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Illinois Tool Works (ITW) EQ Update- 9/20 Qtr.

Current EQ Rating*	Previous EQ Rating
4+	3-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

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

We are raising our earnings quality rating to 4+ (Acceptable)

ITW reported EPS of $1.83 which was 38 cps ahead of the consensus estimate. We are raising our earnings quality rating reflecting the company's strong working capital positions and lack of unusual items in the quarter.

What improved?

- ITW's inventories have essentially tracked flat over the last three COVID-impacted quarters. The sequential increase in sales activity left DSIs at the end of the 9/20 quarter at 55- level with a year ago and in line with historical experience.

- We have noted some small one-time items in the past that have helped the company make earnings estimates such as lower than expected tax rates and unusual jumps in other income. There were no such unusual items in the 9/20 quarter, let alone anything to explain the 38 cps beat.

What to watch

- ITW suspended the buyback in the quarter to conserve cash in the current environment. However, ITW has a history of spending all its free cash flow and more on the buyback. In 2019, the lower share count was providing almost 4% of reported EPS growth so any prolonged reduction in repurchases will have a meaningful impact on reported growth.

- ITW does not offer a non-GAAP earnings presentation in its press release with countless, material adjustments to arrive at "real" earnings. We view this as a positive for earnings quality. However, we do note that ITW has an ongoing restructuring program which results in management often citing higher restructuring costs as hindering margin growth. It even presents the impact of restructuring costs on margins in its 10-Qs and has occasionally cites the EPS impact in conference call discussions. While not as egregious as some companies who regularly adjust earnings upwards by 5-10% for "one-time" charges, we find the adjusted margin numbers distracting given the perpetual nature of the activity.

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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