BEHIND THE NUMBERS
Quality of Earnings Analysis

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Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

BTN Thursday Thoughts

Updates and New Developments on Active BTN Ideas

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The Hershey Company (HSY)
Earnings Quality Update

We are maintaining our earnings quality rating of HSY to 3- (Minor Concern).

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

Summary

HSY’s non-GAAP EPS of $2.53 topped estimates by 12 cps while revenue was also above consensus by $134 million. The company raised its full-year sales growth guidance to 12-14%

from the previous 10-12% and raised its non-GAAP EPS growth guidance to 12-14% from 10-12%.

A lower adjusted tax rate added about 14 cps but this was due to an unusually high rate last year. This year's rate was likely in line with what the market was expecting so we do not see this as integral to the beat. EPS was penalized by 4.8 cps from an increase in other expense from higher write-downs in equity investments qualifying for tax credits and higher non-service components of pension costs.

- Inventory levels declined again despite higher raw materials costs. HSY uses LIFO for about 60% of its inventories. Gross margins are likely benefitting from the delay in replenishing inventories at higher costs which will reverse when it rebuilds. (see detail below.)

- Supply chain disruptions led to a decline in retailer inventories of HSY's products. However, 6% of the company's North American Confectionary sales growth was driven by restocking the retailer channel. The disappearance of the restocking tailwind and an expected increase in price elasticity are expected to result in volume declines in the second half.

- Advertising rose by 3% in the quarter, well below the 19% increase in sales. The company also noted its net pricing result of 9.5% included 2.5 points from lower promotional spending. This is likely driven by product availability issues, but we estimate the lower promotional spending added about 19 cps to earnings in the quarter. Nevertheless, the company expects to increase promotional activity and advertising in the back half. Its outlook now includes a "low-single-digit" increase in advertising expense for the year whereas before it was calling for advertising to remain flat. It also explicitly called for advertising growth to outstrip sales growth next year.

- Management stated that it does not expect recent pricing actions to impact sales until the fourth quarter but has indicated it expects pricing to rise by "high-single digits." The company raised sales growth guidance by 200 bps but they have indicated volumes will decline. Increased promotional activity will be a net drain on pricing. To expect net pricing to drive higher sales with declining volumes and rising promotional activity puts a great deal of pressure on the company to realize all of its price increases without higher than expected elasticity dragging down volume more than expected.

Inventory Levels Continue to Lag

We highlighted in our last review that HSYs inventory levels were declining despite rising raw materials and labor costs. This situation worsened in the quarter. The following tables show inventory components and component-level DSI for the last twelve quarters:

Inventory Component Data	7/03/2022	4/3/2022	12/31/2021	10/3/2021
Raw Materials	$390.557	$383.557	$395.358	$403.374
Goods in Process	$164.444	$150.722	$110.008	$131.523
Finished Goods	$841.036	$685.022	$649.082	$662.073
Adjustments to LIFO	-$187.798	-$187.798	-$165.937	-$170.429
Total Inventory	$1,208.239	$1,031.503	$988.511	$1,026.541
	7/04/2021	4/04/2021	12/31/2020	9/27/2020
Raw Materials	$412.728	$428.678	$388.600	$326.556
Goods in Process	$140.868	$116.894	$104.841	$120.132
Finished Goods	$677.254	$534.660	$645.664	$686.999
Adjustments to LIFO	-$170.428	-$170.430	-$174.898	-$175.204
Total Inventory	$1,060.422	$909.802	$964.207	$958.483
	6/28/2020	3/29/2020	12/31/2019	9/29/2019
Raw Materials	$347.999	$324.674	$271.125	$280.865
Goods in Process	$132.235	$117.818	$98.842	$121.335
Finished Goods	$694.351	$564.906	$614.698	$738.798
Adjustments to LIFO	-$175.205	-$175.205	-$169.414	-$171.927
Total Inventory	$999.380	$832.193	$815.251	$969.071

	7/03/2022	4/3/2022	12/31/2021	10/3/2021
Raw Materials DSI	25.9	25.1	26.8	28.3
Goods in Process DSI	10.9	9.9	7.5	9.2
Finished Goods DSI	55.8	44.8	44.0	46.4
Adjustments to LIFO DSI	-12.5	-12.3	-11.2	-11.9
Total Inventory	80.1	67.5	67.0	71.9

	7/04/2021	4/04/2021	12/31/2020	9/27/2020
Raw Materials DSI	35.3	32.3	30.2	26.1
Goods in Process DSI	12.0	8.8	8.1	9.6
Finished Goods DSI	57.9	40.3	50.1	54.8
Adjustments to LIFO DSI	-14.6	-12.8	-13.6	-14.0
Total Inventory	90.7	68.6	74.9	76.5

	6/28/2020	3/29/2020	12/31/2019	9/29/2019
Raw Materials DSI	34.6	24.7	21.8	21.5
Goods in Process DSI	13.2	9.0	8.0	9.3
Finished Goods DSI	69.1	42.9	49.4	56.4
Adjustments to LIFO DSI	-17.4	-13.3	-13.6	-13.1
Total Inventory	99.4	63.3	65.6	74.0

- HSY utilizes the LIFO method of inventory accounting for about 60% of its inventories which expenses the latest items added to inventory. In periods of rising costs, this will result in lower profits than a company using FIFO as the company's income statement reflects the more expensive inventory first.

- While finished goods increased sequentially and YOY on an absolute basis, it declined considerably on a DSI basis. More noticeably, raw materials fell on an absolute basis. It appears the company will be in a position of buying material amounts of inventory at higher prices to stock up for the upcoming holiday demand. This higher-priced inventory will be expensed first.

LyondellBasell Industries N.V. (LYB)
Earnings Quality Update

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

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

Summary

LYB's. adjusted EPS of $5.19 beat estimates handily by 49 cents. The only adjustment to earnings was adding back 21 cents related to a $69 million impairment to exit a polypropylene unit in Australia.

- There was also a headwind from a 22-cent pension charge that was not forecast and was not adjusted out of non-GAAP EPS.
- A French unit was down longer than anticipated for scheduled maintenance and that hurt EBITDA by $65 million, which we would estimate hurt EPS by about 15 cents.

What to Watch

- The refinery operation had an almost perfect quarter with volumes processed up slightly y/y in 2Q, but the profit spread per barrel nearly tripled. This unit posted $418 million in EBITDA vs. -$81 million in 2Q21 and $148 million in 1Q22. Keep in mind the following:
  - LYB is already seeing the refinery profit spread moderate in 3Q.
  - LYB will operate at the unit 87% capacity rather than 94% due to some minor maintenance.
  - LYB still intends to close the refinery by the end of 2023 as the level of maintenance spending required by then likely exceeds its cash flow generation and it may repurpose the site for new capacity in another division.

- What suffered in 2Q were the European operations due to higher feedstock prices and the lockdowns in China causing both weaker demand there as well as other Asian plants looking for a non-China market to sell product into.
    - LYB is seeing China demand start to recover, but expects a bigger impact in 4Q than 3Q.
    - The level of lost China demand has been huge, so this should come back much stronger than 2Q and 3Q.
    - The net-net should be lower refinery EBITDA in 3Q with improvement in Europe and the US operations should benefit from some inventory refilling at customers after maintenance downtime.
- The new PO/TBA plant was 99% completed in June 2022, so commissioning has begun and start-up will begin in 1Q23.
    - This means LYB's growth capital spending should decline for a few quarters at this point and help free cash flow.
    - The new plant is only expected to operate at about 50% output for 2023 as it turns on and builds up to full capacity.
    - That should create some additional EBITDA in 2023, but a better source in 2024.
- Inventories remain low. We have pointed out that LYB normally carries about 55 days of inventory. It finished 2Q22 at 38 days, down from 41 days after 1Q22 and 4Q20.
    - Some of the recent drop likely relates to falling feedstock costs at the end of the quarter and the COGS in the equation represents a period of higher costs. COGS was up 10% from 1Q while inventories only rose 2%. That likely cost them about 3-4 days in the DSI calculation.
    - We had concerns that boosting inventories may consume $600 million to $1 billion of cash flow. If the lower pricing holds, this may be a smaller headwind.

- Even after paying a special dividend of $1.7 billion in 2Q in addition to the regular dividend of $389 million, debt to EBITDA is only 1.23x.

Altria Group, Inc. (MO)
Earnings Quality Update

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

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

Summary

We have written so much about MO and the numerous bombs aimed at its complete business model, we will refer readers to recent reports and the 2Q22 Focus List.

For 2Q22, MO's adjusted EPS of $1.26 beat forecasts by only 1 cent. It only grew EPS by 3 cents y/y despite several tailwinds:

- A lower share count added 3 cents

- It added back higher litigation/healthcare costs – producing 2 cents. We expected this as courts have reopened after a Covid reprieve.

- It does not quantify the figure, but in 2Q21 MO had marketing costs to roll out IQOS (Heated Tobacco Products) and those did not occur in 2Q22 – that helped EPS too.

What is Worse?

- Smoking took another 15-cent price hike on cigarettes and volumes declined by 10% adjusted for trade inventory movements. That comes after -8% in 1Q22 and -8% in 4Q21. That is due to a combination of higher food and gas prices competing for customer smoking dollars. MO used to manage the decay of volumes with price hikes that grew smoking income. Now, the acceleration of decay by losing new under-21smokers and inflation programs are making this equation unsustainable in our view:

    - Smoking revenues declined y/y in 2Q22 by -2.9% and the net figure of -0.7% looks better only because the price hikes leveraged the excise taxes that didn't change

in amount per pack. Also, MO cut promotional spending that is deducted from revenues.

    - Smoking operating income declined y/y by -0.5% and that was cushioned by the absence of IQOS marketing and helped by lower marketing on cigarettes.

    - Marlboro lost share to discount brands – which may make it more difficult to take enormous price hikes.

    - Smoking is still 87% of the basis for MO’s cash flow.

- Oral Products are primarily moist snuff and are 14% of operating income. Revenue and operating income both declined y/y. The volume decline of 2.5% is misleading given that *on!* did grow. Looking at the primary products of moist snuff, volumes fell by 8.3%.

- Another write-down in the JUUL investment of $1.155 billion lowered the carrying value to $450 million vs. MO’s initial CASH investment of $12.8 billion. As part of the thinking behind this latest write-down, MO viewed the risks of new regulation against e-vapor products, lawsuits against JUUL, and whether JUUL would eventually go bankrupt.

  It’s important to note that MO can walk away from its JUUL investment and pursue other e-vapor opportunities. The trigger is having the value of its investment fall below 10% of the purchase price. MO is not planning on this course of action at this time. However, MO would still have 4,030 lawsuits against it related to JUUL products up from 2,626 last year. The two companies do have an agreement to structure a joint litigation oversight committee should MO terminate other deals with JUUL.

National Instruments Corporation (NATI)
Earnings Quality Update

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

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

Summary

NATI beat non-GAAP 2Q22 estimates by 3 cents and grew results by 1 cent y/y. We saw three areas that helped the beat: a lower tax rate added 0.8 cents, rounding up 0.2 cents, and repurchasing shares added 0.4 cents. So the beat was solid and NATI faced several headwinds:

- Using brokers to locate parts to fulfill orders cost it 400bp of gross margin – this cost NATI 9.8 cents in the quarter.

- The shutdowns in China helped drive Backlog up again by $40 million. This delayed revenue hurt EPS by as much as 18.5 cents (assuming a 74.5% gross margin).

- We took it as a positive that NATI beat revenue forecasts and posted higher sequential revenues too for 2Q, up $10.3 million after the concerns about China coming into 2Q22. Acquisitions accounted for the $10 million in growth, but the deals were already known for 2Q.

What is Positive

- NATI has less exposure to the primary semiconductor market than many think. Much of its sales involve testing equipment for R&D of other semiconductor companies more than selling end-market chips. Those are areas that do not see the swings in demand.

- NATI guided to some sizeable growth for 3Q22: revenue of $410-$440 million and adjusted EPS of 46-60 cents vs. the $396 million and 36 cents just posted. It also noted that supply constraints did not worsen in the quarter. It still expects to see operating margin expand by at least 100bp in 2022.

- The bigger part of news was 2023 guidance. NATI expects to be using very few broker purchases for hard-to-find parts, which was a 400bp margin headwind in 2Q22. They should see margins expand at least 300bp in 2023. Moreover, as we have discussed many times, the backlog of now $250 million will flow through sales and will have minimal impact on operating costs. NATI has over $1.00 per share in pent-up EPS that could flow through as the backlog declines to the normal one week.

- Recent acquisitions are growing rapidly. These new companies heavily target Electric Vehicles and Advanced Driver Assistance Systems. These are still seeing order rates growing at 62%. Aerospace grew orders at 25%, and semiconductor and electronics at 10%.

- NATI was further able to rebuild inventories and this should help revenue growth and start to reduce the backlog further.

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20
Inventory	$344	$308	$289	$237	$211	$197	$194	$210
DSIs	253.6	244.3	222.0	218.0	201.2	196.3	167.6	215.4
Product Sales	$355	$344	$377	$326	$307	$295	$328	$270
P Sales Growth	15.8%	16.5%	15.1%	20.8%	15.1%	7.7%	-1.4%	-11.6%

- Higher sales are still leveraging operating costs of Selling & Marketing, R&D, and G&A. These were 55.1% of sales in 2Q22 vs. 57.5% in 2Q21 and 54.0% in 1Q22 vs. 59.9% in 1Q21. Some of the jump in 2021 related to higher bonus pay, which is now being leveraged. Also, NATI was successful in lowering overall fixed costs. We think this again will play a role in having sales and EPS increase as the backlog is worked down.

Sealed Air Corporation (SEE)
Earnings Quality Update

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

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

Summary

SEE's adjusted $1.01 in EPS beat by 5 cents in 2Q22. The company did not raise guidance on any metric following the beat. We see several areas of low-quality/non-sustainable sources for the beat:

- Lower tax rate added 1.2 cents.
- Adding back recurring 3rd party consulting fees added 2 cents.
- Lower share compensation/profit sharing added 1 cent.
- Adjusted EPS was up 22 cents y/y, SEE gained 29 cents for price increases exceeding commodity inflation plus operating cost inflation such as labor. We think that more than generated the earnings beat.

We think investors should be looking at the following potential headwinds as well:

- Price/Cost spread is supposed to allow SEE to pass through commodity inflation and deflation to customers. It is designed to net out to zero over time and delays in taking price or reducing price vs. commodity cost changes results in this source/drag on earnings. SEE has seen the largest increases in Price/Cost spread creating earnings that we've ever seen in the last two quarters and it is now lapping the first price hikes from 2021. (See Details Below)
- SEE uses FIFO accounting, which helps margins during inflation. Its inventory levels are very high at 87 days vs. the normal 70. Some of the commodity prices are declining at this point and SEE noted that some customers are trying to reduce their own inventories.

That could force pricing strength to weaken and leave SEE with very high-cost inventory to flow through the income statement at lower prices. (See Details Below)

- FX may be a drain on future pricing too. In recent times, SEE was getting price hikes and positive FX revenue growth. That reversed in 4Q21 and now in 2Q22 – the total pricing gain net of FX losses declined sequentially. (See Details Below)

Why Isn't Guidance Being Raised?

- EBITDA guidance started 2022 at $1.20-$1.24 billion vs. 2021's $1.132 billion or 6%-10% growth with dollar gains of $68-$108 million. 1Q saw pricing exceed commodity inflation by $98 million of EBITDA growth and SEE boosted the growth for the year by $10-$20 million. In 2Q, pricing exceeded commodity inflation by $114 million in EBITDA with no raise. Operating costs rose $30 million in 1Q and $58 million in 2Q which still significantly lags the EBITDA growth from pricing.

- The EPS forecasts of $3.95-$4.15 to start the year was boosted by 5-10 cents after 1Q beat by 19 cents. It wasn't raised after SEE beat forecasts by 5 cents in 2Q.

- We think one reason why guidance isn't rising is the Price/Cost metric is supposed to net to zero over time. It allows SEE to pass along changes in commodity prices for its products so price increases should equal the cost increases over time. Large customers look at the same commodity cost indices too. We think SEE is getting far ahead of a long-term zero again, especially with inflation retreating somewhat for fuel, resin, and other plastics. We used to point out that for something that should even out over time, SEE managed to take $179 million in positive Price/Cost with 10 consecutive positive figures from 1Q18 – 3Q20. Here are the recent figures:

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20
Price/Cost EBITDA	$114	$98	$36	-$18	-$36	-$18	-$7	$9

So, from +$179 million, SEE gave back $79 million from 4Q20-3Q21. It has since taken $248 million more.

- Other operating costs are supposed to be SEE's problem to deal with, not the customers'. These are changes in labor, rent, etc. Looking at the EBITDA bridge of y/y growth from Price/Cost, SEE also lists operating costs the same way and often points out its prowess of reducing costs. Even when Price/Cost was running negative for four quarters, SEE was still seeing positive gains in EBITDA from falling operating costs. Now that has become a big headwind and some of that may not decline even if Price/Cost does:

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20
Op Cost EBITDA	-$58	-$30	-$4	$3	-$13	$10	$2	$4

- The CFO already said on the call that is trying to hold guidance flat despite beats because it sees more pressure from these headwinds:

> "*However, on the cost side, both material and nonmaterial they both were up versus our prior expectations. So from the materials side, we're more in this $350 million range, $350 million for the full year. And then on nonmaterial inflation, we expect that to be more about $110 million, where last time we guided about $100 million. So we're trying to provide this transparency as we manage through this, both on driving productivity actions as well as the price realization to help offset those costs and that gave us the confidence to keep the full year guidance.*"

Inventory Is Rising Rapidly at SEE

Everyone knows there have been inflationary pressures for the last year. One of the complaints we have had about several companies is they have avoided replacing inventories at the same rate of sales and their DSIs have been falling. Our view is these companies are betting that they will see inflation recede and will be able to rebuild inventory levels at lower costs.

SEE is the opposite. It is seeing inventories rise much faster and are considerably higher than before Covid at this point. The problem we have for SEE is it uses FIFO accounting. If DSIs are rising at SEE, it means they are building inventories as the costs rise. However, if oil/gas chemicals that become plastic compounds decline in price – SEE will have huge inventories to sell acquired at higher costs:

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20
Inventory	$933	$844	$726	$741	$731	$652	$597	$631
COGS	$980	$941	$1,056	$1,003	$928	$866	$917	$833
DSIs	86.6	80.7	63.2	68.0	71.7	67.8	59.9	69.7

We went back to look at 2019 and DSIs were basically 70 days except for 4Q at 60 days and seasonally 4Q is normally lower. There are several problems we see:

- On the 2Q22 earnings call, SEE reported it is seeing customers who buy packaging products from SEE starting to adjust their inventories due to the sliding economy.

- Some of the pricing changes that SEE takes come from commodity index formulas. Those can go down also. So if volumes decline and pricing starts to retreat – SEE is loaded with higher-cost inventory. Does that work well for more big price hikes?

- Volume is already falling and look at the comps for 3Q and 4Q that are coming:

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20
Food Vol	-2.3%	1.5%	6.2%	5.7%	4.2%	-0.4%	0.3%	-1.8%
Protective Vol	-7.6%	-3.2%	0.9%	3.8%	15.2%	13.0%	7.4%	21.4%

- Gross margin is already not very strong despite FIFO and price hikes. There's an easy margin comp for 3Q22, then those are gone. They will lap the big price hikes announced in 2021 in 3Q and 4Q too:

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20
Pricing	16.1%	16.1%	12.0%	7.8%	2.6%	0.7%	-0.2%	0.0%
Gross Margin	30.9%	33.6%	31.0%	28.7%	30.2%	31.7%	31.7%	32.7%
y/y GM chg in BP	70	190	-70	-300	-250	-220	-140	50

Will FX Losses Mute Price Hikes?

We know the dollar is getting stronger which has reversed the FX situation for SEE. Last year it was bringing in extra revenue with positive FX translation. Now, they are losing more than 100% of price hikes in Asia via FX losses as well as losing most of the European price hikes.

	2Q22	1Q22	4Q21	3Q21	2Q21
APAC Price	$9.6	$6.3	$5.6	$1.1	$2.3
APAC FX	-$14.8	-$9.0	-$2.6	$5.1	$15.7
EMEA Price	$35.9	$28.2	$13.7	$9.3	$3.4
EMEA FX	-$32.5	-$22.2	-$7.7	$5.2	$25.0
N. Am Price	$169.0	$169.1	$142.0	$86.6	$24.7
N. Am FX	-$4.5	-$3.3	-$5.3	$1.9	$5.2
Total Net Price	$162.7	$169.1	$145.7	$109.2	$76.3

North America is carrying the day on pricing but we saw in 2Q22 that even that couldn't continue growing net pricing. And, they will lap their first price hikes taken in 2021 this quarter.

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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