BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

August 16, 2018 | www.btnresearch.com

Eaton (ETN) EQ Review Update- 6/18 Quarter

Current EQ Rating*	Previous EQ Rating
3+	NA

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

We initiate coverage of Eaton (ETN) with a 3+ (Minor Concern) rating.

- No development of new earnings quality issues in the 6/18 quarter.
- ETN's 6/18 quarter adjusted EPS of $1.39 beat consensus estimates by 6 cps. The beat remained intact even after adjusting for lower pension expense of about 2.8 cps and lower R&D which added about a penny.
- Inventory days of sales (DSI) at the end of the 6/18 quarter jumped by approximately five days over the year-ago period, comparable to the year-over-year increase we highlighted in our review of the 3/18 quarter. However, the company's explanation of pre-buying ahead of tariffs seems plausible and alleviates the concern of a buildup of obsolete product. However, a five-day rise in DSIs is always worthy of attention, and with the company recently switching to the use of FIFO for 100% of its inventories, there is the possibility that rising costs will be delayed in hitting the income statement. This could conceivably lead to a negative surprise from higher-than-expected costs in the next couple of quarters. Should inventory balances moderate in the 9/18 quarter, we will likely raise our rating on ETN.

Lower Pension Expense

US pension expense fell by $6 million (1.2 cps) in the quarter due to lower pension settlement costs. Non-US pension expense fell by $8 million (1.6 cps) primarily due to lower

service, interest and amortization costs which are likely the result of higher assumed discount rates. While we view this benefit as non-operational, the company's pension plan assumptions at the end of 2017 were reasonable and we saw no problems with the accounting for the plan.

Lower R&D Expense

We note that R&D expense fell by $5 million (cps) in the quarter. The following table shows R&D expense as a percentage of sales:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Sales	$5,487	$5,251	$5,213	$5,211
R&D Expense	$145	$156	$144	$147
% of Sales	2.6%	3.0%	2.8%	2.8%

	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Sales	$5,132	$4,848	$4,867	$4,987
R&D Expense	$150	$143	$145	$146
% of Sales	2.9%	2.9%	3.0%	2.9%

While the company does not mention the overall level of R&D spending in the conference call, the higher level of spending in the 3/18 quarter makes us think that the decline in R&D expense in the 6/18 quarter was to some degree due to the timing of spending. Still, upcoming quarters may see a minor drag if spending return to its normal 2.8-3.0% range as a percentage of revenue.

Inventory Rising Ahead of Tariff Impact

We noted in our review of ETN's 3/18 quarter that inventory days of sales (DSIs) jumped by more than five days over the comparable year-ago quarter which the company attributed to an acceleration in sales growth, as seen in the following table.

	06/30/2018	03/31/2018	12/31/2017	09/30/2017
Inventory DSIs	68.4	70.1	67.7	64.6

	06/30/2017	03/31/2017	12/31/2016	09/30/2016
Inventory DSIs	63.3	64.7	64.3	63.0

While inventories remained elevated in the 6/18 quarter, the year-over-year increase in DSIs remained steady at approximately five days and declined sequentially from the 3/18 quarter. Management indicated that it engaged in pre-buying ahead of raw materials price increases related tariffs. This seems like a plausible explanation and would be prudent under the current circumstances. As we noted in the 3/18 review, ETN switched to using FIFO accounting for 100% of its inventories in 2018. While this will effectively delay the impact of rising costs on the income statement when compared to the LIFO method, ETN turns its inventories in less than a quarter, so we are not too concerned that investors will be caught off guard by higher than expected costs in the next quarter. We will continue to watch inventory balances in the upcoming quarters and will raise our rating should inventory growth moderate.

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

BTN Research is a research publication structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. Information included in this report is derived from many sources believed to be reliable (including SEC filings and other public records), but no representation is made that it is accurate or complete, or that errors, if discovered, will be corrected.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.