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:

Air Lease Corporation (AL)
Earnings Quality Update

We are maintaining our earnings quality rating of AL at 4+ (Acceptable).

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

Summary

Air Lease's non-GAAP EPS of $1.39 in 2Q22 beat forecasts by 32 cents. The beat looks solid and we will again note that AL likely has $5+ in EPS potential as the supply chain issues for new planes normalizes. The market continues to improve and AL collected $8.7 million of deferred cash rent this quarter vs. a $41.6 million loss of cash rent in 2Q21. That allowed rental revenue to beat forecasts and grow y/y by $93.3 million. That is despite losing rent from the planes nationalized in Russia. Deferred Covid rent is down to $182.1 million from $203.2 million to start the year.

Aircraft sales, trading, and other revenue was low at $12.4 million as there were no aircraft sales. However, 2Q21 included $34 million from selling the Aeromexico claim. Adjusting for this, revenue in this area rose from $5.8 million y/y.

- AL did start the insurance claim process to recover its losses on the Russian aircraft. No details or timeline was provided, but this could boost book value again if resolved favorably. It did point out an insurance headwind of premiums rising $16 million for the year – which is about 14-15 cents in EPS for the year.

- AL also took delivery of 21 new planes in the quarter and is still guiding to only one 787 for 2022, but that could improve in 2023 and beyond. It still kept delivery guidance flat at $3.5-$4.5 billion of aircraft in 2022, but after $0.5 billion in 1Q, $1.4 billion in 2Q, it expects $1.2 billion in 3Q. We believe if they reach that figure for 3Q, the 4Q forecast may be raised. Fleet growth is driving the revenue growth.

- AL's model also involves recycling capital by selling used planes within 6-10 years of their life. That source of earnings has been curtailed by a lack of new plane deliveries. Guidance is still for $750 million in aircraft sales in the second half of 2022, which could build that source of revenues again as well as recycle that capital into new planes.

- It is also a positive that with air travel increasing and a shortage of scheduled deliveries, the value of existing planes is rising. That bodes well for AL for aircraft sale prices. It is also causing customers to seek rent extensions early which is positive for locking in future rental revenue. Higher aircraft values should also make AL's $58 book value look understated.

- Higher interest rates may help AL too. It has 92% of its debt at fixed rates and there are lease escalators on some of its leases. In the bigger picture, customers may increasingly turn to AL for more lease financing that could be cheaper than the customers' borrowing costs allowing AL to grow its business further via sale-leasebacks of existing planes and an increased percentage of customers' fleets being leased vs. purchased.

FX is a red flag worth watching. AL collects rent from customers in US Dollars and aircraft and fuel are often priced in dollars too. Yet, the customers are frequently paid in local currencies so at the same time the world has seen higher commodity prices, customers may be seeing more inflation because their currencies are declining vs the dollar.

Charles River Laboratories International, Inc. (CRL) Earnings Quality Update

We are maintaining our earnings quality rating of CRL at 4- (Acceptable)

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

Summary

CRL reported non-GAAP EPS for the 6/22 quarter 3 cps ahead of the consensus estimate. However, it missed on the top line by about $20 million and downgraded its outlook for 2022 organic sales growth to 10-12% from its previous range of 12.5-14.5% due to expected delays in activity in its CDMO business. It also reduced its outlook for non-GAAP EPS to a range of $10-70-$10.95 from the previous $11.50-$11.75 reflecting larger than expected FX and interest rate headwinds.

We do not have a problem with the overall quality of the beat this quarter. We note that lower stock compensation expense added about 3.3 cps to earnings in the quarter. However, this was almost offset by an increase in the adjusted effective tax rate from 20.4% last year to 21.1% this year which shaved almost 3 cps off earnings. The increase was due to a lower benefit from stock compensation. Its outlook for the full-year adjusted tax rate remained the same at 20% so the 21.1% rate this quarter may have been materially higher than many models were expecting.

We do note several changes and trends that we are not especially concerned about at this point, but do warrant attention in upcoming quarters:

- We have never liked that the company adds back amortization of intangibles to non-GAAP earnings as it skirts the cost of its acquisitions and the number grows every quarter. However, we are more concerned with site “consolidation costs, impairments and other” add backs jumping to over 4 cps this quarter. This appears to be due to litigation-related costs although the company does not discuss these as having had a material impact on its operation in its MD&A in the 10-Q. We consider minor litigation costs to be a normal cost of doing business in this industry and question whether they should be added back to arrive at core earnings.

- Inventory DSIs jumped by 7 days versus a year ago with the bulk of the increase centered in finished goods. We are not overly concerned at this point as the size of the increase is magnified by a low number last year. DSIs are only up by 4 days compared to the 2020 second quarter. CRL carries a relatively low level of inventory, and the bulk of its revenues are generated by services. Therefore, we are not overly alarmed by this increase, but this does warrant keeping an eye on it in the next quarter.

- Accounts payable days have been increasing rapidly YOY over the last three quarters. The company admits the timing of payments to suppliers has boosted recent cash flow. However, the company has ramped up its capital spending program in the last few quarters and it noted in the 2021 10-K that the amount of payments owed for capital spending included in accounts payable tripled in 2021. We suspect this may be behind much of the increase in payables which reduces our concern. Regardless, this is an item to watch next quarter.

- CRL began disclosing the amount of revenue recorded under leases in the 6/21 quarter. This amount doubled YOY to $14 million in the 6/22 quarter after trending flat around $6-$7 million in the previous quarters. We do not know if this increase in lease revenue was actually incremental or if the company moved over revenue previously recorded as traditional sales for essentially a net zero impact on growth. The increase in lease revenue would have accounted for about 13% of the company's total revenue growth for the quarter if it was truly incremental revenue. Regardless, this is another item to watch in the upcoming quarters.

Jump in Non-GAAP Addbacks

The following table shows the company's non-GAAP adjustments for the last eight quarters:

	06/25/2022	03/26/2022	12/25/2021	9/25/2021	6/26/2021	03/27/2021	12/26/2020	9/26/2020
GAAP Earnings Before Taxes	$9.61	$13.90	$13.14	$10.37	-$9.81	$16.72	-$68.64	-$20.35
Amortization of Acquired Intangibles	$37.69	$38.10	$29.40	$34.22	$34.33	$30.20	$28.10	$28.35
Severance	$1.28	$1.94	$1.36	$1.34	$1.46	$0.56	$1.05	$0.82
Acquisition Related Adjustments	-$17.49	$5.72	-$15.56	-$1.57	$16.67	$16.33	$5.72	$3.51
Site Cons Costs, Imps, and Other	$2.81	$1.49	$1.10	$2.04	$0.15	$0.19	$0.88	$3.14
Vent Cap Equity Inv. (Gains) Losses	$9.61	$13.90	$13.14	$10.37	-$9.81	$16.72	-$68.64	-$20.35
W/O Debt Financing Costs	$0.00	$0.00	$0.00	$0.00	$0.11	$25.98	$0.00	$0.00
Loss due to US Pension Termination	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$10.28	$0.00
Other	$3.61	$0.36	$0.00	$0.00	-$0.57	-$2.37	$0.00	$0.00
Adjusted Earnings Before Taxes	$181.62	$172.36	$170.42	$169.65	$169.84	$153.91	$149.82	150.74

We have expressed in past reviews that we don't like the company's practice of adding back amortization of acquired intangibles as it removes the cost of acquisitions on the company's earnings and it is rising consistently every quarter with the company's ongoing acquisitions. This is unfortunately typical practice in the industry.

We are also concerned by the jump in "Site Consolidation Costs, Impairments, and Other" adjustment. We are skeptical that site consolidation costs should be considered non-operating in nature. We also note that the company disclosed the following about the "other" component of the charge:

> *"Other items include certain third-party legal costs related to (a) an environmental litigation related to the Microbial business and (b) responses to a U.S. government industry-wide supply chain management inquiry applicable to our Safety Assessment business."*

The company makes no specific mention of any of these issues in its discussion of factor impacting results in its 10-Q. We would also argue that legal costs are a normal cost of doing business for the company and question the logic of adding smaller costs back. The total impact of this adjustment was over 4 cps in a quarter where the company only beat by 3 cps.

We also want to address the sudden increase in the "other" line item to $3.6 million. The company disclosed that:

> *"Adjustments included in 2022 relate to a purchase price adjustment in connection with the 2021 divestiture of RMS Japan and a reversal of an indemnification asset related to*

a prior acquisition. Adjustments included in 2021 include gains on an immaterial divestiture and the finalization of an annuity purchase related to the termination of the Company's U.S. pension plan."

We do not have a problem considering these adjustments to be non-operational.

Inventory DSIs Increased

We note an unusual increase in inventory DSIs. The following table shows the breakout of DSIs by inventory component for the last twelve quarters:

DSI by Inventory Component	6/25/2022	3/26/2022	12/25/2021	9/25/2021
Raw Materials and Supplies DSI	5.5	5.5	5.4	5.1
Work in Process DSI	6.4	5.6	6.6	4.6
Finished Products DSI	26.0	23.8	20.5	19.9
DSI	37.9	34.9	32.5	29.6
	6/26/2021	3/27/2021	12/26/2020	9/26/2020
Raw Materials and Supplies DSI	5.1	4.7	5.2	5.3
Work in Process DSI	4.5	5.7	6.8	6.9
Finished Products DSI	21.3	23.7	22.4	24.1
DSI	30.9	34.1	34.4	36.4
	6/27/2020	3/28/2020	12/28/2019	9/28/2019
Raw Materials and Supplies DSI	5.1	4.9	5.2	5.1
Work in Process DSI	7.4	6.1	7.6	7.9
Finished Products DSI	21.5	21.6	21.3	20.5
DSI	34.0	32.6	34.1	33.6

We see that the largest part of the increase came from finished goods. The 6/21 DSI level looked unusually low, but the current number is still well above the 6/20 result and is a marked sequential increase. CRL carries a relatively low level of inventory, and the bulk of its revenues are generated by services. Therefore, we are not overly alarmed by this increase, but this does warrant keeping an eye on it in the next quarter.

Payables are Ramping Up but Likely Due to Capex Expansion

Another curious working capital trend is the rapid YOY increase in days payable over the last three quarters:

Days payable	6/25/2022	3/26/2022	12/25/2021	9/25/2021
Trade Accounts Payable	$211	$226	$198	$128
Trade Accounts Payable Days	31.2	35.6	32.3	20.8
	6/26/2021	3/27/2021	12/26/2020	9/26/2020
Trade Accounts Payable	$111	$127	$122	$97
Trade Accounts Payable Days	17.6	22.4	22.7	19.4
	6/27/2020	3/28/2020	12/28/2019	9/28/2019
Trade Accounts Payable	$83	$103	$111	$107
Trade Accounts Payable Days	16.8	20.5	23.7	23.1

The company cites "favorable timing of our vendor and supplier payments compared to the same period in 2021" as a positive factor for cash flow in the 10-Q. Ordinarily, we would be very concerned about such a sharp spike in payables. The jump in inventories almost certainly had an impact on accounts payable as well. However, the company also has rapidly accelerated its capital spending in the last few quarters. It disclosed in the latest 10-K that 2021 accounts payable and accrued liabilities contained $72 million of amounts related to the purchase of property, plant, and equipment versus just $26 million for 2020. We don't know how much capex-related spending was in just accounts payable, but it is possible that this accounted for much of the unusual increase we are seeing in payables which reduces our concern. Still, this is another item to keep an eye on for the rest of the year.

Jump in Lease Revenue

Starting in the 6/21 quarter, the company began disclosing the amount of lease revenue with the following explanation:

“As part of the Company’s service offerings, primarily in the Manufacturing and RMS segments, the Company has identified performance obligations related to leasing Company owned assets. In certain arrangements, customers obtain substantially all of the economic benefits of the identified assets, which may include manufacturing suites and related equipment, and have the right to direct the assets’ use over the term of the contract. The associated revenue is recognized on a straight-line basis over the term of the lease, which is generally less than one year... Due to the nature of these arrangements and timing of the contractual lease term, the remaining revenue to be recognized related to these lease performance obligations is not material to the unaudited condensed consolidated financial statements.”

The following table shows the amount of lease revenue reported from the period available:

	6/25/2022	3/26/2022	12/25/2021	9/25/2021	6/26/2021	3/27/2021	12/26/2020
Lease Revenue Recognized	$13.90	$7.90	na	$5.30	$6.30	na	Na

We are not especially concerned by this disclosure other than the unusual increase seen in the 6/22 quarter. The $7.6 million increase in lease revenue accounted for about 13% of the company’s total revenue growth for the quarter. We do not know if this increase in lease revenue was actually incremental or if the company moved over revenue previous recorded as a sale for essentially a net zero impact to growth. Regardless, this is another item to watch in the upcoming quarters.

Iron Mountain Incorporated (IRM)
Earnings Quality Update

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

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

Summary

IRM beat forecasts for normalized FFO (Funds from Operations) by 2 cents coming in at 74 cents vs. estimates of 72 cents. AFFO came in at 93 cents. IRM touted new growth in many areas but held guidance flat. We believe large price increases drove much of the recent growth. Also, most of the growth was in services such as shredding, picking up/returning documents, and transferring from paper to other media. That revenue declined about 25% during Covid and has been slowly bouncing back since mid-2021. It was further fueled by an acquisition from early in 2022. It was the same story when it comes to poor earnings quality for IRM in 2Q22:

- IRM cut bad debt reserves from 6.1% in 4Q21 to 5.4% in 1Q22 to now 4.8% for 2Q22. That generated 3-cents in FFO and AFFO and produced the entire beat.

- FFO and AFFO both added 3.3 cents by ignoring the principal payments on financing leases. That also would more than cover the entire beat.

- Acquisitions are a way of life for IRM and so are acquisition costs. Both FFO and AFFO were helped by adding back 6 cents related to acquisition costs in 2Q22.

- AFFO was helped by ignoring cash spending on fulfillment costs and customer inducement payments. These are rising again with service revenues and were 7.7 cents of cash expense that was added back in 2Q

- AFFO enjoyed another drop in maintenance capital spending both y/y (adding 1.2 cents) and sequentially (adding 0.8 cents).

- Non-cash rent expense was added back to AFFO for 1.5cents and IRM's estimate of what rent could be raised to in the future helped AFFO another 0.6cents.

- Stock option expense rose was added back for 6.9-cents to AFFO.

- Operating lease expense rose 3.5% y/y with all of the recent sale-leaseback deals.

- AFFO is supposed to represent a free cash flow measure to show dividend sustainability. AFFO was 9cents per share vs. 61.85 cents in dividend. But we see 27 cents of adjustments to AFFO that makes the equation 63cents of cash flow vs. 61.85 cents of dividend and we haven't looked at working capital or acquisition costs.

Other Points To Watch

- The jump in service revenues is not that impressive when looking at it before and after Covid. It should also be noted that the recent acquisition in January is helping this further. Total service revenue rose 33% in 1Q, but acquisitions were 17% of that. For 2Q, acquisitions were 12.5% of the 33.6% reported growth.

Service Growth	4Q	3Q	2Q	1Q
2022			$536.4	$497.0
2021	$434.4	$411.5	$401.5	$374.0
2020	$362.4	$340.4	$305.3	$385.2
2019	$404.1	$388.9	$397.6	$390.9
2018	$402.6	$404.0	$405.4	$391.3

A huge part of the recent growth in service revenues has simply been the economy reopening and lifting results back to a base of just over $400 million per quarter. IRM should have another lift from acquisitions in 3Q and 4Q, but then comps should become tough again.

The other issue the company isn't discussing is that service costs are starting to rise again. These costs dropped with Covid too. And didn't bounce in 2021. But they appear to be ticking up now:

	YTD 22	YTD 21	2021	2020	2019	2018
Cash Service Costs	$38.7	$36.5	$71.8	$75.0	$131.7	$98.7

- What also should be considered is IRM is simply boosting prices. They announced 8.2% organic growth for storage, but only 50bp due to volume. Pricing can be a big help in boosting earnings. If IRM could not boost prices by almost 8% and came in 100bp lower in just the Storage Rental revenue – it would have cost it $7.2 million in AFFO or 2.5 cents and it would be below the dividend considering the other 30 cents of items added back to AFFO that are recurring and/or cash costs. Big price increases can cause customers to rethink just how much they need some of those older documents. And the base business, despite acquisitions, is still declining:

	2Q22	1Q22	4Q21	3Q21
RIM Vol	696.55	699.10	700.87	702.62
Adjacent Vol	8.16	8.08	7.93	7.96
Consumer Vol	25.29	20.47	17.44	16.25

These are the recent figures with no additional records storage acquisitions as the last one was in 3Q21.

- Debt remains very high in our view. Debt to IRM's adjusted EBITDA was $9.9 billion over $1.734 billion or 5.7x. We would add the $275.1 million contingent payment for the latest acquisition and subtract the cash expenses for service fulfillment and principal payments on financing leases. That would make the ratio $10.2 billion over $1.617 billion or 6.3x.

- The cash flow statement continues to show a huge disconnect from AFFO, which is supposed to be 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 and how much more can they sell? We will say it again – IRM is trading for 16.1x EBITDA of $1.617 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 $37. At 11x, the stock would be under $26.

	2Q22	2Q21	1Q22	1Q21	2021	2020	2019
AFFO	$270.9	$264.2	$184.4	$181.0	$1,011.9	$887.5	$867.0
Cash from Ops	$291.4	$320.4	$54.5	$68.8	$758.9	$987.7	$966.7
Capital Spending	$169.1	$150.1	$161.1	$145.5	$611.1	$438.3	$693.0
Acquisitions	$0.8	$35.7	$717.9	$0.0	$204.0	$118.6	$58.2
Pymts for Business	$22.5	$17.4	$16.2	$19.1	$71.8	$75.0	$131.7
JV Investments	$0.0	$56.6	$0.0	$6.5	$78.6	$18.3	$19.2
Cap Lease Pymts	$9.7	$11.2	$10.4	$12.4	$46.1	$47.8	$58.0
+ Sale Leasebacks	$91.1	$197.3	$5.4	$12.4	$278.3	$564.7	$166.1
Free Cash flow	$180.4	$246.7	-$845.7	-$102.3	$25.6	$854.4	$172.7
Dividend	$179.8	$178.8	$184.4	$181.0	$718.3	$716.3	$704.5

Warner Bros. Discovery, Inc. (WBD)
Earnings Quality Update

We are reducing our earnings quality rating of WBD to 3- (Minor Concern).

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

Summary

WBD's 2Q22 was messy as expected with impairments and restructuring charges as it completed the merger. It ended up becoming the "Big Bath" quarter of getting as much bad news as possible announced and clearing the decks to announce some tougher decisions not originally forecast. The company lowered guidance for 2022. After 1Q, WBD thought the company was about $300 million behind the $12 billion EBITDA plan (with a Warner being $500 million behind on goals). After 2Q, WBD announced a number of areas where it disagrees with prior Warner policies or did not see the ROI figures to justify continuing some of what was in the forecast. It cut 2022's forecast EBITDA by about $2 billion. On top of that, it sees some macro-economic pressures as it set guidance for 2022 EBITDA at $9.0-$9.5 billion.

No one owns this for 2022, and we think 2023's forecast of "at least $12 billion in EBITDA" may prove conservative. This may take a year longer to reach the figures discussed when the deal was announced of $14 billion in EBITDA after $3 billion in synergies. There are some big moving parts here, but WBD is laying out a case for both cost synergies and rising revenues along with debt reduction. The potential still looks strong in our view, but we cut the rating to 3- from 3+ as we see how long it takes to start showing improvements. We are also still only working with one partial quarter of data that isn't pro forma.

We can review some accounting policies now where we see some positives on earnings quality. Also, WBD has not changed its forecasts on meeting debt repayment goals, which we think also cuts through much of the write-offs and points to there still being solid cash flow here. WBD also released six-quarters of proforma figures for each division. All of this is positive in our view.

What Was Strong?

- WBD kept its debt reduction guidance of being at 3x EBITDA or below by mid-2024 or sooner. That is the same plan from April 2021 despite two reductions in EBITDA guidance. And, the plan to achieve it is well-defined. (See Below).

- AT&T was counting some cellular customers who were eligible for free HBO Max in subscription numbers even if they were not activated. WBD has removed those from the metrics as well as only counting the HBO Max and Discovery+ paying subscribers and effectively reduced the subscriber count by about 10 million.

- Many of the changes WBD is now planning for the business will lead to lost revenue in 2022 but should stimulate revenue growth going forward. Yet, guidance is for 2022 to suffer revenue and cost hits and 2023 will see cost savings produce the growth in EBITDA. 2023 guidance looks light to us if some of the revenue bounces back too. We saw multiple points in its plans that will focus on revenue. (See Below).

- We give high marks to WBD for the acquisition accounting. It only assigned about 20% of assets to Goodwill and amortization periods on other intangibles do not look out of line. In fact, Discovery has a history of using accelerated amortization which is more conservative. It also has a history of being more conservative than many other companies in dealing with routine items such as sales commissions, capitalized software, and depreciation. (See Below).

- Many of the forecasts being used look conservative and detailed. For example, while EBITDA will add back restructuring and integration costs – they are listing Free Cash Flow estimate net of those types of one-time costs as they will consume some cash.

- Less than one-quarter into the deal, WBD already has $1 billion of cost savings in progress and sees few hurdles to achieving the $3 billion run rate in 2023.

What Was Weak?

- We've seen "Big Bath" quarters dropped before that set things up for only improvement going forward - so we'll play along for now. This could have been handled better than largely confirming guidance in May and then saying too much was unknown a couple of months later. WBD was able to cancel CNN+ a few minutes after closing the deal and some TV shows about an hour after that – so they were far enough along on ROI and content quality decisions to make those calls quick. AT&T publicly said that it pulled content off other platforms to hold it exclusively for HBO Max. So, it's tough to tell investors that was the number one part of the $2 billion surprise. Changing that policy may make sense and this management has a history of trying to get more revenue out of content – which makes good sense. It will cost money in 2022 and should help 2023. (See Below).

- There was considerably more disclosure provided by WBD than we see from almost any other company doing a large deal. We would still like to see a 10-K style listing of accounting policies sooner than next February given how large this deal was. Management freely admits that they are still finalizing the allocation values for the deal, so we will not hold this too much against them. We hope to see the level of detail continue.

- Some of the other obvious headwinds that impacted 2Q results should have been easy to point to on the 1Q call as well – such as sports fees were rising, new market launch costs for streaming were higher than expected. (See Below).

What Is Driving Guidance Change?

Proforma Adjusted EBITDA for 2Q22 declined by $812 million to $1,764 million from proforma 2Q21 of $2,576 million. This can be broken down largely to a few areas:

- Studios were down $30 million and flat without FX. 2Q22 saw higher gaming business but a **tough movie comp given more releases in 2Q21**. However, fewer releases in 2Q22 also meant lower marketing. Without an FX headwind, Studios came out flat on EBITDA.

- Networks were down y/y by $295 million in 2Q22. This was the combination of an apples-to-oranges comp of having Chilevision in the 2021 quarter but not in 2022. Also, while revenues were up for sports, **payments for sports rights increased at a faster rate. WBD also guided to a 3Q22 headwind due to having some NBA finals games to start 3Q21 that didn't happen this year.**

- Direct to Consumer did see revenue growth y/y but EBITDA was down $325 million as **marketing rose faster than revenues, new market launches cost money and there were still rising programming costs to add content.**

- Corporate overhead on a proforma basis rose by $64 million too.

Some of these fall under the catch-all of "We didn't get this level of information in the AT&T forecasts before the deal closed." The rest would be WBD changing its course from what was planned for the 2nd Half of 2022.

What Are the Changes in Direction?

WBD also spelled out a six-part change in operating plans and programming that WBD expects will cost $2.0 billion of EBITDA in 2022. These will be a combination of losing revenues on content that won't be aired and therefore are out of initial projections, adding costs for new content, as well as operating model changes that will require some time or investment. Some of these already changes already played a role in the $800 million decline y/y for 2Q22 EBITDA.

The new EBITDA guidance for 2022 had dropped from $11.7 billion to $9.0-$9.5 billion. Some of this is a weaker economy, but the bulk will come from the following:

- AT&T was limiting some content distribution and making it exclusive to HBO Max. This cost the company high margin revenue as the content costs would be flat. Also, given that HBO Max was starting out, its revenue stream may have been lighter than what other existing platforms may have paid.

  WBD has made the point very clear that it sees the value in the content and monetizing it via several cash registers. So purposefully pulling programs off TNT or SKY doesn't mesh with the new policy direction. WBD sees higher revenue potential from getting paid by additional platforms for the same content.

  - Upfront – this means working on new distribution deals which will consume time and money. Some may be newer platforms like Amazon Prime or Hulu rather than more common situations of going to AMC or TNT. WBD also plans to charge its own cable channels the same price and deal with its internal distributors at arm's length.

  - Going forward – this should boost total revenues because each platform will pay vs. only HBO Max. Content costs wouldn't increase, so the incremental dollars should have higher margin. Also, content costs are amortized on an accelerated basis based on number of expected airings. This could speed up the full amortization and result in future results with selling content value and having no content costs (other than potential royalty payments.)

- AT&T limited the number of Business-to-Business distributors for HBO Max as well. This is essentially making it possible for people to sign up for HBO Max through platforms they may already use such as Amazon Prime or Dish Network. WBD wants subscriber growth and believes that it has very desirable content to monetize. It wants to expand growth potential in this area too.

- The third and fourth reasons revolve around content that was expected to be released in 2022 that will not. This involves kids and animated shows/movies and larger movies where WBD does not believe the quality is high enough and the estimated ROI does not justify additional marketing and distribution costs. Mostly, the focus is more on not wanting to release content that hurts the value of their other content. The high-level example of this is canceling the completion and release of Bat Girl. These decisions will do three things:

  - It led to write-offs/impairments in content of $496 million in 2Q22. Those would be viewed by many as non-cash write-offs, However…
  - It means WBD will lose revenue because those projected were expected to be sold into distribution channels later this year, And…
  - It means WBD will need to invest more in content to fill that void.

    - This is a problem that looks likely to be fixed, but in 2022 it cuts revenue and boosts costs.

- It also includes canceling other shows and programming related to its existing linear (cable) channels. This is much like the prior issue. Writing off the contracts is a one-time event, but they still must fill the programming hole. In 2022, WBD pays the costs twice and gets paid once. The goal is to have more popular shows that command higher ad revenue going forward.

- There was higher corporate overhead allocated to WarnerMedia by AT&T than Discovery estimated and that hurt forecasts.

It is also worth mentioning that WBD sees peak losses in EBITDA for streaming in 2022 and that will mitigate in 2023 to profitability in 2024 and $1 billion in positive results for 2025.

Guidance for 2023 May Look Light

WBD has pointed to 2023 to generate “at least $12 billion in adjusted EBITDA.” It has pointed to $3 billion in synergies being in place and $6 billion in Free Cash Flow.

WBD has already started to attack overhead cost-cutting and canceling low-ROI projects. It is merging the two streaming businesses together including adding programming and technical user features to them. It is rethinking much of the marketing spend on streaming as well and where spending makes no sense. Overhead staff and systems are being merged too. This type of cost-cutting has been obvious since the deal was announced. We think WBD will meet its goals in this area.

However, guidance is essentially adding $3 billion of cost cuts to the low-forecast of 2022 EBITDA of $9.0 billion. There is no revenue growth built into the forecasts and we think there are several areas to expect revenue gains to materialize:

- WBD is pitching itself as the Fifth Network to advertisers given the large number of channels and platforms it can offer as well as live sports. That should lead to better advertising rates than either company was getting separately. We have already read that WBD was getting higher rate increases than other players in the spring of 2022.

- We know 2022 revenue will be impaired by content that was expected to run in 2022 that was canceled on streaming, theaters, and cable channels. They will have created replacements for that this year which will be in place for 2023. That should help revenues rise y/y too.

- There are discounted subscriptions to HBO Max that may roll over at a higher price. WBD already said on the earnings call that it expects to raise the price point beyond the heavily discounted rates. Instead of $10-$12 ad-free, and $5 with limited advertising where they pick up another $5 from the ads – it may become $12 and $7 with limited advertising. They are also talking about free streaming with full advertising – but that may not be a 2023 story.

- Thinking of the streaming cadence too with peak losses in 2022, lower losses in 2023, profits in 2024, and $1 billion in profit in 2025 – it's possible WBD could see a $1 billion positive swing just from streaming results in 2023.

- WBD also said it wants to expand distribution channels and sell content in multiple ways. Those are creating new costs in 2022, but in 2023 could be producing more revenue.

- There's also a $28.7 billion Film/TV library that wasn't ignored by AT&T, but WBD is speaking that they see greater ways to monetize that too.

- Much of the incremental revenue doesn't come with much incremental cost either. As Jean-Briac Perrette, the CEO of Streaming said on the call, *"based on the operating leverage in the business, we believe we can achieve incremental margins of around 50% of every dollar of additional revenue growth."*

  We think that type of leverage exists in other revenue buckets at WBD and why it is looking more closely at how it gets its content in front of more eyes.

Guidance for Debt Reduction Remains in Place

When the deal was announced in the Spring of 2021, Discovery expected to start with $60 billion in debt which would be 5x EBITDA of $12 billion. The goal was to be at $14 billion in revenue by the end of 2023 via cost synergies and two years (mid-2024) after closing have a Debt to EBITDA level of 3x or lower. Despite the cut in 2022 starting EBITDA levels, it looks very reasonable that WBD will reach its goal in the same time frame. They are keeping that forecast:

Gunnar Wiedenfels – the CFO said on the earnings call:

> *"We are reiterating our long-term gross leverage target of 2.5 to 3x, which we expect to hit by the end of 2024, and our gross leverage will be within our current ratings category by mid-2024 or earlier. As stated before, we will continue to dedicate virtually all free cash flow generated to debt reduction until then."*

- It started with a lower debt figure of probably just over $52 billion and in the first months retired $3.5 billion in debt. It ended June with $52.5 billion in debt and $3.9 billion in cash for a net $48.6 billion – compared to an expected $60 billion. Trailing 12-months of EBITDA is $9.8 billion which puts the ratio at 4.95x.

- WBD is forecasting that it will receive $1.2 billion from AT&T for working capital adjustments and along with cash flow, will reduce debt by another $2.5 billion by the end of August 2022. That moves debt to $46.1 billion in August and Free Cash Flow net of all the restructuring and transition expenses is expected to be $3 billion in 2022. We are assuming that $2.5 billion includes part of the $3 billion, which means another $1.7 billion reduction to $44.4 billion by year-end. They are guiding to a multiple of 4.8x – which is the midpoint of EBITDA guidance of $9.0-$9.5 billion.

- WBD expects EBITDA of at least $12 billion in 2023 and says that will convert to $4-$6 billion of Free Cash Flow. If that's $5 billion – Debt falls to $39.4 billion and 3.3x $12 billion in EBITDA.

- By the end of 2023, the ratio would only be about 3.1x if EBITDA came in at $12.5 billion. It would be at 3.0x if EBITDA stayed at $12 billion by mid-2024.

This still looks like a goal that WBD could meet without any outlandish forecasts.

Accounting Procedures - Allocating the Acquisition

We have one 10-Q with and presentation after the merger and one area we wanted to spend more time on once there was an SEC document with combined figures was accounting quality. The allocation of the purchase price is still subject to adjustment likely through 1Q23:

> *"The purchase price allocation is preliminary and subject to change.* ***The Company is still evaluating the fair value of film and television library, intangible assets, and income taxes, in addition to ensuring all other assets and liabilities and contingencies have been identified and recorded****. The Company has estimated the preliminary fair value of assets acquired and liabilities assumed based on information currently available and will continue to adjust those estimates as additional information pertaining to events or circumstances present at the Closing Date becomes available during the measurement period.* ***The Company will reflect measurement period adjustments, if any, in the period in which the adjustments occur, and the Company will finalize its accounting for the Merger within one year of the Closing Date.****"*

At this point, we do like that Goodwill did not become the largest component of the purchase price. If we look at fixed assets (non-working capital items that may be depreciated or amortized), Goodwill is only about 20% of the total:

Long-term Assets	4/8/22	% of deal
Film/TV Library	$28.7	27.4%
Intangibles	$44.9	42.9%
Goodwill	$21.5	20.6%
PP&E	$4.3	4.1%
Non Curr. Assets	$5.2	5.0%

Everything including Goodwill will be subject to impairment testing based on forecasted cash flows.

It is not clear at this point how the Film/TV Library will be expensed. We know a normal film's content costs are capitalized and then amortized over the expected number of showings for its estimated life. Discovery uses a straight-line or accelerated method for each project that will expense it over a maximum of 10 years. However, in reality, over 90% is amortized by the third year. Time Warner before AT&T used the same method and also pointed to over 90% of content costs being amortized by the third year.

Normal content amortization is not added back to EBITDA is a key point. It builds like inventory and then is expensed with revenues – but is not considered a non-cash item.

What makes the Film/TV Library more problematic is there are classic movies where the initial content costs were long ago fully expensed. Yet, those can be aired on cable TV and draw advertising, released again as anniversary showings in theaters, maybe holiday movies many people watch every year, etc. There should also be movies that spawned spin-offs or sequels where the tie-in to the original classic may mean the new sequel is expected to have a longer life and draw in more revenues than if the original didn't exist. At this point, we know that WBD used multiple methods to value the Library that incorporated book value and estimated income/cash flows over extended times to determine the value.

We know that Time Warner was amortizing its film library on a straight-line basis over four years. We also know that from the valuation methods used, WBD stepped up the value of the Library to an estimated fair market value of $28.7 billion. There are pro forma numbers that show the amortization of stepped-up library values for the Adjusted EBITDA calculation:

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
Amort Content Step Up	$902	$513	$534	$498	$708	$823

There is simply less information in a 10-Q and at this point, we have one data point that isn't pro forma. And, WBD has said it is still setting the final values for the assets. If they were doing a straight-line amortization over four years – amortization should be $1.8 billion per quarter. The movement in the figure suggests it is being amortized by a method that expenses Library content when it is aired.

Our conclusions in this area are:

- WBD gets high marks for not assigning the bulk of the purchase price to Goodwill.

- The expensing of new content costs is done on an accelerated basis and appears to match norms and be conservative.

- The sizeable Library valuation is being amortized, and while the policy is not completely clear, that expense is being added back to EBITDA – which is the primary figure investors are following here as the acquisition moves forward.

- We believe history has shown there are far more Gateway Computers and Betamax video recorders than Oreo Cookies when companies assign tremendous value to eternal life Goodwill. However, WBD probably can make the case that Superman and Jimmy Stewart holiday movies do have long lives.

- As WBD is expensing the Library rather than assigning it to Goodwill, the accounting in this area may be conservative. We would still like to see more details.

Accounting Procedures – Other Amortization Policies

When we look at the accounting at Discovery before the deal, we see evidence of conservative policies as well. Here are some examples:

- Sales commissions are largely expensed as incurred or in under one year. We see companies that capitalize and amortize this expense over as long as five years.

- Capitalized software is amortized over 2-5 years. That used to be the gold-standard rate in our view, but most companies we follow have moved to 3-7 years or 5-7 years. Time Warner before AT&T was using 3-7 years. Discovery stayed more conservative.

- Depreciation for Broadcasting equipment, furnishings, fixtures is over 3-5 years. That is the bulk of PP&E. Again 5-10 years is more common and Time Warner was 3-10, so Discovery is staying more conservative.

- We mentioned Film and TV Content amortization that is tied to forecasts on the number of times a film or program is aired, and the official policy says as long as 10 years. However, some content is expensed as incurred (or over a very short time) such as news, and the rest as an accelerated amortization where more than 90% will be expensed within three years.

- There were intangibles at Discovery from other mergers in the past – primarily Customer Relationships and Trademarks. These were being amortized straight-line over 10 years. They changed the policy to an accelerated sum of the years digits in 2021 to expense them faster.

If we look at the breakdown of Intangibles that came with the deal, WBD assigned $44.9 billion to various accounts here:

Intangibles	**New on 4/8/22**	**Wgt Avg Life**	**Total with Discovery on 6/30/22**	**Wgt Ave Life**
Trade Names	$21.1	25 yrs	$21.8	32 yrs
Relationships	$14.7	6 yrs	$17.7	8 yrs
Franchises	$7.9	35 yrs	$7.8	35 yrs
Other	$1.2	6-14 yrs	$1.3	6-14 yrs
Total	$44.9		$48.6	

We did not see any specific reference to amortization being straight line or accelerated and again with one data point, that is tougher to see. However, there is a future schedule provided for these intangibles that points to 56% of the amortization to occur within five years and it looks like they are using an accelerated method like sum of the years digits:

	2H 22	**2023**	**2024**	**2025**	**2026**
Future Amortization	$3,790	$6,497	$4,976	$3,600	$2,590

There is a large piece of relationship intangibles being expensed over an average of six years so that does account for some of the rapid decline in forecasted amortization. But the decline in the expense should be more muted and steadier if there were straight-line assumptions being used.

Finally, the focus of this company for probably the next year will be adjusted EBITDA. GAAP earnings will likely contain several adjustments. We also do not see anything too outlandish in WBD's definition of adjusted EBITDA:

- It starts with operating income and adds back depreciation and amortization – that obviously includes the amortization of the acquired intangibles too. They also eliminate intersegment items.

- One-time (or short-lived) items such as restructuring/consolidation costs, impairments, transition/integration items along with gains/losses are added back too. As long as we're not seeing these continually three years from now – we're fine with these adjustments.

- The amortization of the stepped value of the Film/TV library. That also makes sense to us and we discussed this above.

- Adding back share compensation and the amortization of capitalized interest on content. We would view both as ongoing expenses. The share compensation appears to be the only material part of this at $90-$115 million per quarter from the pro forma tables. That's a minor accounting concern when weighed against other positive quality items we found at this point.

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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