BEHIND THE NUMBERS
Quality of Earnings Analysis
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Review of Industrial Receivables Reserves

Some Industrials have been benefitting from declining bad debt reserves

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Introduction and Receivables Analysis Primer

There are a handful of decent books that cover the basics of earnings quality analysis. A common thread among them seems to be that accounts receivable is the first area on which analysts should focus their attention during a forensic review of the financial statements. This is for good reason as aggressive revenue recognition can materially impact the bottom line. However, most instruction seldom gets past the basic principle that receivables rising faster than sales is a bad thing. Some earnings quality screening tools automatically dock a company's score if receivables growth trips some pre-determined threshold as if being one notch below indicates no trouble at all and one notch above indicates outright malfeasance. ***We are firm believers that good analysis requires much more nuance and that earnings quality analysis, much like investing itself, is as much art as it is science.***

This report will address the points analysts should be considering when reviewing a company's receivables-related disclosures. We will then discuss the results of our examination of the receivables of over 70 industrial companies which includes a more in-depth look at 10 companies that have seen their recent results materially impacted by unusual changes in receivables-related items.

DSOs Rising

We will start with the well-documented concept that receivables rising faster than sales over time is a red flag. The gold-standard measure used to capture the relationship between revenue and receivables is "days sales outstanding", or DSO, which we calculate as ending accounts receivable multiplied by 91.25 days divided by quarterly revenue. Other variations include calculating this using annual data or choosing to average the beginning and ending receivables balances.

The DSO balance should generally be compared to the year-ago result to account for seasonality in billing. Any increase should be viewed with caution- but how big an increase is too much? Unfortunately, there is no easy answer. The real value is not added by calculating the ratio but rather in the interpretation of the trend in the ratio and the components that make it up. The following should be considered:

A jump in DSOs is not concerning if any of the following are true:

- The company made an acquisition in the middle of a quarter which skewed the DSO upward as the full amount of acquired receivables were reflected in the ratio while only a few weeks of revenue were recorded.

- The company acquired a business that operates with a higher or lower amount of receivables relative to sales than the company's legacy business. This could result in an increase in DSO for the next 4 quarters or until the company can bring down the working capital requirements of the new business.

- Revenue is growing very rapidly or is experiencing a sudden acceleration resulting in new receivables being generated that have not had time to be collected before the end of the period.

However, if none of these conditions exist, then an increase in DSO could be an indication of a less benign situation including:

- The company was falling behind on its sales quota for the quarter and offered generous payment terms or other incentives to customers if they would commit to buying before the end of the quarter. This essentially pulls revenue from the next quarter into the current quarter. That may help the company make this quarter's numbers but puts it in the position of starting the next quarter "in the hole."

- The company is experiencing a slowdown in collections which may be an indication of deteriorating macro conditions in its end markets. However, it may also be an indication that the company's sales mix has shifted to larger, more powerful customers able to demand longer payment terms.

Being able to accurately determine which one of the above factors is driving the DSO change requires digging into press releases, conference call transcripts, and management discussion and analysis (MD&A) sections of SEC filings looking for answers. Once again we see ratios and screening don't provide answers, they merely help identify the best places to dig.

Changes in Bad Debt Allowance

When a company books a receivable, it almost always records it net of an estimated allowance for amounts that will not be collected due to customer default. Almost all companies with large receivables balances report this allowance either on the balance sheet next to the receivables heading or in a footnote. Analysts should track the allowance as a percentage of gross receivables over time and start asking questions if this figure begins to decline, considering the following:

- It is normal for a company to increase the allowance percentage during economic slowdowns. The 2008 financial crisis and Covid saw many companies take large charges to build their reserve levels to 2 or 3 times their normal levels.

- As economic conditions normalize, a decline in the allowance percentage is to be expected. However, analysts should be alarmed by any sudden decline in the allowance percentage during stable financial conditions or if the allowance percentage falls below its long-term historical norm.

- Keep in mind that some companies include reserves for estimated discounts and returns in the bad debt allowance and it is often difficult to tell which component is moving the account. This should be considered when comparing the absolute reserve percentage between companies.

Provision Expense and Write-Offs

When analyzing changes in the bad debt allowance, analysts should keep in mind that the account is moved up and down by factors including provision expense associated with newly booked receivables, collections of receivables, changes in estimates of the collectability of receivables already provided for, and write-offs of existing receivables. Unfortunately, many companies do not disclose provision expense and write-offs quarterly. Some record provision expense in the operating cash flow section of the cash flow statement while some may record both provision expense and write-offs in a separate footnote. If provided, this information can give much greater insight into the actual profit impact from movements in the reserve.

- Analysts should track provision expense as a percentage of sales over time and take note of any unusual declines.

- Often, a company may record a credit as opposed to an expense which indicates it is reversing previously booked allowances into earnings. Even if this is warranted by improving credit experience, it nonetheless represents a non-operating, unsustainable benefit to current profits. In some cases, management will point such an item out in its discussion of results. Unfortunately, this is not always the case, and any time such material benefits are not discussed while comparably-sized headwinds are highlighted or

even added back to non-GAAP results, it should reduce management’s credibility in the mind of the analyst.

Receivables Factoring

Another receivables-related item that is often overlooked by investors is factoring arrangements under which the company sells accounts receivables to third-party financing companies. This allows the company to receive its cash more quickly. In most situations, the company maintains the responsibility to collect the receivables and remit the cash to the factoring company when it is collected. Under such arrangements, the receivables are removed from the company’s balance sheet even though they are still outstanding. This requires the analyst to add the amount of factored receivables that remain outstanding back to receivables left on the balance sheet to get a meaningful DSO calculation.

GAAP does not maintain uniform disclosure requirements related to receivables submitted to factoring programs. Any information provided can typically be found in the footnotes although it is occasionally disclosed separately on the balance sheet.

Analysts should consider the following when evaluating factoring arrangements:

- The purpose of DSO analysis is to examine how rapidly receivables are being generated. Therefore, factored balances that have not been collected must be added back to receivables on the balance sheet or the DSO ratio will be understated.

- When the company sells receivables, it is almost always booked as an operating cash flow. Thus, an acceleration in receivables factoring will provide a temporary boost to cash flow growth that must be taken into consideration when analyzing cash flow trends.

Below, we dig into the receivables details for ten industrial companies that displayed recent unusual movements in their allowance for bad debt accounts.

Johnson Controls (JCI)

We see several items of concern with JCI's receivables and reserves. At first glance, JCI has reduced its bad debt allowance considerably in recent years and it remains well below pre-Covid levels:

Year ended September:	FY 23	FY 22	FY21	FY20	FY19	FY 18
DSO	83.0	83.6	88.3	89.7	90.5	90.3
Receivables	$6,006	$5,727	$5,613	$5,294	$5,770	$5,622
Sales	$26,793	$25,299	$23,668	$22,317	$23,968	$23,400
Allowance for Bad Debts	$90	$66	$110	$173	$173	$169
Allowance % of Gross Receivables	1.48%	1.14%	1.92%	3.16%	2.91%	2.92%

It looks like sales dipped in fiscal 2020 with Covid, the bad debt reserves were held flat and then declined in 2021 and 2022 before a small uptick in 2023. Plus, DSO's are lower which may indicate customers are be paying faster. But let's dig deeper:

- Late in fiscal 2021, JCI started to factor receivables. When receivables are sold, they are removed from the balance sheet, but they must be added back when calculating DSO. When we include the outstanding amounts of sold receivables, JCI's DSO's have gone up, even though reserves are half the pre-Covid level.

	FY 23	FY 22	FY 21	FY 20	FY19	FY 18
DSO	92.3	90.4	90.2	89.7	90.5	90.3
Receivables	$6,006	$5,727	$5,613	$5,294	$5,770	$5,622
Factored Receivables	$681	$476	$127	$0	$0	$0.0
Reserves	$90	$66	$110	$173	$173	$169
Total	$6,777	$6,269	$5,850	$5,467	$5,943	$5,791

- Factoring benefits cash flow by turning receivables into cash sooner. In fiscal 2023, JCI reported free cash flow of $1.819 billion defined as cash from operations less capital spending and a financing adjustment. We would adjust free cash flow down by $726

million for acquisitions, which JCI routinely makes - which would drop free cash flow to only $1.093 billion. Now consider that JCI had $681 million in cash flow due to factoring.

- The y/y change in bad debt reserves is a net figure to reflect new provisions to the allowance, amounts written-off, FX changes, and acquisition adjustments. Before 2023, JCI gave more color on movement in the reserve by disclosing bad debt expense and write-off activity. The sudden disappearance of this disclosure is a mark against the company's earnigns quality in our minds. We can assume that fiscal 2023 had an increase in bad debt expense. That is compared to fiscal 2022 and 2021 where JCI booked a bad debt credit and wrote off some sizeable past reserves:

	FY 23	FY 22	FY 21	FY 20	FY19	FY 18
Bad Debt Expense	n/a	-$2.0	-$3.0	$20.0	$37.0	$14.0
Charged-Off	n/a	-$38.0	-$65.0	-$21.0	-$21.0	-$17.0
Ending Reserve	$90.0	$66.0	$110.0	$173.0	$173.0	$169.0

- JCI likely saw bad debt expense of at least $30 million in fiscal 2023. That would have been a 4-cent headwind for EPS. Consider that during fiscal 2023, JCI results differed vs. estimates by 0 cents, 1 cent, 0 cents, and -2 cents for a net miss of 1 cent for the year.

- Now, should the reserve be closer to 2.5%-3.0% of receivables? JCI is forecasting mid-single-digit revenue growth, which at 5% is $28.1 billion for fiscal 2024. Let's assume the DSOs improve to 91 days. That would mean receivables would be $7.0 billion. At 2.5%, credit reserves would need to rise to $175 million, and at 3.0%, to $210 million. That would mean at a minimum an EPS headwind of $85-$120 million or 11-15 cents in 2024. The company is saying it should be able to ask for more upfront payments in 2024, which would lower receivables, but we still see this as a headwind of at least 10 cents.

- Guidance calls for 2024 adjusted EPS to rise from $3.50 to $3.65-$3.80 with mid-single-digit growth in sales and 25bp improvement in EBITDA. Those two items are worth about 35 cents – why is the forecast only rising 15-25 cents? It may be bad debt reserves being rebuilt.

- Before last quarter when JCI missed forecasts by 2 cents, you must go back to 2021 to find a quarter where JCI either hit estimates on the nose or beat by 1 cent. If we look at

the last few quarters with JCI building the credit loss allowance – it still managed to report a quarter with a decline:

	4Q 23	3Q 23	2Q 23	1Q 23	4Q 22
Allowance	$90	$89	$94	$74	$62
Factored receivables	$681	$397	$402	$384	$476
Receivables	$6,006	$6,540	$6,002	$5,722	$5,727
Total Receivables	$6,777	$7,026	$6,498	$6,180	$6,265
Sales	$6,906	$7,133	$6,686	$6,068	$6,725
Allowance % Sales	1.30%	1.25%	1.41%	1.22%	0.92%
DSO	90.3	89.6	87.5	93.7	84.8

- DSOs and receivables went up in the June 2023 quarter. Yet, the allowance declined by $5 million. That may well reflect more write-offs of prior reserves, but since JCI stopped providing that data, we do not know. We know that a $5 million drop was worth at least 0.6 cents in a quarter when JCI only met forecasts.

Dover Corp (DOV)

At first glance, DOV does not show many surprises in annual results before, during, and after Covid. The reserves dropped with higher sales in 2018 and 2019, but DSOs were not out of line. Covid showed lower sales and higher reserves. DOV kept higher reserves post Covid through 2022 amid higher sales that were likely helped with some inflation:

	FY 22	FY 21	FY 20	FY 19	FY 18	FY 17	FY 16
DSO	64.2	61.4	61.3	61.4	63.4	62.5	75.4
Receivables	$1,516,871	$1,347,514	$1,137,223	$1,217,190	$1,231,859	$1,183,514	$1,265,201
Sales	$8,508,088	$7,907,081	$6,683,760	$7,136,397	$6,992,118	$6,820,886	$6,043,224
Allowance for Bad Debts	$39,399	$40,126	$40,474	$29,381	$28,469	$34,479	$22,015
Allowance % of Gross Receivables	2.53%	2.89%	3.44%	2.36%	2.26%	2.83%	1.71%

What caught our attention was a big drop in reserves in the last two quarters. We see that just looking at the drop in allowances to receivables would have provided DOV with 2.5 cents in June and 2.2 cents in September. The company only beat by 2 cents last quarter, so we dug deeper.

	3Q 23	2Q 23	1Q 23	4Q 22	3Q 22	2Q 22	1Q 22	4Q 21
DSO	65.6	67.8	64.1	64.7	63.3	64.0	64.3	61.8
Receivables	$1,548,675	$1,561,162	$1,460,970	$1,516,871	$1,497,062	$1,514,455	$1,446,670	$1,347,514
Sales	$2,153,268	$2,100,086	$2,079,023	$2,139,181	$2,158,291	$2,158,715	$2,051,901	$1,989,235
Allowance for Bad Debts	$33,960	$38,452	$40,329	$39,399	$36,395	$37,388	$40,321	$40,126
Allowance % of Gross Receivables	2.15%	2.40%	2.69%	2.53%	2.37%	2.41%	2.71%	2.89%
EPS Impact of Sequential Decline in Allow. %	$0.022	$0.025	-$0.013	-$0.013	$0.000	$0.000	$0.000	$0.001

DOV gives great disclosure on credit losses and bad debt expense on a quarterly basis. What we have seen is post-Covid, this tends to be all over the place:

Bad Debt Expense				Write-Offs			
4Q	3Q	2Q	1Q	4Q	3Q	2Q	1Q

2023		$311	-$989	$1,422				-$3,489	-$644	-$727
2022	$2,761	$2,848	-$1,242	$1,185			-$1,142	-$2,279	-$438	-$603
2021	$309	$2,535	$2,097	$112			-$1,316	-$1,531	-$1,487	-$973

- A big reason the allowance dropped so much in 3Q23 was DOV wrote off $3.5 million in reserves. That doesn't impact EPS, but it was the largest reduction to bad debt reserves post-Covid. That could require DOV to rebuild the total reserve.

- But look at bad debt expense last quarter at only $311 thousand, and that followed a credit in 2Q23 of $989 thousand. Normally bad debt expense is well over $1 million.

- On a y/y basis, DOV picked up $2.5 million from lower bad debt expense in 3Q23 – that helped EPS by 1.4 cents when DOV beat by 2 cents.

- However, by 3Q23, DOV's reserve had fallen to only 2.15% of receivables and the company has booked only $744 million in bad debt expense through three quarters. Getting the reserve back to $38 million may require $4-$5 million in bad debt expense in 4Q23. DOV had a large bad debt expense in 4Q22, but $4-$5 million would be an EPS headwind of 1 cent. That's for a company with several recent beats of only 1 cent.

The Timken Co. (TKR)

TKR has recently been posting lower sales growth reducing guidance. This is due to both "softer end-market demand" and "decreasing channel inventories." We included the following table:

	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21
Gross Margin	31.1%	31.9%	33.0%	27.4%	29.4%	30.6%	30.1%	23.1%
Inventory	$1,202.4	$1,251.7	$1,209.4	$1,191.3	$1,132.6	$1,158.0	$1,112.6	$1,042.7
DSI	139.4	131.8	130.4	132.9	128.7	131.9	129.1	122.9
EPS Guide	$6.85-6.95	$6.90-7.30	$7-7.50	$6.50-$7.10	$5.80-5.95	$5.50-5.80	$5-$5.40	$5-$5.40
Org. Growth Guide	0.25%	2.50%	4.00%	3.00%	11.50%	9.00%	10.00%	11.00%

This is resulting in TKR seeing lower receivables too. That, in turn, is boosting the reserves as a percentage of receivables. In reality, the allowance fell in dollar terms last quarter:

	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21
DSO	56.4	58.2	54.8	59.0	59.1	59.8	60.4	56.7
Receivables	$706,500	$811,900	$758,100	$699,600	$735,500	$756,300	$743,900	$626,400
Sales	$1,142,700	$1,272,300	$1,262,800	$1,082,000	$1,136,400	$1,153,700	$1,124,600	$1,007,300
Allowance for Bad Debts	$17,200	$17,900	$17,600	$17,900	$16,100	$17,500	$17,500	$16,900
Allowance % of Gross Receivables	2.38%	2.16%	2.27%	2.49%	2.14%	2.26%	2.30%	2.63%

The problem we see is in 2024. At some point, channel destocking should end (remember that TKR was quick to adjust manufacturing to deal with that). It may not be 4Q23 or 1Q24, but at some point, TKR should see higher sales and receivables again. Even DSO's look low at this point despite lower sales growth. Historically, bad debt reserves run closer to 4% of receivables:

	FY 22	FY 21	FY 20	FY19	FY 18	FY 17	FY 16
DSO	56.0	54.6	59.5	51.8	55.0	54.8	70.8
Receivables	$699,600	$626,400	$581,100	$545,100	$546,600	$457,600	$524,900
Sales	$4,496,700	$4,132,900	$3,513,200	$3,789,900	$3,580,800	$3,003,800	$2,669,800

Allowance for Bad Debts	$17,900	$16,900	$16,500	$18,100	$21,900	$20,300	$20,200
Allowance % of Gross Receivables	2.49%	2.63%	2.76%	3.21%	3.85%	4.25%	3.71%

- With inflation, sales could hit $4.7-$4.8 billion, and assuming DSOs of 56-57, that could mean receivables of $750 million. A 4% reserve would be $30 million, and TKR would need to raise it a net $13 million (probably $16-$17 million as annual write-offs are often $3-$5 million). That would be 17-18 cents of headwind for EPS.

Watts Water Technologies Inc. (WTS) – Raising Outlook and Reserves are Low

WTS's bad debt allowance is conspicuously low relative to its pre-Covid level which may result in a material headwind in 2024.

Unlike TKR, WTS has raised its outlook for sales throughout 2023. It started with a forecast of -4% to +3% with a -1% FX and now has boosted the bottom of the forecast and is predicting +3% growth with a -3% FX headwind. It has boosted margin forecasts too.

WTS has seen the reserve as a percentage of gross receivables increase during 2023. However, the allowance as a percentage of receivables has been inflated by lower DSOs taking down the receivable total. If DSOs were closer to 50 days, WTS would have an allowance of 4.34% of receivables instead of 4.42%.

	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21
DSO	46.6	46.5	52.2	42.5	48.1	46.3	51.6	42.5
Receivables	$257,600	$271,400	$269,800	$233,800	$257,000	$267,100	$261,700	$220,900
Sales	$504,300	$532,800	$471,700	$501,900	$487,800	$526,600	$463,200	$473,900
Allowance for Bad Debts	$11,900	$12,000	$11,700	$10,700	$11,700	$11,200	$11,800	$10,300
Allowance % of Gross Receivables	4.42%	4.23%	4.16%	4.38%	4.35%	4.02%	4.31%	4.46%

The bigger issue is that pre-Covid, WTS had a reserve in the high 6% range. It has a way to go to reach that level again. It would require at least $5 million more in bad debt expense. It may require as much as $10 million as WTS's write-offs have been $4.0-$5.2 million in the last three years. A $10 million bad debt expense would be double the $5.2 million WTS booked in 2022. An incremental $5 million would be a 12-cent EPS headwind. Below is the annual table for reserves showing pre-Covid numbers too:

	FY 22	FY 21	FY 20	FY19	FY 18	FY 17	FY 16
DSO	42.5	44.0	47.2	49.4	47.3	53.4	51.0
Receivables	$233,800	$220,900	$197,600	$219,800	$205,500	$216,100	$198,000
Sales	$1,979,500	$1,809,200	$1,508,600	$1,600,500	$1,564,900	$1,456,700	$1,398,400

Allowance for Bad Debts	$10,700	$10,300	$11,100	$14,300	$15,000	$14,300	$14,200
Allowance % of Gross Receivables	4.38%	4.46%	5.32%	6.11%	6.80%	6.21%	6.69%

Hubbell, Inc (HUBB)

HUBB has enjoyed plummeting bad debt expense the last two quarters courtesy of an inflated bad debt allowance. However, it looks like the benefit is mostly played out at this point.

HUBB boosted bad debt reserves coming out of Covid. The company had little explanation other than basically pointing out rising sales means rising receivables which required adding to reserves. We would note that DSOs did not get too far out of the normal range. The allowance rose from the normal pre-Covid level of 0.8%-0.9% of receivables to 1.9%:

	FY 22	FY 21	FY 20	FY19	FY 18	FY 17	FY 16
DSO	54.0	58.0	54.1	62.3	58.3	53.0	54.4
Receivables	$741,600	$675,300	$553,300	$683,000	$725,400	$540,300	$530,000
Sales	$4,947,900	$4,194,100	$3,682,500	$3,946,600	$4,481,700	$3,668,800	$3,505,200
Allowance for Bad Debts	$14,300	$10,600	$10,600	$7,700	$4,800	$4,600	$4,700
Allowance % of Gross Receivables	1.89%	1.55%	1.88%	1.11%	0.66%	0.84%	0.88%

In recent quarters, HUBB has reduced its allowance slightly and is already enjoying lower bad debt expense:

	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21
DSO	56.6	54.2	55.3	55.5	55.5	56.7	61.4	56.0
Receivables	$852,900	$811,200	$778,300	$741,600	$800,500	$780,500	$777,900	$675,300
Sales	$1,375,800	$1,365,900	$1,285,400	$1,219,600	$1,316,200	$1,256,000	$1,156,100	$1,100,100
Allowance for Bad Debts	$13,200	$13,600	$13,900	$14,300	$14,800	$13,900	$11,500	$10,600
Allowance % of Gross Receivables	1.52%	1.65%	1.75%	1.89%	1.82%	1.75%	1.46%	1.55%
Provision Expense	-$100	$0	$100	$1,700	$1,300	$2,800	$1,600	$1,400
Provision Exp % of Sales	-0.01%	0.00%	0.01%	0.14%	0.10%	0.22%	0.14%	0.13%

- If the reserve percentage drops from 1.5% back to 0.9%, it would mean an absolute decline of about $5.4 million. That would be about 8 cents in EPS to HUBB.

- Notice that bad debt expense was already a credit last quarter and zero the quarter before compared to $1.3 million and $2.8 million in the year-ago periods. If bad debt expense had remained flat as a percentage of sales in those quarters, it would have shaved approximately 4 cps off second-quarter earnings and 2 cps off the third quarter's- so much of this move may already have happened.

- Also, HUBB is reporting adjusted EPS of nearly $4 per quarter so 2 cents is likely immaterial. The best appears to be over.

Generac Holdings (GNRC)

While GNRC's allowance for bad debts appeared to jump in 2022, we do not see it resulting in a benefit to earnings in upcoming quarters.

GNRC looks very similar to HUBB at first glance. In 2022, it saw a big jump in bad debt reserves. If that dropped back down, GNRC should enjoy lower bad debt expense if not outright credits:

	FY 22	FY 21	FY 20	FY19	FY 18	FY 17	FY 16
DSO	41.2	52.6	54.3	52.2	58.0	59.9	60.1
Receivables	$522,458	$546,466	$374,906	$319,538	$326,133	$279,295	$241,857
Sales	$4,564,737	$3,737,184	$2,485,200	$2,204,336	$2,023,464	$1,679,373	$1,447,743
Allowance for Bad Debts	$27,664	$12,025	$12,001	$6,968	$4,873	$4,805	$5,642
Allowance % of Gross Receivables	5.03%	2.15%	3.10%	2.13%	1.47%	1.69%	2.28%

The jump in the allowance was the result of a $17.9 million specific credit loss related to a customer who filed bankruptcy in 2022. If we adjust for that, the allowance in 2022 was under $10 million, or about 1.84% of receivables.

	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21
DSO	50.2	49.3	50.4	45.4	45.5	48.9	49.0	46.7
Receivables	$589,226	$540,332	$490,384	$522,458	$542,528	$692,291	$609,870	$546,466
Sales	$1,070,667	$1,000,420	$887,910	$1,049,232	$1,088,258	$1,291,391	$1,135,856	$1,067,071
Allowance for Bad Debts	$29,580	$29,610	$28,660	$27,664	$12,025	$12,001	$6,968	$4,873
Allowance % of Gross Receivables	4.78%	5.20%	5.52%	5.03%	2.17%	1.70%	1.13%	0.88%

- Last quarter, GNRC's ratio dropped from 5.20% to 4.78%. The same $17.9 million specific reserve is still impacting the figure.

- Look at recent sales. In early 2023, GNRC saw y/y sales growth turn negative as it worked down channel inventory. Lower sales meant lower receivables, so the high reserve figure looked even more inflated.

- In 3Q23, sales picked up and so did receivables. That drove down the percentage.

- At this point, the bankruptcy related reserve has been expensed. The claim will be resolved in the future and may result in some level of recovery for resulting in a credit for bad debt expense. However, much of that reserve will be written off and it will disappear from the allowance. We think that will return GNRC’s results to normal.

Honeywell International (HON)

Just like GNRC, HON had fairly stable reserve stats for some time. Suddenly in early 2022, they jumped.

	FY 22	FY 21	FY 20	FY19	FY 18	FY 17	FY 16
DSO	75.5	71.5	75.3	73.5	64.7	78.7	74.9
Receivables	$7,440,000	$6,830,000	$6,827,000	$7,493,000	$7,508,000	$8,866,000	$8,177,000
Sales	$35,466,000	$34,392,000	$32,637,000	$36,709,000	$41,802,000	$40,534,000	$39,302,000
Allowance for Bad Debts	$326,000	$177,000	$202,000	$146,000	$197,000	$202,000	$272,000
Allowance % of Gross Receivables	4.20%	2.53%	2.87%	1.91%	2.56%	2.23%	3.22%

	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21
DSO	77.6	79.8	80.9	73.9	75.1	78.9	77.6	72.0
Receivables	$7,833,000	$7,994,000	$7,862,000	$7,440,000	$7,363,000	$7,738,000	$7,119,000	$6,830,000
Sales	$9,212,000	$9,146,000	$8,864,000	$9,186,000	$8,951,000	$8,953,000	$8,376,000	$8,657,000
Allowance for Bad Debts	$342,000	$350,000	$336,000	$326,000	$349,000	$378,000	$326,000	$177,000
Allowance % of Gross Receivables	4.18%	4.19%	4.10%	4.20%	4.53%	4.66%	4.38%	2.53%

- In 1Q22, HON took a reserve of $183 million to receivables due to the Russia/Ukraine war. At some point, that reserve will be written off or reversed back into earnings. We don't either case helps or hurts the view of sustainable earnings.

- HON does say that at times it sells receivables and they are removed from that balance sheet when that happens. We do not see this being quantified so it may not be very large. That could skew the ratios.

Watsco Inc. (WSO)

WSO does not disclose any quarterly information regarding its bad debt reserves. However, we noticed that its allowance skyrocketed in 2022:

	FY 22	FY 21	FY 20	FY19	FY 18	FY 17	FY 16
DSO	37.0	40.0	38.1	40.3	39.7	39.6	40.6
Receivables	$747,110	$698,456	$535,288	$533,810	$501,908	$478,133	$475,974
Sales	$7,274,344	$6,280,192	$5,054,928	$4,770,362	$4,546,653	$4,341,955	$4,220,702
Allowance for Bad Debts	$18,345	$11,315	$7,087	$7,943	$6,503	$6,049	$6,169
Allowance % of Gross Receivables	2.40%	1.59%	1.31%	1.47%	1.28%	1.25%	1.28%

The allowance for bad debts triple compared to pre-Covid levels. Sales are up too, but the ratio of allowances to receivables has still doubled. Sales growth has slowed in 2023 as WSO has sought to reduce its inventory levels and customers were destocking too.

At first glance, if allowances returned to normal levels of 1.2%-1.3% of receivables – WSO could see some lower bad debt expense help drive EPS. That could be the case because the company called out the jump in 2021 and 2022 to single events:

- In 2022, the jump in bad debt reserves was due to a single delinquent client. That one account moved the total accounts more than 90 days past due from 0.9% to 2.4% of receivables.
- In 2021, the jump was also due to a single client. Other accounts were improving as even with the jump in reserves the amount of accounts 90 days past due fell from 1.4% to 0.9%.
- Thus, if credit issues stay isolated to specific accounts, WSO could get some tailwind in this area.

SiteOne Landscape Supply Inc (SITE)

SITE saw its reserves rise in 2021 and 2022. According to the company, this was simply the result of it changing its assessment of the credit outlook for the economy and its customer base. We saw no discussion of specific issues.

	FY 22	FY 21	FY 20	FY19	FY 18	FY 17	FY 16
DSO	40.8	40.8	39.0	43.3	48.6	42.5	36.9
Receivables	$455,500	$393,800	$292,800	$283,400	$285,300	$219,900	$169,000
Sales	$4,014,500	$3,475,700	$2,704,500	$2,357,500	$2,112,300	$1,861,700	$1,648,200
Allowance for Bad Debts	$21,700	$13,500	$9,100	$8,300	$5,900	$4,700	$4,300
Allowance % of Gross Receivables	4.55%	3.31%	3.01%	2.85%	2.03%	2.09%	2.48%

However, we noticed that write-offs were a credit in 2021 and below normal in 2022. This helped keep the reserve higher:

	FY 22	FY 21	FY 20	FY19
Bad Debt Expense	$10.9	$4.3	$3.0	$5.9
Charged-Off	-$2.7	$0.1	-$2.2	-$3.5

The level of reserves has continued to rise with higher sales and higher receivables in 2023. But, the allowance percentage is off its highs. If SITE can lower the reserve by 100bp-200bp – that could help EPS by 10-20 cents. However, some of that may emerge from simply writing off prior reserves, reducing the allowance and not impacting earnings.

	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21
DSO	43.1	38.4	54.1	46.7	41.6	39.5	49.5	44.6
Receivables	$540,400	$569,600	$496,100	$455,500	$502,800	$527,100	$437,100	$393,800
Sales	$1,145,100	$1,353,700	$837,400	$890,000	$1,102,600	$1,216,600	$805,300	$805,200
Allowance for Bad Debts	$24,200	$22,200	$21,500	$21,700	$18,400	$15,900	$14,800	$13,500
Allowance % of Gross Receivables	4.29%	3.75%	4.15%	4.55%	3.53%	2.93%	3.28%	3.31%

Applied Industrial Technologies Inc. (AIT)

AIT appears primed to benefit from lower bad debt expense in the upcoming quarters. Consider the company's allowance percentage for the last seven years:

Year ended June:	FY 23	FY 22	FY 21	FY 20	FY19	FY 18	FY 17
DSO	57.8	62.0	57.4	49.9	56.1	64.3	54.3
Receivables	$708,395	$656,429	$516,322	$449,998	$540,902	$548,811	$390,931
Sales	$4,412,794	$3,810,676	$3,235,919	$3,245,652	$3,472,739	$3,073,274	$2,593,746
Allowance for Bad Debts	$22,334	$17,522	$16,455	$13,661	$10,498	$10,964	$9,628
Allowance % of Gross Receivables	3.06%	2.60%	3.09%	2.95%	1.90%	1.96%	2.40%

It is common for AIT to have a bad debt reserve under 2%. We understand Covid boosting that, but it remained higher than normal after the recovery too. We see that the quarters are showing improvement:

	1Q 24	4Q 23	3Q 23	2Q 23	1Q23	4Q 22	3Q 22	2Q 22
DSO	60.3	57.4	57.9	59.0	60.2	57.8	59.0	56.3
Receivables	$694,922	$708,395	$705,638	$654,510	$674,136	$656,429	$618,079	$520,134
Sales	$1,095,188	$1,158,074	$1,132,035	$1,060,280	$1,062,405	$1,061,459	$980,662	$876,874
Allowance for Bad Debts	$22,922	$22,334	$22,573	$25,510	$21,173	$17,522	$18,098	$16,703
Allowance % of Gross Receivables	3.19%	3.06%	3.10%	3.75%	3.05%	2.60%	2.84%	3.11%

The allowance percentage already peaked in December 2022 at 3.75%. Accounts over 90 days past due were rising during 2022, running over 4%. AIT was calling out credit deterioration and bankruptcies in the Service Center customer base. In the last three quarters, the 90-day number dropped to 3.5%, 2.5%, and now 2.9%. We can see that bad debt expense has dropped too, helping EPS:

	1Q 24	4Q 23	3Q 23	2Q 23	1Q23	4Q 22	3Q 22	2Q 22
Bad Debt Exp	$867	$943	-$4,897	$5,579	$3,994	$288	$1,577	$531

- In December, ATI took a large increase in bad debt expense that was a 10-cent headwind y/y to EPS.

- March 2023 saw it reverse much of the charge and book a y/y tailwind of 13 cents.

- ATI normally beats estimates by 1-4 cents per share. If it can reduce the allowance to 2%, that would represent 17 cents of additional EPS. We would expect that to occur via lower-than-normal bad debt expense over time.

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