BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Cintas (CTAS) EQ Update- 6/20 Qtr.

Current EQ Rating*	Previous EQ Rating
3-	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 an explanation of the EQ Review Rating scale, please refer to the end of this report

We are lowering our earnings quality rating to 3- (Minor Concern) from 4+ (Acceptable)

CTAS reported adjusted EPS of $1.35 in the 5/20 quarter which was 13 cps ahead of consensus estimates. However, we identified about 16 cps in likely one-time benefits to earnings in the period along with other items worth noting.

- CTAS capitalizes certain commission costs to obtain contracts. We estimate that the amount of costs deferred jumped by more than 20% YOY despite a 10% decline in sales in the same period. Costs that are deemed to be "incremental to obtaining the route servicing customer contract" are deferred which appears to give management discretion in deciding which costs are capitalized. If management became more aggressive in capitalizing costs in the quarter, it would have artificially boosted earnings. We estimate if the amount of capitalized costs as a percentage of sales had remained the same, it would have shaved over 4 cps off EPS in the quarter.

- Stock compensation expense declined in the 5/20 quarter, adding over 10 cps to earnings in the period.

- The effective tax rate fell to 20.4% from 21.7% which added 2 cps to earnings in the quarter.

- Accounts receivable DSOs at the end of the 5/20 quarter jumped to 49.4, a 2.8-day increase versus the year-ago quarter. CTAS noted in the 10-K that it reevaluated its allowance for bad debts given the impact of COVID on its customers which resulted in the company boosting the allowance to 6.7% of gross receivables from 4.0% last year. DSOs calculated on a gross basis (which adjusts for the increase in the reserve) rose by more than 4 days. This is not overly alarming given that revenue fell by almost 10% in the quarter. CTAS's fourth quarter ended on 5/31, so revenue was not participating in much of the upside in reopenings. After adding back the increase in allowance, receivables fell by about 2%. We suspect this is an indication of delayed payments more than the company luring in revenue with payment terms. We will view another increase in DSOs in the first fiscal quarter with skepticism, as we will a noticeable takedown in the allowance percentage.

- Inventory DSIs rose by 9.5 days over the year-ago quarter largely centered in the Uniform Direct Sales segment. CTAS increased the allowance for obsolete inventories to 10% of gross inventory balances from the high 8% range of the previous few quarters. It is worth noting the company stated in the 10-K 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. The concern here is that the company will be able to utilize this inventory in the event of a recovery and profits will be artificially boosted from the new lower cost basis.

Increase in Deferred Commissions

Since the adoption of ASC 606 in 2018, CTAS has capitalized its commission costs to obtain contracts and amortized them on a straight-line basis over the expected period of benefit. CTAS discloses the balance of deferred commissions as well as the periodic amortization costs. We calculate an estimated amount of commissions capitalized in each quarter as a plug number shown in the table below:

	5/31/2020	2/29/2020	11/30/2019	8/31/2019
Beginning Deferred Commission Balance	$295.8	$290.9	$283.3	$275.6
Amortization of Deferred Commissions	$20.1	$19.7	$19.2	$18.8
Estimated Commissions Deferred (PLUG)	**$27.6**	$24.6	$26.8	$26.5
Ending Deferred Commission Balance	$303.3	$295.8	$290.9	$283.3
Sales	$1,619.6	$1,810.6	$1,843.7	$1,811.1
Commissions Deferred at Previous % of Sales	1.70%	1.36%	1.45%	1.46%

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

Despite a near-10% YOY decline in revenue in the 5/20 quarter, the estimated amount of commissions deferred rose by over 20% YOY and over 10% sequentially. We would have expected the company to significantly throttle back its efforts to get new accounts in the middle of COVID shutdowns, yet deferred commission costs jumped. Note that the company explains in its 10-K that commissions are deferred when they are "deemed to be incremental for obtaining the route servicing customer contract" which seems to give management some wiggle room in determining which costs are "incremental." If costs were aggressively deferred, it would have artificially benefitted results in the quarter. We estimate if the rate of capitalization as a percentage of sales had remained consistent with last year, it would have cost the company a little over 4 cps in earnings in the quarter.

Explanation of EQ Rating Scale

Rating	Description
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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