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:

IBM (IBM) and Kyndryl (KD) Earnings Quality Update

We are maintaining our earnings quality rating of IBM at 2- (Weak).

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

Summary

There was more evidence of short-term items helping IBM's recent results from spinning off low-margin Kyndryl (KD). Last Friday, KD disclosed that IBM lost a court case with BMC Software in May. BMC was awarded $1.434 billion dollars by the court.

The point is BMC sued IBM's managed infrastructure unit over events from 2017. That unit was spun off as part of Kyndryl. At this point, IBM is appealing the decision, but it is possible KD may be paying some or all of this penalty.

- KD lists this in its SEC documents as a potential risk, here is the disclosure from its first-ever 10-Q in discussing the September 2021 quarter:

"In July 2017, BMC Software, Inc. ("BMC") sued IBM in the U.S. Court for the Southern District of Texas in a dispute involving IBM's managed infrastructure services business. BMC alleges IBM's removal of BMC software from one of its client's sites at the client's request constituted breach of contract and trade secret misappropriation. IBM defeated BMC's motion for injunctive relief, completed the client's transformation project and counterclaimed for breach of contract. ***In September 2021, the trial court overruled in part and granted in part the magistrate judge's recommendations on summary judgment, dismissing IBM's counterclaims and permitting some of BMC's claims for damages to proceed.*** *The case remains pending."*

- The separation documents describe liabilities for Kyndryl – will mean *"all Liabilities to the extent relating to, arising out of or resulting from:* ***(i) the operation or conduct of the SpinCo Business as conducted at any time prior to the Distribution*** *(ii) the operation or conduct of the SpinCo Business or any other business conducted by SpinCo or any other member of the SpinCo Group at any time after the Distribution, (iii) the SpinCo Assets*

- The separation documents also point to failures of management prior to the distribution and obligations of shared contracts. IBM was in charge at the time of BMC's claims and KD and IBM are sharing the contracts. That was the big reason for the 4Q20 giant restructuring charge. It allowed KD's customer contracts to be rewritten and gave the customers access to IBM as well.

- KD's results are not stellar as we have discussed. Its EBITDA and margins are in decline and any portion of $1.434 billion it may need to pay could be material:

KD results	2022e	2021p	2020p
Adj. EBITDA	$2,300	$2,749	$2,922
Margin	13-14%	14.6%	15.3%

- KD took some sizeable charges that should have pulled costs out of its operations: Workforce rebalancing is termination costs that reduces the number of workers. This was $159 million in 2020, then $918 million in 2021, and only $39 million in 2020. EBITDA adds that back, but fewer employees should be boosting margin going forward and that's not happening. The transaction charges in 2021 were $627 million and included employee bonuses and contract fees paid to suppliers and customers. That was added back to 2021

EBITDA too and should help margins too. Instead, we see that 2021 EBITDA was 20% below 2019 levels and KD is guiding to lower EBITDA and margins in 2022.

- For IBM, KD is still a growth vehicle. It keeps selling more to KD, which KD passes through to its customers. As a result, KD's revenues are declining, but IBM is pulling an increasing part of its revenue growth by getting a larger share of KD's business. In 4Q21, KD's revenues declined 7.5% from $4.9 billion to $4.6 billion (down $371 million) and KD wrote off $469 million in goodwill as margins fell too. IBM's sales to KD rose by $549 million in that y/y comparison. In 1Q22, KD's revenue fell another 7.1% y/y (down $340 million). But, IBM gained $685 million in sales to KD in the same period.

- IBM spun off KD at over $40/share in October 2021. The stock is $10 now!

Mowi ASA (MHGVY)

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.

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Summary

Mowi (MHGVY) is the largest salmon farmer in the world with 20% of the market. The ADS trades at $24.40. The dividend of 2.9% is expected to be at least 50% of earnings and the company has a history of paying special dividends as well. Net debt is only 1.5x EBITDA. Before Covid, Mowi's dividend was often over 5% of the current stock price. We believe the market is still missing the long-term potential here and only trades Mowi based on spot prices for commodity salmon and the memory of Covid lockdowns. The lockdowns stopped many international flights, which made it cost-prohibitive to get fresh salmon to Asia, hit restaurant consumption, which in turn meant that supply headed to those areas was instead sold closer to where it was produced and glutted those markets driving down prices.

- Free cash flow net of maintenance and growth-oriented capital spending plus working capital growth, is more than twice the dividend.

- Mowi's goal is to average an ROE of 12%. In 2020 and Covid it was 8.3% and 2021 started slow and was 13.4%. Otherwise before and after Covid, Mowi has been operating at more than twice its goal for years (currently 23.4%).

- Salmon consumption remains very low – 1.7kg per capita in the US, 0.6kg in Japan, 0.1kg in China/HK. Total protein consumption is rising worldwide and demand is growing faster than supply for salmon. Only 2 million tons of farmed salmon are eaten worldwide now.

- Mowi's growth investments will allow it to boost its own supply steadily for many years and it has brand names and consumer products that allow for premium pricing. It has already doubled German consumption per capita and has just started the same plan in the US. Every 20% increase in US per capita consumption requires 110,000 more tons of farmed salmon or 5.5% of world supply. China/HK is about 80,000 tons of consumption now and growing tripling that would only have per capita consumption at 0.3 kg/per year.

- Other investments will allow it to reduce costs per kg of salmon produced. Mowi has seen good success in this area already.

- The industry has consolidated into more of an oligopoly and has several barriers to entry including there are few geographic places to viably have a salmon pen, licenses are limited by governments, and it requires heavy upfront capital to open new facilities.

Two Accounting Issues to Be Aware

There is a non-cash accounting item called Biomass. This is the estimated value of the salmon being raised. As fish grow for three years, the value of the biomass increases and then declines when fish are harvested. It then grows again when new smolts (young salmon) are added to the sea pens. There is more going on here than that. New smolts are forecast that they will grow to a harvest weight of 4.8kg. The first assumptions are:

- How many fish (smolts) are being added to the pens. They do not forecast that 100% survive to maturity and are harvested.

- There are assumptions for what the pricing will be for harvested fish and the amount of feed that the fish will eat. Both are heavily influenced by the current prices for salmon and current costs of feed.

- Labor, overtime, fuel, and treatments for fish all have assumptions too in the computing biomass.

Over the three years, assumptions can change for the positive or negative on biomass and Mowi will change the value of its biomass. This is a non-cash item that impacts reported earnings and the equity balance. It bounces up and down.

- The easy ones to understand are salmon prices or feed costs changing. Both of these can change on basic supply and demand issues.

- Fish health can be impacted by parasites and diseases which do multiple things to biomass.

    - Fish with these issues don't eat as much and therefore don't grow as quickly. At harvest time, the whole pen is emptied at the same time and fish that are below the 4.8kg forecast are worth less.

    - At times, this is a preventative measure and the whole pen may be harvested early. That saves on feed and treatments, but the lower total weight impacts the revenues.

    - There are also additional costs of treating fish. Mass drug treatments are down considerably over the years. But, physically picking up fish and cleaning lice off them is done at times which involves more labor costs and the fish may slow their eating after being handled out of the water.

    - Fish that have treatments are not as large, and often sell for less per kg than fish that have not – which hurts biomass because it lowers pricing too
- The larger and more developed the young salmon (smolt) are when they go into the sea pen, the higher the starting biomass will be. We expect this to increase going forward and will explain below in freshwater expansion.

Mowi reports results with and without this biomass adjustment (Operational Biomass). The total amount of the biomass is now €1.66 billion. In the last five years, this non-cash adjustment has been positive and negative:

Mowi in Euros	2021	2020	2019	2018	2017
Biomass Adj.	119.8	-145.6	-127.5	146.4	-340.3

- 2021 saw higher forward prices boosted biomass, but a lower amount of fish partially offset the pricing

- 2020’s Covid made it difficult to get salmon into all markets with grounded international travel, which glutted local markets and reduced forward pricing

- 2019 saw some lower pricing and a reduced fish count

- 2018 had higher pricing and fish counts improved

- 2017 had adjustments to the biomass change process and fewer fish after a big 2016

We expect biomass figures to generally increase going forward:

- Demand is exceeding supply, which is expected to continue and is helping pricing

- Inflation is boosting feed costs and that also adds to biomass

- MOWI expects to grow smolt size, which means more investment in new fish as they go into pens

The second area to watch is foreign exchange relationship: the NOK (Norwegian Krone) to the Euro and NOK to the US Dollar. The company reports its costs and revenue in Euros. Its larger competitors in Norway have revenues and costs in NOK. So when the NOK depreciates against the Euro as happened during Covid:

- Norwegian competitors can sell at lower prices in Euros initially and report higher margins because fish grow for three years and much of the feed that already went into fish was cheaper.

- However, the cheaper NOK causes competitors’ feed costs to increase faster than Mowi’s going forward.

- This is a wash over the life of the fish, but there are quarters where Mowi’s profit looks lower due to the FX change and competitors show higher margins. This reverses quickly as the competitors see costs increase faster in the future. It’s a timing issue.

- Historically, the NOK is about 9.5 to the Euro since 2015 with spikes of 11.5-12.5 during Covid. It is currently at 10.1, so this may be more likely to decline a little and help MOWI more than its local competitors.

Then Mowi trades in NOK in Norway, and its ADS in the US trades in dollars. Norway produces lots of oil and the last time oil prices were well above $100, the NOK was about 5 to the dollar. Since oil fell from $100+ in 2014, the NOK has been 8.5-9.0 to the dollar, other than spiking to nearly 12 early in Covid. At the current 9.5x and oil at $122, we think the NOK has more reason to strengthen than depreciate. Appreciation of the NOK moves the ADS's price up in dollar terms and vice versa. The NOK rising to 8.5x, is about a 12% positive move in the ADS price. The reverse is also true. The NOK falling to 10.5x, should cut the ADS price in dollars by 10%.

Cash Flow, Growth, Investors

The large holders of Mowi are more focused on dividends than share repurchases. The Norway Public Pension Fund owns just under 15% and billionaire investor John Fredriksen owns 27%. The company's goal is to pay at least 50% of earnings out as dividends and it will declare special dividends as well when it has excess capital. There is a history of that happening in 2017-2019. During Covid, the dividend was suspended for the final three quarters of 2020. It has been reinstated as the salmon market recovered and the company's increased focus on more growth investing in the business:

MOWI in Euros	TTM 3/22	2021	2020	2019	2018	2017
Cash from Ops	880.1	833.1	502.7	759.0	620.9	632.4
CapX	254.9	346.2	292.7	315.8	244.7	250.9
Free Cash Flow	625.2	486.9	210.0	443.2	376.2	381.5
Dividend	282.5	226.8	132.9	544.9	532.4	640.3

During 2017-19, Mowi boosted its debt from 0.9x to 1.5x as a way of paying out excess capital as dividends. Debt is 1.5x now, but the free cash flow is also a much higher percentage of the current dividend. After 1Q22, Mowi announced a dividend hike that includes a special dividend that represents 68% of underlying earnings, so this trend may be returning. They are basing it on the forward look of strong cash flow as industry supply growth is expected to be near zero for the rest of 2022 helping strong salmon pricing.

We think it is important to see three other items within cash flow: growth capital spending, working capital growth, and ancillary cash flow streams. The company expects capital spending to be €300 million in total for 2022.

Mowi in Euros	TTM 3/22	2021	2020	2019	2018	2017
Working Capital	-45.8	-26.4	-56.5	-103.9	-147.7	-94.7
Cash from affiliates	15.2	107.9	25.5	44.9	29.0	34.7
CapX for freshwater	80.0	60.0	65.0	65.0	35.0	50.0
CapX for Improvements	50.0	40.0	20.0	50.0	50.0	
CapX for Consumer		10.0	15.0	30.0	20.0	25.0
CapX for Feed					60.0	35.0

- Working capital consumes cash at Mowi as the company grows inventories with more fish plus inflation. They expect €90 million in total working capital build in 2022. The working capital drag is already reflected in the reported Cash from Operations in the prior table.

- Cash from Affiliates are dividends and proceeds from sales of those investments. There were three of these: Nova Sea 49%, FinnoyFisk 45%, and Dess Aquaculture 50%. In 2020, Dess was sold with the proceeds arriving in 2021. This cash is NOT in the free cash flow table above.

The growth capital spending is going into several areas and is part of the total capital spending in the free cash flow table. The other way to look at Mowi is of €300 million of expected capital spending in 2022, €130 million is going to growth projects and €170 million is maintenance. So what is Mowi investing in:

- Building feed operations is largely complete. This makes Mowi more vertically integrated and gives it lower feed costs overall. It also enables Mowi to command higher prices for its salmon as it can show what the fish ate over its entire lifespan.

- Consumer products take Mowi further away from the commodity nature of salmon. Commodity salmon is called HOG (Head-On Gutted) fresh salmon. It’s the whole fish. Consumer products involve more processing for smoked salmon, smaller pieces cut as individual servings, sushi, and other customer convenience sizes and products. This enables Mowi to charge more for salmon too, gives them more vertical integration, and a brand name to pitch. Mowi rolled this out in Germany in 2007 when Germany was eating 1.1kg of salmon per capita and about 500 tons was going into value-added consumer products. By 2015, Germany was eating 2.1kg per capital with 7000 tons going into value-added consumer products. Germany is now at 2.7kg per person.

The United States is where the new consumer products push is rolling out for Mowi. It has multiple processing plants in the US and is rolling pursuing the same type of market growth it saw in Germany. The US is at 1.7kg of salmon per capita now, but is already the largest market in the world at 550,000 tons of salmon. Growing the US market per capita rate by 0.5-1.0kg means an enormous amount of additional salmon sales. And Mowi has good shipping abilities into the US. Mowi produces 20% of the world's salmon at just under 500,000 tons. If the US market grows from 1.7kg to 2.0kg per capita, that's 110,000 more tons of salmon needed, and the goal is to double the US market over 10-years. China is 0.1kg, Japan is at 0.6kg – both representing big growth potential too.

- Freshwater is the key to boosting volumes and this will be a continuing area for capital spending for several more years. The problem with salmon farming is it requires colder ocean water that is also sheltered such as fjords in Norway or the long coast along Chile. There are not many other places to do this in a sizeable manner. Plus, the governments regulate the number of licenses given for seawater pens. While salmon are growing in the sea, they are also more subject to parasites like sea lice and gill diseases. In nature and in farming, salmon start their lives in fresh water and move to the ocean. So when it's tougher to boost fish raised in sea pens, the answer is to let them live longer in fresh water. Mowi's started this already and is forecasting that it will spend €400 million on this project from 2021-26.

  Most smolts put into sea pens are < 100 grams in size. The goal of keeping smolts in fresh water longer is to let them grow to > 500 grams in size before putting them into sea pens. That means the fish spend less time in sea pens and the current sea pens can produce much more salmon as they turnover faster. Being in fresh water also reduces the exposure of parasites and other health issues. And larger fish should be stronger and healthier and more developed when they do reach sea water. Fewer health issues and stronger fish should also boost quality and result in premium pricing for Mowi salmon. With initial freshwater facilities in operation, Mowi saw 17% of its smolts put into sea water > 250 grams in 2020. By 2026, Mowi's goal is to have 70% of its smolts > 500 grams going into sea pens.

- Capital Spending on Improvements is a catchall of growth initiatives that include expanding sea pen capacity and reducing farming costs through more automation to minimize wasted feed and total labor needed. It can also mean more efficient harvesting with larger equipment and faster processing. Mowi has reduced fixed costs by €182 million since 2018 and pulled another €45 million out in 2021. It sees much more potential here in cutting overtime, FTEs in the process, and medical treatment costs.

Mowi Is Not as Cyclical as Many Think

Salmon farming has been around for decades. In the early days, there were many small players who lacked the capital and knowledge to do it well. Production was characterized as trial and error and shoveling huge amounts of ground-up fish parts into pens to feed salmon. That feed attracted other fish and parasites. Parasitic treatment may have been treated by dumping chemicals into the pens. There would be population crashes in pens at times and two years' worth of salmon would all die, others would escape the pens. If the market prices were high, some producers would harvest early to capture that higher price even on lower volume and hurt the pricing. Much of that has changed for the better as we have already discussed above.

There can still be hiccups to this for a quarter or two if a particular region harvests more fish earlier than expected. This generally self-corrects quickly because now that company/region is low on fish to harvest going forward and supply drops. It takes time for the new fish to grow. We should also mention that there is seasonality to this market as wild salmon enter the market more heavily in late summer.

- The mom & pops are gone. This industry has consolidated significantly. Norway had about 70 competitors in 1997, it now has 23. Chile has dropped from 35 to 10. Scotland has 4, Australia has only 2. The ones that remain are better capitalized and have a commitment to building toward a growing market. The market requires players to produce enough salmon to deal with the high fixed costs of the business to remain competitive.

- The governments have created huge barriers to entry. Not only do companies need to buy licenses for salmon pens, there have been regulations established for farming methods, and oversight into fish health, regulations on use of medicines, and limits on fish numbers in pens. All of that costs more money now than it did 25-30 years ago and our discussion in the prior section shows how much cash for working capital, maintenance, and growth projects consume.

- Farm-raised salmon is still a niche market. The world is eating about 2 million tons of farmed salmon per year vs. 70 million tons of beef, 109 million tons of pork, and 129 million tons of poultry. Protein consumption from animal sources is rising. The wild salmon market is declining and many other wild sources of fish are too. It is possible to grow the farmed salmon market and not even need people to switch from beef or chicken to salmon.

- Demand is rising faster than supply and this has been the case for years. Covid was the exception when there were fewer flights from Chile to the US or from Norway to Shanghai. Supply growth has stalled industrywide from a normal 5%-6% CAGR until 2017 to becoming 3%-4% which is expected through 2025 (with 0% to negative growth in 2022). That compares to demand growth that has been running at 8% except for a dip during Covid. Efforts to spur demand more including more people opting for healthier protein sources should keep demand strong in our view and help pricing remain firm.

- Mowi has several reasons why its pricing can be higher than the industry overall.

    - As noted above, branding and consumer products give it more value-added product to sell which is higher than commodity salmon prices.

    - Mowi often sells much of its salmon (40%-60%) on contract to remove some of the short-term gyrations of pricing. When pricing is very high, they will put more contracts on or when lockdowns were ending, Mowi took many contracts off to gain spot market price exposure.
    - Vertical integration allows it to show full chain of custody of fish, what it ate, where it was raised, health inspections, when it was harvested, and when and where it was processed. All of this gives them the ability to charge more as well as have a higher percentage of their harvest rated as superior in quality. That adds to pricing too.

    - Some fish get premiums based on size – a 6kg fish may sell for more per kg than a 4kg fish. With the investments to enlarge current sea pens, Mowi may be able to produce more fish that grow to 6kg. With the investments in fresh water helping fish grow stronger and healthier, they may grow more quickly in the sea pens as they will not have periods of slower eating. That too, may produce more large salmon.

The Scotts Miracle-Gro Company (SMG)

Update after reduced guidance

SMG was hit hard this week as the company lowered guidance. It now expects non-GAAP EPS of $4.50-$5. US Consumer sales are now expected to be down 4-6% compared to a previous outlook of -2% to +0-2%. Hawthorne is now expected to be down 40-45%.

The company is hosting its Investor Day today. We have the following observations/questions going in.

- It appears that the shortfall in Consumer sales is a result of unexpected inventory management moves made by cautious large retailers rather than dramatically overinflated expectations for point of sale takeaway. We will look for more color in this area in the investor day presentation.

- Accounts receivables DSO did post a curious spike in the most recent quarter and warrants watching closely in future quarters. However, we do not see signs of channel stuffing.

- Inventory continues to build. Some of this is due to lower Hawthorne demand and may require markdowns to clear. Some is due to higher costs on the consumer side and unexpected declines in replenishment orders. While expected production cutbacks may negatively impact cost per unit, this may be offset by higher prices being matched against historically lower-cost inventories under the FIFO method in the next quarter.

- The Debt/EBITDA limit in the credit agreement was raised to 6.4 from 4.5 for the short term.

Unexpected Fall in Replenishment Orders

On the conference call following the 3/22 quarter, the company characterized the US Consumer business as having had a strong quarter despite a late start to Spring for most of the country. CEO James Hagedorn stated:

> **"Let me start with the U.S. consumer segment, which had a very strong second quarter and sales consistent with our guidance. In fact, we were tracking to do even**

> **better, but lousy weather resulted in fewer replenishment orders in the second half of March**."

Hagedorn went on to explain that POS (point of sale) growth remained weak heading into May and guided investors to the lower end of its sales growth for the full year of 0-2%. His stance was very cautious and wanted it was early to be making hard targets:

> *"Still though, it was a solid quarter. But because of our seasonality, I know the elapsed time between the end of Q2 and this call makes those results somewhat dated.* ***So this morning, we'll share what we know in real time. POS entering May is down 12% in dollars.***
>
> ***The slowdown in consumer takeaway led to fewer orders in April from some of our retailers. As a result, we need shipments to improve double digits for the balance of the year to be flat against last year's levels. I want to be clear, that number is achievable. In the first seven months of the year, we faced POS comps of plus 35%.***
>
> ***From now through year end, the comp is minus 9%.*** *Still, finishing the year in positive territory is an admittedly aggressive goal.* ***That's why we see the low end of our sales guidance plus or minus 2% from last year as a pretty good outcome. As you remember from our last call, we were hopeful we'd have upside to our guidance.***
>
> ***But you don't need to be a meteorologist to understand why the season is off to a rough start. In most parts of the country, I'd say spring was delayed by at least three weeks. The good news is the momentum now appears to be on our side. Not only have we seen explosive growth over the past two weeks.***
>
> ***What's interesting and encouraging is that our earliest season products are what's going through the register right now. A year ago, those units would have moved three or four weeks ago. This is reinforcing our belief that the biggest challenge has been weather****. POS in key Southern markets that was down double digits just three weeks ago is now just mid-single digits down in response to warmer weather and retailer promotions that had been delayed until after the Easter weekend.*
>
> ***Entering May, POS is down 13% and 20%, respectively, in the Northeast and Midwest. That's not far from where the Southern markets were a month ago. While the season has been compressed, it's important to remember that lawn and garden season typically stretches well into mid-June in these markets, sometimes later.***

> ***So we're confident we'll see POS levels continue to gain ground in the weeks ahead.***
>
> ***But what is an accurate target? Frankly, there are simply too many moving pieces right now to give you anything more than an educated guess, and I don't want to do that right now. To provide you with a more informed point of view, we need a few more weeks since 55% of our POS is still in front of us****."*

However, the company announced this week that while POS growth recovered towards the end of May, its replenishment orders from major retailers fell $300 million short of its expectations:

> "The Scotts Miracle-Gro Company (NYSE: SMG), the world's leading marketer of branded consumer lawn and garden as well as indoor and hydroponic growing products, said consumer purchases of its core lawn and garden brands surged in May with **unit volume now trending towards the Company's original assumptions for the season. However, a variety of factors prompted the Company to lower its outlook for both sales and adjusted earnings for fiscal 2022.**
>
> **Consumer purchases at the Company's largest retail partners were at near-record levels in May, resulting in year-to-date POS that is approximately 6 percent lower in dollars and 9 percent lower in units than a year ago. The year-over-year decline at the end of May was half of what it had been entering the month due to strong results in all major markets in the Midwest and Northeast.**
>
> **'The recent improvement in consumer engagement has POS units trending toward our initial expectations and we expect further gains as the year continues,'** said Jim Hagedorn, chairman and chief executive officer. **"POS dollars, however, will likely fall short of our initial assumption of flat from 2021 levels due primarily to above-average declines in lawn fertilizer and grass seed, which command higher prices and margins but also tend to be more susceptible to poor spring weather. While there remains enough time in the year to see continued improvement in our controls and gardening categories, that is not likely to be the case with most of the products in our lawn care portfolio.**
>
> 'Also, while it is encouraging that consumers have demonstrated lawn and garden activity remains an important part of their lifestyle, **we did not see the replenishment orders we expected from our retailer partners since mid-May. In fact, retailer orders were more than $300 million below our plans for the month in the U.S. Consumer segment**

alone. This surprising trend has put significantly greater pressure on our fixed cost structure that, when coupled with the commodity cost increases we have experienced since the start of the war in Ukraine, will cause us to fall well short of the revised financial targets we established in March.'"

Overall, we believe the company was forthcoming in the 3/31 quarter conference call and we believe the shortfall in replenishment orders represents retailers conservatively managing their inventories as POS data remained somewhat on track. The company is hosting its investor day today and we will be looking for more color on current and expected trends. However, there are three red flags we will be looking more closely at:

Receivables Spiked in the 3/22 Period

The following table shows the calculation of DSOs for the last 12 quarters:

	4/2/2022	1/1/2022	9/30/2021	7/03/2021
Revenues	$1,678.4	$566.0	$737.8	$1,609.7
Trade Receivables	$990.1	$310.8	$483.4	$1,058.0
Accounts Receivables Pledged	$444.5	$104.0	$0.0	$0.0
Total Receivables	$1,434.6	$414.8	$483.4	$1,058.0
Total Receivables Days of Sales	77.8	68.2	58.3	59.8

	4/03/2021	1/02/2021	9/30/2020	6/27/2020
Revenues	$1,828.8	$748.6	$890.3	$1,492.7
Trade Receivables	$1,230.3	$346.6	$474.8	$970.1
Accounts Receivables Pledged	$177.8	$151.1	$22.3	$177.8
Total Receivables	$1,408.1	$497.7	$497.1	$1,147.9
Total Receivables Days of Sales	70.1	62.5	53.0	70.0

	3/28/2020	12/28/2019	9/30/2019	6/29/2019
Revenues	$1,382.8	$365.8	$497.7	$1,170.3
Trade Receivables	$994.7	$192.7	$223.9	$395.8
Accounts Receivables Pledged	$177.8	$43.3	$84.5	$351.1
Total Receivables	$1,172.5	$236.0	$308.4	$746.9
Total Receivables Days of Sales	77.2	57.4	57.6	58.1

We see that despite a YOY decline in revenue, total accounts receivable remained flat which drove DSI up by more than 7 days. While this compares favorably to the 3/20 quarter, that period was impacted by the pandemic which could have led to a delay in collecting receivables. Also, the company's discussions of revenue during the period make it sound like the late spring was leading to weaker revenue growth at the end of the quarter which doesn't make it sound like higher receivables were being driven by late-quarter orders in which revenue was recognized but receivables had not yet been collected.

The only thing the company stated about receivables in the 10-Q was:

> *"The six months ended April 2, 2022 was also impacted by extended payment terms with several of our major vendors across the U.S. Consumer and Hawthorne segments, as well as Monsanto,* ***for payments originally due in the final weeks of fiscal 2021 that were paid in the first quarter of fiscal 2022."***

The extended payment terms referenced in the explanation seem to indicate they were offered in the 12/21 quarter and collected in the 3/22 quarter. This could have been a factor in the YOY DSO increase seen in the 12/21 period but would not have impacted the 3/22 DSO. We will be keeping an eye on movements in receivables in upcoming quarters.

Inventory Continues to Climb

The increase in inventory continued into the 3/22 quarter as seen in the following table:

	4/2/2022	1/1/2022	9/30/2021	7/03/2021
Finished Goods DSI	96.3	251.3	115.5	54.3
Raw Materials DSI	27.8	70.4	35.3	18.0
Work in Porcess DSI	9.0	22.8	13.1	6.3
DSI	133.1	344.6	163.9	78.6

	4/03/2021	1/02/2021	9/30/2020	6/27/2020
Finished Goods DSI	55.1	129.5	55.0	29.0
Raw Materials	18.5	36.4	23.2	11.9
Work in Porcess	5.6	14.2	9.4	5.5
DSI	79.2	180.0	87.6	46.5

	3/28/2020	12/28/2019	9/30/2019	6/29/2019
Finished Goods DSI	56.8	174.0	78.6	43.7
Raw Materials	17.0	50.8	30.0	14.5
Work in Porcess	7.4	22.6	14.5	6.8
DSI	81.2	247.4	123.1	65.0

Management offered the following explanation of the buildup in the conference call:

> *"Inventory is $575 million higher than this time last year. Again, the drivers are lower volume, particularly at Hawthorne, and higher costs within the U.S. consumer business. As it relates to Hawthorne, we had initially planned the year assuming double-digit growth and had been building inventory to meet that demand.*
>
> *While we slowed and, in some cases, ceased production as we lowered our sales forecast, much of the inventory had already been built or purchased. In the U.S. consumer business, our goal is to be in a better competitive position to meet the needs of our retail partners. Indeed, while we are flush with inventory, we are seeing signs of stress with some of our competitors who are not able to build ahead of the season.*
>
> *While we accomplished what we set out to do, inventory levels are now higher than we expected as retailers adjusted their shipments in March and April due to the slow break of the season. Depending on what we see with volume in the weeks ahead, we may decide to slow down some of our manufacturing earlier in the year than normal. While this has a P&L impact on gross margin rate, it will help accelerate an inventory improvement. As you can see, there are a lot of moving pieces in the story right now, and they leave us with a higher level of uncertainty than we would normally have at this time of the year."*

The buildup in Hawthorne products is a concern given this is being driven by the legal pot market which is admittedly overbuilt at the moment. It may take time and markdowns to clear this. On the consumer side, we see the buildup as less concerning given the company's price increases. While reducing manufacturing may have an impact of increasing the cost per unit manufactured, rising prices will be matched against older inventories under the FIFO method which should offset this, particularly in the next quarter.

Still, the company continued to warn against higher costs in the conference call:

> *"But there is one more challenge none of us control, which is commodity prices. By the end of this year, we'll likely have given up roughly 400 basis points of gross margin in two years despite what we thought were aggressive double-digit price increases. And we're taking more pricing in the fourth quarter, and again, it will be aggressive. But the truth is we're still just chasing it, like other people.*
>
> *Even if commodities start to ease, it will take a few years to claw back the margin we've lost. That sucks. So we're taking other decisive actions effective today to realign the business, reduce our SG&A and get the company back an appropriate -- to an appropriate level of profitability. We've set a target to reduce our overhead structure by roughly 10% before the start of fiscal '23.*
>
> *The effort will be in all areas of the business. At Hawthorne, we'll shrink the size of our supply chain network and reduce staffing levels. In our U.S. consumer businesses and corporate cost centers, we'll also run skinnier and be more mindful of redundant roles, processes, and other structural issues that can lead to inefficiencies.*
>
> *So you should anticipate restructuring charges in Q3 and Q4. I want to make sure I'm clear here. I am committed to the five pillars of our strategy. Our core brands still offer real growth opportunity."*

It will be important to monitor the progress of the cost cuts and restructuring charges looking for reduced quality of unsustainable cuts.

Rising Debt Is Worth Watching

A final key item to be looking at is the company's debt load. This week's announcement included the revelation that the company amended its credit agreement to allow Debt/EBITDA to climb as high as 6.5 in the short term. This is a concern we will spend some more time digging into after investor day.

We view SMG's core lawn and garden business as very attractive. As we pointed out in our original review, growth in the company's Hawthorne segment was unsustainable given its reliance on the volatile pot market. Longer-term, SMG may offer significant value, but the company definitely has its short-term hurdles to overcome before that may be realized.

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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