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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Eaton Corporation (ETN) EQ Review Update-9/18 Quarter

Current EQ Rating*	Previous EQ Rating
3+	3+

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

We maintain our *EQ Review* rating on Eaton (ETN) at 3+ (Minor Concern).

- Inventory continued to build in the quarter, rising by about 5 days over the year-ago quarter. Management attributed this again to pre-buying ahead of tariffs. Our concern level remains low at this point that there is an unexpected buildup in product.

- R&D expense fell again in the quarter, providing an almost 3 cps headwind to earnings growth. This boost will reverse should R&D revert to a historical level in upcoming quarters.

Inventory DSI Continues to Build

We have noted in the past that the company's inventory days (DSI) have been rising which management attributed to pre-buying ahead of tariffs. This trend continued into the 9/18 quarter as inventory days (DSI) rose by 5 days over last year's quarter (as adjusted for the change to 100% FIFO inventory accounting.) Management's explanation likewise remained the same in the third quarter conference call:

> *"I would say for sure we did, as I think we talked about a little bit last quarter, we did some pre-buying in terms of inventory to get out in front of the tariffs and protect our customers, and so we did build a little bit of inventory during the course of Q3 that we'd expect to unwind in Q4, and as we go forward. But nothing that I would say is material. Our cash flow numbers in the quarter, $1 billion dollars of free cash flow, and we are maintaining our guidance for the year, and so everything that we've done, we expect to largely unwind it during the course of the year."*

As we have noted before, the company's accounting change to utilizing 100% FIFO on all US inventories in the 12/17 quarter would serve to delay the recognition of higher-cost inventory in a period of rising raw materials costs like we are experiencing now. Given the combination of likely pre-buying and rising costs, we are not especially concerned that the observed increase in inventory represents an unusual buildup in excess inventory.

R&D Continues to Decline

Research and development expense registered another year-over-year decline:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Sales	$5,412	$5,487	$5,251	$5,213
R&D Expense	$138	$145	$156	$144
% of Sales	2.5%	2.6%	3.0%	2.8%

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Sales	$5,211	$5,132	$4,848	$4,867
R&D Expense	$147	$150	$143	$145
% of Sales	2.8%	2.9%	2.9%	3.0%

If R&D had remained a constant percentage of revenue versus the year-ago period, it would have taken about 2.9 cps off of earnings. It is reasonable to expect R&D to return to its longer-term rate closer to 3% which will prove to be a headwind to earnings 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 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.

Disclosure

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