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:

- Colgate-Palmolive Company (CL)
- The Hershey Company (HSY)
- Iron Mountain Incorporated (IRM)
- National Instruments Corporation (NATI)
- Sealed Air Corporation (SEE)
- Starwood Property Trust, Inc (STWD)

Colgate-Palmolive (CL)

Update after 3/22 Quarter Results and 10-Q Review

CL missed non-GAAP EPS estimates by a penny for the 3/22 quarter. It also cut its guidance for the full year. It now expects raw materials costs will rise 22% for the year compared to previous forecasts for 13%.

- We previously warned that inventory trends were pointing to higher than expected costs. While DSIs increased in the 3/22 quarter, inventory growth adjusted for inflation still seems to be lagging unit sales growth meaning the company will have to stock inventory with even higher-priced items.

- A drop in other expense/income added 1.9 cps from a VAT refund while lower advertising added over 3 cps. Neither benefit is sustainable.

- CL announced its latest restructuring charge- right on schedule

- The company is still pricing aggressively in Latin America despite the FX headwind almost disappearing.

Inventory Increased but Is Still Low- More Pressure Likely Ahead

CL saw gross margin decline in the 12/21 quarter from rising costs. We warned then that CL uses FIFO inventory accounting for 75% of its inventory balances and LIFO for the rest. Gross margin should have been getting help from price increases boosting revenue while rising costs on FIFO inventories were delayed from hitting the income statement. Meanwhile, inventories were declining on a unit basis implying that the quarter could have benefitted from liquidating lower-cost LIFO layers. Our concern was that as the company began to rebuild inventories at higher costs, this benefit would go away. Let's look at where inventory DSIs stand now:

	3/31/2022	12/31/2021	9/30/2021	6/30/2021
Raw Materials DSI	27.1	25.2	23.2	25.1
Work in Process DSI	2.5	1.9	2.3	2.6
Finished Goods DSI	71.5	62.3	64.8	68.1
Non-Current inventory DSI	-6.3	-5.0	-4.4	-5.0
Total DSI	94.8	84.4	85.8	90.8

	3/31/2021	12/31/2020	9/30/2020	6/30/2020
Raw Materials DSI	24.4	24.8	22.2	22.6
Work in Process DSI	2.5	2.5	2.7	2.9
Finished Goods DSI	66.6	68.7	67.9	68.2
Non-Current inventory DSI	-5.2	-4.5	-2.9	-3.0
Total DSI	88.4	91.6	90.0	90.8

We see that DSIs are beginning to rise both sequentially and year-over-year. However, look at the inventory component growth rates:

Inventory Component Growth Rates	3/31/2022	12/31/2021	9/30/2021
Raw Materials	18.8%	11.2%	15.6%
Work in Process	4.2%	-13.3%	-8.3%
Finished Goods	14.8%	-0.6%	6.0%
Non-Current inventory	28.3%	22.0%	72.0%
Total Inventory	14.8%	1.1%	5.8%

Remember that cost inflation was running well into the double-digit range at the end of 2021, meaning that the 11% growth in raw materials inventories in the 12/21 quarter which represented a decline on a unit basis. Now consider some of management's color on the outlook for inflation in 2022 given in the 3/22 quarter conference call:

> *"**What that means is that material costs will be up over 20%** for the full year on a year-on-year basis. So we put some context a little bit underneath what's happening in those commodities. **Natural gas is up over 60%.** And natural gas is used to power many of our plants and importantly, many of our suppliers' plants, which puts pressure on their costs and timing. **Soybean and corn are up by over 1/3; palm is up 25% and increasing**. So as we said earlier, what that means for the year, **fats and oils, including palm will be up over 60% year-to-year and doubled since 2020.***
>
> ***Resins are up over 20%.** And these two categories combined, fats and oils and resins make up a significant portion of the material spend and on a combined basis are up nearly 40%. Take Listerine, another important material, and that's more than doubled year-to-year. So as we've looked at logistics, we saw similar cost inflation. And since we've seen that increase, we've over $150 million since our expectations in January, that translates to logistics being up nearly 20% for the full year. And -- some of this increase is because we prioritize meeting clients' needs."*

The company will still be rebuilding significant unit inventory during the next couple of quarters with higher-cost units. They are already seeing the benefits from raising prices on the revenue line, but the cost of sales line has yet to feel the full brunt of these higher-cost inventories. We continue to worry that this lead to even more pressure on margins ahead.

Other Income Jumped Due to a VAT Refund

Other (income)/expense fell to $8 million after adjustments for restructuring charges versus $28 million in last year's first quarter. This added 1.9 cps to EPS growth in the period. The company does not specifically cite what drove this improvement although it does mention that the operating margin in the Latin American segment received a 70 bps boost primarily from a value-added tax refund which was recorded in other (income)/expense.

Advertising Fell

CL spent an unusually high amount of advertising in the 12/20 and 3/21 quarters and has now enjoyed two quarters of easy comparisons as shown in the following table.

	3/31/2022	12/31/2021	9/30/2021	6/30/2021
Advertising	$506	$489	$503	$494
Advertising % of Sales	11.5%	11.1%	11.4%	11.6%

	3/31/2021	12/31/2020	9/30/2020	6/30/2020
Advertising	$535	$549	$476	$439
Advertising % of Sales	12.3%	12.7%	11.5%	11.3%

	3/31/2020	12/31/2019	9/30/2019	6/30/2019
Advertising	$484	$426	$423	$416
Advertising % of Sales	11.8%	10.6%	10.8%	10.8%

Advertising fell sharply, both on an absolute and percentage of sales basis, adding 80 bps to operating margin and over 3 cps to EPS in the 3/22 quarter. This benefit will wane going into the 6/22 period when the company faces a more normalized level of spending. While advertising was below 11% of sales before the pandemic, we are skeptical that it can return to that level soon given the degree to which the company is increasing prices.

Another Restructuring Charge- Right on Schedule

It seems CL can't live long without restructuring. Its 2018 plan just ended last year and it started 2022 by announcing its latest "2022 Global Productivity Initiative" which is *"intended to reallocate resources towards the Company's strategic priorities and faster growth businesses, drive efficiencies in the Company's operations and streamline the Company's supply chain to reduce structural costs."* The plan is expected to be completed by mid-2023 and result in $200-240 million in charges before tax. CL incurred $82 million of charges under the plan in the 3/22 quarter which, of course, were added back to non-GAAP results. Roughly 75% of the charges are expected to be related to severance and pension termination. While the components of the charges seem less open-ended than many plans, we still question why expenses that seem to be incurred almost every year should be considered one-time in nature. We also will be very surprised if the company doesn't end up expanding the scope of this plan before mid-2023 which will increase the likelihood that ongoing expenses are being included in the charges and added back to adjusted results.

Latin American Pricing Impact Still Disproportionate

At 21% of sales, Latin America is CL's largest segment. However, the segment continues to generate a disproportionate, and in our mind, unsustainable source of organic growth due to the impact of adding back negative FX impact. The following table shows year-over-year organic growth in Latin America broken down by the volume, pricing, and foreign exchange impact.

	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020
Reported Sales Change	5.5%	3.5%	11.0%	12.5%	2.0%	-2.5%
Organic Volume	-3.5%	-1.0%	2.5%	2.5%	1.0%	1.0%
Pricing, Coupons, Incentives	10.0%	7.0%	5.5%	6.0%	8.5%	9.5%
FX	-1.0%	-2.5%	3.0%	4.0%	-7.5%	-13.0%
Organic Sales Change	6.5%	6.0%	8.0%	8.5%	9.5%	10.5%

A few quarters ago, the company was increasing prices in its Latin American segment near 10% to offset the impact of high inflation in the region. This was essentially offsetting a huge negative FX impact. Now, the company continues to price aggressively in Latin America but the FX penalty has declined dramatically. The aggressive pricing led to a 3.5% fall in volumes in Latin America and we are skeptical about how long the company can continue to price this aggressively in Latin America

The Hershey Company (HSY)

Update after 3/22 Quarter Results and 10-Q Review

HSY reported non-GAAAP EPS that was 43 cps ahead of consensus. The key to the beat was higher than expected revenue which topped guidance by more than 6%. However, the company raised guidance for the full year by only 7 cps indicating it expects a reversal of the tailwinds seen in the first quarter.

- Revenue benefitted from retailers restocking inventory, a longer Easter season, and greater than expected price inelasticity. All of these tailwinds will fade over the remainder of the year.

- An unusual beneficial inventory valuation boosted EPS by about 8 cps. This will reverse in the upcoming quarters. Raw materials also continued to decline, foreshadowing inventory being replenished at much higher costs which will pressure margins quickly under LIFO. Management now expects 60-80 bps more gross margin erosion for the full year.

- Current forecasts do not incorporate more pricing action beyond what was announced by the end of last year. We believe rising costs may result in higher price increases which could hurt unit growth, lead to more market share losses, and require more advertising.

- Advertising expense fell in the quarter which we estimate added about 5 cps to EPS growth. We expect this will turn to a headwind in the back half, particularly if the company must raise prices further.

Retail Takeaway Down

Sales rose by 16.1% in the 4/22 quarter. Higher prices contributed 6.9% of the growth, volume 4.6%, and acquisitions another 4.6%. However, remember that sales growth represents sales into the retail channel, not sales to consumers. Disclosure in the 10-Q indicated that retail takeaway for the company's products declined in the quarter:

> *"For the first quarter of 2022, our total U.S. retail takeaway declined 1.4% in the expanded multi-outlet combined plus convenience store channels (IRI MULO + CStores), which includes candy, mint, gum, salty snacks and grocery items. Our U.S. candy, mint and gum ("CMG") consumer takeaway decreased 4.4% and experienced a CMG market*

share loss of approximately 156 basis points as a result of capacity constraints limiting the Company's ability to fully service consumer demand."

Thus, much of the company's sales growth in the period was a result of retail customers restocking inventory. Still, management contends that revenue growth is being held back by capacity constraints which were exacerbated by the company gaining significant market share after the pandemic. In particular, it noted being out of Easter-focused merchandise but admitted that customers simply bought "everyday Hershey favorites" to finish topping their Easter baskets. So, instead of a chocolate bunny, consumers bought a regular Hershey bar instead. Overall, the fact that more went into the retail channel than came out in the quarter points to retailers rebuilding inventories and as the company admitted, this tailwind is expected to play out in the second half.

Management admitted in the call that sales held up in the wake of price increases than it had previously expected. However, it also observed that the waning of government subsidies and rising inflation will make price inelasticity more of an issue during the remainder of the year.

"As we dissect the business in the first quarter, clearly, within the first quarter the large majority of our sales were related to stronger elasticities that had been realized in the marketplace, but we do anticipate, as we look further out in the year, that we'll see some moderation on those elasticities, perhaps back to more historic levels, and a lot of that is driven by that reduction in government subsidies and the continued inflation pressure that we think consumers will experience"

Inventory Valuation Anomaly Added Material Boost

We focused on HSY's inventory balances in our last review, noting that its inventories were declining on both a dollar and a unit basis, particularly in the raw materials component. HSY uses LIFO inventory accounting for 60% of its inventory balances. With units low, we warned that the company would be rebuilding inventory at much higher prices and LIFO would result in those costs hitting the income statement immediately. Gross margin adjusted for hedging gains and losses was flat with last year. This was better than the company expected. However, management noted that there was an unusual valuation impact that benefitted results:

"One was inventory revaluation, which is sort of an unusual thing, we see it in times of higher inflation, which has the impact of giving a benefit to the P&L and putting more costs on the balance sheet to reflect the cost of goods value there. So, that was 100 basis points to the Confection segment in this quarter, that won't repeat going forward."

A 100 bps impact on margins in North American Confectionary would amount to about 8 cps in unusual benefits that will not recur. In fact, that will result in even more pressure on gross margin in the upcoming quarters. Let's look at the inventory components below:

	4/3/2022	12/31/2021	10/3/2021	7/04/2021
Raw Materials	$383.557	$395.358	$403.374	$412.728
Goods in Process	$150.722	$110.008	$131.523	$140.868
Finished Goods	$685.022	$649.082	$662.073	$677.254
Adjustments to LIFO	-$187.798	-$165.937	-$170.429	-$170.428
Total Inventory	$1,031.503	$988.511	$1,026.541	$1,060.422

	4/04/2021	12/31/2020	9/27/2020	6/28/2020
Raw Materials	$428.678	$388.600	$326.556	$347.999
Goods in Process	$116.894	$104.841	$120.132	$132.235
Finished Goods	$534.660	$645.664	$686.999	$694.351
Adjustments to LIFO	-$170.430	-$174.898	-$175.204	-$175.205
Total Inventory	$909.802	$964.207	$958.483	$999.380

Notice that raw materials dropped sequentially and year-over-year. Also, remember that the company is experiencing rapid raw materials cost increases which means that raw materials inventories were down even more on a unit basis. This puts the company in a position of rebuilding these inventories at a time when prices are still rising and these costs will hit the income statement quickly given that the company uses LIFO for 60% of its inventories. This will be further magnified by the above-mentioned valuation adjustment as the costs that were delayed from hitting the income statement in the first quarter will hit in the next quarter when that inventory is sold.

Therefore, it is no surprise that the company is now forecasting an additional 60-80 bps of pressure on gross margin for 2022 with the full year erosion expected to be 120-140 bps. Importantly, none of the company's forecasts expect any new pricing action beyond what was announced before the end of 2021. Given the inventory situation and rising costs, we would not be suspired to see either more downgrades to the gross margin outlook and/or the announcement of more price increases. And as the company has pointed out, it expects price inelasticity to become more of an issue as the year moves on.

Lower Advertising Helped the Quarter

HSY has been limiting its advertising spend over the last couple of quarters which it contends is simply matching its lower output. However, advertising spending declined by almost 1% from the year-ago first quarter. We estimate that if it had increased in line with unit sales, it would have cost the company almost 6 cps in earnings in the quarter. During the remainder of the year, we expect the company will have to significantly accelerate its advertising spending, particularly if it does end up increasing prices beyond what it is currently forecasting. This will be a meaningful headwind to earnings growth.

Iron Mountain (IRM)

Update after 3/22 Quarter Results

We are maintaining our earnings quality rating of IRM at 1- (Strong Concern).

Summary

IRM beat forecasts for normalized FFO (Funds from Operations) by 1 cent coming in at 72 cents vs. estimates of 71 cents. AFFO came in at 91 cents. Both measures were down sequentially. IRM effectively boosted guidance slightly as it held forecasts flat, but it is losing $45 million in revenue and $15 million in EBITDA from deconsolidating some companies purchased with OSG Records. It was the same story when it comes to poor earnings quality for IRM in 1Q22:

- FFO and AFFO both added 3.6 cents by ignoring the principal payments on financing leases.
- Both FFO and AFFO were helped by adding back 6 cents related to acquisition costs and losses in Ukraine.
- AFFO was helped by ignoring cash spending on fulfillment costs and customer inducement payments of 5.5 cents.
- AFFO was helped by maintenance capital spending declining $11 million sequentially which added 3.7 cents – yet AFFO still fell from 4Q21.
- Non-cash rent expense was added back to AFFO for 1.1 cents and IRM's estimate of what rent could be raised to in the future helped AFFO another 0.6 cents.
- Stock option expense was added back for 3.9 cents to AFFO.
- Operating lease expense rose 8.2% y/y with all of the recent sale-leaseback deals.

The company made another acquisition for $718 million, which grew debt further. Debt is now 6.0x trailing adjusted EBITDA. If we take into account the business funding expenses such as fulfillment and the principal payments on financing leases, EBITDA drops from $1.685 billion to $1.572 billion, and the ratio rises to 6.5x. It is important to note that the latest acquisition was only an 80% position and IRM still has a deferred purchase obligation for the other 20% that will cost $200-$531 million more. IRM is valuing that now at $276.3 million which would push the debt to EBITDA to 6.6x.

The cash flow statement continues to show a huge disconnect from AFFO, which is supposed to be a proxy for free cash flow. Even ignoring acquisitions, which IRM needs to replace attrition in its record business, the company only produces enough cash flow to cover the dividend in periods with very high asset sales. We will say it again – IRM is trading for 16.4x EBITDA of $1.572 billion which excludes capital lease payments and payments for business such as fulfillment. The multiple would not be that high without spending on growth, but the company's cash flow doesn't support the growth and the dividend. Assuming no growth and 13x EBITDA, the stock would fall under $35. At 11x, the stock would be under $24.

	1Q22	**1Q21**	**2021**	**2020**	**2019**
AFFO	$184.4	$181.0	$1,011.9	$887.5	$867.0
Cash from Ops	$54.5	$68.8	$758.9	$987.7	$966.7
Capital Spending	$161.1	$145.5	$611.1	$438.3	$693.0
Acquisitions	$717.9	$0.0	$204.0	$118.6	$58.2
Pymts for Business	$16.2	$19.1	$71.8	$75.0	$131.7
JV Investments	$0.0	$6.5	$78.6	$18.3	$19.2
Cap Lease Pymts	$10.4	$12.4	$46.1	$47.8	$58.0
+ Sale Leasebacks	$5.4	$12.4	$278.3	$564.7	$166.1
Free Cash flow	-$845.7	-$102.3	$25.6	$854.4	$172.7
Dividend	$184.4	$181.0	$718.3	$716.3	$704.5

National Instruments (NATI)

Update after 3/22 Quarter Results and 10-Q Review

We are maintaining our earnings quality rating of NATI of 5+ (Strong).

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

Summary

NATI's 1Q22 saw non-GAAP EPS of 41 cents, missing by 2 cents and revenue was light by $17 million. We have not had many issues with NATI from an earnings quality standpoint. The largest differences between GAAP and non-GAAP (22 cents) are adding back stock compensation (13 cents) and amortization of acquired intangibles (7 cents). While we don't like adding back amortization, NATI does use a rapid amortization period and only capitalizes a small fraction of software development costs.

Business and orders remained strong but the backlog grew as NATI was unable to fulfill orders and book the revenue. We have already seen a similar period in early 2021 due to inventory shortages. The timing of when sales normalize again is the unknown and NATI reduced 2Q revenue guidance to $370-$410 million vs. the $385 million booked in 1Q22. Here is what we view as the key points:

- NATI's revenue is the wildcard. It continues to invest in R&D, and marketing. When sales are impaired, those costs deleverage on margins.

- Backlog grew to 8 weeks, up $56 million – indicating business was stronger than what they could fill beyond the Shanghai shutdown.

- NATI attributed $15 million of lost revenue to the China shutdown – that would be almost 7 cents in EPS vs. the 2-cent miss.

- The backlog grew from the normal 1 week in 4Q20 to 2 weeks, 4 weeks, and 6 weeks before dropping to 5 weeks in 4Q21. Those extra sales did not create additional overhead costs and 4Q21 posted record sales and margin gains.

Positive – Broad Inventory Is Up

In early 2021, backlog was growing because NATI was low on inventory. That is now corrected and arguably the Shanghai issues at the end of 1Q helped NATI reach the inventory levels it prefers. Its operating model relies on avoiding out-of-stock situations.

	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20
Inventory	$308	$289	$237	$211	$197	$194	$210
DSIs	244.3	222.0	218.0	201.2	196.3	167.6	215.4
Product Sales	$344	$377	$326	$307	$295	$328	$270
P Sales Growth	16.5%	15.1%	20.8%	15.1%	7.7%	-1.4%	-11.6%

- We estimate that DSIs would be about 232-235 if the additional $15 million of sales had occurred
- In early 2021, shortages were more broad-based and that started backlog growing
- NATI is blaming both Shanghai's shutdown and one supplier that has underperformed for the backlog growing to 8 weeks
- Low-end guidance of 12% revenue growth for the year assumes neither situation is resolved this year – we consider that a place where NATI could outperform
- NATI is adding new suppliers, raising prices, and redesigning products to use available parts – but sees the supply constraints for some key parts impacting 2Q – that is the big risk near term.

Positive – Margins Can Quickly Expand as Revenue Recovers

In 1Q22, NATI noted gross margin declined by 400bp. This was the result of using more brokers to procure hard-to-find parts for 4%, higher freight costs for 1% offset by 1% price increases. As noted above, NATI is redesigning some products to reduce hard-to-find parts and adding new suppliers as well as boosting prices more to offset these headwinds. It is still forecasting 100bp of better gross margin for 2022 overall.

We think the hidden power of margin leverage comes from the overhead costs. NATI spends a consistent amount on SG&A, R&D, and G&A expenses. When sales are light (or the backlog is growing because orders could not be fulfilled), these flat costs hurt margins:

	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20
Sales	$385	$421	$367	$347	$335	$368	$308
SG&A	$120	$122	$117	$111	$117	$135	$110
R&D	$82	$92	$82	$81	$80	$74	$71
G&A	$33	$33	$31	$30	$33	$37	$37
adjustments						$30	$5
Costs % Sales	61.1%	58.7%	62.7%	64.3%	68.7%	58.5%	69.1%

Sales were impaired for 1Q-3Q21 and the overhead expenses saw deleveraging of margins by 10 percentage points. 1Q22 would have been essentially flat on margin sequentially (58.8%) had NATI had the extra $15 million in sales that were delayed due to lockdowns in Shanghai.

Guidance for 2Q22 is for revenue of $370-$410 million. That would make these costs 57.3%-63.5% of sales. The $370 million assumes Shanghai sales are lost for the full quarter. Both figures would likely see backlog grow futher too. But 4Q21, when backlog dropped a week, shows how quickly margins expand here while NATI keeps its investment level up. NATI did say it expects 2Q22 to be the peak of expenses for the year.

The backlog and the higher sales despite the problems in Shanghai point to very strong demand and NATI pointed several times on the earnings call to demand exceeding their forecasts. Here is what they said about Shanghai for 2Q22:

> *"We do anticipate Shanghai opening up within the quarter. What's hard to predict is what happens after that in China. But what's helpful is that it's region by region and not broad-based overall China. The situation we had at the end of the quarter is Shanghai is our main hub for customs. The in and out that goes through there was a significant impact at the end of the quarter. What we aren't able to size is what might happen in Q2, if anything, extends there or has an impact in a different way."*

Sealed Air (SEE) Earnings Quality Update

Update after 3/22 Quarter

We are maintaining our earnings quality coverage of SEE at 2- (Weak).

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

Summary

After missing forecasts in 4Q21, SEE's adjusted EPS of $1.12 in 1Q22 beat by 19 cents. All of this can be seen in the price increases coming in above cost inflation in 1Q. Pricing of 16.1% added $204 million to revenue y/y for 1Q – SEE only beat revenue forecasts by $25 million:

- Guidance for revenue was raised by only $50 million for the year after the beat.
- Pricing exceeding cost inflation produced $98 million in EBITDA for the quarter. SEE only raised guidance for EBITDA by $10-$20 million for the year.
- The $98 million in EBITDA would have dropped to the pretax line too – it was worth 49 cents in EPS. Subtracting higher operating costs related to future growth projects of $30 million (15 cents) the price hikes would still net to 34 cents of EPS, but SEE raised guidance for EPS by only 5 cents.
- Depreciation rose in 4Q21 without explanation and declined by $5.5 million in 1Q22 – this added 3 cents to EPS for 1Q22.
- Third-party consulting fees were again added back in 1Q22 – this was 2 cents of EPS.

Clearly, SEE does not expect this to continue and noted that:

- The pricing gain of 1Q was the result of past price hikes announced in 3Q and 4Q coming through for commodity items and formula pass throughs for commodities like resin.
- It expects to see 2/3 of the commodity inflation fall in 1Q and 2Q and then moderate significantly in the 2H22. The formula pass-throughs should lower pricing.

- It is still seeing higher labor and non-material costs – which rose $24 million in 1Q (12 cents of headwind) – those are expected to continue even if price/cost pass-through impacts for commodities reduce revenues.

- It is not clear if SEE is including the higher stock compensation (up $6 million y/y) and profit-sharing (up $3 million y/y) in that $24 million.

- SEE is not getting volume gains and the tough comps continue. The company looks very tied to pricing as the source of growth.

- The guidance for a 2% headwind from currency looks low to us given that we believe a considerable amount of pricing and positive currency changes were seen in 2021 from Latin America.

Volume Comps Remain Tough for the Next Two Quarters

	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20
Food Vol.	1.5%	6.2%	5.7%	4.2%	-0.4%	0.3%	-1.8%
Protective Vol.	-3.2%	0.9%	3.8%	15.2%	13.0%	7.4%	21.4%

After 4Q21, SEE was forecasting 2%-3% volume growth. After 1Q22, SEE just posted a company-wide volume figure of -0.6% and it is talking about tough comps ahead. Plus, SEE is talking about supply chain issues making it tougher to drive volumes. We still believe this could be an area of disappointment, which again makes pricing the only driver of growth. In fact, a case could be made that SEE would need more pricing to offset larger decreases in volume.

Will SEE Repeat the Gross Margin Gain?

For several quarters, SEE has taken large pricing gains. Yet, gross margin was still declining y/y even though SEE uses FIFO accounting which should help during inflation.

	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20
Pricing	16.1%	12.0%	7.8%	2.6%	0.7%	-0.2%	0.0%
Gross Margin	33.6%	31.0%	28.7%	30.2%	31.7%	31.7%	32.7%
y/y chg GM bp	190	-70	-300	-250	-220	-140	50

To fully understand how strong the pricing was on margins and EPS, we estimate how much pricing SEE needed to produce a flat gross margin of 31.7% equal to 1Q21?

- COGS should be flat whether products were sold at $10 or $12 and we know that figure. COGS was $940.6 million for 1Q22.

- $940.6 million divided by 68.3% (COGS % of sales) implies that it would require sales of $1.377 billion to reach a 31.7% gross margin.

- Sales were $1.267 billion in 1Q21 and lost 0.6% in volume implying 1Q22 sales without price increases would have been $1.260 billion. So, pricing had to be $117.5 million to make this work. That would have been a 9.3% price increase. Looking at 4Q21 and 3Q21 - 9.3% would have been a very strong increase and would have kept gross margin flat.

Given that we know the 16.1% pricing gain in 1Q22 included catching up prior price hikes for a full quarter rather than partial periods and the contract pass-throughs came in too - how sustainable is 16.1% pricing growth? Management has said that 1Q saw past price hikes flow through for a full quarter and pass-through contracts raised prices too. They are going to start lapping those price increases starting in 2Q22. Management also said that labor and other non-commodity costs are rising too and they can't pass those through as easily. Also, SEE expects material inflation to subside which could lower pass-through contracts even if labor continues to increase. Negative volume could further hurt margins too if labor and other costs are still rising. On the positive side, SEE has some easy margin comps coming.

Had pricing been 10%-12% in the quarter, gross margin would have come in about 32.1%-33.3%. That would be an improvement, but not as great as 1Q22's 16.1% pricing generated.

Starwood Property Trust (STWD)

Update after 3/22 Quarter Results and 10-Q Review

We are maintaining our earnings quality rating of STWD at 5+ (Strong).

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

Summary

STWD's 1Q22 non-GAAP EPS of 76 cents beat estimates by 25-cents. The key parts of this beat are:

- CECL bad debt reserves declined by $3.6 million adding 1.2 cents
- It realized a gain of $84.7 million on the sale of a previously-acquired property through foreclosure which added 26.7 cents.

As we noted after 4Q21, STWD does not have much in the way of loss shields left to avoid paying special dividends on GAAP earnings. In 1Q, STWD's GAAP earnings were $1.02 which recognized the 27-cent gain on the sale of the foreclosed property and:

- $173.3 million from marking the apartment property to Fair Market Value or 55 cents.
- It lost much of its depreciation shield on GAAP earnings on this deal and recognizes investment income on the investment. Depreciation was down $9.8 million and replaced by higher investment income.

When asked about payments of special dividends, STWD noted that will be determined at the end of 2022 and if necessary would likely be paid quarterly in 2023. Per the CFO Rina Paniry:

> *"So, the special dividend related -- as it relates to the Orlando gain, which was really the outsized performance for the quarter, we look to a full year because the dividend is based on full year taxable income and we look to pay that out over four quarters. And so, we wouldn't be making a determination today as to a special dividend related to that gain. We will see how the year plays out and ultimately make that determination as we approach the end of the year to see whether or not we've covered. So, it's not a decision that we would make today."*

Higher Interest Rates Help Income

STWD notes that a 200bp increase in LIBOR adds about 11 cents to annual EPS (both GAAP and non-GAAP). This is due to:

- The loan book is 98% floating rate and is up 33% y/y

- STWD has LIBOR floors with a weighted average of 57bp, which is down from 77bp in 4Q.

- LIBOR is now breaking past many of those floors (some are still over 200bp) so more of the portfolio will capture rising interest rates at this point.

STWD Has Line Of Sight to Higher Income and Higher FMV Marks on Woodstar Property

- The property is seeing rent increases of over 9% based on incomes in the area and inflation figures looking backwards. Much of the recent inflation is NOT in the increases the government agencies are authorizing now.

- Of the $218 million gross increase (remember STWD owns a net 79.4% which is how that became $173 million above) – the bulk of the FMV gain is coming from rising income on the properties via higher rental rates. That was $137 million of the mark.

- The debt on the property has a blended rate below the market rate so that also added to the higher valuation by $65 million.

- And there is a 100bp LIBOR cap on the floating rate portion of the debt, the value of that cap rose another $16 million.

- This FMV mark could likely be even higher – except STWD is not reducing its cap rate in doing the valuation. It sees the cap rate it is using as about 25%-30% higher than the market.

- It marks to FMV quarterly, so with rent increases, this should continue to produce GAAP income from a higher mark.

The key thing to remember about the apartments is once rent is raised it cannot fall again as that is the deal with the housing authorities. Also, these are still cheaper rents than other properties without housing authorities involved, so they stay full.

STWD's Balance Sheet Is Built to withstand Volatility

We recommend readers look at our note from April 9, 2021 on how STWD focuses as much on its financing as it does its assets. A few highlights are worth noting here given the current environment:

- STWD does not rely on warehouse lending – so its cost of funds does not rise rapidly with interest rates even though many of its assets benefit from that. Conversely, it uses interest caps, floors, and other derivatives to hedge falling rates.

- STWD matches durations – there are not investments on 4-year loans that stretch out to 8 years when rates rise being financed by 30-day money.

- One of the biggest keys is how much of the financing and assets are off-balance sheet with securitizations and CLOs. This means STWD has little margin call risk and much less mark-to-market risk for assets in a downturn. It has only 2.1x equity in debt on the balance sheet, with another 1.6x off-balance sheet and is basically non-recourse.

- Using fixed corporate debt also leaves STWD with $3.8 billion in unencumbered assets it could borrow against if needed.

- The risk of negative marks is also mitigated by writing loans in the low 60s for loan-to-value.

In 1Q22, STWD saw interest rate spreads widen on some deals but also saw the safety-first practices on the financing side offset much of that. Losses on mortgage loans matched almost perfectly with gains on derivatives and hedges in place. There is not a history here of short-term thinking in this area. There are times, STWD will note it has a larger unrealized gain on a

LIBOR floor or cap and it's not recognized in book value. But, they don't sell it if it is still providing the protection it was set up to cover.

STWD Writes/Buys Loans with a View of Being Willing to Own the Property

STWD likes to point out that all the defaulted property they have taken over has resulted in gains. This quarter, that was highlighted by the Orlando distribution center it acquired through a default and resold for an $85 million gain. This process has happened a few times in STWD's history and its history has been a cumulative positive income figure from work-out situations. This led STWD to joke that its $51 million CECL loss reserve required by GAAP should actually be $0 and boost book value more. (They are not doing that)

We think this mindset is driven by many years of focus:

- Buying/writing loans with a low loan-to-value in the beginning. The normal blocking and tackling STWD does is to acquire a portfolio of loans and go them all individually and sell off ones that don't meet their credit standards.

- They own one of the largest special servicers in the industry – which is hired to work out troubled loans and either refinance, restructure or foreclose and resell the property – so they have the infrastructure and experience to deal in this area.

- Having a balance sheet that allows them to wait out market events rather than have fire sales on troubled properties.

There are many conference calls that are primarily reading the news – "our sales were X our income was Y and we think our customers will continue to eat." We always recommend STWD calls very much just for the commentary and rationale behind some deals, where they are seeing risks/opportunities where the competition cannot play. They are much better than college.

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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