BEHIND THE NUMBERS
Quality of Earnings Analysis
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Cintas Corp (CTAS)
Earnings Quality Update- 8/21 Qtr.

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 3- (Minor Concern) and adding it to our On Deck Sell list.

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

Summary

CTAS reported EPS of $3.11 in the 9/21 quarter which was 35 cps ahead of the consensus estimate. However, the company's outlook for FY '22 given at the end of last quarter called for the tax rate to increase to "19.5%-20.5%" from FY '21's 13.7%. The company has highlighted the negative impact this would have on FY '22 results. However, the effective tax rate came in at 11.0% in the 8/21 quarter versus the year-ago period's 7.8%. While this was a headwind to EPS growth in the quarter, we suspect it was likely well below the tax rate most analysts had modeled. Since every percentage point change in the tax rate would have impacted EPS by about 4 cents, we could easily see the lower tax rate accounting for 20-30 cps in the upside versus consensus. We also note that the company spent $400 million on share buybacks in the 5/21 quarter followed by $660 million in the 8/21 quarter with the resulting decline in the share base adding about 6 cps to EPS growth. Offsetting some of these benefits was a 5.5 cps increase in stock compensation expense. Still, the earnings beat is less impressive than it appears at first glance.

- We noted in our last update on CTAS that the company dramatically increased its reserve for obsolete and slow-moving inventory which was largely related to its inventory of PPE products. We were concerned that the company would be able sell this inventory in the next couple of quarters and realize unusually high profits due to the reduced cost basis. However, the reserve stayed essentially flat in the 8/21 quarter indicating that the company was unable to move meaningful amounts of this inventory in the quarter. The reserve as a percentage of gross inventory has remained at roughly double the pre-Covid norm for the last two quarters.

- First Aid and Safety Services revenue fell by 2.6% and segment gross margin improved to 44.8% from 40.2% in last year's August quarter. However, the improvement in gross margin was due to a mix shift away from lower margin PPE products and segment gross margin remained well below the 2019 level of 49%. This coupled with the still elevated inventory reserve does not make us think the quarter benefitted meaningfully from selling reduced cost basis PPE inventory. However, the reserve balance and what we are hearing about demand and pricing from other players in the PPE area such as PDCO makes us believe the company may very well have to incur additional reserves or write downs in upcoming quarters.

- Like most other companies, CTAS is facing both higher materials cost and labor cost headwinds. Management also reminded investors that a large portion of its costs are capitalized into rental inventories and recognized over time. However, the company is currently raising prices to cover the costs so it will get the full beneficial impact of that immediately. While this effect will boost margins in the next quarter or two, it is setting the company up for possible disappointments after that when price increases stop and the higher cost inventory is still being amortized.

- We also note that the company mentioned in its discussion of results that an asset sale helped offset the impact of higher costs on SG&A expense. However, this was not quantified in the 10-Q or the conference call so we do not know the impact on earnings.

Inventory Reserve Remained Elevated

We noted in our last update on CTAS that the company dramatically increased its reserve for obsolete and slow-moving inventory which was largely related to its inventory of PPE products. We were concerned that the company would be able sell this inventory in the next couple of quarters and realize unusually high profits due to the reduced cost basis. However, the reserve stayed essentially flat in the 8/21 quarter indicating that the company was unable to move

meaningful amounts of this inventory. The reserve as a percentage of gross inventory has remained at roughly double the pre-Covid norm for the last two quarters:

	8/31/2021	5/31/2021	2/28/2021	11/30/2020	08/31/2020	5/31/2020
Total Net Inventory	$463.692	$481.797	$533.211	$534.128	$488.165	$408.898
Reserve for Obsolete/Slow-Mov. Inventory	$110.20	$111.00	$63.60	$52.30	$48.20	$45.50
% of Gross Inventories	19.2%	18.7%	10.7%	8.9%	9.0%	10.0%

While Uniform Rental and Facility Services revenue rose by 8.2% as customers' employees returned to work, revenue of First Aid and Safety Services fell by 2.6% as a result of declining PPE sales. Management discussed this dynamic in the conference call:

> *"Our first aid and safety services operating segment revenue for first quarter was $199.1 million compared to $204.5 million last year. First quarter revenue was up against a very difficult comparison and last year's first quarter in response to the COVID-19 pandemic, personal protective equipment or PPE sales were surging, propelling the business to grow organic revenue over 17%. At that time PPE comprise an outsized percentage of first aid and safety services revenue mix. As discussed on previous earnings calls, the amount of PPE has declined as COVID case counts have fallen from peak levels. However, PPE remains a larger percentage of the revenue mix than it was pre-COVID."*

We would also point out that First Aid and Safety Services gross margin improved from 40.2% in the 8/20 quarter to 44.8% in the 8/21 quarter. However, this was due to lower-margin PPE revenues falling in the mix and First Aid and Safety Services gross margin was well below the 8/19 quarter level of 49%.

Given the elevated reserve and the gross margin trend, we do not see evidence that the company benefitted meaningfully from the sale of lower cost basis PPE inventory. However, we continue to question why the inventory has not been written off if it is not moving and given what we are seeing from other companies participating in PPE such as PDCO, we suspect the demand and prices for these products are only deteriorating. While CTAS's profits have already absorbed the negative impact of building the reserve, we believe future writedowns are possible. We will also be skeptical of any unusual improvement in First Said and Safety Services gross margins in future quarters if the company is able to sell this inventory.

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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