BEHIND THE NUMBERS
Quality of Earnings Analysis
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Behind the Numbers

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Cintas Corporation (CTAS)
Earnings Quality Update

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are maintaining our earnings quality rating of CTAS at 3- (Minor Concern)

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

Summary of the Quarter

CTAS reported EPS of $3.12 in the second fiscal quarter ended November topping earnings estimates by 9 cps. While the tax rate of 22.1% was higher than the 18.0% rate last year, the company issued guidance for a full-year rate of “over 20%” after the first quarter ended in August

in which it recorded an effective tax rate of only 15%. Therefore, we doubt November's 22% was meaningfully above what analysts were expecting.

Management raised guidance for the full year ending March from a range of $12.30-$12.65 to a range of $12.50-$12.80, or 15 cps on the top end, signaling that it expects some of the momentum to carry forward. However, we saw more signs of unsustainable benefits in the quarter:

- The unusually high reserve for obsolete inventory fell again by almost $20 million despite an increase in inventory. We documented in the last review how this reserve was built up to reflect the falling value of PPE products after the start of COVID. It remained elevated until it started to decline in the August quarter. A $20 million sequential decline in the reserve could have added 15 cps to profits in the quarter. The inventory reserve is now about 12% of gross inventory versus the high 8% range pre-COVID, so there is still some room left to benefit from further cuts to the reserve. ***(See detail below)***

- The "other assets" component of long-term other assets has increased in the last three quarters. We suspect this relates to amounts paid to customers at the beginning of contract periods which the company amortizes over time. The account jumped by over $50 million in the 5/22 quarter and then by $10 million in the 11/22 quarter which could be an indication of an increased rate of capitalizing these amounts. For perspective, a $10 million increase amounts to 7 cps. ***(See detail below)***

- Gross margin improved by 100 bps in the 11/22 quarter. However, the bulk of this improvement came from a huge expansion in the First Aid and Safety Services segment which accounts for only 11% of sales. The improvement is a result of strong sales along with lower-margin Covid-related PPE sales falling out of the mix. Margins are now 200 bps above their pre-COVID levels. This source of growth is unsustainable and may be subject to reversal if demand conditions normalize. ***(See detail below)***

Inventory Reserve Continued to Trend Down- Possible 15 cps

We documented in past reviews how CTAS beefed up its reserve for obsolete inventory in the 5/21 quarter to reflect the falling value of personal protection equipment (PPE) after the initial

wave of COVID. As we can see in the following table, the company maintained the elevated reserve level for several quarters before sharply reducing it in the 8/22 quarter:

	11/30/2022	8/31/2022	05/31/2022	2/28/2022
Total Net Inventory	$514.839	$473.888	$472.150	$486.750
Reserve for Obsolete and Slow-Moving Inventory	$70.200	$89.100	$100.300	$103.000
Reserve % of Gross Inventory	12.0%	15.8%	17.5%	17.5%

	11/30/2021	8/31/2021	5/31/2021	2/28/2021
Total Net Inventory	$464.864	$463.692	$481.797	$533.211
Reserve for Obsolete and Slow-Moving Inventory	$106.600	$110.200	$111.000	$63.600
Reserve % of Gross Inventory	18.7%	19.2%	18.7%	10.7%

	11/30/2020	8/31/2020	5/31/2020	2/29/2020
Total Net Inventory	$534.128	$488.165	$408.898	$352.924
Reserve for Obsolete and Slow-Moving Inventory	$52.300	$48.200	$45.500	$34.100
Reserve % of Gross Inventory	8.9%	9.0%	10.0%	8.8%

The reserve decline continued in the 11/22 quarter despite a significant increase in inventory balances. We don't know the exact nature of the reserve decline. If the reserve was simply reduced, it would have resulted in an increase in profits. However, the company states clearly in its accounting policies that once an item in inventory is written down, it can't be written up again. On the other side, if the reduction in the reserve was the result of inventory that was written down being sold, it would result in unusually high profit margin sales. However, the company has specifically stated in the last couple of quarters that PPE sales have declined to virtually nothing. Regardless, it is likely the company has not had to record normal levels of expense associated with new inventories while still being able to report high reserve levels. Note that a $20 million reduction in the reserve amounts to a potential benefit of 15 cps to the quarter.

Also, note that the reserve has fallen as a percentage of gross inventory from over 19% at its peak to 12% now. However, the pre-pandemic norm was in the high 8% range which leaves room for more potential benefits to EPS in the upcoming quarters.

Other Assets Increasing

CTAS records an "other assets" account under long-term assets on its balance sheet. It also breaks out the components of this account in the footnotes. The bulk of the value of the account

is mostly comprised of capitalized contract costs which are commissions paid to sales staff that CTAS defers and amortizes over time. Those amounts have been tracking relatively in line with sales and amortization as a percentage of average account balances looks reasonable.

However, the company also discloses an “other” segment of that account which showed a sharp jump in the 5/22 quarter and has continued to rise. We suspect this relates to amounts that the company pays to customers at the beginning of a contract term which it amortizes over time. Consider the explanation of these payments from the 10-Q:

> *“Variable consideration also includes consideration paid to a customer at the beginning of a contract. Cintas capitalizes this consideration and amortizes it over the life of the contract as a reduction to revenue. These assets are included in prepaid expenses and other current assets and in other assets, net on the consolidated condensed balance sheets.”*

The following table shows the “other” portion of other long-term assets on a days of sales basis for the last eight quarters:

	11/30/2022	8/31/2022	05/31/2022	2/28/2022
Sales	$2,174.9	$2,166.5	$2,074.7	$1,960.5
Other Assets	$117.5	$107.5	$105.0	$67.3
Days of Sales	4.9	4.6	4.7	3.1

	11/30/2021	8/31/2021	5/31/2021	2/28/2021
Sales	$1,922.3	$1,897.0	$1,835.7	$1,777.1
Other Assets	$62.4	$64.9	$81.0	$72.3
Days of Sales	3.0	3.1	4.1	3.7

The sudden increase in the 5/22 quarter followed by a $10 million sequential increase in the 11/22 quarter looks unusual. This is concerning as it could represent an increased rate of capitalization of sales incentives. To put this in perspective, the $10 million sequential increase in the November quarter amounted to over 7 cps.

First Aid and Safety Gross Margins Have Spiked

CTAS has been posting strong organic revenue growth as customers have returned to normal activity post-COVID. However, the company's profit growth has also been driven by an expanding gross margin which jumped a full percentage point to 47% in the 11/22 quarter. The following table shows the November quarterly gross margin broken down by segment for the last five years:

Gross Margin by Segment	11/30/2022	11/30/2021	11/30/2020	11/30/2019	11/30/2018
Uniform Rental and Facility Services GM (79% of sales)	47.0%	46.8%	47.5%	46.6%	45.3%
First Aid and Safety Services GM (11% of sales)	50.5%	43.5%	43.0%	48.4%	48.0%
All Other GM (10% of sales)	43.7%	42.8%	43.1%	41.8%	41.2%
Total Gross Margin	47.0%	46.0%	46.7%	46.2%	45.1%

While the Uniform Rental and Facility Services segment represents almost 80% of sales, the bulk of the margin improvement is being generated by the First Aid and Safety Service segment which only accounts for about 11% of sales. Sales of this segment spiked during the pandemic as the company sold personal protective equipment (PPE) to its customers. These sales generated lower margins than its core Frist Aid sales which resulted in a sharp decline in gross margin in 2020. In 2021, sales declined due to difficult comps but growth returned in the last five quarters with gross margin improving as sales of lower-margin PPE products have essentially dried up. However, the segment gross margin is now over 200 bps higher than it was before the pandemic. Management attributes this to an increased emphasis on employee health post-pandemic, leverage, and cost cuts. Still, this looks like an area of unsustainable growth which may be subject to some reversal if demand normalizes.

Lamb Weston Holdings, Inc. (LW)
Earnings Quality Update

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

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

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

Summary of the Quarter

LW's EPS of $1.28 topped expectations by 54 cps. We continue to see the company's earnings quality as being high. We featured LW as a top value name in our Focus List in 2021 when it was selling closer to $50. While the company offers less upside today at nearly $100 and selling for around 16 times a normalized EBITDA, we believe the company still offers reasonable value as it continues to expand its capacity and looks to consolidate the remainder of its LWM joint venture.

- LW has seldom utilized much in the way of non-GAAP adjustments. However, the company has included meaningful adjustments in the last couple of quarters for the impacts of its natural gas derivatives which involved restatement of last year's quarters for non-GAAP purposes. We are not alarmed by this as the unusual conditions in the energy markets are making for wild swings which are impacting earnings to a higher degree than normal.

- As conditions have returned to a more normal level, the company has resumed its capital spending program as it builds out capacity in Idaho, China, and Argentina. Trailing 12-month capex was $429 million and its goal is to spend between $475 million and $525 million for the full year, or about 9-10% of sales. However, maintenance capex is closer to $130 million, which will free up considerable cash to reduce debt, (about 2.4x adjusted EBITDA) and/or pay dividends when expansion normalizes.

- LW plans to buy the remaining 50% share of its LWM Netherlands-based joint venture for €525.0 million in cash and €175.0 million in shares of stock. This solidifies the company's position in Europe and allows it to expand at an operation it already knows well. The company's share of the joint venture is currently reported as an equity investment. The deal is expected to close in the fourth fiscal quarter after which all of LWN's results will be consolidated on the company's financials.

- On the surface, LW company is paying about 33 times EBITDA for the remaining 50% of LWM. However, that figure is based on LWM's EBITDA of $46 million for the fiscal year ended in May of 2022. That figure was severely depressed by conditions in Europe. It is not unrealistic to estimate a core EBITDA figure of more than double that amount which brings the acquisition multiple down to 16-17 times earnings before any cost savings are considered. Consolidating results and cutting expenses will be another boost to LW's cash flow going forward.

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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