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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Illinois Tool Works (ITW) EQ Update 9/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3-	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 a more detailed explanation of the EQ Review Rating scale, please refer to the end of this report

We are lowering our earnings quality rating to 3- (Minor Concern) from 3+ (Minor Concern).

ITW reported EPS of $2.04 which beat the consensus estimate by 10 cps. 7 cps of the upside was driven by a positive tax liability adjustment. Management maintained the full-year guidance as the lower tax rate is expected to offset a like amount of higher than previously forecast FX headwinds. While inventory levels improved during the quarter, an unusual boost from other income added about 5 cps to EPS in the quarter which is larger than the earnings beat after adjustment for the tax benefit which calls into question the quality of the beat.

- Other income rose to $26 million in the 9/19 quarter from $10 million in the year-ago period. There was no mention of this move in the 10-Q nor was it discussed on the conference call. We know that the non-service components of pension costs are included in this account, but those amounts were roughly flat with the 9/19 quarter. This decline added about 5 cps to earnings growth in the quarter.

- We note that amortization of intangible assets declined by 2.2 cps in the 9/19 quarter versus a 1.7 cps decline and 1.2 cps decline in the 6/19 and 3/19 quarters, respectively.

There were no unusual impairments cited and this is likely related to the businesses reclassified as held for sale in the 6/19 quarter. If so, the reduced level of amortization expense will continue to provide a mild tailwind to results for another three quarters.

- Inventory management improved in the quarter with inventory days down over 3 days versus the year-ago third quarter. This marks the end of a string of increases and reduces our concern in this area.

- Management warned that margins in the fourth quarter will be negatively impacted by higher restructuring spending as it has accelerated its restructuring activities. We have noted in past reviews that the company does not quantify its restructuring spending and does not add it back to adjusted EPS. Rather, it cites the basis point impact on margins in its MD&A sections and mentions it in its conference calls. On one hand, we like the lack of tampering with reported EPS. However, management still appears to have leeway to blame higher than expected costs on restructuring spending with less visibility into the duration and ultimate restructuring spending levels.

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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