BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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# Eaton (ETN) EQ Update -12/18 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 are maintaining our earnings quality rating of ETN at 3+ (Minor Concern)**

- Warranty expense fell by 20 bps as a percentage of sales in 2018 as 2017 experienced both higher warranty claims and expense. As of the end of the year, the warranty reserve was about 10 bps lower as a percentage of sales. Overall, the company does not appear to be grossly under-reserved and the provision expense is moving in-line with warranty settlements. Still, 2018 enjoyed an easy comparison that provided what we view as a non-operational boost to operating margins on the order of 16 bps (6 cps) which is not likely to repeat in 2019.

- The increase in inventory has moderated as the year-over-year rise in DSIs fell to under 2 days in the 12/18 quarter. Note that this is the first year-over-year comparison that does not require an adjustment for the company's change to FIFO (first-in, first-out) inventory accounting in the 12/17 quarter. We have not been overly concerned by the inventory increase as the company's explanation of pre-buying ahead of tariffs was plausible. The moderation in growth now makes this a non-issue in our view.

- The company enjoyed two quarters of declining R&D expense which has now flattened. The company projects pressure on margins in 2019 as it is investing in its eMobility segment.

While the R&D benefit is over and the inventory build has abated, the warranty expense increase prompts us to keep our earnings quality rating at 3+ (Minor Concern)

## Warranty Expense Declined

ETN only discloses its warranty reserve detail on an annual basis. The 10-K contained the following data on the progression of the account:

| | 12/31/21018 | 12/31/2017 | 12/31/2016 |
|---|---|---|---|
| Beginning Warranty Allowance | $188 | $180 | $195 |
| Provision Expense | $139 | $163 | $117 |
| Amounts Settled | -$145 | -$156 | -$130 |
| Other | -$6 | $1 | -$2 |
| Ending Warranty Allowance | $176 | $188 | $180 |
| Allowance % of Sales | 0.81% | 0.92% | 0.91% |
| Provision Expense % of Sales | 0.64% | 0.80% | 0.59% |

Provision expense jumped in 2017 to 0.8% of trailing sales as warranty claims increased. However, claims decreased in 2018 and provision expense fell by 16 bps. The ending allowance was about 10 bps lower as a percentage of trailing sales at the end of 2018. Overall, the company does not appear to be grossly under-reserved and the provision expense is moving in-line with warranty settlements. Still, 2018 enjoyed an easy comparison that provided what we view as a non-operational boost to operating margins on the order of 16 bps (over 6 cps) which is not likely to repeat in 2019. Given the disclosure is on an annual basis, it is impossible to tell if the benefit of lower warranty expense disproportionally benefitted a particular quarter during the year.

# 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 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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