BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Eaton (ETN) EQ Update

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 3+ (Minor Concern).

ETN's adjusted EPS of $1.26 beat the consensus estimate by a penny.

- Other income rose by $8 million which would have provided a 1.6 cps boost to EPS, more than the reported beat. The company did not discuss the move in the 10-Q or on the call. We do know that about $3 million of the change was a result of lower pension and post-retirement benefits expense (other than service charge) which is included in other income. We also note that foreign currency derivatives not designated as hedges posted a $40 million gain in other income although the year-ago 10-Q does not disclose the income statement impact of such amounts.

- The service component of pension and postretirement (not included in other income) benefits expense declined another $3 million, or about a half a penny.

- Inventory days of sales jumped by almost 4 days over the year-ago quarter. While the company did not specifically address inventory levels on the call, there were comments made that seemed to indicate that slower orders in the Hydraulics segment could have been at least partially to blame:

  "And I would say that our orders were certainly weak in Q1. If you take a look at some of our customers, all the names that you know well, I would say their sales are holding up better than our orders are. And so there could be a better outlook as we look forward. We are not sure to what extent. There is some inventory

repositioning taking place in this segment. But right now, it's really more a function of weaker volumes."

- We note that the detail of the company's deferred revenue disclosure indicates that customers made $208 million in deposits in the 3/19 quarter versus $232 million in the year-ago quarter and $271 million in the 12/18 quarter. This is likely a reflection of the lower order activity cited above. Deferred revenue recognized during the quarter also declined so we are not concerned about aggressive revenue recognition.

- R&D expense was flat despite a rise in sales. The decline as a percentage of sales added less than a half a cent to EPS in the period, but the company stated at the end of 2018 that R&D investment in eMobility is expected to pressure margins in 2019.

- ETN's $671 million in buybacks in the 12/18 quarter followed by the $180 million in the 3/19 quarter led to an almost 3.5% reduction in the average number of shares in the quarter compared to last year. While the buyback and dividend consumed more than free cash flow in the last two quarters, the company has not been a long-term dependent on an unaffordable buyback to drive growth. However, next year we will see what the company does when this significant year-over-year EPS tailwind dries up.

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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