

Illinois Tool Works (ITW) EQ Review Update- 6/18 Quarter

Current EQ Rating*	Previous EQ Rating
3-	NA

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

We initiate coverage of Illinois Tool Works (ITW) with a 3- (Minor Concern)

ITW's adjusted EPS of \$1.97 was in-line with the consensus expectation, while revenue fell \$10 million below expectations. The increase in accounts receivable DSOs was more modest in the 6/18 quarter, but deferred revenue showed a material sequential decline, leaving the possibility of aggressive revenue recognition open. Aggressive revenue recognition can be a serious sign of future problems but the fact we do not have a year-ago deferred revenue number to compare to, coupled with the smaller increase in receivables causes us to rate ITW a 3 rather than a 2. We also note that growth in inventories has leveled off, alleviating that area of concern.

Receivable Increase More Muted, But Deferred Revenue Declined

Accounts receivable DSOs showed a noticeable 3.4-day year-over-year increase in the 3/18 quarter was evidence that revenue was pulled forward into that quarter and possibly contributed to the revenue shortfall seen in the 6/18 quarter. However, as seen in the table below, the year-over-year increase fell to under 2 days in the 6/18 quarter:

	6/30/218	3/31/2018	12/31/2017	9/30/2017	6/30/2017	3/31/2017
Sales	\$3,831	\$3,744	\$3,629	\$3,615	\$3,599	\$3,471
Accounts Receivable	\$2,878	\$2,874	\$2,628	\$2,672	\$2,629	\$2,534
DSOs	68.6	70.0	66.1	67.4	66.7	66.6

Accounts receivable was essentially flat in the 6/18 quarter compared to a 4% sequential increase in the comparable period a year ago, giving more evidence that revenue recognition was less aggressive in the 6/18 quarter. While this trend still warrants close attention in the next quarter, the more modest increase in receivables alleviates the concern with receivables somewhat.

However, we also note that the company began reporting deferred revenue in its footnotes for the last three quarters:

	6/30/218	03/31/2018	12/31/2017
Sales	\$3,831	\$3,744	\$3,629
Deferred Revenue	\$236	\$254	\$205
Deferred Revenue Days	5.6	6.2	5.2

It is difficult to draw an analytical conclusion without a year-over-year comparison available, but the sequential decline of \$18 million is a concern as it leaves open the possibility that the timing of recognizing revenue was accelerated, or there is a slowdown in new business being signed. This metric will provide more insight as we move forward and have historical data to establish a better trend.

Inventory Growth Back In-Line

ITW's inventory DSIs were showing notable increases in the 12/17 and 3/18 quarters, as seen in the table below:

	6/30/218	3/31/2018	12/31/2017	9/30/2017	6/30/2017	3/31/2017
Cost of Sales	\$2,231	\$2,181	\$2,125	\$2,094	\$2,087	\$2,003
Inventory	\$1,320	\$1,335	\$1,220	\$1,225	\$1,199	\$1,158
DSIs	54.0	55.9	52.4	53.4	52.4	52.8

However, the rate of year-over-year increase in DSIs slowed noticeably in the 6/18 quarter to 1.6 days and inventory balances declined sequentially. This alleviates our concern in this area.

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 as 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 score 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.

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