth Investments and Shareholders

While the focus of many conference calls is on "what is the price of ethane vs. the price of propylene" as it certainly does change all the time. However, we think the focus should be on what is the long trend of LYB regardless of these price/cost moves in relation to its cash generation?

Covid in 2020 certainly led to prices for commodities that make up plastic declining and certainly less demand for fuel and LYB does sell chemicals that are added to transportation fuel. Yet, LYB has always been out-earning its cash needs of maintenance capital spending and its dividend – even during Covid. Plus, it has been able to fund a strong growth investment program too and retire more shares:

Free Cash Flow	TTM 3/22	2021	2020	2019	2018	2017
Cash from Opers	$8,626	$7,695	$3,404	$4,961	$5,471	$5,206
Maint. Cap Ex	$865	$758	$793	$1,024	$1,052	$1,019
Free Cash Flow	$7,761	$6,937	$2,611	$3,937	$4,419	$4,187
Growth Cap Ex	$1,200	$1,201	$1,154	$1,670	$1,053	$528
Acquisitions	$106	$106	$2,440	$0	$1,776	$0
Dividends	$1,505	$1,486	$1,405	$1,462	$1,554	$1,415
Share Repurchases	$680	$463	$4	$3,752	$1,854	$866
Cash Left	$4,270	$3,681	-$2,392	-$2,947	-$1,818	$1,378
Change in Debt	-$3,594	-$3,925	$3,498	$3,031	$416	-$503
Working Cap on CFO	-$356	-$960	$311	-$13	$93	-$593

A few things to highlight here:

- Acquisitions are adding more production at plants already operating – there are no delays in adding new supply to the market. Integrating those deals also has generally led to improvements in removing bottlenecks in supply and production and improved cash flow too.

- The growth capital spending has led to LYB adding more capacity and several plants have turned on in recent years with more in 2023 coming

- The company defined its mid-cycle EBITDA as $7 billion per year in 2017 (not a banner year but not Covid either and without LCM described in the accounting section). All this steady growth investment has the company's mid-cycle EBITDA over $8 billion now and should be about $8.5 billion in 2023.

- Using the mid-cycle EBITDA as a base figure – LYB is still trading for only 5.25x that EBITDA figure and debt is 1.12x it. And, it is unlikely to stop growing in 2023. If it did, it would repurchase even more shares and still create EPS growth.

- Notice also that even though the dividend per share is rising, the dividend outlay is almost flat due to the share repurchases. It has much more room to grow.

- Often debt rises to make a large deal or a large share repurchase and then is paid down after that.

- Looking at working capital changes over time, LYB has seen working capital hurt cash from operations due to inflation in 2017 and 2021 and produce cash flow in 2020. Those changes are included in the first line of the table – Cash from Operations. As noted earlier, unit inventory levels may still require more cash investment in the near term.

LYB Is Not a Cyclical to the Degree Many Think – Long Term Demand and a Lower Cost Edge Are in Place

- Plastics are used in making and packaging products for food, hygiene, healthcare, and consumer items.

- Demand growth did not dip for plastics in the recessions of 1990-91 or 2001, dipped slightly for 2009, and took off again quickly in 2010. It never dropped during Covid.

- Large populations in SE Asia, NE Asia, and India still have a per-capita plastic consumption about 1/3rd less than Europe and a greater discount to North America.

- Asia is the marginal producer – The US is the lowest cost producer via cheap natural gas liquids and natural gas which powers the chemical plants. High profitability is seen when operating rates are above 90% for chemical plants. That gives pricing power.

- In drilling natural gas or oil in the US, many wells produce multiple NGLs (Natural Gas Liquids – ethane, propane, butane), which are byproducts and can be refined into feedstocks for plastic chemicals like ethylene and propylene. In much of the world, these feedstocks come from refined oil products called naphtha. High oil prices lead to more oil drilling and more NGL production and less cost increase in NGLs while the cost for naphtha rises more with oil.

- Since US shale drilling, the old relationship of oil trading for 6.0-6.2x US gas (based on equivalent energy content) has blown up and US gas now trades on its own supply and demand. That ratio has been as high as 40:1 and is often in the teens vs 6:1. Right now it is about 15:1. While there are several products/chemicals in this relationship – LYB and other US chemical plants are the lowest cost plants when the relationship between oil to gas is 8:1 or higher. That is the case if oil is $110 and gas is $6 (18:1), or if oil is

$40 and gas is $3 (13:1). The higher-cost plants elsewhere in the world are still much more cyclical and are forced to cut back on production if demand growth slows.

- All chemical plants still require regular maintenance and are offline while some of this is being done. In some years, 10%-15% of plants may be offline for several months during maintenance and LYB has years where it has more maintenance projects than others too. That reduces total capacity for chemical plants below the listed amount of all plants.

- Rising demand is driving the need for more chemical plants. However, many of the same issues impacting the world on steel, computer chips, and other supply chain issues are slowing construction. Also, permitting and government issues also delay projects and construction takes longer than planned.

- Plus, the supply chain issues and remaining lockdown threats are still making some demand hard to fill – sectors in autos, aerospace, machinery, and infrastructure are all scrambling for supplies and all use plastic. We would argue that there remains considerable pent-up demand after Covid that still needs to be filled.

Sysco (SYY)

Update on 3/22 results and 10-Q review

We are maintaining our earnings quality rating of SYY at 3- (Minor Concern) and our Top Sell rating.

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

Summary

SYY ‘s non-GAAP EPS of 71 cps blew estimates away by 16 cps. The driving force behind the beat was a solid revenue figure which came in 6% above analysts’ expectations. However, the company raised its guidance for the full year ended 7/22 from $3.00-$3.10 to $3.16-3.26. This is essentially the size of the earnings beat indicating the company is not expecting the improvement to continue into its fourth quarter.

We saw several concerns in the period:

- The revenue beat was solid with US Broadline growth of 43% featuring 20% volume growth and 16% inflation. Management indicated that conditions improved and viewed them as strong exiting the quarter. However, comments made by other companies that supply the restaurant industry such as Ecolab (ECL) and Lancaster Colony (LANC) seem more reserved in their outlooks.

- The company recorded a $29.6 million pretax charge to write down the value of Covid-related personal protection equipment inventory which is added back to non-GAAP results. While we have seen such charges at companies like Cintas (CTAS) and Patterson Dental (PDCO) several quarters ago, the timing of this charge seems strange given the fact its customers struggled with Omicron during much of the quarter. Our concern is that if the inventory is sold at a later date, it could result in artificially high profits given the reduced cost basis.

- As we expected, the company’s adjusted provision for credit losses expense swung to a headwind in the 3/22 quarter after providing a boost to EPS growth for the last several quarters. With normalized comparisons and the possibility of slowing conditions requiring a rebuilding of reserves, we expect this will remain a material headwind for the next several quarters.

What Drove the Revenue Beat?

SYY's revenue beat appears solid. The 42.6% revenue growth in US Broadline was driven by 20% case volume growth and 16.7% inflation with the balance coming from a 4.5% boost from acquisitions and 2.4% from "other". Much of the growth was due to easy comparisons against a Covid-muted 2021 period. Compared to a pre-Covid 2019 period, sales grew by 15.3% which when taking into account the impact of inflation, implies a decline in volumes. Still, revenue was better than expected which the company seems to be attributing to market share gains.

However, we are very skeptical that revenue growth can continue to outperform. The company stated in the 10-Q regarding business trends in the quarter:

> *"Our third quarter began with disruptions from the Omicron variant of COVID-19, which negatively impacted consumer demand and our customers due to the reintroduction of significant restrictions on their businesses. These conditions persisted through February; however, we experienced a strong market rebound beginning in late February and during March, as the impact of this variant lessened and restrictions eased."*

However, this seems slightly at odds with comments we have read from other suppliers to the restaurant business. Consider the statement from Ecolab's (ECL) CEO in its conference call regarding its restaurant supply business:

> *"**if we look at restaurants, especially in the U.S...you clearly see a slowdown of demand, which is most probably related to inflationary pressure because of oil, because of COVID, because of mortgages, you name it.** But that's very early. So those are indications that are probably so important to follow."*

Also, Lancaster Colony (LANC) recently reported a 2% *decline* in volumes in the Foodservice side of its business in its 3/22 quarter. Management gave a seemingly less optimistic assessment of the restaurant business as well:

> *"Now, as we think about the impact on Foodservice, here's what my observation is. I don't think Omicron necessarily changed our consumer behavior. It impacted in Foodservice our operators' ability to staff and run their restaurants. So if you look at their volume and transaction trends during that period, you might see some of those same sort of trends because of their ability to staff the restaurants, not because people were necessarily pulling back on how they were eating.*

> ***Now, as we've looked at the most recent few weeks, even after the quarter is closed into April, what we're seeing generally across our consumer segments or our Foodservice segment, is that sales are continuing to grow, really driven by pricing. But if you look at the transaction trends, the transaction trends are probably down, let's say low single-digits, in some cases mid-single digits.*** *Now, there are some winners that are doing a little better, some losers that are doing a little bit worse. But we're also comping a point in time where, if you remember last year right now this very same week, QSR [quick service restaurants] transactions were up about 50%, right? So we're comping it against a really elevated base in the same period. But as you looking at the model on Foodservice and you're estimating transactions, right now sales up, let's call it, mid-single digits somewhere around there, particularly in the QSR space,* ***transactions probably off low-single digits with some winners and losers in there****. But that gives you a rough idea of where we are."*

We realize that ECL and LANC are not direct comps to SYY. Still, their cautious outlook for the restaurant industry is worth considering. Inflation, $5+ gas prices, rising rates, stimulus checks gone, and talk of a recession may put a damper on consumers' appetites for dining out.

So what did drive SYY's revenue outperformance in the quarter? We have a few thoughts which we admit are speculation but we believe are worth taking into consideration:

- SYY has gained market share during the pandemic given its ability to offer some additional services. With restaurants having trouble with staffing during Omicron, this was likely even more attractive. However, we remain skeptical that the company can continue to make permanent inroads after conditions normalize given restaurants' preference to maintain a diversified supplier base.

- Restaurants can't stock up on perishable items like meats and dairy. However, they could stock up on more dry goods and pre-buy in an inflationary market to get ahead of expected price increases. This could have accelerated towards the end of the quarter as talk of inflation increased with the Russian invasion of Ukraine.

- As dining returned towards the end of the Delta wave last summer and fall, we experienced restaurants only bringing condiments to tables on request rather than keeping the table stocked at all times. We have seen less of this as the pandemic has worn on and we wonder if restaurants restocking on items like salt, pepper, and ketchup could have been a temporary boost to revenue that will fade.

Inventory Valuation Charge

SYY took a $29.6 million pretax charge in the 3/22 quarter to write down the value of Covid-related personal protection equipment in inventory due to the reduction in realizable value. We saw these kinds of charges for companies like Cintas (CTAS) and Patterson Dental (PDCO) a few quarters ago, but this is the first time SYY has taken such a charge. We find the timing of this charge unusual, especially when we know its customers were struggling with the Omicron outbreak through much of the quarter. Our concern with such charges is we do not know if the inventory was disposed of or if it will be sold at a later date and generate artificially large profits given the reduced cost basis.

Adjusted Provision for Bad Debts Turned to a Headwind

We have been highlighting how SYY's provision for bad debts after adjustment for pre-pandemic receivables was providing a 3-4 cps tailwind to EPS growth in the last few quarters which we predicted could reverse in the 3/22 quarter. This did come to pass, as shown in the following table:

	4/2/2022	1/1/2022	10/2/2021	7/3/2021
GAAP Provision (Credit) for Bad Debts	-$0.936	-$0.589	$2.097	-$15.070
Provision (Credit) for Bad Debts Removed from Non-GAAP	-$5.717	-$6.438	-$7.061	-$22.441
Provision (Credit) for Bad Debt Used in Non-GAAP Earnings	$4.781	$5.849	$9.158	$7.371
Percentage of Revenue	0.03%	0.04%	0.06%	0.05%
EPS Impact of Change in Provision %	-$0.029	$0.021	$0.031	$0.046

	3/27/2021	12/26/2020	9/26/2020	6/27/2020
GAAP Provision (Credit) for Bad Debts	-$43.428	-$16.452	-$77.790	$190.389
Provision (Credit) for Bad Debts Removed from Non-GAAP	-$33.473	-$30.271	-$98.629	$169.903
Provision (Credit) for Bad Debt Used in Non-GAAP Earnings	-$9.955	$13.819	$20.839	$20.486
Percentage of Revenue	-0.08%	0.12%	0.18%	0.23%
EPS Impact of Change in Provision %	$0.044	$0.002	-$0.010	-$0.015

The better than expected performance in the quarter more than covered for this headwind. However, we see that the company faces more normalized comparisons in the upcoming quarters. Also, the company's allowance for doubtful accounts as a percentage of gross receivables is down to 2.6%. While this is slightly above the pre-pandemic level, we could see tightening economic conditions preventing the company from lowering this further or even force a rebuilding of reserve requiring a further increase in provision expense. Therefore, we believe this area remains a potentially material headwind that should continue to be monitored.

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.

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