BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Eaton (ETN) EQ Update 9/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3+	3-

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 a more detailed explanation of the EQ Review Rating scale, please refer to the end of this report

We are raising our earnings quality rating to 3+ (Minor Concern) from 3- (Minor Concern).

ETN's adjusted EPS of $1.52 in the 9/19 quarter was a penny ahead of expectations.

- The buyback continues to add a significant boost to EPS growth with the numbers of shares declining by 4.1% in the 9/19 quarter. Free cash flow after the dividend fell $102 million short of covering the buyback in the 12 months ended 9/19 with acquisition requiring over $275 million more in cash. However, as we have pointed out in past reviews, the company's relatively light leverage has made this less alarming. In addition, more cash will be coming in with the expected sale of the Lighting business projected to bring in an additional $1.4 billion in cash in the first quarter of 2020. Management indicated in the call that this would enable it to continue with aggressive share repurchases: *"Rick, I would think of it this way. Our expectation would be take down 1% to 2% float and then the proceeds from Lighting on top of that, so you'll end up with considerably more than 1% to 2%."*

- Other income jumped to $2 million in the 9/19 quarter from an expense of $7 million a year ago. The company does not discuss what drove this. We know that this account includes non-service pension costs which increased by about $5 million, as well as a portion of the charges related to the planned lighting divestiture. We are uncertain of what drove the positive offset, but the observed change on the income statement would have added about 1.5 cps in EPS improvement.

- Accounts receivable from customers fell by 2 on a days of sales basis. Days payable also increased by 4.6 days. However, this was partially offset by an increase in inventory DSIs of 3.5 days. Management stated on the call that it anticipates an improvement in inventory which will provide a continued tailwind to cash flow growth in 4Q ’19 and into 2020. The increase in inventory was spread fairly evenly over raw materials, work in-process, and finished goods. This makes us less concerned that the company will have to discount to unload excess inventory in the fourth quarter.

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 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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