BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH
BTN Research

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

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Illinois Tool Works (ITW) EQ Update-3/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3+	3+

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

We maintain our earnings quality rating of 3+ (Minor Concern).

We note no major developments in earnings quality in the quarter.

- Inventory DSIs were up less than 4 days versus the year-ago quarter with most of the increase focused in raw materials. Management cited more favorable raw materials costs as a factor in the quarter and we are not overly concerned with the buildup in inventory.

- One of the main issues we have with the company remains the extent to which EPS is being boosted by the buyback. Average diluted share count fell by 3.8% in the 3/19 quarter. However, while trailing-12 free cash flow of $2.5 billion more than covered the $1.9 billion dividend, the remainder fell over $500 million short of covering the $1.9 billion in share buybacks. Just looking at the quarter, the buyback was $375 million with $1.5 billion forecasted for all of 2019.

- The company accelerated its restructuring program, resulting in a 6 cps headwind from higher restructuring charges. On the positive side, ITW does not add back restructuring charges in its non-GAAP numbers as many companies do. However, it does quantify the impact in its presentations of margin progression and cites the EPS impact on its conference calls. On the downside, the company does not disclose the progression of the restructuring reserve in its 10-Qs which takes away any insight as to when the cash is actually spent on the restructuring activity. The company does not even disclose the absolute dollar amount classified as restructuring expense in the quarter. We do know that just the increase in restructuring charges in the 3/19

quarter represented 70 bps of sales or about $25 million and the company takes regular restructuring charges. This is more than adequate to theoretically create a "cookie jar" reserve to draw on for ongoing operating expenses to potentially manage earnings which erodes the perceived quality of the company's reported earnings.

Explanation of EQ Rating Scale

Rating	Explanation
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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