BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Cintas (CTAS) EQ Review

Current EQ Rating*	Previous EQ Rating
4-	NA

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

We initiate earnings quality coverage of CTAS with a rating of 4- (Acceptable).

We have never had serious concerns with CTAS's earnings quality. The business model is obviously levered to the economy, and having bought G&K Services (its largest competitor) in 2017, there is some question as to how it can keep the growth story alive longer-term. Integration of G&K continues and will be key to meeting future expectations, but those issues are beyond the scope of this report. From an accounting perspective, recent results have received some one-time benefits as well as some one-time drags which prompts us to give the company an initial rating of Acceptable. We will continue to follow the below issues on a quarterly basis.

- CTAS adopted ASU 2014-09 for revenue recognition on June 1, 2018, the first day of its fiscal year. The result has been a net positive EPS impact of 4 cps in the 8/18 and 11/18 quarters. The 10-Q for the 2/19 quarter is not available yet but we assume a similar benefit. While the company has mentioned the beneficial dollar amounts of the impact on SG&A spending in its conference calls, it is absent from its MD&A discussions in the 10-Q and is not included as an adjustment to EPS in its non-GAAP presentation. The benefit has boosted EPS by about 2% and added 200 bps to the reported operating income growth. This boost will disappear after the 5/19 quarter.

- Accounts receivable days of sales (DSO) have increased between 2-4 days year-over-year for the last three quarters after adjustment for the new revenue recognition standards. This could be an indication of the extension of more generous credit terms to customers.

- The reserve for obsolete inventory dropped by more than $6 million in the 8/18 and 11/18 quarters compared to the 5/18 level despite a rising trend in inventory. We estimate it would take about 6 cps to restore the reserve to the year-ago level.

- Depreciation expense jumped by $7.6 million in the 2/19 quarter versus a year ago after two quarters of declines. This would have been about a 5.5 cps drag on EPS growth in the quarter.

Accounting Change Providing a Tailwind

CTAS adopted ASU 2014-09 (Topic 606) for revenue recognition beginning on June 1, 2018, the first day of its fiscal year. The company chose to implement the new standard under the modified retrospective approach under which it does not restate past results but instead discloses what current results would be under the old method which can be used for comparative purposes.

Topic 606 impacted CTAS's results in two ways. The first involves the capitalization of contract costs. Previously, the company typically expensed its costs to obtain contracts. However, under the new revenue guidance, the company now capitalizes most of its commissions and amortizes them on a straight-line basis over the expected period of benefit. This resulted in a significant increase in the company's "prepaid expenses and other current assets" account as well as its "other assets" account. On the income statement, this led to a substantial decline in selling general and administrative expenses.

The second area of impact was related to the company's business of selling finished products to customers. When the company produces products for customers that have no alternative use (think custom uniforms or accessories) the company has an enforceable right for payment for the work done to date. Under the new revenue recognition standards, the company has moved from a point-in-time recognition model to an over-time model of recognition based on finished goods completed with no alternative use. Adoption resulted in an increase in accounts receivable and a reduction in inventory. The main income statement impact was a reduction in revenue. Note that the new revenue recognition method does not materially impact cash flow.

Management addressed the impact of the adoption of the new standard in the conference call for its fiscal fourth quarter ended 5/31/2018:

> *"The guidance does include the impact of a change to our Cintas partner retirement policy in which the retirement age and tenure requirements were reduced.*
>
> *This change results in a shorter time period over which future stock-based compensation grants will be amortized. It is a non-cash impact, and it is expected to increase stock-based compensation expense by roughly $20 million in fiscal '19.*
>
> *And lastly, the guidance also includes the impact of adoption of the Accounting Standard Update 2014-09, revenue from contracts with customers. With the adoption, we expect the following.* ***Fiscal '19 revenue will be negatively affected by roughly $8 million along with the loss of the incremental operating margin associated with that revenue.***
>
> ***SG&A, however, will benefit from the capitalization of sales rep commission payments and the subsequent amortization of those commissions over the expected service period of our contracts. This is also a non-cash impact, and we expect the net benefit to be roughly $16 million to $19 million.***
>
> ***Overall, these last two non-cash items included in guidance will both be recorded in SG&A and generally will offset each other to have only a minor negative impact."***

The statement implies that the net beneficial impact from the revenue recognition impact will be offset by the negative impact of the change in the retirement policy. While this is true when viewed over the entire year, we believe there is potential confusion from the quarterly timing of the impacts. The company took a $19 million charge in the 8/18 quarter related to the retirement policy change. However, the impact of the new revenue recognition policy is spread over four quarters. Footnotes in the 10-Qs reveal that the net impact of the accounting change is adding about 4 cps to EPS versus a year ago on a quarterly basis. The company did mention the benefit to SG&A expense from the accounting change in the conference calls from its 8/18 and 11/18 quarters. However, there was no mention of the impact in the "Management Discussion and Analysis" sections of the corresponding 10-Qs. In addition, there was no mention in its press releases and it is not included in its non-GAAP adjustments disclosures for those periods.

While management's guidance includes the impact, the incremental 4 cps would have added about 2.2% to adjusted EPS in the 11/18 quarter. Likewise, pre-charge operating income growth for the six months ended 11/18 would have been 8.1% versus the reported 10.4%. We do not have the 2/19 10-Q yet. While there was no mention of the benefit in the 2/19 quarter conference call, we believe it will likely be similar to the previous two quarters.

While management has discussed the benefit of the change multiple times and we are not alleging the company is intending to mislead, the absence of the benefit from non-GAAP disclosures and the Management's Discussion sections could leave some investors unaware of a material tailwind to quarterly EPS growth which will disappear after the fourth quarter.

Receivable DSOs Are Up

CTAS has seen an acceleration in its accounts receivable growth in the last three quarters. The following table shows accounts receivable days of sale (DSO) for the last eight quarters. Note that sales and accounts receivable figures for the 8/18 and 11/18 quarters are calculated under the old revenue recognition method to be comparable to historical periods:

	2/28/2019	11/30/2018	8/31/2018	5/31/2018
Accounts Receivable	$878.0*	$889.7	$824.3	$804.6
Sales	$1,682.3*	$1,719.2	$1,698.5	$1,669.6
DSO	47.6	47.2	44.3	44.0

	2/28/2018	11/30/2017	8/31/2017	5/31/2017
Accounts Receivable	$779.2	$764	$732	$736
Sales	$1,589.1	$1,606.4	$1,611.5	$1,530.3
DSO	44.7	43.4	41.4	43.9

We see that DSOs jumped by 2.9 days year-over-year in the 8/18 quarter and 3.8 days in the 11/18 quarter. *As the 2/19 10-Q is not available yet, we are unable to calculate a DSO based on the old revenue recognition method. However, the following table compares DSO calculated under both methods for the 11/18 and 8/18 quarters:

	11/30/2018	8/31/2018
Adjusted DSO	47.2	44.3
As-Reported DSO	48.0	45.0

In both quarters for which we have adjusted data, the adoption of the new revenue recognition standard added about 0.8 days to DSO. If we reduce our 2/19 DSO figure above by that amount, we still see that DSO in the 2/19 quarter jumped by two days over the year-ago period. This is a meaningful increase and could be an indication of a change in the extension of credit terms that has benefitted sales growth.

Inventory Reserve Is Down

CTAS records an allowance for obsolete inventories which it discloses in the footnotes to its 10-Qs. The following table shows the calculation of the inventory reserve as a percentage of gross inventory for the last five quarters:

	11/30/2018	8/31/2018	5/31/2018	2/28/2018	11/30/2017
Net inventory	$334.0*	$315.4*	$280.3*	$274.8	$272.8
Inventory Reserve	$31.9	$31.2	$37.0	$38.5	$37.5
Reserve % of Gross Inventory	8.7%	9.0%	11.7%	12.3%	12.1%

**accounted for under pre-ASU 2014-09*

Note that the 11/18, 8/18 and 5/18 inventory balances are shown as calculated under the old revenue recognition method. Recall from above that the adoption of the new revenue recognition standard resulted in a significant reduction to inventory as products manufactured for sale to customers where there is no alternative use and the company has an enforceable right to receive payment have been moved to receivables. We doubt there was a meaningful impact on the inventory reserve related to this change as the associated inventories moved to receivables would have been made to customer order with little opportunity to become obsolete.

There was a sharp decline in the inventory reserve in the 8/18 quarter which brought the allowance down to the 9% range from its previous 12% level. CTAS does not disclose the inventory reserve prior to 2017 so we can't get a longer-term historical perspective on the allowance level. Nevertheless, the approximate $6 million drop in the allowance despite a rising inventory level looks out of line. To restore the reserve to its 12% level would require approximately 6 cps in expense.

Depreciation Decline Ended in the 2/19 Quarter

The following table shows quarterly depreciation expense as a percentage of net property, plant and equipment for the last eight quarters.

	2/28/2019	11/30/2018	08/31/2018	05/31/2018
Net PPE	$1,424.1	$1,410.5	$1,394.6	$1,382.7
Quarterly Depreciation	$57.3	$54.4	$52.7	$58.2
Depreciation % of Net PPE	4.0%	3.9%	3.8%	4.2%

	02/28/2018	11/30/2017	08/31/2017	05/31/2017
Net PPE	$1,367.6	$1,353.2	$1,341	$1,324
Quarterly Depreciation	$49.7	$54.0	$53.6	$51.1
Depreciation % of Net PPE	3.6%	4.0%	4.0%	3.9%

CTAS's depreciation expense tends to be lumpy, but the 2/19 depreciation jumped by $7.6 million over the year-ago quarter which would have been about a 5.5 cps drag on EPS growth in the period. If depreciation remains in the $58 million range, it will make for more difficult comparisons in the 8/19 and 11/19 quarters.

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 recent 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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