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BTN Research

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

October 16, 2020 | www.btnresearch.com

Cintas (CTAS) EQ Update- 8/20 Qtr.

Current EQ Rating*	Previous EQ Rating
4+	3-

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

We are raising our earnings quality rating back to a 4+ (Acceptable)

CTAS destroyed estimates in the 8/20 quarter with EPS of $2.78 coming in 65 cps ahead of targets. While revenue also topped targets by almost 3%, the bulk of the beat came from a massive reduction of costs, much of which will likely return over the next couple of quarters.

Items that Deteriorated

- DSIs based on inventories for sale rose by almost 17 days over the year-ago quarter following a 10-day increase in the 5/20 quarter. The company contends this is due to stockpiling high-demand items such as hand sanitizer and personal protection gear which will presumably be sold quickly. This tempers our concern level but we will be more alarmed if inventories do not show signs of moderation in the next quarter. (Concern level: MEDIUM)

- Lower stock-based compensation added about 9 cps to EPS growth in the quarter. (Concern level: LOW)

- The effective tax rate fell to 7.8% from 10.1% a year-ago which added about 7 cps to EPS in the quarter.
  (Concern level: LOW)

Items that improved

- Estimated capitalized commissions fell to 1.4% of revenue from the elevated 1.7% we documented in the previous quarter. This reversed the estimated 4 cps EPS boost in the 5/20 quarter, eliminating our concern in this area for the time being.

- Receivables DSOs fell one day in the 8/20 quarter versus the year-ago period. This confirms that the almost 3-day YOY increase in the previous quarter was due to slow collections from COVID.

- The allowance for obsolete inventories fell to 9% from 10% in the year-ago quarter and in-line with the pre-COVID trend. We do note that numbers indicate there may have been a further building of the reserve for custom-made inventories, but the increase was immaterial compared to the increase in the previous quarter.

Other Items

- CTAS capitalizes the cost of rental items in an inventory account and amortizes them over the estimated life of the items. Amortization as a percentage of rental revenue is still climbing despite lower sales but this should reverse soon as existing items become fully amortized. This will provide a temporary artificial tailwind to margins which will level out as rental inventories are replenished.

Inventory Continued to Climb

(Concern level: LOW)

We noted in our review of the 5/20 quarter that CTAS's inventory DSIs rose by roughly 10 days YOY. The following table shows that the increase continued into the 8/20 period:

	8/31/2020	5/31/2020	2/29/2020	11/30/2019
Cost of Sales	$920	$912	$986	$991
Total Inventory	$488	$409	$353	$348
DSI	48.8	41.3	32.6	32.0

	8/31/2019	5/31/2019	2/28/2019	11/30/2018
Cost of Sales	$962	$970	$927	$943
Total Inventory	$336	$335	$340	$322
DSI	32.2	31.7	33.0	31.1

Keep in mind that the total inventory figure above is made up of products the company sells including custom-made uniforms (mainly to the cruise/hotel industry) and other products sold through its catalogs during service visits. This is separate from the "uniforms and other rental items in service" balance which is amortized over the expected life of items under rental agreements.

Management focused discussion of the buildup in inventory on items that have been in particularly high demand due to COVID such as personal protective equipment and hand sanitizer:

> *"Much of that buildup is in some of the items that are in high demand right now. The hand sanitizer and there you got to look at that in a lot of different ways. It's the actual fluid itself, the container that comes in, the dispensing units that we need, the stands and so forth. And so there is a build-up of that inventory. But these are things that we are doing to take advantage of the opportunities that are in the marketplace right now. And we're very confident that because we've been able to do this and do it in such short order that we are winning business daily, because we have inventory. We talked about - one of the examples I gave earlier on was that we got a very large account, because we were able to deliver masks in a matter of days that other companies were telling that prospect it would take months to get those."*

The 8/20 10-Q also stated:

> *"While there was minimal disruption to our supply chain, Cintas did experience an increase in inventory, primarily personal protective equipment and facility services inventory, caused by the impact of COVID-19."*

If the increase in inventory consisted of masks and hand sanitizer which the company will sell quickly, this is not as big a concern. Management is telling investors that it is picking up new customers by being able to supply items such as hand sanitizer that its competitors cannot manage to procure. The following story was told in the conference call:

> *"We had another example of a large customer, multilocation customer that decided to give a third of their hand sanitizer stand business to us, a third one of our competitors and a third competitor. We implemented that program with thousands of stands in a week. One of the competitors came back and said we can't deliver it within your timeframe. So they gave us that third. We did that the next week thousands of stands. And the third competitor can only do about half of what they said they could do so they're giving us half of that third of the business. And it's because we have the inventory available today to service those accounts."*

This gives a glowing picture of how much better the company is at sourcing these COVID-related items that are suddenly in demand and even more incredible that it was able to source them and still register a 20% sequential increase in its inventory balance. Going forward, if demand is robust and the increase in inventory is all from these fast-moving items, we would expect to see the increase in inventory begin to level out in the next couple of quarters and will more concerned if we don't see signs of inventory moderation in the next quarter.

Stock-Based Compensation Fell Again

(Concern level: LOW)

Stock-based compensation again declined in the 8/20 quarter:

	8/31/2020	5/31/2020	2/29/2020	11/30/2019
Stock Based Compensation	$29.055	$19.007	$27.030	$29.003

	8/31/2019	5/31/2019	2/28/2019	11/30/2018
Stock Based Compensation	$40.395	$33.657	$30.769	$28.612

We estimate that this added about 9 cps to EPS in the quarter. However, given the trend, we suspect this would have been factored into many analysts' models. That and given that the size of the earnings beat in the quarter prompt us to give this a low level of concern.

Effective Tax Rate Fell

(Concern level: LOW)

CTAS's effective tax rate fell to 7.8% in the quarter from 10.1% a year ago:

	8/31/2020	5/31/2020	2/29/2020	11/30/2019
Adjusted Effective Tax Rate	7.8%	20.4%	18.9%	20.1%

	8/31/2019	5/31/2019	2/28/2019	11/30/2018
Adjusted Effective Tax Rate	10.1%	21.6%	20.1%	23.6%

Management attributed this to "certain discrete items, primarily the tax accounting impact for stock-based compensation." The company did not give guidance for the tax rate for the 8/20 quarter in the 5/20 quarter conference call. However, we doubt analysts modeled the tax rate decline. If the tax rate had remained constant with the year-ago period, it would have shaved about 7 cps off of EPS in the quarter. We nevertheless rate this as a low concern given that the company beat EPS expectations in the quarter by 65 cps.

Receivables DSOs Declined Indicating Good Collections

We noted as a minor concern in our review of the 5/20 quarter that receivables DSOs rose by almost 3 days, likely due to slower collections from COVID. As the following table shows, DSOs fell back inline which eliminates our concern in this area.

	8/31/2020	5/31/2020	2/29/2020	11/30/2019
Sales	$1,747	$1,620	$1,811	$1,844
Trade Receivables	$866	$870	$943	$949
Trade Receivables Days of Sales	45.6	49.4	47.4	46.8

	8/31/2019	5/31/2019	2/28/2019	11/30/2018
Sales	$1,811	$1,794	$1,682	$1,718
Trade Receivables	$918	$910	$878	$904
Trade Receivables Days of Sales	46.6	46.7	47.0	47.9

Inventory Reserve Percentage Declined

CTAS significantly raised the allowance for obsolete inventories in the 5/20 quarter due to concerns that some of its custom-made uniforms would not be sold. The following table shows that the allowance percentage declined from 10% to 9% in the 8/20 quarter and was level with the year-ago reserve percentage:

	8/31/2020	5/31/2020	2/29/2020	11/30/2019
Total Net Inventory	$488.165	$408.898	$352.924	$348.304
Reserve for Obsolete and Slow-Moving Inventory	$48.200	$45.500	$34.100	$33.800
	9.0%	10.0%	8.8%	8.8%

	8/31/2019	5/31/2019	2/28/2019	11/30/2018
Total Net Inventory	$336.290	$334.589	$339.805	$321.874
Reserve for Obsolete and Slow-Moving Inventory	$33.400	$32.700	$32.600	$31.900
	9.0%	8.9%	8.8%	9.0%

However, remember that the sequential increase in inventory was due to stocking up on items like hand sanitizer and masks- items that have very little risk of becoming obsolete in the current environment. Much of the custom-made uniform inventory is sold to airlines, hotels, and cruise lines making us doubt the company spent anything to build those inventories up in the quarter. If we take the sequential increase in the reserve relative to the sequential increase in gross inventory, it appears the company reserved on new inventories at about 3.5%. This seems high for the high-turn COVID-related products which makes us wonder if the bulk of the increase was from further increasing reserves related to custom uniforms. Still, this amount is immaterial compared to the increase seen in the 5/20 quarter.

Deferred Commissions Improved

We documented in our last update on the 5/20 quarter that there were indications that the company significantly increased its capitalization of sales commission costs. We estimated that this could have added 4 cps to EPS in the 5/20 quarter. However, as we see below, the situation reversed in the 8/20 quarter as estimated deferred commissions fell to $24.6 million from $26.5 million in the year-ago period:

	8/31/2020	5/31/2020	2/29/2020	11/30/2019
Beginning Deferred Commission Balance	$303.3	$295.8	$290.9	$283.3
Amortization of Deferred Commissions	$20.4	$20.1	$19.7	$19.2
Estimated Commissions Deferred (PLUG)	$24.6	$27.6	$24.6	$26.8
Ending Deferred Commission Balance	$307.5	$303.3	$295.8	$290.9
Sales	$1,746.6	$1,619.6	$1,810.6	$1,843.7
Commissions Deferred % of Sales	1.41%	1.70%	1.36%	1.45%

	8/31/2019	5/31/2019	2/28/2019	11/30/2018
Beginning Deferred Commission Balance	$275.6	$271.7	$266.7	$259.7
Amortization of Deferred Commissions	$18.8	$18.4	$18.0	$17.6
Estimated Commissions Deferred (PLUG)	$26.5	$22.3	$23.0	$24.6
Ending Deferred Commission Balance	$283.3	$275.6	$271.7	$266.7
Sales	$1,811.1	$1,793.7	$1,682.3	$1,718.3
Commissions Deferred % of Sales	1.46%	1.24%	1.37%	1.43%

We estimate that this could have represented a 4 cps drain on EPS in the period. The company's better than expected revenue and cost-cutting measures served to more than offset the increased cost. This reduces our level of concern going forward and was a factor in raising our rating.

Amortization of Rental Inventories Will Become a Temporary Tailwind

We discussed inventories for sale above, but those are separate from the company's "uniform and other rental items in service" inventory. CTAS capitalizes these inventories and amortizes the cost over the expected life of the asset which is 18 months for uniforms and 8-60 months for items such as mats, mops, linens, and restroom dispensers. The following table shows the balance of in-service inventories and days of sales based on uniform rental sales for the last eight quarters:

	8/31/2020	5/31/2020	2/29/2020	11/30/2019
Uniforms and Other Rental Items in Service	$756.364	$770.411	$818.486	$817.859
Uniform Rental and Facility Services Sales	$1,394.411	$1,270.970	$1,448.021	$1,469.976
Days Sales	49.9	55.8	51.4	50.6

	8/31/2019	5/31/2019	2/28/2019	11/30/2018
Uniforms and Other Rental Items in Service	$796.187	$784.133	$773.534	$758.246
Uniform Rental and Facility Services Sales	$1,454.527	$1,428.392	$1,358.322	$1,390.778
Days Sales	50.4	50.5	51.3	49.6

In service inventory and the associated DSI cannot be interpreted as a traditional inventory account since the inventory is not sold. It is more like a property, plant, and equipment account where revenue is generated by the asset over its service life. The DSI figure here serves to give us an idea of how these assets are growing over time relative to the revenue it is producing. If the amortization time frame was too long, we would expect to see the DSI figure rise over time as assets are left on the balance sheet longer than their actual service life. Instead, we see DSI tracking fairly steadily except for the COVID bump in the 5/20 quarter.

CTAS does not disclose the amortization expense associated with the account, but if we just use the 18-month period for uniforms, we get a rough estimate of about $130 million in quarterly amortization expense. This amounts to a little less than 20% of total uniform rental cost of sales.

We can see om the above table that the account has trended down the last two quarters as the company's clients have experienced headcount reductions, curtailing the need to add new items to the inventory, yet the amortization of existing items continues to reduce the balance. Therefore, amortization expense will not decline to match lower sales immediately but will eventually decline as older items become fully-amortized. Management pointed this out in the 5/20 conference call:

> *"Amortization expense was 300 basis points higher this fourth quarter compared to last. This non-cash expense is a significant headwind in the short term but will improve in ensuing quarters because purchases of new items were reduced and more existing items will become fully amortized."*

In the 8/20 quarter conference call, management stated that the amortization of rental inventory was 80 bps higher than the year-ago quarter. Amortization expense may begin to decline over the next couple of quarters even as uniform rental revenue picks back up. This will result in a temporary boost to margins, possibly over the next couple of quarters, that will level out as the company adds new goods to in-service inventories which will drive amortization back up.

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 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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