BEHIND THE NUMBERS

EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Cintas (CTAS) EQ Update 11/19 Qtr

Current EQ Rating*	Previous EQ Rating
4+	4+

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

*For a more detailed explanation of the EQ Review Rating scale, please refer to the end of this report

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

CTAS clobbered earnings estimates in the 11/19 quarter by reporting $2.27 per share, a full 23 cps ahead of the consensus. As discussed below, we estimate about half the upside was from a lower tax rate. The midpoint of the company's guidance range for the year ended 5/20 is $8.70 which represents almost 16 percent growth with the consensus for 5/21 calling for growth to moderate to just over 9%. This makes the company's PE of over 32 times the 5/20 estimate seem somewhat lofty. There is some question as to what the company will do to drive growth once the benefit of integrating legacy G&K customers is over. However, at this point, we are not seeing signs of the company being overly aggressive in its reporting.

- CTAS's effective tax rate for the 11/19 quarter declined to 20.1% from 24.2% in the year-ago period which the company attributed to discrete items, namely stock-based compensation. We estimate this added about 12 cps to earnings growth in the period which is still only about half the reported earnings beat in the quarter. The company is expecting a full-year tax rate of 19.2% but the rate can fluctuate from period to period.

- Accounts receivable days of sales fell by approximately one day in the quarter compared to the year-ago level. Management attributed the improvement to the end of disruption caused by converting G&K receivables collections over to its own systems. During the fiscal year ended 5/19, each quarter saw DSOs increase by 2-4 days over the comparable year-ago periods after adjusting for the mandated adoption of ASC 606. As we noted in our review of the last quarter, that increase fell to just one day in the 8/19 quarter and as of the 11/19 quarter, it has reversed. This reduces our concern level regarding accounts receivable.

- There were essentially no buybacks made in the quarter after several quarters of accelerated spending on repurchases. Management indicated that this did not reflect a change in its capital allocation strategy and stated in the call: "*One thing to keep in mind is we, in the first week of December, we made $268 million payment related to our dividend, and we also have some debt interest payments. So we're back into CP in the month of December, but we will look at the buyback opportunistically as we move through the rest of the year."* The share count in the 11/19 quarter declined by 2.3% versus the year-ago quarter, providing a comparable boost to EPS growth in the period. If the share count were to remain sequentially flat next quarter, it would still be about 1% below the year-ago level. The company generated roughly $800 million in cash flow after dividend payments for the trailing 12-month period ended 11/19. To reduce the share count another 1% next year would take approximately $300 million in cash which the company should be able to more than cover with a good cushion left over for debt reduction.

- It has been over two years since the G&K acquisition, but the company is still reportedly benefitting from converting old customers from G&K branded uniforms to Cintas uniforms. The premium Cintas uniforms are, according to the company, allowing it to potentially charge higher prices for them. Converting these customers to higher-priced, higher-margin uniforms has been a growth opportunity. It is unclear how much room is left for growth, but we found the following exchange on the conference call informative:

  > *"From an inventory conversion standpoint, we are in the midst of that. And those happened at different such times, Andrew. So for example, if we have a customer that's got 10 wears, for example, in legacy G&K inventory, we maybe in a style where as they turn, in other words, as they have turnover and they replace their open positions with new hires and we put them into legacy G&K current garments, there's going to be a point in time at which we run out of those*

garments, whether it's the style or the size. And that happens at very different intervals depending on the kind of garment that they have. And so it is a customer-by-customer approach.

When they start to run out of -- when we start to run out of G&K legacy garments, we will start to put them into Cintas garments and generally, that can be all at once, because we don't want them to have different looks. But as I said, that is a customer-by-customer decision point based on the style. So, it's really hard to give you a full percentage, because it's happening all over the country. We are not finished with that. We are still working our way through G&K legacy inventory.

When they get on to Cintas inventory, as you know, pricing becomes a customer-by-customer conversation as well. And there may be some where we -- there is no change at all and we put them in something that's, let's say, at a work wear type of a garment. There may be others where we give them an opportunity to upgrade into a Carhartt garment, for example. And in that case, there may be times where we will increase the pricing, or adjust the pricing as its necessary. So it is a customer-by-customer decision on when to convert and then it's also a customer-by-customer decision on what does that pricing and what does that contract look like."

Analayst
"And do you think the customer recognizes that the Cintas uniform on average is a better uniform than the legacy uniforms they had?"

Mike Hansen
"I can give you anecdotally, the answer is yes. We need to be doing a pretty good job of showing why they're moving into a Cintas garment, and what are the features and functions of that new garment. It may be that it's softer, it may be that it little bit better, it maybe that is -- that the fabric breath is a little bit better. And generally when we explain those kinds of features to the customer, they get it and they understand. And it doesn't take very long for them to be in those garments to recognize that there's a quality difference."

Uniform Rental gross margin rose by 130 bps in the quarter due to the "increase in revenue and continuous improvements in process efficiency." It is impossible to tell how much of this could have been driven by converting G&K legacy customers to premium Cintas uniforms. With two years having passed, we are skeptical that conversion could still be having much

of a large impact, so we do not believe conversion could be accounting for a large part of the growth at this point.

Explanation of EQ Rating Scale

Rating	Explanation
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 Concerns"	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 may 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 the next quarter. 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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