BEHIND THE NUMBERS
Quality of Earnings Analysis

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Eaton Corp. (ETN)
Earnings Quality Update- 6/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are downgrading our earnings quality rating of ETN to 3- (Minor Concern) reflecting the change to adding back amortization and the rise in debt.

We are also adding ETN to our On Deck Sell list. Our decision to not add as a Top Sell at this time is driven by the final easy comp in the upcoming third quarter after which the higher debt and rising payables will become more of an issue.

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

Summary

ETN has been beating forecasts of late, by 15-cents in 2Q21 and 20-cents in 1Q21. We see several changes in accounting policy that may be helping such as the change to FIFO in the US in 2017 now that inflation is higher. Also, ETN changed its adjusted EPS calculation in 1Q21 to add back amortization of acquired intangibles for the first time. That was a known event, but adding back amortization was worth 25-cents and 18-cents in EPS for 2Q and 1Q. It is also worth noting that pension expense became pension income in 2Q and 1Q and y/y added 8-cents to EPS in both periods.

We believe there are still some tailwinds for margin gains for the rest of 2021 as recent acquisitions have had minimal impact on results in the first half. ETN boosted margin guidance twice. As some of these non-organic sources of sales and margin growth such as filling the Covid pent-up demand and acquisitions lap – we're not certain ETN's 2022 will look as rosy. It should be solid – but the rate of growth may diminish noticeably.

What is strong?

- The Covid bounce has been strong for Eaton sales. Even after divesting more sales than it acquired, 2Q21 sales were close to pre-Covid highs. 2Q21 was the easiest comp to match against, the future comps are still easy but not to the same degree.

- High backlog should help maintain strong sales growth for the rest of 2021. Also, aerospace has been a negative growth story with weak commercial aviation sales – that remains an area that could see improvement going forward.

- Inventory levels have been rebuilt to near-historic levels. There could be some higher commodity cost noise in that where dollar figures rose more than units, but inventory may not be a large consumer of cash flow in the near term.

- Increased margin guidance may still be conservative to finish the year.

What is weak?

- Freezing US pension plans at the start of the year and paying out some lump-sum distributions reduced service cost and some amortization y/y in 1Q and 2Q. This added 8-cents to EPS in both periods and should be a tailwind for the rest of 2021. We don't regard this as a true improvement in operating results.

- We estimate that Eaton picked up 85bp of operating margin in 2Q21 simply from Covid pent-up demand being met and leveraging costs like depreciation and R&D. That's nearly 8-cents in EPS last quarter. Going forward, R&D is increasing again and the sales comps are not nearly as easy as 2Q.

- Divesting the lighting business and the hydraulics unit helped margins too. Both of these had EBITDA margins of about 11% and subtracting them gave the remaining ETN business an increase in margin of 190bp. Those units were classified as discontinued for most of 2020. We think Covid's lower sales masked some of this benefit that is being seen in 2021. This is not an item that should improve further.

- Recent acquisitions came with much higher margins. So far Tripp Lite with an EBITDA margin of 34% has only been in place since mid-March and Cobham's 29% margin since June 1. Simply adding these to the mix should boost margins by 50bp. There are 3-more quarters of apples-to-oranges comps to come. However, we again do not see this as a source of never-ending margin gains.

- Changing non-GAAP earnings definitions to add back amortization of intangibles is causing the spread between GAAP and non-GAAP EPS to widen. It is boosting earnings at a time the stock is already trading for high multiples of 22x adjusted EPS.

- Debt is up to 3.6x EBITDA following the acquisitions compared to years of the multiple being about 1.5x. Payables are also being stretched at this point too – rising from 50 days to 64.

What to Watch?

- Eaton is guiding to neutral impacts on margins from commodity inflation. That is rare among many companies we follow. We believe FIFO is helping it navigate, but we also see that inventory turnover is returning to normal rates which are slower than what ETN has enjoyed recently. Eaton changed US accounting (about 55% of sales) from LIFO to FIFO in 2017. We think it is getting its first real test of commodity inflation.

- Eaton has not allocated its intangible assets yet for the Tripp and Cobham deals. We were not pleased to see the earlier Souria-Sunbank deal use a 20-year amortization life for customer relations and 15-years for acquired technology. Also with heavy goodwill in all three deals – Eaton is limiting the seen cost of these acquisitions.

- Receivables and payables are two areas of working capital that may consume cash flow going forward if they move toward historical norms.

Margin Gains Coming from Inorganic Sources – Sales Bouncing from Covid Leverage Fixed Costs

Eaton has been steadily boosting segment operating margin guidance since the start of the year:

Rising Guidance	Aug	May	Feb
Range 2021 Op. Marg.	18.4%-18.8%	18.1%-18.5%	17.6%-18.0%

The segment margins exclude restructuring costs and amortization of intangibles. This compares to 2019's margins of 17.4% and 2020's 16.5%. Looking at the explanation on the earnings calls for this higher guidance, we see several times that ETN is simply planning to benefit from higher sales returning and leveraging fixed costs. Plus, it sees restructuring helping as well as adding new acquisitions:

> 2Q21 call, *"Our sales were $5.2 billion, up 35%, 27% organically and above the midpoint of our guidance. For the Second Quarter in a row, we delivered record segment margins. Q2 margins were 18.6%, up 390 basis points from prior year, and up 90 basis points sequentially. <u>Our portfolio changes, the sale of Lighting and the acquisition of Tripp Lite, solid execution, and benefits once again from our multiyear restructuring program all contributed to the improvement.</u>*
>
> *And we've raised the margin guidance in each of our segments with the exception of e-mobility<u>. We continue to expect organic incremental margins of around 30% and for price and commodity cost to be approximately neutral for the year.</u>*
>
> 1Q21 margins were 17.7%, *"<u>These results, once again, were driven by good execution, cost savings and really favorable mix due to the divestiture of lighting</u>. We're also pleased with the 11% orders growth in the quarter. This was driven by once again strength in data center and residential markets. I'd also note that for the full year, <u>we continue to expect net price versus inflation to be neutral."</u>*

Here are the last 10-quarters of margins including pre-Covid:

Oper. Margin	**4Q**	**3Q**	**2Q**	**1Q**
2021			18.6%	17.7%
2020	17.4%	17.6%	14.7%	15.8%
2019	16.9%	18.7%	17.9%	16.0%

y/y change	**4Q**	**3Q**	**2Q**	**1Q**
2021			3.9%	1.9%
2020	0.5%	-1.1%	-3.2%	-0.2%

We agree with ETN – higher sales are helping margin as fixed costs are leveraged, but that was really only an issue for 2Q21:

	2Q21	**2Q20**	**2Q19**	**1Q21**	**1Q20**	**1Q19**
Sales	$5,215	$3,856	$5,533	$4,692	$4,789	$5,305
Depreciation	$121	$110	$127	$116	$112	$128
Res & Dev	$154	$126	$151	$148	$153	$156
Deprec % Sales	2.32%	2.85%	2.30%	2.47%	2.34%	2.41%
R&D % Sales	2.95%	3.27%	2.73%	3.15%	3.19%	2.94%

ETN picked up 85bp of margin from having better leverage of depreciation and R&D in 2Q21 vs. 2Q20. The issue is 2Q20 was the weakest period for sales at under $3.9 billion. ETN was essentially doing $5.2 billion per quarter prior to Covid. For 3Q and 4Q20 comps at $4.5-$4.7 billion, we expect there to be some additional margin leverage. However, R&D has increased back above $150 million per quarter vs. the $126, $132, and $140 million of 2Q-4Q 2020. Depreciation has risen too. On $5.3 billion in sales vs. $4.7 billion – the operating leverage may be immaterial.

We want to emphasize that sales and backlog are high and could keep driving this for a couple more quarters, but the easiest comps are done:

	2Q21	1Q21	4Q20	3Q20	2Q20
Sales	$5,215	$4,692	$4,687	$4,526	$3,856
BLog Elect Am	43%	23%	12%	11%	11%
BLog Elect Global	50%	17%	14%	7%	2%
BLog Aerospace	0%	-11%	-14%	-11%	-5%

Quarterly sales used to be routinely greater than $5.3 billion. ETN is now back to this level. These three divisions are about 75% of total sales and backlog has been rising rapidly y/y – except at aerospace at this point. Our concern is much of the easy gains have already been seen as a result of bouncing off Covid and filling delayed orders. We would expect sales growth to remain positive for the rest of 2021, but the rate of change to moderate.

Inorganic Source of Margin Gain – Portfolio Changes

In addition to comparing pre-Covid to 2021 numbers, portfolio changes were a key to margin gains. In March of 2020, ETN completed its lighting unit sale and in August 2021 it completed the sale of its hydraulics operation, but announced that sale in January 2020 and it was classified as a discontinued operation. What is important to realize is these two businesses had only 11% EBITDA margins and were out of the results except for all but 1-month of 2020 for hydraulics.

Revenues in 2019 were $21.4 billion before these divestments and EBITDA without other income/expense was $4.2 billion for a margin of 19.8%. Pulling the divestitures out: We know the Lighting business was $1.7 billion in sales and there was EBITDA of $187 million for 2018 (the numbers used to determine the selling price). We know the hydraulics unit had 2019 sales of $2.2 billion and EBITDA of $250 million. Both margins were 11%. Simply taking these out of the mix: revenue becomes $17.5 billion and EBITDA $3.8 billion – the margin rises from 19.8% to 21.7% - an increase of 190bp. This is margin gain from subtraction.

Also, we know ETN added three significant sized businesses:

- Souria-Sunbank in December 2019 – sales of $363 million, EBITDA $76 million = margin of 21%.
- Tripp Lite in March 2021 – sales of $400 million, EBITDA of $138 million = margin of 34%
- Cobham June 1, 2021 – sales of $700 million, EBITDA of $200 million – margin of 29%

The latter two are 2020 sales so those are Covid impaired. We would expect those sales to be higher in 2021 and thereafter simply from Covid recover like the rest of ETN's business. However, simply adding these to the base figure of divested numbers for 2019 – revenues become $19.0 billion and EBITDA $4.2 billion for a margin of 22.2%. That's another 50bp of margin gain. Covid recovery sales should be bouncing for these acquired units too and probably creates some operating leverage too. Also, keep in mind, Tripp Lite only helped 13-days in 1Q21 and Cobham 29 days in 2Q21. ETN has not seen the full impact of these margin gains. These deals should be helping boost margins into the first half of 2022.

In looking at the recent sales growth in the section above, it is definitely worth noting that ETN divested $3.9 billion in sales and acquired about $1.5 billion for a net loss of $2.4 billion annually or $600 million per quarter. Yet, 2Q21 saw revenues of $5.2 billion, and looking back at 2018-19, ETN was doing about $5.3-$5.5 billion in sales per quarter. So the pent-up demand from Covid has been strong. The bigger question may be "Is the new base for sales actually below $5 billion/quarter?"

Inorganic Source of Margin Gain – FIFO Change

FIFO accounting helps with inflation. We noted in the past that ETN changed its US inventory accounting from LIFO to FIFO in the 4Q17. FIFO tends to help gross margin during inflationary times because selling prices tend to rise, but the company is selling the goods bought earlier at lower costs. Based on results, we still estimate that 55% of sales are in the US and would be helped more with the FIFO change.

At the time of the FIFO change, ETN went back and looked at the difference in EPS under both methods and found that it was often +/- 1 or 2 cents per quarter during the years of 2017 and 2016. Often it was no change. However, when looking at some of the commodities that ETN uses, we see several now at or near all-time highs:

- Aluminum was $1800/ton pre-Covid, fell to $1400 – now is about $2800.

- Copper was $2.75/lb pre-Covid, fell to $2.10 – is off its highs, but still is $4.30 – near 25-year highs

- Steel was $90/ton pre-Covid – is also off the highs of $220 but still at $150.

- Silver is $25 vs. $15 pre-Covid

- Nickel is at 10-year highs.

- Gold rose with Covid and may be the only raw material down in price.

- We know electrical components are difficult to get and plastic is up too.

We do find it curious that Eaton has said on the last two earnings calls it expects cost inflation to be neutral for results. It's not as though ETN is merely a distributor turning inventory 15-18x per year. Historically, inventory turnover is only about 5.3x. Covid disrupted this with lower sales and lower inventory levels. But into the teeth of the rapid commodity inflation, inventory turnover at Eaton is slowing back to normal levels.

	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20
Inventory Turn	5.3	5.3	6.0	5.8	5.4	5.6

Inventory levels are increasing too – it is common for ETN to have about 68-71 days of inventory.

	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20
Inv. DSIs	68.5	67.8	61.1	63.2	67.6	64.7

It would be difficult to quantify this on a margin and EPS level. But we believe the FIFO change from 2017 is getting its first real test and if ETN is able to navigate this environment without commodity inflation negatively impacting results – then FIFO is helping here.

Acquisition Accounting Has Changed at ETN

As noted above, ETN has made three recent acquisitions. ETN also changed its accounting policy for adjusted earnings. In 2021, it started to add back amortization of acquired intangibles to non-GAAP earnings.

There are three points to be made here:

- The acquisitions consumed cash – ETN borrowed some of the money too. Yet, the largest costs related to the deals are going to be excluded from earnings. It is as though the sales and cash flow that will come in from these acquisitions had no cost. That is a big incentive to grow via acquisition over building in-house.

- ETN uses very long amortization lives. On the Souria-Sunbank deal it is amortizing customer relationships over 20-years and acquired technology over 15-years. It has not yet broken out the allocation of these items for Tripp Lite and Cobham or their amortization lives, but the amount could be huge.

- Because Tripp Lite only closed on March 17, 2021 and Cobham on June 1, 2021 – their amortization has made very little impact on results yet. We expect the spread between GAAP and non-GAAP EPS to widen.

	Souria	**Tripp**	**Cobham**
Purchase Price	$907	$1,651	$2,800
Intangibles	$370	$630	$1,575
Goodwill	$457	$921	$1,088
% of Price ignored	91%	94%	95%

	2Q21	**1Q21**	**4Q20**	**3Q20**	**2Q20**	**1Q20**
GAAP EPS	$1.26	$1.14	$1.18	$1.11	$0.13	$1.07
Acq/Divest chgs	$0.18	$0.09	$0.06	$0.05	$0.20	$0.02
Restructuring	$0.03	$0.03	$0.04	$0.02	$0.37	
Intang. Amort	$0.25	$0.18				
NonGAAP EPS	$1.72	$1.44	$1.28	$1.18	$0.70	$1.09

Investors are excited about ETN stock because of rising earnings as Covid ends and more infrastructure is built. However, we think there should be more concern that earnings will be inflated by ignoring the cost of recent deals to boost non-GAAP EPS. That also ignores that goodwill is not expensed at all. Over 40-years, this recently acquired Goodwill would be costing quarterly EPS another 4-cents.

The Balance Sheet Isn't Ignoring the Acquisitions

Historically, Eaton has carried low leverage – normally about 1.5x EBITDA. Recent debt has jumped to 3.6x. It was only 2.0x on impaired Covid results. Also, payables are increasing faster too:

	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20
Net Debt	$11,562	$9,213	$6,956	$7,478	$7,772	$8,012
EBITDA Mult.	3.6	3.0	2.4	2.1	2.0	1.9
Payables	$2,484	$2,172	$1,987	$1,788	$1,620	$1,785
Days Payable	63.8	61.4	57.5	53.9	51.2	49.2

It seems likely that inventory and receivables will also need to grow further and consume cash flow. For years, inventory was over 70 days and receivables between 65-70 days:

	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20
Inventory	$2,668	$2,399	$2,109	$2,096	$2,138	$2,346
DSI	68.5	67.8	61.1	63.2	67.6	64.7
Receivables	$3,341	$3,065	$2,904	$2,876	$2,647	$2,951
DSO	58.3	58.8	57.0	58.5	62.5	56.1

We also noted that warranty accruals dropped in 2020 to only $151 million. That is not surprising given the economic situation, but the expense was only $100 million. In 2019 it was $204 million. We would expect this to grow again in 2021, and $100 million would be about a 4-5 cent headwind per quarter for EPS.

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 Concern)- 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 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 upcoming quarters. 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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