BEHIND THE NUMBERS
Quality of Earnings Analysis
March 27, 2023

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Behind the Numbers

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Agilent Technologies, Inc. (A)
Earnings Quality Update

We are downgrading our earnings quality rating of A to 4- (Acceptable) from 5+ (Strong)

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

Summary

Agilent (A) reported non-GAAP EPS of $1.37 in the 1/23 quarter which was 6 cps ahead of the consensus. However, have some concerns with working capital buildups and a decline in a key accrual.

- Accounts receivable DSOs jumped by 10 days YOY in the 1/23 quarter. DSOs have been on an upward trend in the last few quarters which the company has blamed on China and unbilled receivables related to its nucleic acid business. However, in addition to those factors, it noted in the 1/23 10-Q that the primary cause of the DSO increase was "shipments near the end of the quarter." This could be an indication that sales were pulled into the most recent quarter at the expense of the upcoming 4/23 quarter which could make it more difficult to meet neat-term targets. ***(See below for detail)***

- DSIs jumped to 133.8 in the 1/23 quarter, a more than 23-day increase from a year ago. Management noted in the 10-Q that *"inventory days on-hand was 127 days as of January 31, 2023 compared to 103 days as of January 31, 2022 mainly due to increased inventory levels to meet customer needs and to compensate for long lead time in ordering from our suppliers."* Many companies were increasing inventory levels to get ahead of supply chain problems, but this much of an increase this late seems a little out of place. A's gross margin is showing solid improvement, jumping by 40 bps YOY in the 1/23 quarter aided by pricing gains and "good cost discipline." However, a buildup of higher-cost inventories now could be foreshadowing cost pressure as these inventories hit the income statement as COGS. ***(See below for detail)***

- Despite rising revenue and an increase in settlements made, the provision expense for new warranties fell by $2 million versus the year-ago quarter. We estimate that the decline in warranty expense as a percentage of quarterly sales added almost a penny per share to EPS in the quarter. The warranty accruals as a percentage of T12 sales fell to 40 bps versus over 50 bps in 2021. We estimate it would take about 3 cps in expense to increase the reserve to a more normal 55 bps of sales. ***(See below for detail)***

Receivables Are Rising

The following table shows trade receivables and unbilled receivable DSOs for the last twelve quarters. Note that unbilled receivables are a component of trade receivables:

	1/31/2023	10/31/2022	7/31/2022	4/30/2022
Trade Receivables	$1,459	$1,405	$1,345	$1,237
Trade Receivables Days of Sales	76.4	69.9	72.0	68.5
Unbilled Receivables	$276	$275	$273	$247
Unbilled Receivables Days of Sales	14.5	13.7	14.6	13.7

	1/31/2022	10/31/2021	7/31/2021	4/30/2021
Trade Receivables	$1,205	$1,172	$1,122	$1,075
Trade Receivables Days of Sales	66.2	65.0	65.1	62.7
Unbilled Receivables	$207	$197	$182	$165
Unbilled Receivables Days of Sales	11.4	10.9	10.6	9.6

	1/31/2021	10/31/2020	7/31/2020	4/30/2020
Trade Receivables	$1,087	$1,038	$930	$886
Trade Receivables Days of Sales	64.6	64.4	67.9	64.4
Unbilled Receivables	$154	$153	$150	$130
Unbilled Receivables Days of Sales	9.2	9.5	10.9	9.5

Points to note:

- DSO's have been rising year-over-year for the last few quarters as a result of increases in both trade receivables and unbilled receivables.

- Consider management's explanation for the increase in receivables from the last three quarters of SEC filings:

From the 12/22 Q:

> *"The increase in DSO was due to **higher shipments near the end of the quarter. In addition, DSO increased due to higher unbilled receivables driven by growth in our nucleic acid solutions business, that has a longer cash conversion cycle."***

From the 9/22 K:

> *"In 2022, accounts receivable used cash of $321 million, compared to $128 million in 2021, and $107 million in 2020. Days' sales outstanding as of October 31, were 68 days in 2022, 64 days in 2021 and 63 days in 2020. **The increase in accounts receivable***

related to the transitory impacts of shutdowns in China. In addition, we had a change in the mix of unbilled receivables primarily due to our nucleic acid solutions business, which has a longer cash conversion cycle."

From the 6/22 10-Q:

"In the nine months ended July 31, 2022, accounts receivable used cash of $233 million compared to cash used of $69 million for the same period in 2021. Days' sales outstanding as of July 31, 2022 and 2021 was 70 days and 64 days, respectively. ***The increase in accounts receivable related to the transitory impacts of shutdowns in China as well as an increase in unbilled accounts receivable."***

- While the company blamed China and the nucleic acid business for the increase in receivables each of the last three quarters, it added "shipments near the end of the quarter" as the primary contributor to the 10-day year-over-year increase seen in the 1/23 quarter. This could be an indication that sales were pulled into the most recent quarter at the expense of the upcoming 4/23 quarter which could make it more difficult to meet neat-term targets.

Inventory Is Increasing

The following table shows inventory DSI's by component for the last twelve quarters:

DSI by Inventory Component	1/31/2023	10/31/2022	7/31/2022	4/30/2022
Finished Goods DSI	70.9	63.1	66.9	64.8
Purchased Parts and Fabricated Assemblies DSI	62.9	54.9	57.1	52.4
DSI	133.8	118.0	124.1	117.1

	1/31/2022	10/31/2021	7/31/2021	4/30/2021
Finished Goods DSI	61.2	58.2	60.9	58.0
Purchased Parts and Fabricated Assemblies DSI	49.0	46.1	46.7	45.5
DSI	110.2	104.3	107.7	103.5

	1/31/2021	10/31/2020	7/31/2020	4/30/2020
Finished Goods DSI	56.0	57.4	70.9	68.2
Purchased Parts and Fabricated Assemblies DSI	45.6	41.7	50.4	54.1
DSI	101.5	99.2	121.3	122.3

Points to note:

- DSIs jumped to 133.8 in the 1/23 quarter, a more than 23-day increase from a year ago.

- Management noted in the 10-Q that *"inventory days on-hand was 127 days as of January 31, 2023 compared to 103 days as of January 31, 2022 mainly due to increased inventory levels to meet customer needs and to compensate for long lead time in ordering from our suppliers."*

- Many companies were increasing inventory levels to get ahead of supply chain problems, but this much of an increase this late seems a little out of place.

- A's gross margin is showing solid improvement, jumping by 40 bps YOY in the 1/23 quarter aided by pricing gains and "good cost discipline." However, a buildup of higher-cost inventories now could be foreshadowing cost pressure as these inventories hit the income statement as COGS.

Warranty Accruals Declined

The following table shows warranty accruals expense and the accruals balance as a percentage of revenue for the last eight quarters.

	1/31/2023	10/31/2022	7/31/2022	4/30/2022
Accruals for Warranties Including Change in Estimates	$11	$12	$12	$13
% of Sales	0.63%	0.65%	0.70%	0.81%
Settlements Made During the Period	-$13	-$13	-$11	-$13
Warranty Accruals Ending Balance	$28	$30	$31	$30
Warranty Accruals Ending Balance % of T12 Sales	0.40%	0.44%	0.47%	0.46%

	1/31/2022	10/31/2021	7/31/2021	4/30/2021
Accruals for Warranties Including Change in Estimates	$13	$11	$15	$11
% of Sales	0.78%	0.66%	0.95%	0.72%
Settlements Made During the Period	-$13	-$13	-$15	-$11
Warranty Accruals Ending Balance	$30	$30	$32	$32
Warranty Accruals Ending Balance % of T12 Sales	0.47%	0.47%	0.52%	0.55%

Points to note:

- Despite rising revenue and an increase in settlements made, the provision expense for new warranties fell by $2 million versus the year-ago quarter. We estimate that the decline in warranty expense as a percentage of quarterly sales added almost a penny per share to EPS in the quarter.

- The warranty accruals as a percentage of T12 sales fell to 40 bps versus over 50 bps in 2021. We estimate it would take about 3 cps in expense to increase the reserve to a more normal 55 bps of sales.

Ecolab Inc. (ECL)
Earnings Quality Update

We are raising our earnings quality rating of ECL to 3+ (Minor Concern) from 3- (Minor Concern)

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

Summary

ECL reported non-GAAP EPS of $1.27 which was 2 cps ahead of the consensus estimate. We did not see significant problems with the quality of the beat. In fact, provision for bad debt expense turned to a headwind and results were negatively impacted by an unusual jump in the allowance for returns. This prompts our upgrade in rating. While we don't like anything resembling earnings management, it appears to us that the company may be set up to enjoy some non-operational tailwinds if these allowances are allowed to drift down.

- We warned in our last review how a decline in bad debt expense added 3 cps to earnings in the 9/22 quarter. However, this reversed sharply in the fourth quarter as the bad debt provision rose to $11.3 million from $2.6 million in the year-ago quarter. The increase as a percentage of sales shaved over 2 cps off EPS growth. The allowance for bad debts rose to 2.6% of gross receivables which is above the pre-Covid norm of about 2%. ECL appears to be adequately reserved for bad debts at this point and analysts should be watching provision expense carefully in upcoming quarters for signs of the company taking reserves back into earnings. ***(See below for detail)***

- The allowance for returns and credits as a percentage of sales was running in the 0.5%-0.6% range in 2020 and 2021 which was consistent with the pre-pandemic experience. However, the return reserve percentage began to increase in 2022 and then skyrocketed to 1.8% of sales in the fourth quarter. The sudden increase looks very unusual. This was likely a material headwind to sales growth in the quarter and analysts should be looking for signs of any unusual benefit from the company releasing the reserve into revenue in the upcoming quarters. ***(See below for detail)***

- Amazingly, the company is still adding back costs associated with "Covid-19 activities" to its non-GAAP earnings. This jumped to $3.1 million (about a penny per share) in the 12/22 quarter from $2.5 million the previous quarter.

- The LIFO reserve spiked again sequentially to 7.3 days of cost of sales from 5.2 in the September quarter as a clear sign of continued inflation. The company warned in the call that “the cost of what we buy keeps going up, albeit at a lower rate of increase than what we saw in the past few quarters.” It also warned that “it takes a quarter or two to get through the system generally,” which we believe refers to costs working their way through inventory. Gross margins have improved sequentially but the company is not forecasting year-over-year improvement until the second half. As such, we would expect to see the LIFO reserve begin to trend down and watch for inventory to peak here at 73 days and decline in the first half.

- In November, the company approved the Europe Program in which it will incur $130 million in pretax charges to cut costs in the segment. The fourth quarter included $67 million in related charges which were added back to non-GAAP results. In February, the company announced it was expanding the plan to focus on its Institutional and Healthcare businesses in other regions as well. The price tag for the plan was raised to $195 million and is expected to be complete by 2024 and produce $175 million in cost savings by the end of 2024. This is all in addition to the “Institutional Plan” which started in 2020 and expanded in 2021 and the Accelerate 2020 plan which started in 2018 and was recently completed at a pretax cost of $254 million. The ongoing nature of the restructurings and expansion of the plans is a negative for earnings quality in our view. However, offsetting this concern is the fact that the bulk of these costs have been classified specifically as severance-related and do not appear on the surface to contain open-ended items such as management’s time.

- DSOs were essentially flat with the year-ago level and the previous quarter. However. The company’s comment in the 10-K that working capital negatively impacted cash flow primarily due to “past due receivables higher than last year due to pricing and energy surcharge rollout” caught our eye. The absolute amount of both past due and current receivables would be increased as a result of price increases, as would sales. This explains why DSO was not impacted. However, for the company to specifically mention past due receivables this way seems curious and could be an indication it is starting to see credit stress from its customers. The increase in the allowance percentage discussed above could also be signaling the same. We don’t assign a high degree of concern to this, but analysts should keep this in mind going into the first half of the year.

Allowance for Doubtful Accounts and Returns/Credits

ECL discloses both its provision for bad debt expense and its allowance for doubtful accounts in its quarterly filings. We warned last quarter that EPS benefitted by a penny per share from a decline in bad debt expense. However, an increase in the provision expense as a percentage of sales in 4Q22 shaved over 2 cps off EPS. ECL's allowance for bad debts was running around 2% of gross receivables before the company raised them to 3% during the pandemic. It dropped them to 2% again by the end of 2021, but as we see in the following table, the reserve percentage has returned to the mid-2 % level:

	12/31/2022	9/30/2022	6/30/2022	3/31/2022
Gross Receivables	$2,770.0	$2,783.2	$2,740.9	$2,577.7
Allowance for Expected Credit Losses	$71.9	$68.9	$72.9	$69.5
Allowance for Doubtful Accounts % of Gross Receivables	2.60%	2.48%	2.66%	2.70%

	12/31/2021	9/30/2021	6/30/2021	3/31/2021
Gross Receivables	$2,531.2	$2,440.1	$2,391.8	$2,341.5
Allowance for Expected Credit Losses	$52.8	$56.0	$60.8	$69.5
Allowance for Doubtful Accounts % of Gross Receivables	2.09%	2.29%	2.54%	2.97%

ECL appears to be adequately reserved for bad debts at this point and analysts should be watching provision expense carefully in upcoming quarters for signs of the company taking reserves back into earnings.

Allowance for Returns/Credits

The company records a reserve for future returns and pricing credits which it estimates at the time of sales. The reserve is generated as a reduction of sales and recorded as a reduction of accounts receivable. Note that the reserve for bad debts we discussed above is separate from the reserve for returns and credits. The following table shows the allowance for returns as a percentage of quarterly sales for the last eight quarters:

	12/31/2022	9/30/2022	6/30/2022	3/31/2022
Allowance for Expected Returns	$59.0	$37.1	$24.9	$17.8
Revenue	$3,671.2	$3,669.3	$3,580.6	$3,266.7
Allowance for Expected Returns % of Sales	1.61%	1.01%	0.70%	0.54%

	12/31/2021	9/30/2021	6/30/2021	3/31/2021
Allowance for Expected Returns	$19.0	$20.4	$19.3	$16.8
Revenue	$3,364.6	$3,320.8	$3,162.7	$2,885.0
Allowance for Expected Returns % of Sales	0.56%	0.61%	0.61%	0.58%

	12/31/2020	9/30/2020	6/30/2020	3/31/2020
Allowance for Expected Returns	$16.0	$15.3	$14.2	$18.0
Revenue	$3,065.3	$3,018.6	$2,685.7	$3,020.6
Allowance for Expected Returns % of Sales	0.52%	0.51%	0.53%	0.60%

Points to note:

- The allowance for returns and credits as a percentage of sales was running in the 0.5%-0.6% range in 2020 and 2021 which was consistent with the pre-pandemic experience.

- The return reserve percentage began to increase in 2022 and then skyrocketed to 1.8% in the fourth quarter. The sudden increase looks very unusual. This was likely a material headwind to sales growth in the quarter and analysts should be looking for signs of an unusual benefit from the company releasing the reserve into revenue in the upcoming quarters

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

We are reinitiating earnings quality coverage of SWK with a 3- (Minor Concern) rating.

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

Summary

Stanley Black & Decker (SWK) has seen the rapid earnings growth it experienced in 2020 disappear. The company enjoyed rapid growth from a DIY home remodeling boom induced by people focusing on their homes during Covid and seeking to maximize their home values as real estate prices rose. Now, the pandemic has wound down, people are going back to work, and rising interest rates are hurting housing and construction. Volume growth has vanished:

Tool & Outdoor	**2022**	**2021**	**2020**	**2019**	**2018**
Volume	-12%	17%	-1%	4%	6%

SWK exited 2022 with weak DIY spending. It is forecasting a base case of -5% volume growth in Tools in the 1H23 and -3%-3.5% for the 2H23. Margins are also expected to remain weak in 2023 but improve in 2H23.

Adjusted EPS for 2022 was abysmal coming in at $4.62 from initial guidance of $12.00-$12.50. Amazingly, SWK reported that it “beat” forecasts in three of the four quarters:

	4Q22	**3Q22**	**2Q22**	**1Q22**
Adj. EPS	-$0.10	$0.76	$1.77	$2.10
Estimate	-$0.35	$0.70	$2.13	$1.70

The business has seen material changes in recent years via acquisitions and divestitures and is now viewed as a potential turnaround story. We are updating our work on the company to review pluses and minuses for recent results, earnings quality, and goals.

Inventory is bloated and will cause multiple negative effects as it is taken down. We note several unsustainable benefits including tax items and lower rebate and warranty accruals. Near-term guidance is poor as SWK addresses past problems. As a result, we believe the market may take a “wait and see” approach which may result in a flat stock price.

However, there is value in the company’s brands and even if home sales stagnate, homeowners remodeling should drive demand further out. More importantly, the company has a turnaround plan which incorporates the following goals:

- Organic growth of 2-3x its market with a 35% gross margin
- Streamline the cost structure in SWK and its supply chain by $2 billion
- Reduce SKUs and inventory levels to boost cash flow
- Pay down debt and reward shareholders with dividends and repurchases

If SWK’s restructuring is successful there is considerable leverage potential. For a $75 dollar stock, investors would likely write off 2023, but EPS could return to a $9-$10 run rate in 2024 and grow from there.

What to Watch

- Inventory levels remain far above normal – peaking at 190 days vs. normal levels of 85-100 days. SWK purposefully built it up, but now business has slowed. This consumed cash flow and after entering 2022 with a forecast for $2 billion in free cash flow, SWK posted -$2 billion. **(See Below).**
- SWK is now letting inventory decline and saw a steep drop in the 2H22 but remains at 165 days. It is forecasting another $750-$1 billion decline in 2023 and will reduce SKUs too. This is will have a cascade of negative effects on margins:
    - SWK is reducing production so sales exceed new supply and reduce inventory. But, this is unwinding operating efficiency as fixed costs are not being leveraged. Gross margin has plummeted to under 20% - **(Negative - See Below)**

- Reduced production means higher-cost raw materials are not declining much, and inflation should continue to impact results for all of 2023. **(Negative – See Below).**

- Slowing unit sales are also reducing total cost of goods sold from initial forecast levels. Inventory DSIs get inflated because of this and it may take longer for DSI levels to reach normal levels. **(Negative – See Below).**

- The cash flow benefit of lower inventory levels has been offset by falling accounts payable. In the 2H22 – A/P fell $794 million which consumed cash and offset the $775 million from lower inventory. Payables are now 66 days vs. a normal 90-110 days. This should be a tailwind for cash flow now **(Positive – See Below.)**

- SWK continues to invest in the company despite lower sales. SWK is reporting higher advertising and R&D in dollar terms. **We see this as a positive for earnings quality.**

	2022	**2021**	**2020**	**2019**
Sales	$19,947	$15,281	$12,750	$12,913
Research in SG&A	$357	$276	$200	$241
Research % sales	1.79%	1.81%	1.57%	1.86%
Advertising in SG&A	$119	$99	$76	$91
Co-Op Advertising Net of Sales	$358	$375	$351	$318
Co-Op Advertising in SG&A	$32	$20	$16	$6
Total Advertising	$509	$493	$443	$414
Total Advertising % Sales	2.51%	3.15%	3.38%	3.13%
R&D % of sales adj. for price hike	1.89%	1.85%		
Adv. % sales adj for price hike	2.65%	3.23%		

- SWK bought more consumer product sales and divested some non-consumer divisions in 2021 and 2022.

- The price increases boosted sales by 7% in 2022 and 3% in 2021. We estimate that the price hikes leveraged these costs by 10-14 bps as a percentage of sales.

- The lower volume figures seen in 2022 likely had a negative impact on Co-Op advertising levels.

- One-time tax items benefited 2022 EPS that are unlikely to repeat. The first was an intra-company transfer of intangible assets that was a $153.3 million benefit. The second was a change in the valuation allowance for deferred taxes of $25.1 million. **These two items added $1.14 in EPS to SWK's 2022 results of $4.62**. They also helped the effective tax rate come in at -7% vs. initial guidance for a 10% rate and 2023's guidance is for 10% again. **Negative**

- Warranty accruals have been declining as new expenses lag settlements. This has helped earnings for several quarters. Every $5 million is worth 3 cents to quarterly EPS. It's often between $5-10 million. **Negative**

SWK	12/31/22	10/01/22	7/02/22	4/02/22	1/01/22	10/2/21	7/3/21	4/3/21
New Warranties	$155.3	$117.0	$78.7	$39.6	$150.1	$108.9	$70.4	$36.6
Settlements/FX	-$163.2	-$129.4	-$82.0	-$38.0	-$156.9	-$118.0	-$77.4	-$41.3
Benefit to earnings	$7.9	$12.4	$3.3	$1.6	-$6.8	$9.1	$7.0	$4.7

- The allowance for Rebates and Sales Returns declined with lower sales volumes in 2022 from $408.5 million to $376.6 million. We estimate this generated 18 cents in EPS and should be a headwind as volumes recover. **Negative**

- There are three sources of potential earnings headwinds due to rising interest rates that should be felt in 2023. **Negative:**

    - Pension income declined slightly from $8.2 million in 2021 to $6.4 million in 2022. The discount rates used to determine obligations were 5.36% and 4.70% for 2022. However, the rates used to calculate interest cost for pension income were only 2.28% and 1.69%. **The interest rate could rise by 300 bps. Interest cost would rise from $56.5 million to about $100 million – a $43.5 million headwind or 25 cents per share.**

    - SWK has $2.1 billion in outstanding commercial paper. The rate rose from 0.1% in 2021 to 2.3% in 2022. This could easily rise by 300 bps this year and add $63 million to interest expense or 37 cents unless the balance is paid down.

    - The company sells some receivables at a discount to collect cash more quickly. There were $110 million sold receivables outstanding at the end of 2022 which cost SWK $4.1 million. Throughout 2022, $496 million were sold. That loss jumped from $2.0 million in 2021. This could be a larger loss figure in 2023.

- Goodwill is $8.5 billion with other intangibles of $4.5 billion – this compares to $9.7 billion in equity. Goodwill is not amortized and SWK does not amortize much of its intangibles related to tradenames. In the current environment, there is a risk of impairments from using a higher discount rate. More importantly, a lower outlook for sales and margins could make the future forecasted cash flows decline too although the company may argue that it is addressing profitability with the restructuring plan. Investors should remain aware of this impairment risk.

- The debt should be watched too. SWK has long-term debt of $5.4 billion and short-term borrowing of $2.1 billion with $400 million of cash. There are almost no maturities in 2023 or 2024 for the long-term debt. In February 2023, SWK amended the covenants on its credit lines to give it more cushion in the near term. Adjusted operating income was $1.2 billion in 2022 and adding depreciation, EBITDA was $1.6 billion. So debt is 4.4x EBITDA. Guidance is for SWK to boost margins and pull $2 billion of the cost structure by 2025. That should make debt more than serviceable. However, near-term guidance is for the results to be very poor in early 2023 as the company works to bring down inventory levels. Lower inventory and the current state of payables should generate cash for SWK in the near term also.

- The latest restructuring plan appears to have some reasonable goals. SWK normally has a gross margin of 33%-35%, so hitting 35% again with specific targets for cost-cutting could be achieved. Simply having the inventory overhang correct and getting rid of the higher-cost inventory should be a big help. Even if SWK cannot achieve the full cost cutting plans, we still think 2024 should start to see meaningful EPS recovery with annualized run rates that top $10, without forecasting sales growth. It's possible to see a $15 EPS in 2025-26 starting from under $5 in 2022 and 2023. **(See Below).**

Inventory Is Causing Many of the Recent Problems

Rising inventory has been a major red flag for SWK. There is seasonality to SWK's sales for Christmas sales and summer so figures must be compared year-over-year. **For years,**

inventory ran between 100 days leading into those quarters and generally runs about 85 days in other periods. Look at recent inventory levels:

SWK Inv.	12/31/22	10/01/22	7/02/22	4/02/22	1/01/22	10/2/21	7/3/21	4/3/21	1/02/21
Finished Product	$3,461	$3,840	$4,115	$4,023	$3,486	$2,777	$2,512	$2,170	$1,884
Work in Progress	$339	$357	$456	$429	$395	$350	$299	$251	$169
Raw Materials	$2,062	$2,150	$2,065	$1,816	$1,539	$1,007	$868	$716	$586
Total Inventory	$5,861	$6,347	$6,636	$6,268	$5,420	$4,134	$3,680	$3,137	$2,639
DSI Finished	97.4	112.7	117.5	116.5	111.1	98.6	93.8	84.6	71.0
DSI Wrk Progress	9.5	10.5	13.0	12.4	12.6	12.4	11.2	9.8	6.4
DSI Raw Mat	58.0	63.1	59.0	52.6	49.1	35.7	32.4	27.9	22.1
Total DSI	**164.9**	**186.3**	**189.5**	**181.5**	**172.8**	**146.7**	**137.4**	**122.3**	**99.5**

Coming out of Covid in late 2020, demand surged with a 15% jump in 4Q20. **SWK was afraid of running out of inventory and sought to stock up:**

- 4Q20 earnings call – SWK noted that buying at retailers was running 30%-40% higher by June 2020 and inventory in the channel was below normal.
- 1Q21 earnings call – SWK said retailer inventories were still 4-5 weeks too low and production was ramping as much as possible.
- 2Q21 earnings call – SWK was boosting guidance for sales as it was filling higher retailer demand and higher consumer sell-through. It wanted to boost inventories more.
- 3Q21 earnings call – SWK saw strong demand for 2021 plus 2022 and beyond. It continued to see the need to build more inventory but had resolved some sourcing bottlenecks.
- 4Q21 earnings call – SWK was planning to build inventory beyond normal levels to overcome bottlenecks in the supply chain.
- 1Q22 earnings call – SWK thought it still needed large inventories but it might be able to reduce that investment by 2H22.

Inventories continued to rise at that point because demand fell off the table and volume dropped rapidly:

Tools & Outdoor	12/31/22	10/01/22	7/02/22	4/02/22	1/01/22	10/1/21	7/3/21	4/3/21	1/02/21
Volume	-12%	-12%	-16%	-6%	-8%	11%	38%	42%	15%

In 4Q21, SWK also bought the 80% of MTD that it didn't own which added $901 million in inventory and it bought Excel which added another $50 million in inventory.

The buildup in inventory also crushed cash flow. The initial guidance for 2022 called for SWK to generate $2 billion in Free Cash Flow. However, it came in at -$2 billion and SWK is now guiding to $0.5-$1.0 billion for 2023:

SWK FCF	2022	12/31/22	10/01/22	7/02/22	4/02/22
Cash Ops	-$1,460	$651	-$426	-$444	-$1,241
Cap Ex	$530	$131	$114	$146	$140
Free Cash Flow	-$1,990	$521	-$540	-$590	-$1,381
Working Cap chg.	-$1,705	$593	-$393	-$568	-$1,336

Fixing Inventory Will Lead Cascade of Negative Effects on Margins

After the large build-up inventory, SWK is reversing course. Part of its latest restructuring plan is to reduce inventory in dollar terms to free up cash. It also intends to reduce SKUs. The company cheered a reduction of $775 million in the 2H22. It believes it will free up another $500 million early in 2023 and forecasts full-year inventory reduction of $750 million to $1 billion.

There are several other areas that inventory is impacting:

- **Inventory reduction has yet to have a net positive cash flow impact because accounts payable is declining too.** In the 2H20, inventory fell by $775 million but payables used up $794 million in cash flow at the same time. Historically payables are about 90 days and were 110 days in late 2021 and early 2022. At 66 days now, this could likely increase and contribute to cash flow going forward.

SWK A/P	12/31/22	10/01/22	7/02/22	4/02/22	1/01/22	10/2/21	7/3/21	4/3/21	1/02/21
Payables	$2,344	$2,493	$3,139	$3,368	$3,424	$3,056	$2,999	$2,653	$2,320
Payables DSP	66.0	73.1	89.7	97.5	109.1	108.4	112.0	103.5	87.5

- Working down inventory is having a negative impact on gross margin even with hefty price increases:

	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
Adj. Gross Margin	19.5%	24.7%	27.9%	31.3%	29.0%	32.3%	35.9%	37.4%
Pricing	7%	8%	7%	5%	5%	2%	2%	2%
Volume	-10%	-10%	-13%	-6%	-8%	8%	31%	29%

Lower volumes are deleveraging fixed costs like depreciation and salaries. SWK has also reduced production so operating efficiency is unwound. In the section above, look how high raw materials are and those are still not declining much. SWK obviously bought surplus inventory into the teeth of inflation. Lower production will mean high-priced inventory will be flowing through gross margin for a longer time. SWK is paying more for supply-chain activities as well.

- For GAAP margins, SWK marked up the carrying value of MTD's inventory at the time of the acquisition. That has the impact of lowering GAAP gross margin. Normally this type of accounting adjustment is short-lived. As soon as the acquired inventory is sold, this goes away. Again, the poor volume is likely stretching this issue out over a longer period than initially thought. We actually consider assigning a higher value to inventory more conservative than putting it into something like goodwill or intangibles with no amortization or the amortization added back.

The Restructuring Plan Involves Inventory Correcting and Reasonable Structural Changes

While SWK is clearly seeing the effects of inflation and too much inventory hurting sales and margins, fixing the inventory level should only require some time. The wildcard there is weaker demand from lower new housing demand. Our opinion is that the speed at which people trade homes will slow as those with 3% mortgages will not want a 6%-7% mortgage on their new house and will opt to stay in place longer. That should still help SWK in the future as people repair and remodel their existing homes.

Getting past inflation will be helped in two areas:

- There are still some prior price hikes that have not annualized yet – so there should be another 2%-3% better pricing in 2023.

- Working down the higher cost inventories and some commodity cost relief is happening now. After 2023, some cheaper product should be in COGS.

However, this process involves lower manufacturing rates until inventory levels have been reduced. With lower operating rates deleveraging fixed costs in 2023 – SWK is forecasting a gross margin of in the mid-high 20% range. The key variable is when do operating rates normalize – mid-2023 or the end of 2023?

SWK's plan for a turnaround centers on three primary pillars.

- Boosting gross margin to 35%+ by 2025, by pulling $1.5 billion in cost out of the supply chain.

- Reducing SKUs in inventory should allow SWK to source more efficiently and use less real estate.

- Pulling $500 million out of SG&A costs on an annualized run rate by the end of 2023.

When we look at restructuring plan goals, a key question we ask is "has the company done this before?" While the portfolio has changed in recent years, SWK has a history of gross margin in the 33%-35% range:

	2022	2021	2020	2019	2018
Gross Margin	26.0%	33.6%	34.2%	33.5%	35.2%

Pulling $1.5 billion in cost out of the supply chain is worth 900 bps in gross margin. Simply returning to normal production levels and leveraging fixed costs like depreciation and salaries should help too. We will also point out that some of this is pure inflation that is coming down. For example, diesel fuel is down about 25% from the spring of 2022, resin is down about 15%, and steel about 25%. SWK is still rolling through higher-priced inventory before it will gain some benefits from lower costs. That will contribute to a weak 2023.

Part of the $1.5 billion is expected to come from using less warehousing and real estate for its supply chain with the SKU rationalization and running with lower inventories. That, in turn, should also mean less in wages. That sounds doable as well.

SWK claims that by the end of 2022, it had already reached $200 million of the projected $500 million in targeted annualized SG&A savings. SWK lists "other distribution costs" in SG&A and these have been up considerably of late:

	2022	2021	2020	2019
Other Distrib	$499	$416	$347	$327

These are salary and facility costs according to management. If this is rationalized along with the supply chain real estate – this could be another $100 million.

We know 2022 was a disaster for earnings and 2023 is unlikely to be much better with negative sales growth possible. There's a reason the stock is down from $220 to $74. But there is considerable earnings leverage here even if management is not fully successful in its restructuring targets. We think SWK could see a sizeable earnings recovery in 2024-26. Let's assume sales of $16-$18 billion, interest expense rising 20%, and only $300 million in SG&A cuts from the $3.2 billion level of 2022 – what does EPS look like at different levels of gross margin? Here is a quick "back of the envelope" view:

Gross Margin	**30%**	**30%**	**30%**	**32%**	**32%**	**32%**	**34%**	**34%**	**34%**
Sales	$16,000	$17,000	$18,000	$16,000	$17,000	$18,000	$16,000	$17,000	$18,000
Gross Profit	$4,800	$5,100	$5,400	$5,120	$5,440	$5,760	$5,440	$5,780	$6,120
SG&A	$2,900	$2,900	$2,900	$2,900	$2,900	$2,900	$2,900	$2,900	$2,900
Interest	$400	$400	$400	$400	$400	$400	$400	$400	$400
20% tax rate	$300	$360	$420	$364	$428	$492	$428	$496	$564
Net Income	$1,200	$1,440	$1,680	$1,456	$1,712	$1,968	$1,712	$1,984	$2,256
EPS	$8.00	$9.60	$11.20	$9.71	$11.41	$13.12	$11.41	$13.23	$15.04

- Giving SWK full credit of $500 million in SG&A savings would add about $1.00 to EPS in all these scenarios.

- Normally the core tax rate is closer to 10% - using that would add about $1.20 to EPS in all these scenarios.

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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