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Illinois Tool Works (ITW) EQ Review Initial Update- 9/18 Quarter

Current EQ Rating*	Previous EQ Rating
3-	3-

ITW reported 9/18 adjusted EPS of $1.90 which beat the consensus by 2 cps. However, the company missed revenue targets as sales were pressured by lower automotive activity in Europe and China as well as FX pressures. We will need the 10-Q filing to do a final rating for the quarter, and for now, we maintain our *EQ Review Rating* of 3- (Minor Concern). We note the following observations based on the numbers in the press release:

- DSOs jumped almost 3 days over the year-ago period and reached a multi-year high. We will be looking for commentary on receivables in the 10-Q along with the deferred revenue balance. We will view another sequential decline in deferred revenue with concern.

- DSIs jumped by almost 5 days over the year-ago quarter. Some of this increase almost certainly reflects rising raw materials costs and the use of FIFO accounting for the bulk of its inventories. However, the sudden acceleration in the DSI increase could also indicate an unplanned buildup of product and increases the risk of future discounting.

Receivables DSOs Continue to Trend Higher

We have noted in past quarters that accounts receivable days of sales (DSO) were rising and this trend continued into the 9/18 quarter:

	9/30/2018	6/30/218	3/31/2018	12/31/2017
Sales	$3,613	$3,831	$3,744	$3,629
Accounts Receivable	$2,777	$2,878	$2,874	$2,628
DSOs	70.1	68.6	70.0	66.1

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Sales	$3,615	$3,599	$3,471	$3,399
Accounts Receivable	$2,672	$2,629	$2,534	$2,357
DSOs	67.4	66.7	66.6	63.3

While the pace of year-over-year growth in DSO moderated somewhat in the 6/18 quarter, the widening of the gap accelerated to 2.7 days in the 9/18 quarter. We know that the company is working to push through higher prices to combat both rising raw materials costs and tariffs. However, this should be reflected in both sales and receivables numbers and not have a material impact on the DSO trend. Therefore, we view the almost 3-day increase in DSO with growing concern. Also, when we get the 10-Q filing for the quarter, we will be paying close attention to the company's deferred revenue balance. PG will still not be reporting a year-ago number to compare to which will limit the potential insight, but another sequential decline in deferred revenue will add to our concern about the quality of the 9/18 quarter's revenue.

Inventory Balances Also Jumped Again

In addition to rising receivables, we have observed that inventory days (DSIs) have been increasing. The rate of increase accelerated in the 9/18 quarter.

	9/30/2018	6/30/218	3/31/2018	12/31/2017
COGS	$2,096	$2,231	$2,181	$2,125
Inventory	$1,338	$1,320	$1,335	$1,220
Inventory DSIs	58.3	54.0	55.9	52.4

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
COGS	$2,092	$2,087	$2,003	$2,006
Inventory	$1,225	$1,199	$1,158	$1,076
Inventory DSIs	53.4	52.4	52.8	48.9

Despite essentially flat cost of sales, inventory at the end of the 9/18 quarter jumped by over 9% from the year-ago period, resulting in a 4.9-day increase in DSI. Some of this increase likely reflects rising raw materials prices. A little over 20% of the company's inventories are accounted for under the LIFO (last-in, first-out) method with the balance accounted for under FIFO (first-in, first-out). This means that for the bulk of inventories, the newer, higher cost inventories remain on the balance sheet longer before being recognized in cost of sales with the delay approximating around 60 days. ITW has been increasing prices for several quarters and noted in the 9/18 quarter commentary that price increases are now offsetting raw materials cost increases on a dollar-for-dollar basis. Still, the rising inventory balances are evidence that there are higher-cost inventories still waiting to be recognized. Note that ITW does not hedge its raw materials purchases.

Additionally, given that raw materials costs have been increasing for some time, the sudden acceleration in the DSI increase coupled with the admitted lower-than-expected performance in certain segments of the business leaves open the possibility that there was an unplanned buildup in inventory in the period, increasing the risk of future discounting to move those products. Again, we will be looking for more color on the inventory increase when the 10-Q is released.

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.

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