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Stanley Black & Decker, Inc. (SWK)
Earnings Quality Update

We are maintaining our earnings quality rating of SWK of 4+ (Acceptable)

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

Summary

SWK's 4Q23 Non-GAAP EPS of $0.92 beat by 14 cents. It beat the raised annual guidance for 2023 of $1.00-$1.40 with $1.45. SWK guided to a backloaded 2024 with EPS of $3.50-$4.50. It is worth noting that selling its infrastructure business could be a 25-27-cent headwind for 2024 as that is what that business earned pretax in 2023.

Reviewing the 10-K shows several areas to watch. SWK had some tailwinds that helped earnings in 2023 by 31 cents that may not recur vs. headwinds of 21 cents. We are keeping our rating at 4+ despite the forecast for a back-loaded 2024. The company continues to show improvements in margins and working capital. Sales volumes were seeing the rate of decline slow, but it reaccelerated in 4Q:

- Advertising is reported on an annual basis. It was down in several areas in 2023 vs. 2022 and 2021. However, it is up from Pre-Covid levels:

	2023	2022	2021	2020	2019	2018
Advertising	$110.5	$118.9	$98.6	$76.6	$90.4	$101.3
Co-Op - lower sales	$325.1	$358.1	$374.1	$351.0	$323.2	$315.8
Co-Op - SG&A	$27.8	$31.8	$19.5	$15.8	$6.9	$5.4
Total	$463.4	$508.8	$492.2	$443.4	$420.5	$422.5

SWK reports advertising in three areas. One set of co-op deals is accounted for as a reduction in sales. Every type of advertising was down in 2023 and added 24 cents to adjusted EPS. On the positive side, SWK still spent more than pre-Covid levels. We would expect this to become a headwind again as SWK completes the right-sizing of its inventory and demand improves.

- R&D spending is up to the highest levels in years. On weak sales volumes, this was a minor headwind of 2 cents last year. However, we consider this a positive sign as SWK introduces more new products:

	2023	2022	2021	2020	2019	2018
R&D Spending	$362.0	$357.4	$276.3	$200.0	$255.2	$275.8

- Stock compensation for the 4Q was down $1.6 million (less than 1 cent in EPS), and down $6.9 million for the year (down 4 cents). We would expect this to return as a headwind as the business starts to grow again.

- Bad debt expense dropped in 2023 from $14.3 million to $8.7 million, which helped EPS by 3 cents. The company also wrote off a large amount of prior reserves - $38.7 million vs. $3.6 million in 2022. As a result, the bad debt reserve is now 5.6% or $76.6 million vs. 8.0% or $106.6 million in 2022. A reserve of 7.5%-8.0% is more common. We would expect SWK to need to rebuild this and a 1% move is about 7 cents in EPS headwind.

- Pension expense was $27.5 million vs. income of $6.4 million in 2022 and income of $8.2 million in 2021. The biggest impact was a 3% increase in interest expense and amounted to an 11-cent headwind. For 2024, SWK is cutting its rate of return assumption, which could produce another headwind although interest expense is likely to fall too.

- Warranty expense was up all year - $39.1 million vs. $38.3 million in 4Q and $171.3 million in 2023 vs. $155.3 million in 2022. For 4Q, that was largely a non-event and for the year an 8-cent headwind. We expect this to rise further as sales recover. SWK has seen a rise in warranty accruals already too up $9.7 million y/y. Rebate accruals are up y/y too by $34.6 million. Those accruals may mitigate some of the headwind in 2024.

What to Watch

The Rate of Volume Decay Accelerated again

SWK Vol.	12/30/23	9/30/23	7/1/23	4/1/23	12/31/22	10/1/22	7/2/22	4/2/22	1/1/22
Overall	-7%	-3%	-5%	-11%	-10%	-10%	-13%	-6%	-8%
Tools/Outdoor	-8%	-3%	-6%	-13%	-12%	-12%	-16%	-6%	-8%
Industrial	-5%	-4%	-1%	-2%	1%	5%	4%	-5%	-9%

- SWK noted that the industrial market overall was weak except for Aerospace. The resolution of the auto strikes in 3Q were expected to see this market recover in 4Q. It had some pricing but clearly volume was weak.

- Outdoor expects to continue suffering from customer destocking in early 2024. That could see a weak 1Q too.

- Tools experienced soft consumer demand but solid professional demand

- SWK now expects weakness to continue until 2H24.

Inventory Has Shown More Improvement

Inventory	12/30/23	9/30/23	7/1/23	4/1/23	12/31/22	10/1/22	7/2/22	4/2/22	1/1/22
Finished Product	$2,913	$3,014	$3,258	$3,472	$3,461	$3,840	$4,115	$4,023	$3,486
Work in Progress	$263	$274	$238	$260	$339	$357	$456	$429	$395
Raw Materials	$1,563	$1,690	$1,787	$1,928	$2,062	$2,150	$2,065	$1,816	$1,539
Total Inventory	$4,739	$4,978	$5,283	$5,660	$5,861	$6,347	$6,636	$6,268	$5,420
DSI Finished	100.0	95.9	93.4	102	97.4	112.7	117.5	116.5	111.1
DSI Wrk Progress	9.0	8.7	6.8	7.6	9.5	10.5	13	12.4	12.6
DSI Raw Mat	53.6	53.8	51.2	56.7	58	63.1	59	52.6	49.1
Total DSI	**162.6**	**158.3**	**151.4**	**166.3**	**164.9**	**186.3**	**189.5**	**181.5**	**172.8**

- Selling the infrastructure business will lower inventory by $96.5 million based on 12/30 figures.

- SWK has cut inventory by almost $2 billion at this point and forecasts another $400-$500 million in inventory cuts during 2024.

- The company has seen gross margin continue to improve as production has normalized and SWK has reduced lower-margin SKUs.

	12/30/23	9/30/23	7/1/23	4/1/23	12/31/22	10/1/22	7/2/22	4/2/22
Gross Margin	29.8%	27.6%	23.6%	23.1%	19.5%	24.7%	27.9%	31.3%

- We have discussed in the past that margins were crushed by reduced factory utilization. We know that SWK also boosted prices in recent quarters to help margins. Had pricing come in 1% lower in 4Q, the margin would have been 29.1% and would have hurt EPS by 20 cents. SWK noted that its pricing was 50bp above its own forecast due to lower promotional mix.

- The forecast calls for gross margin to be 30% throughout 2024 and exit the year in the low 30s. That should be where the EPS growth comes from and the target is still 35% on gross margin longer-term.

- Sales are still weak with destocking and weak consumer buying. The turnaround is taking longer than initially thought, but 500bp of margin improvement is a strong tailwind that should help 2024 and 2025. Every 100bp is worth about 85 cents in annualized EPS on $16 billion in sales. There is likely a case to make for an additional $1 billion of sales in the future too. However, guidance would indicate not to expect higher sales in 1Q or 2Q of 2024.

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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