BEHIND THE NUMBERS
Quality of Earnings Analysis

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Cintas Corporation (CTAS)
Earnings Quality Update- 6/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are downgrading our earnings quality rating of CTAS to 3- (Minor Concern).

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

Summary

CTAS beat the consensus EPS estimate for the 5/21 quarter by 16 cps. We did not see any significant quality problems with the fiscal fourth quarter, but our review of the recent 10-K turned up an item of interest- a significant jump in allowances for obsolete inventories that could impact the quality of upcoming quarters.

The following table shows the company's net inventory balances and the reserve for obsolete inventories for the last eight quarters:

	5/31/2021	2/28/2021	11/30/2020	8/31/2020
Total Net Inventory	$481.797	$533.211	$534.128	$488.165
Reserve for Obsolete and Slow-Moving Inventory	$111.00	$63.60	$52.30	$48.20
% of Gross Inventories	18.7%	10.7%	8.9%	9.0%

	5/31/2020	2/29/2020	11/30/2019	8/31/2019
Total Net Inventory	$408.898	$352.924	$348.304	$336.290
Reserve for Obsolete and Slow-Moving Inventory	$45.50	$34.10	$33.80	$33.40
% of Gross Inventories	10.0%	8.8%	8.8%	9.0%

We can see that in the 5/21 quarter, the company boosted its allowance for obsolete and slow-moving inventory by $47.4 million from the previous quarter. The following is the company's discussion of the matter in its 10-K:

> *"The disruption created by the COVID-19 pandemic beginning in the fourth quarter of fiscal 2020 resulted in larger quantities of inventory on hand as of May 31, 2021 and 2020. As of May 31, 2021, our Uniform Rental and Facility Services and First Aid and Safety reportable operating segments held an excess amount of personal protective equipment inventory on hand. The excess inventory, determined through specific identification, resulted in an increase to the obsolescence reserve of $43.6 million as of May 31, 2021, in comparison to May 31, 2020. As of May 31, 2020, an incremental obsolescence reserve was recorded within our Uniform Direct Sales operating segment due to larger quantities of inventory remaining on hand, at the consolidated balance sheet date, as a result of disruption created by the onset of the COVID-19 pandemic."*

As noted above, in last year's fiscal fourth quarter the company also increased its allowance for obsolete inventory related to lower demand for certain products due to the pandemic. However, this was a much smaller $11.7 million sequential increase. Increases to the reserve are recorded as SG&A expenses and the larger increase in 2021 must have been a significant drain on growth in the 5/21 quarter. However, this was not offered as a non-GAAP adjustment nor did we see any discussion of the impact in the MD&A or on the conference call beyond the company calling out the unusual increase to reserves in the year-ago quarter:

> *"Operating margin increased 660 basis points to 19.4% in the fourth quarter of fiscal '21, compared to 12.8% in the fourth quarter of fiscal '20. Fiscal '20, fourth quarter operating income was affected by many items caused by COVID-19, including additional reserves on accounts receivable and inventory, severance and asset impairment expenses and lower incentive compensation expense. Excluding these items, the fiscal '20 fourth quarter operating margin was 15.5%. All of these items were recorded in last year's selling and administrative expenses."*

The company reminds investors in its inventory disclosures that "*once a specific inventory item is written down to the lower of cost or net realizable value, a new cost basis has been established and that inventory item cannot subsequently be marked up."* If the company can sell this inventory in the next couple of quarters for higher than the marked-down value, it could lead to an artificial boost to margins in those quarters. This seems like a reasonable possibility given the spread of COVID variants and the return of mask mandates. For reference, $5 million in incremental operating profits amounts to over 3.5 cps in earnings.

We would also remind investors that a lower effective tax rate added over 3 cps to EPS growth in the quarter. However, the company expects its effective tax rate for fiscal 2022 to be in the 19.5% to 20.5% range compared to 2021's 13.7%. Management has prepared investors for this well, explaining the higher tax rate will cost about $0.85 per share and 800 bps in EPS growth.

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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