BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Snap-on Inc. (SNA)- Initiate at SELL

Snap-On (SNA) has been the growing target of criticism for the last couple of years. Short interest is at a noticeably high 17% of the float with onlookers citing problems including slowing growth at the company's flagship tools distribution business, increasing extension of credit to its franchisees and customers, and rising default levels. The stock price fell at the beginning of 2018 as these issues came to the forefront. However, some of the lost ground has been recovered and management was essentially declaring a turnaround in the fourth quarter, boasting of positive franchise sales growth and improving credit quality metrics. However, a closer look at the numbers indicates that the problems are not behind us.

- SNA has rapidly increased its extension of credit to its franchisees over the last several years as evident by growth in its contract receivables balances. Despite this, franchisees posted negative organic growth in 2018. SNA books revenue at the time it sells product to the franchisee which means the company could have essentially financed the stuffing of the franchise distributor channel. The recent weak sales growth could be indicating that the channel has been saturated and it will be difficult to restore growth rates to their historical levels. In addition, the accelerated depreciation for new equipment under the Tax Act likely provided a material tailwind

to purchases made by the company's end users, yet organic sales growth remained weak in 2018.

- In addition to extending credit to franchisees, the company also provides financing to end-user customers via its finance receivables portfolio. Finance receivables have outgrown sales for several years. While this reversed in the first two quarters of 2018, the growth in finance receivables days once again resumed in the back half. Yields on the finance receivables portfolio exceed 17%, implying that these customers would have a difficult time getting financing anywhere else and that revenue growth would be considerably slower without the increase in credit extension.

- While the company's low debt levels could conceivably allow it to continue to grow its financing operations, it may be difficult to do so without rising losses in the portfolio. Despite management touting improved loss rates across the whole portfolio in the fourth quarter as evidence of improvement in credit quality, we note that delinquencies in the contract receivables portfolio have more than doubled versus a year ago. Contract receivables allowances as a percentage of receivables are less than 1% versus almost 2% in 2011. A boost of 50 basis points in the allowance for the total credit portfolio would cost over 14 cps in EPS.

- Finance segment operating profits have provided a huge boost to overall profit growth, rising as a percentage of total operating profit by more than 200 basis points in the last four years. Throttling back credit extension would not only mute growth in the core business, it would eliminate growth from the Finance Division as well.

- The company's core automotive service and repair market faces secular headwinds from the increasing complexity of cars forcing more repair work to dealerships and away from "mom-and-pop" shops. In addition, automakers continue to push to make it more difficult for non-OEM diagnostics equipment to be used to service their cars.

Overview of Business

SNA was founded in 1920 to develop its original interchangeable socket set and soon launched its unique mobile van distribution system which it utilized to distribute its hand tools primarily to automotive repair shops. Over the years, SNA has expanded into other

specialty tool and diagnostic equipment markets and currently breaks its business down into four reporting segments whose results for the last five years are shown below:

Sales	2018	2017	2016	2015
Commercial & Industrial	$1,051.6	$986.1	$863.0	$895.5
Snap-on Tools Group	$1,613.8	$1,625.1	$1,633.9	$1,568.7
Repair Systems & Information	$1,075.3	$1,075.7	$933.5	$888.6
Financial Services	$329.7	$313.4	$281.4	$240.3
% of Sales				
Commercial & Industrial	25.8%	24.7%	23.3%	24.9%
Snap-on Tools Group	39.6%	40.6%	44.0%	43.7%
Repair Systems & Information	26.4%	26.9%	25.1%	24.7%
Financial Services	8.1%	7.8%	7.6%	6.7%

Operating Profit	2018	2017	2016	2015
Commercial & Industrial	$199.3	$186.5	$168.0	$169.4
Snap-on Tools Group	$264.2	$274.7	$281.1	$256.0
Repair Systems & Information	$342.6	$335.5	$297.8	$273.4
Financial Services	$230.1	$217.5	$198.7	$170.2

% of Operating Profit	2018	2017	2016	2015
Commercial & Industrial	19.2%	18.4%	17.8%	19.5%
Snap-on Tools Group	25.5%	27.1%	29.7%	29.5%
Repair Systems & Information	33.1%	33.1%	31.5%	31.5%
Financial Services	22.2%	21.4%	21.0%	19.6%

Organic growth rates for each segment are shown below:

	2018	2017	2016	2015	2014
Commercial & Industrial	4.1%	4.5%	0.1%	5.8%	9.5%
Snap-on Tools	-1.0%	-0.4%	5.6%	10.9%	7.6%
Repair Systems & Information	-1.4%	7.6%	4.7%	4.9%	4.9%
Financial Services	5.2%	11.3%	17.1%	11.8%	18.7%
	0.5%	3.4%	2.9%	7.1%	6.9%

Commercial & Industrial Group

The Commercial and Industrial segment serves customers including aerospace, railroads, natural resources, military, heavy-duty fleet and maintenance, and power generation

industries. In addition to hand tools and power tools, the company's solutions include specialty tools, tool management, organization solutions, and sourcing services. Products are distributed either directly or through independent distributors.

Snap-On Tools Group

The Snap-on Tools Group sells the company's proprietary line of hand tools, power tools, and equipment to the company's base of franchisees who distribute via mobile vans to vehicle service and repair technicians. The company also generates revenue from initial and ongoing franchise fees which totaled $16.2 million in 2018, up from $15.2 million and $13.9 million in 2017 and 2016, respectively. At the end of 2018, the company had approximately 3,450 routes in the US and 1,350 in international markets.

Repair Systems & Information Group

The Repair Systems & Information Group sells handheld and PC-based diagnostic products, service and repair information products, parts catalogs, business management systems, and point of sales systems to vehicle service shops and OEM dealerships. Products are distributed directly and through distributor channels.

Financial Services

The Financial Services segment provides several financing programs to both franchisees and end-customers including installment sales and lease contracts to customers who need extended payment plans, and business loans and vehicle leases to franchisees.

Weakness in Snap-on Tools Group

One of the most obvious trends seen in table 1 above is the rapidly declining share of sales and profits generated by the company's flagship Snap-on Tools segment. This trend has been going on for years, but as we saw in the above table, organic growth for the segment turned abruptly negative in 2017. The following table shows the organic growth for the segment for the last eight quarters to give a more detailed perspective of the timing of the weakness:

	12/29/2018	09/29/2018	06/30/2018	03/31/2018
Snap-on Tools	0.4%	0.1%	-1.5%	-2.7%

	12/30/2017	09/30/2017	07/01/2017	04/01/2017
Snap-on Tools	-3.0%	-1.6%	0.5%	2.5%

We see that the year-over-year declines in organic growth started in the 9/17 quarter. In the conference calls that followed, the company discussed the slowdown and steps it was taking to combat it:

From 12/17 quarter conference call:

> *"Now, let's move to the individual operating groups and their fourth quarter results. The Tools Group. Organic sales down 3% and operating earnings of $67.3 million, representing a margin rate of 16.4%, down 120 basis points.* ***We do believe our actions to reinvigorate the van channel sales will be effective, but they didn't create improvement in the fourth quarter. In the quarter and throughout the year, however, the Tools Group did confirm the strength and the market-leading position of its van network. It wasn't evident in the recent financials, but it was clear in the franchisee health metrics we monitor each period.*** *The franchisees are strong and the turnover is low and that positivity was once again acknowledged by multiple publications, listing Snap-on as a franchise of choice."*

From the 1Q 18 conference call:

> *"We are seeing turbulence, but our van network remains strong. You can see it in the franchisee metrics. The financial and physical indicators, again this quarter, they remain favorable matching the clear optimism we see when we meet our franchisees."*

From the 2Q 18 conference call:

> ***"Now onto the Tools Group. Organic sales down 1.5% reflecting primarily a low single digit decline in the U.S. and essentially flat international results.*** *Operating earnings, $79 million, down 2.1%, an OI margin of 19.2%, lower by 30 basis points*

but still among the group's strongest. ***We do believe our actions to reinvigorate the van channel are bearing fruit. Now this quarter didn't create an overall increase, but they did positively affect the U.S. franchise operations.*** *Tool Storage showed some recovery led by the new high margin midrange KCP 1422, and handheld diagnostics also made progress, authoring another increase in software sales as we roll out more Apollo and ZEUS units with the revolutionary intelligent diagnostics feature, the data package sales that accompanies most of those units builds our software "penetration, and software sales did grow again this quarter."*

From the 3Q 18 conference call:

"Now on to the Tools Group. Organic sales about flat, 0.1%, but a return to growth in the U.S. operation, up low single digits. And that return to growth was offset by variation internationally*. That's the story of the Tools Group. Operating income in the quarter was $59.3 million and that compares to $56.4 million in 2017. The OI margin was 15.2%, an 80 basis point increase. Favorable product mix, higher margin new products, software, the benefits of RCI, and the favorable foreign currency, they made the difference."*

From the 4Q 18 conference call:

"Now let's talk about the Tools Group. Organic sales about flat, up 0.4%. But continued growth in the U.S. operations up low single-digits, a positive that was again offset by a decline in international operations including the UK. Operating income in the quarter was $57 million, comparing to $67.3 million in 2017. ***The OI margin was 14.0%, a 240 basis point decrease. You can see that in the recent swing to unfavorable currency transaction from a positive position in the prior quarter, in product mix, and in the increased spending to strengthen franchisee support. Those were all the drivers of that margin."***

We can see from the above discussions that the company has been fighting the slowdown in sales to its franchisees with the introduction of new products along with spending to strengthen support to franchisees which negatively impacted margins in the 12/18 quarter. While comp sales growth turned slightly positive in the last two quarters, bear in mind that this was against very easy comps and hardly signals a clear return to the 5-10% growth seen in the 2014-2016 period.

We also observe that the Tax Act provided bonus depreciation of 100% for qualified equipment placed in service after 9/27/2017 and before 12/31/2022. Qualified equipment is defined as tangible personal property with a recovery period of 20 years or less. We believe it is reasonable to assume that the Tax Act could have provided a meaningful tailwind to spending by many of the company's customers, yet growth has remained anemic.

In addition, as we will see below, the company's sales to franchisees have received a boost over the last few years from a rise in financing extended to franchisees.

Franchisee Revenue Recognition

SNA states the following in its 10-K regarding the timing of its revenue recognition:

> *"Snap-on recognizes revenue from the sale of tools, diagnostic and equipment products and related services based on when control of the product passes to the customer or the service is provided and is recognized at an amount that reflects the consideration expected to be received in exchange for such goods or services."*

However, it is important to realize that in transactions with franchisees, the franchisee is the customer and the company books the sale at the time the product is passed on to the franchisee. Consider the following explanation later in the 10-K:

> *"In some cases, the nature of Snap-on's contracts give rise to variable consideration, including rebates, credits, allowances for returns or other similar items that generally decrease the transaction price. These variable amounts generally are credited to the customer, based on achieving certain levels of sales activity, product returns and making payments within specific terms.*
>
> ***In the normal course of business, Snap-on allows franchisees to return product per the provisions in the franchise agreement that allow for the return of product in a saleable condition.*** *For other customers, product returns are generally not accepted unless the item is defective as manufactured. Where applicable, Snap-on establishes provisions for estimated sales returns. Estimated product returns are recorded as a reduction in reported revenues at the time of sale based upon historical product*

return experience and is adjusted for known trends to arrive at the amount of consideration to which Snap-on expects to receive. Variable consideration is estimated at the most likely amount that is expected to be earned. Estimated amounts are included in the transaction price to the extent it is probable that a significant reversal of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is resolved. Estimates of variable consideration and determination of whether to include estimated amounts in the transaction price are based largely on an assessment of the anticipated performance and all information (historical, current and forecasted) that is reasonably available."

So, revenue is booked when product is sold to franchisees and allowances for sales returns are recorded. This creates several possibilities for the distortion of economic reality. First, the franchisee sales channel (about 40% of total sales) can be stuffed when franchisees buy product from the company which builds up in their inventory. This will be an important factor as we examine franchisee financing in the next section.

Second, the franchisees can return product to SNA under certain provisions. If SNA does not adequately allow for returns when it books sales, it could result in an over-reporting of revenue. The company discloses its accrued new tool return balance on an annual basis. In 2018, the accrual jumped to $43.7 from $23.9 a year ago, an enormous increase on a 1.5% increase in sales which may indicate the company was catching up on being under-reserved in previous periods.

Trend of Increased Franchisee Financing

In addition to extending traditional trade receivables to its customers, SNA also offers financing to its customers and its franchisees through its wholly-owned finance subsidiary. The company describes the program in its 10-K as follows:

"Snap-on also generates revenue from various financing programs that include: ***(i) installment sales and lease contracts arising from franchisees' customers and Snap-on customers who require financing for the purchase or lease of tools and diagnostic and equipment products on an extended-term payment plan; and (ii) business loans and vehicle leases to franchisees.*** *The decision to finance through Snap-on or another financing source is solely by election of the customer. When assessing customers for*

potential financing, Snap-on considers various factors regarding ability to pay, including the customers' financial condition, debt servicing ability, past payment experience, and credit bureau and proprietary Snap-on credit model information, as well as the value of the underlying collateral.

Elsewhere in the 10-K, the company provides a more detailed definition of contract receivables versus and finance receivables:

> *"**Snap-on's finance receivables are comprised of extended-term installment payment contracts to both technicians and independent shop owners (i.e., franchisees' customers) to enable them to purchase tools and diagnostic and equipment products on an extended-term payment plan, generally with average payment terms of approximately four years.** Finance receivables are generally secured by the underlying tools and/or diagnostic or equipment products financed.*
>
> ***Snap-on's contract receivables, with payment terms of up to 10 years, are comprised of extended-term installment payment contracts to a broad base of customers worldwide, including shop owners, both independents and national chains, for their purchase of tools and diagnostic and equipment products. Contract receivables also include extended-term installment loans to franchisees to meet a number of financing needs, including working capital loans, loans to enable new franchisees to fund the purchase of the franchise and van leases, or the expansion of an existing franchise.** Contract receivables are generally secured by the underlying tools and/or diagnostic or equipment products financed and, for installment loans to franchisees, other franchisee assets."*

The company does not break out how much of contract receivables represent loans to franchisees, but given various comments, and characteristics of the loans (9% yield for contract receivables vs. 17% for finance receivables) indicates to us that the bulk of the contract receivables are loans to franchisees.

The following table shows the calculation of contract receivables days of Snap-on Tools Group revenues for the last five years:

	2018	2017	2016	2015	2014
Snap-on-Tools Group Sales	$1,613.8	$1,625.1	$1,633.9	$1,568.7	$1,455.2
ST Contract Receivables	$98.3	$96.8	$88.1	$82.1	$74.5
Days of Sales	21.9	21.4	19.4	18.8	18.4
LT Contract Receivables	$344.9	$322.6	$286.7	$266.6	$242.0
Days of Sales	76.9	71.5	63.2	61.2	59.9
Total Contract Receivables	$443.2	$419.4	$374.8	$348.7	$316.5
	98.9	92.9	82.6	80.0	78.3

We see that the company rapidly expanded its contract receivables balances over the last few years with a marked acceleration in 2017 which corresponds to the slowdown in sales to franchisees. In addition, we can see that the bulk of the increase in contract receivable days is in long-term financing. We can also see in the table below that the trend of increasing contract receivable days continued on a quarterly basis throughout 2018:

	12/29/2018	09/29/2018	06/30/2018	03/31/2018
Snap-on Tools Groups Sales	$407.4	$389.8	$411.9	$404.7
ST Contract Receivables	$98.3	$105.6	$87.6	$92.0
ST Contract Days	22.0	24.7	19.4	20.7
LT Contract Receivables	$344.9	$338.1	$332.6	$326.1
LT Contract Days	77.3	79.1	73.7	73.5
Total Contract Receivables	443.2	443.7	420.2	418.1
Total Contract Receivables Days	99.3	103.9	93.1	94.3

	12/30/2017	09/30/2017	07/01/2017	04/01/2017
Snap-on Tools Groups Sales	$409.2	$392.7	$413.8	$409.4
ST Contract Receivables	$96.8	$99.8	$82.4	$84.5
ST Contract Days	21.6	23.2	18.2	18.8
LT Contract Receivables	$322.6	$310.4	$299.4	$292.6
LT Contract Days	71.9	72.1	66.0	65.2
Total Contract Receivables	$419.4	$410.2	$381.8	$377.1
Total Contract Receivables Days	93.5	95.3	84.2	84.1

Keep in mind that from SNA's perspective, for franchise sales, the customer is not the shop that buys a wrench but rather the franchisee who stocks the wrench. Therefore, SNA has essentially been extending credit to its own customers to buy its products.

This financing can take the form of working capital loans, business loans or vehicle leases. We found the following quote from the 3Q 17 conference call interesting:

> *"Secondly, we're expanding the space on the vans. One of the reasons you see, in a lot of cases, you can see it reflected in franchise finance, is that the* ***van drivers are buying or leasing bigger trucks, 20-foot trucks, not the 16-foot trucks, giving them more retail space.*** *And we believe these kinds of things -- better product, more space and then we're working on helping them with their time so they have more time to sell. That's what wins for us."*

If franchisees are using their contract financing to lease or buy bigger vans which they then stock with more SNA products, it is very concerning that we have not seen a bigger jump in organic sales growth to franchisees.

In the next section, we will take a look at the credit metrics for the contract receivables portfolio.

Contract Receivables Metrics Deteriorating

SNA attracted some negative attention in late 2017 from increasing loss rates in its finance receivables portfolio which we will discuss in a section below. Management is touting recent improvement in its finance portfolio delinquency rates. However, management's quarterly disclosure shows the delinquency rates for its finance receivables (which it refers to as "extended credit") as well as delinquency rates for the total portfolio. The finance receivables balance is roughly four times the size of the contract receivables balance, so the credit metrics of the finance receivables dominates the total portfolio figures. As we will examine in the next section, while credit metrics of the finance receivables portfolio are improving on the surface, this could have been helped by their recent rapid growth. Meanwhile, the credit metrics for the contract receivables portfolio are getting worse by the quarter despite growth in the portfolio outstripping sales to franchisees.

Delinquency data for contract receivables is shown below:

Contract Receivables Metrics	12/29/2018	09/29/2018	06/30/2018	03/31/2018
30-59 days past due	0.38%	0.40%	0.47%	0.38%
60-90 days past due	0.27%	0.31%	0.21%	0.21%
>90 days past due	1.16%	0.85%	0.82%	0.57%
Total past due	1.81%	1.56%	1.51%	1.16%
>90 Days and Still Accruing	0.04%	0.04%	0.05%	0.09%

	12/30/2017	09/30/2017	07/01/2017	04/01/2017
30-59 days past due	0.28%	0.34%	0.36%	0.29%
60-90 days past due	0.14%	0.17%	0.21%	0.26%
>90 days past due	0.45%	0.41%	0.44%	0.52%
Total past due	0.87%	0.91%	1.01%	1.07%
>90 Days and Still Accruing	0.14%	0.14%	0.18%	0.13%

Total percentage of past due contract receivables more than doubled from the 12/17 to the 12/18 quarter and jumped 25 bps sequentially. Similar deterioration can be seen in the percentage of non-performing loans and loans on non-accrual status:

Contract Receivables	12/29/2018	09/29/2018	06/30/2018	03/31/2018
Performing	98.66%	98.95%	98.94%	99.27%
Nonperforming	1.34%	1.05%	1.06%	0.73%

	12/30/2017	09/30/2017	07/01/2017	04/01/2017
Performing	99.46%	99.47%	99.4%	99.4%
Nonperforming	0.54%	0.53%	0.6%	0.6%

	12/29/2018	09/29/2018	06/30/2018	03/31/2018
Contract Receivables Non-Accrual Status %	1.30%	1.00%	1.01%	0.64%

	12/30/2017	09/30/2017	07/01/2017	04/01/2017
Contract Receivables Non-Accrual Status %	0.40%	0.41%	0.41%	0.47%

Another item to consider is that the number of franchisees has remained essentially flat. While SNA does not break out the exact number of franchisees, it does give an approximate route count in its 10-Ks which disclose the following:

approximate route count	2018	2017	2016	2015
US	3,450	3,500	3,500	3,500
International	1,350	1,400	1,400	1,300
Total	4,800	4,900	4,900	4,800
Franchise Fees Collected	$16.2	$15.2	$13.9	$12.1

These numbers are approximate and the decline in routes in 2018 was likely exaggerated by rounding. The flat-to-down trend in the number of franchisees indicates that the debt per franchisee is increasing rather than debt being extended to open new franchised routes.

We are also puzzled by the increase in franchise fees. The company charges an initial franchise fee when a franchise is established as well as an ongoing monthly fee. The fee revenue has been growing materially while the number of franchisees is not even holding steady. This implies either the company is regularly raising its fees, or possibly turnover among its franchisee base.

The skyrocketing rate of delinquencies, non-performing rates and non-accrual contract receivables are very concerning and not at all indicative of improving health in the portfolio. It appears that SNA has been supporting its franchisees through aggressive extension of loans and increased spending to support the franchisees. It is quite reasonable to think that this money was used by franchisees to increase their inventory levels and lease new trucks which required even more purchases of the company's products to stock. Despite this, organic growth in sales to franchisees grew by less than half a percentage point in the 12/18 quarter despite being up against a very easy comparison. To top it all off, it appears a rapidly increasing percentage of franchisees are having trouble staying current on those loans.

Increase in Customer Financing

As discussed above, the company extends credit directly to its franchisees which is included in its contract receivables balances. However, the largest part of its finance portfolio is its finance receivables which mostly represent loans directly to customers including franchisees' customers.

The following table shows the calculation of finance receivables days of Commercial & Industrial Group and Repair Systems & Information Groups sales for the last five years:

	2018	2017	2016	2015	2014
Commercial & Industrial Group Sales	$1,051.6	$986.1	$863.0	$895.5	$952.1
Repair Systems & Information Group Sales	$1,075.3	$1,075.7	$933.5	$888.6	$870.4
	$2,126.9	$2,061.8	$1,796.5	$1,784.1	$1,822.5
ST Finance Receivables	$518.5	$505.4	$472.5	$447.3	$402.4
ST Finance Receivables Days	87.8	88.2	94.7	90.3	79.5
LT Finance Receivables	$1,074.4	$1,039.2	$934.5	$772.7	$650.5
LT Finance Receivables Days	181.9	181.4	187.3	155.9	128.5
Total Finance Receivables	$1,592.9	$1,544.6	$1,407.0	$1,220.0	$1,052.9
Total Finance Receivables Days	269.6	269.7	281.9	246.2	208.0

Total finance receivables days have risen almost 90 days in the last five years, indicating a rapid increase in the use of customer financing to support sales growth. While total finance receivable days were flat sequentially in 2018, when we look at them on a quarterly basis, we see the year-over-year increase resumed in the last two quarters:

	12/29/2018	09/29/2018	06/30/2018	03/31/2018
Commercial & Industrial Group Sales	$270.0	$255.7	$267.1	$258.8
Repair Systems & Information Group Sales	$275.1	$252.6	$275.6	$272.0
	$545.1	$508.3	$542.7	$530.8
ST Finance Receivables	$518.5	$519.0	$514.4	$512.2
ST Finance Receivables Days	86.8	93.2	86.5	88.1
LT Finance Receivables	$1,074.4	$1,058.3	$1,051.3	$1,035.9
LT Finance Receivables Days	179.9	190.0	176.8	178.1

	12/30/2017	09/30/2017	07/01/2017	04/01/2017
Commercial & Industrial Group Sales	$273.2	$250.8	$236.5	$225.6
Repair Systems & Information Group Sales	$292.2	$260.3	$271.1	$252.1
	$565.4	$511.1	$507.6	$477.7
ST Finance Receivables	$505.4	$505.8	$496.5	$484.7
ST Finance Receivables Days	81.6	90.3	89.3	92.6
LT Finance Receivables	$1,039.2	$1,018.6	$998.6	$966.3
LT Finance Receivables Days	167.7	181.9	179.5	184.6

The following table shows delinquency data for the finance receivable portfolio:

Finance Receivables	12/29/2018	09/29/2018	06/30/2018	03/31/2018
30-59 days past due	1.17%	1.08%	1.04%	0.82%
60-90 days past due	0.73%	0.74%	0.65%	0.62%
>90 days past due	1.23%	1.19%	1.00%	1.25%
Total past due	3.13%	3.00%	2.69%	2.70%
>90 Days and Still Accruing	0.96%	0.94%	0.76%	0.98%

	12/30/2017	09/30/2017	07/01/2017	04/01/2017
30-59 days past due	1.21%	1.01%	0.99%	0.80%
60-90 days past due	0.87%	0.73%	0.63%	0.59%
>90 days past due	1.26%	1.22%	0.94%	1.12%
Total past due	3.33%	2.97%	2.57%	2.50%
>90 Days and Still Accruing	0.96%	0.98%	0.72%	0.84%

While the year-over-year increase in delinquencies reversed in the 9/18 quarter, note that the improvement corresponds to the increase in finance receivables that started in the 9/18 quarter. This likely improved the delinquency metrics by virtue of simply including less seasoned receivables in the mix. Similar trends are seen in the non-performing and non-accrual detail below:

Finance Receivables	12/29/2018	09/29/2018	06/30/2018	03/31/2018
Performing	98.31%	98.30%	98.49%	98.26%
Nonperforming	1.69%	1.70%	1.51%	1.74%

	12/30/2017	09/30/2017	07/01/2017	04/01/2017
Performing	98.25%	98.24%	98.49%	98.34%
Nonperforming	1.75%	1.76%	1.51%	1.66%

	12/29/2018	09/29/2018	06/30/2018	03/31/2018
Finance Receivables Non-Accruals Status %	0.73%	0.76%	0.76%	0.75%

	12/30/2017	09/30/2017	07/01/2017	04/01/2017
Finance Receivables Non-Accruals Status %	0.79%	0.80%	0.79%	0.82%

SNA has clearly utilized increasing customer financing to drive growth in revenue from external customers. In addition, the company's Financial Services segment has become an increasing percentage of total profits as shown in the following table:

	2018	2017	2016
Operating Earnings Before Financial Services	**$726.0**	**$664.6**	**$662.4**
Adjustment for Legal (benefit)/Expense	-$4.3	$45.9	
Adjustment for Currency	-$4.4	$8.6	$21.5
Adjusted Operating Earnings Before Financial Services	$717.3	$719.1	$683.9
% of Total Adjusted Operating Earnings	75.7%	76.8%	77.5%
Operating Earnings From Financial Services	**$230.1**	**$217.5**	**$198.7**
% of Total Adjusted Operating Earnings	24.3%	23.2%	22.5%
Total Adjusted Operating Earnings	$947.4	$936.6	$882.6

The total reported operating income has not only been boosted by the increase in extension of credit to franchisees and external customers, but also by the growth in finance segment profits. This could easily reverse should the company have to throttle back on growth in the portfolio, or if bad debt expense were to rise. The following table shows the reserve percentages for finance receivables and contract receivables:

	12/29/2018	09/29/2018	06/30/2018	03/31/2018	12/30/2017	09/30/2017
Finance Receivables Allowance %	3.71%	3.64%	3.63%	3.63%	3.53%	3.43%
Contract Receivables Allowance %	0.96%	1.03%	1.13%	1.09%	1.08%	1.23%

Despite the rapid increase in delinquencies, contract receivables allowance for bad debts as a percentage of receivables has been declining. Investors should remember that in 2011, the contract receivables allowance percentage was 2.4% and finance receivables allowance percentage was 3.7%. For perspective, if the allowance percentage for the whole finance portfolio increased by 50 basis points, it would cost about 14.5 cps in charges.

Granted, SNA's debt load is manageable at just over 1 times EBITDA, so leverage is not an immediate barrier to continuing to extend credit. However, if the credit portfolio continues to deteriorate and losses mount, it will begin to limit the company's ability to spur the top line with continued credit extension without causing obvious problems. To put this in perspective, in the 12/18 quarter Commercial and Industrial revenue plus Repair Systems & Information revenue fell by over $20 million versus the year-ago quarter. However, finance receivables jumped by more than $35 million in the same time frame which implies that the revenue decline could have more than doubled without the increase in credit extension.

Headwinds to Growth for Independent Repair Related Services

As the bulk of the company's business relates to automotive service and repair, investors should be aware of the challenges facing these markets. The Bureau of Labor Statistics (BLS) predicts that the number of automotive service technicians will grow by 6% between 2016 and 2026. This is roughly in-line with the average growth in other occupations. However, the BLS also notes:

> *"The number of vehicles in use is expected to continue to rise. More entry-level service technicians will be needed to perform basic maintenance and repair, such as replacing brake pads and changing oil, on these vehicles.* ***New technologies, however, such as electric vehicles, may limit future demand for automotive service technicians and mechanics because these vehicles will be more reliable and thus require less frequent maintenance and repair."***

The increasing complexity of cars is causing more car owners to seek service and repairs at dealerships rather than mom-and-pop service shops. This phenomenon is documented in the attached 6/18/18 article of *Auto News.* Also, consider this 9/5/17 article from Quartz entitled The Connected Car of the Future Could Kill off the Local Auto Repair Shop. We found this quote very interesting:

> *"Some worry that eventually, services like GM's Onstar could share data they receive from connected cars with local GM dealers, who offer repairs and maintenance service, but they won't necessarily share this type of information with Dykstra or the other 180,000 independent auto repair businesses in the United States, which could leave them at a disadvantage. Or worse, manufacturers will move data that shops need to fix cars, some of which is currently accessible by the OBD port, to these new connected systems, where it will be less accessible to independent businesses."*

Likewise, for years automakers have been moving towards making the software in their cars more difficult to access through encryption and seeking to have their code copyright protected. This trend will likely continue under the guise of protecting cars from being hacked, but it will also make it more difficult for makers of third-party diagnostic tools to make and sell universal diagnostic equipment. The result will likely be even more pressure for owners to get their cars fixed at the dealership, thus bypassing suppliers like SNA.

It is also important to realize that a mechanic employed by a mom-and-pop shop often is required to provide his own tools. The larger the shop or dealership, the more likely it is it will be able to provide a full range of its own tools. As business shifts to these larger shops, it is likely putting more pressure on the Snap-on franchisees who sell to mechanics at smaller shops.

Another obstacle to growth is the fact that most of these tools last a very long time. Once someone buys a socket set, they will not need to replace it anytime soon.

> *'Dealerships will send you a message that says 'your oil sensor says that your oil is ready' and we have a bay open at this time, come on in,'" says Greg Potter, the executive manager of the Equipment and Tool Institute, a trade association of automotive tool and equipment manufacturers. "It's a good idea, a good model. But very difficult to compete with."*
>
> ***That would impact not only repair service businesses like Dykstra's, but also the companies that sell these shops parts and tools,*** *which together with repair shops that aren't associated with a dealership are called the "aftermarket."*

ConAgra Brands

We are moving CAG back to a SELL recommendation after the recent pop in stock price over Q3 results that gave people some relief because they were not a surprise on the level as Q2. The company still cut revenue and gross margin guidance after Q3 results. It is still highlighting minor parts of its portfolio posting growth, while the bulk of the portfolio is posting weaker sales. It still believes that success will be determined by turning Birdseye, Duncan Hines, and Wishbone around from negative sales growth situations, which is what hurt Q2 results so much and results continue to lag there. We believe that much of Q3 sales gains were the result of easy comps and some one-time events. Readers should refer back to the January 10, 2019 report where we discuss that digesting Pinnacle Foods now requires fixing major revenue issues, not just cost-cutting and the August 9, 2018 report that pointed out that Pinnacle Foods already cut many costs and had not been seeing much if any top line gains.

There is an Investor Day on April 10 coming up where ConAgra plans to unveil more new products and marketing ideas along with updating synergy targets. That is a short term wild card that could give the stock another boost.

- Legacy CAG continues to show nuggets of growth, but overall new products offset losses in old products and total dollar sales growth continues to decline. It has dropped from 3.1% to 0.7% overall growth in four quarters.

- 3Q19 sales were helped by easy comps after the hurricanes hurt volume by 220bp in 2Q and by a horrible -6.3% comp from 3Q18. Margins are also aided by sales gains, if sales growth drops, margin pressure could become an issue too.

- Kroger and Wal-Mart both reported that their last quarter had a significant push from people stocking up on food ahead of numerous winter storms and the government shutdown essentially pulled food stamp spending forward by giving people 2 payments in December and an early February payment.

- CAG should have benefitted in 3Q19 from these same factors and because its quarter ended in late February it captured even more of the bad storm sales than Kroger and Wal-Mart whose quarters ended in late January and early February. Wal-Mart expects a headwind next quarter.

- Pinnacle sales continue to fall. The change in retail sales has been swift falling from 2.1% growth to -4.6% growth in four quarters. Distribution volumes are falling at 5%-15% rates for the key brands and CAG does not expect this to improve much until 9-12 months from now.

- CAG held sales guidance and is projecting operating margin to come in at the high end of forecast at Pinnacle which may already be an aggressive forecast. It is removing SKUs, boosting store advertising, which is a reduction to sales and margin and the gross margin is under pressure.

- Pinnacle's sales are already coming in below initial forecast, that is a headwind that will offset any synergies CAG achieves here. After 2Q, gross margin was coming in 230bp below forecast, even if that improves a bit, that is still a big headwind to offset planned synergies.

- Synergies are expected to be $215 million. $100 million of lost sales at the prior gross margin is about $30 million in headwind, 100bp of lost gross margin on forecasted sales is also $30 million. CAG is facing both situations. It is also ramping up marketing at a rate faster than synergies. It reported $12 million achieved in Q3, it boosted marketing by $17 million.

How About That Legacy ConAgra Business?

Again, in the third quarter, CAG highlights some smaller areas of the portfolio and reports great sales growth in terms of Retail Dollars:

	3Q19	2Q19	1Q19	4Q18	3Q18
Frozen Single-Serve Meals	8.3%	11.3%	10.0%	13.0%	13.2%
Snack Foods	7.5%	6.4%	3.2%	5.8%	5.7%

At the same time, the company as a whole, is seeing weaker results in Retail Dollar Growth:

	3Q19	2Q19	1Q19	4Q18	3Q18
CAG Legacy	0.7%	1.0%	1.7%	3.1%	2.2%

That continues to look like what we would expect, new products get higher pricing and post better growth, but older products are marked down and cleared to make room for the new product. The grocery stores have not suddenly found significant new selling space nor do we believe people are suddenly eating more food overall. If they ate a frozen single-serve meal – they probably didn't buy canned spaghetti at the same time. One sale is made and one sale is lost.

It is also important to realize how easy the comps were for growth in 3Q19. This was the first time, CAG called out some expenses related to brand building that are accounted for as a reduction to sales. This is not a new policy for in-store displays, vendor slotting fees, etc. But, it is new in that CAG is pointing out that it ramped up spending in this area to get product into stores.

Organic Growth	3Q19	2Q19	1Q19
CAG Legacy Vol	1.2%	-2.2%	0.0%
CAG Legacy Price	0.7%	0.6%	1.2%
Brand Building	1.4%	0.0%	0.0%
	3.3%	-1.6%	1.2%

We know the company said in 2Q that hurricanes had a negative impact on volumes of 2.2% and that should have effectively moved some sales into 3Q. But look at the comps they faced in more detail sequentially and year over year:

Grocery/Snacks	3Q19	2Q19	1Q19	4Q18	3Q18
Volume	2.1%	-2.2%	0.1%	-0.3%	-4.1%
Price/Mix	0.8%	0.3%	0.0%	1.4%	-2.2%
Total	2.9%	-1.9%	0.1%	1.1%	-6.3%

Grocery/Snacks is 43% of legacy sales. They had a negative -6.3% organic comp from 3Q18. Going backwards, that means the $838.3 million in sales this unit posted in 3Q18 fell by $56.4 million. That's a super easy comp, and CAG didn't even recover half of that total in 3Q19 when it posted a $24.3 million y/y gain. On top of that, the weak hurricane hampered 2Q19 should have pushed sales into 3Q19 too to create sales growth – the company estimates it gained 50bp of sales from this in the grocery unit. This is the division that includes the retail sales dollar growth of 7.5% in 3Q and 6.4% in 2Q for snacks like powdered cocoa mix, popcorn, and Slim-Jims. There are clearly other products offsetting those gains.

Refrigerated	3Q19	2Q19	1Q19	4Q18	3Q18
Volume	3.5%	0.5%	0.5%	2.9%	1.8%
Price/Mix	-1.1%	0.0%	0.9%	2.3%	0.8%
Total	2.4%	0.5%	1.4%	5.2%	2.6%

Refrigerated is 36% of legacy sales. 3Q18 was not awful but look at the comp they face in 4Q. They also had a weak 2Q19 that should have pushed some business into 3Q this year.

The remaining 21% of legacy is International and Food Service – both of which posted negative results driven by drops in volume of 2.0% and 6.7%.

After this glowing quarter – CAG cut revenue guidance from 1-2% growth to +1% growth even though it forecasts a late Easter helping 4Q by as much as 150bp y/y on sales. We think the gains in 3Q were juiced further by other one-time events too.

Looking at margins for the two key units, it is clear that there is no substitute for sales gains to drive margins. If sales growth falters, it could hurt margins too:

Op. Margin change	3Q19	2Q19	1Q19	4Q18	3Q18
Grocery/Snack	142bp	-2bp	-129bp	121bp	-257bp
Refrigerated	17bp	100bp	-162bp	109bp	-58bp

Recent Grocery Sales Helped by Food Stamp Timing and Winter Storms

We think a big reason CAG sales were better than many anticipated was the grocery stores reported very strong comp sales in their most recent quarter too. They also did it against the toughest comp registered a year before:

Kroger	Q4	Q3	Q2	Q1
2018	1.9%	1.6%	1.6%	1.9%
2017	1.5%	1.1%	0.7%	-0.2%

Wal-Mart	Q4	Q3	Q2	Q1
2018	4.2%	3.4%	4.5%	2.1%
2017	2.6%	2.7%	1.8%	1.4%

This did not just happen out of the blue that people decided to eat at home more and buy more stuff at grocery stores. The government shutdown played a role. Food Stamp cards were refilled for January before December 21. The February payment was pulled forward too and paid by January 20. The result was recipients received funding twice in December and had their February payment pulled forward into January. This extra and early money was spent in the stores.

Also, heavy winter storms hit much of the country between December and February. Ice and snow closed restaurants, stopped pizza delivery, closed businesses so people stayed at home. Many people were warned to stock up on additional food at home by weather people in the media. Well – they did! Here are some anecdotal reports:

Seattle Times discussing the results of an early February snowstorm

> *"But if Snowmageddon taketh away, it also giveth. Many grocery stores landed in the "winner" column.* ***QFC stores, most of which are in the Puget Sound region, saw a 50 percent increase in grocery sales and a 30 percent increase in customer traffic Thursday and Friday, compared to those days last year.*** *For the week, the chain saw "more in sales than we typically do during Thanksgiving week," spokesman Zach Stratton said."*

Detroit Free Press talking about the January Polar Vortex:

> *" Gary Winters, store manager at Busch's Fresh Food Market on Sheldon and Five Mile in Plymouth, said they were extremely busy this past weekend and being shopped heavily on Monday…This weekend, Winters said they did 40 percent more business than normal. Hot items were bread, ground beef, eggs, milk, water and bananas. At Busch's, they also had a 20 percent off wine sale. Winters said they set records with the wine sale, up 40 percent over last year.* ***"With every snowstorm, we always have an increase in sales,*** *" said Tom Violante Jr. of Holiday Market in Royal Oak. "The hoarding mentality is alive and well."*

CBS in Birmingham, Alabama in January:

> *"'I am getting some essentials: oreos, sausage, lettuce, things to make grilled cheese, soup and I'm headed to bread,' said Lauri Soong, a customer. "Milk, bread, the staples and some cheese," said Dan Brown. "We got bread and some snacks I like because we don't have school tomorrow," said Rachel French. The shelves kept being refilled by*

employees at the Piggly Wiggly in Homewood trying to keep up with the demand. "Kind of crazy but fun at the same time because you get a lot of new faces that you normally don't have, kids come in and do the same thing, want to stock up in case it's a long haul," said Emanuel Turner, manager at Piggly Wiggly. ***The manager said every time before a weather event, the crowds pour in."Snacks go fast. Soups, canned vegetables, can soup, snack food goes real fast****," said Turner."*

Kroger was asked about food stamps and weather for sales and said 44bp of its comp sales last quarter was due to those events. Wal-Mart said early food stamps were 40bp of its comp sales. It also noted that winter storms drove strong sales but did not quantify it. It further noted that food stamps will be a headwind for it in the current quarter because it clearly pulled sales forward last quarter.

The other thing to keep in mind is Kroger and Wal-Mart did not experience the full winter storm impact in their results, but ConAgra did. Kroger's quarter ended on February 2, Wal-Mart on January 25, and ConAgra on February 24. So, the grocers may still have a bit of strength in their first quarters, but ConAgra already reported another month of people buying food ahead of storms.

The other headwind that may occur is people loaded up on more stuff for storms and then have to work off the pantry inventory at home. That could also mean weakness for the current quarter. We used to follow Energizer and if there was a hurricane warning – Energizer sales would pop as people stocked up on batteries – then sales would crater because they wouldn't need any more until Christmas. Canned food and frozen food could likely have similar trends because the shelf life at home is longer just like batteries.

Pinnacle Sales Continued to Fall and May Offset Synergies

Considering that grocery stores had so many boosts to 3Q sales – Pinnacle Foods products should have benefited right? Think again – their decay accelerated at that time:

Pinnacle Retail	3Q19	2Q19	1Q19	4Q18	3Q18
Sales change	-4.6%	-3.0%	-1.4%	1.1%	2.1%

During this time, the three major brands: Birdseye, Duncan Hines, and Wishbone have seen distribution volumes fall at 5%-15% so the company is shedding market share. We are

actually surprised CAG did not cut the sales forecast again for these brands. We also should remind readers that all three brands were posting flat to negative sales growth despite efforts to refocus products while at Pinnacle Foods. **CAG did confirm that it does not expect improving trends at Pinnacle Foods until the second half of fiscal 2020 (essentially 9-12 months from now.)**

ConAgra held its guidance flat for this unit which is sales light $160 million for the current year and gross margins running 230bp below forecast. To put this in bigger terms – PF had $3 billion in sales for calendar 2018 and a gross margin of over 30%. Let's just call that $900 million in gross profit that was expected. Being light on margin by 100bp is $30 million of lost gross profit as it being light on $100 million of revenue. CAG faces both issues now. If going forward, this acquisition produces $2.8 billion in sales at 28% margin, the expected gross profit would fall to about $800 million. If we allow that CAG could cull lower margin business and sacrifice sales to restore gross margin – and they hit 30% on $2.7 billion in sales, that's still only $810 million in gross profit vs the forecasted $900 million. Any margin gain from combining facilities or buying product better than Pinnacle did would be part of the cost saving from synergies. We think the current situation with this acquisition of weaker sales and margins could be a sizeable offset to any integration savings.

ConAgra is touting that is looking for $215 million in synergies and no revenue synergies. It reported that it already has $12 million in cost-cutting completed. However, it may have already lost $100 million in annualized gross profit given current Pinnacle Foods results, which could offset nearly half the synergies investors are expecting. This is a key point as ConAgra did not expect to have to rebuild PF's brands, product lines, and rekindle revenue and gross margins. They were looking to simply merge production lines, cut management, combine distribution assets and reduce costs against the revenue and gross margins PF was reporting.

Also, we noted earlier that CAG called out its organic sales growth in 3Q19 was 140bp lower because it ramped up branding building investments to pay stores to stock and pitch new products. The 140bp in lower organic sales in 3Q was about $28 million. It paid for some of this with a reduction of nearly $11 million in advertising expense that is reflected in SG&A. This is still new investment of $17 million in 3Q19 that did not appear called out when this merger was completed. We thought more marketing would be needed, and if this continues then that will offset some more of the cost synergies CAG is forecasting which so far are only $12 million.

This change also effectively lowered gross margin by reducing sales. In the past, the advertising would have come at the SG&A level and not impact sales or gross margin. So, Pinnacle saw a 100bp additional hit to gross profit from this change and it will impact total CAG gross margin too and is likely a reason behind the reduced margin guidance. We are not adjusting for this when we discussed the 200bp drop in margins above. Just be aware, this is likely an ongoing item and it will make the margin look even lower and the company is guiding to more brand-building investment. Margin at Pinnacle came in at 14.4% before inventory valuation adjustments. CAG is guiding to 14.6%-14.9% for the fiscal year, which indicates they see Pinnacle results improving likely via cost-cutting offsetting weakness in sales and gross margin. Given the sales trends and gross margin issues – we would consider that forecast aggressive.

The company would not be pinned down much on repeated questions trying to see how lower Pinnacle sales could fall before they start to rise nor would they comment on margins beyond next quarter. The 10-Q is not available yet and the company is promising to give more color on synergies in April at the Investor Day.

Healthcare Services Group (HCSG) – 10K Released

We maintain our SELL recommendation on HCSG after seeing the 10-K. The SEC issues appear to have legs and that investigation is ongoing even though HCSG completed its own internal review. The credit quality of receivables is falling rapidly with 26% of the gross receivables outstanding to clients in bankruptcy or other litigation or financial distress. Despite management's continued claims that it is speeding up collections – receivables are up as sales growth turned negative. Some may view the EPS as impaired given a huge surge in bad debt expense in 2018. Even adding a good portion of that back, the P/E here would still be about 23 with no signs of growth and other potential headwinds. We urge readers to refer back to our February 7, 2019 initial review of the 4Q18 where we list several one-time items that helped EPS, which likely came in about 28-cents rather than the reported 42-cents.

- **The focus of the SEC is looking at HCSG's rounding of EPS in its reported results. Looking at six years of quarterly reporting, HCSG routinely rounded up 0.4-0.5 cents per quarter.** This resulted in a situation where annual EPS was often 2-cents lower than the sum of the four quarters EPS. This investigation is still ongoing.

- **Credit quality is still declining. HCSG recorded a $51 million charge to bad debt in 2018, which dwarfs prior years of $2-4 million.** It also saw a surge of receivables moved to long-term notes receivable and the first time HCSG booked a bad debt allowance there. **Yet, the receivables outstanding to troubled customers is still more than twice the total allowance. Troubled receivables rose almost 400% last year.**

- **The receivable balance is growing! We needed the 10-K to get data HCSG does not provide in its earnings release. We found that despite claiming that during 2018, the company moved one-third of its customers to a payment schedule of multiple times per month, receivables are still higher now than 2017 and sales have now turned down. DSO's are at an all-time high at 81 days.** We estimate that if the payment speed has picked up, A/R should have fallen by about $100 million not risen by $36 million.

- **There is still no growth here for despite a growth valuation of the stock after the drop to $33. The customer totals remain flat, sale growth has turned negative and should**

fall for dietary going forward. Tax cuts fueled EPS growth in 2018 and should be an 8-cent headwind in 2019.

- **HCSG has also reported that it lacked the manager numbers to grow and has been correcting that in 2018. Manager totals are down slightly from 2017** and employees are flat. They don't offer many perks and without adding new accounts would have a tough time offering advancement. We believe the tight labor market and the structure of HCSG's business of hiring people that come with a WOTC tax shield for earnings ensure some heavy churn.

The SEC Investigation Continues

The company delayed filing its 10-K report as it conducted its own internal investigation on its EPS calculations. The SEC's investigation is still ongoing. This is a company that has had several rounding issues in reporting higher EPS growth. The rounding up streak suddenly ended when the SEC started asking questions in late 2017:

4Q EPS	2018	2017	2016	2015	2014	2013
Reported EPS	$0.42	$0.27	$0.28	$0.13	$0.22	$0.08
Non-Rounded EPS	$0.423	**$0.270**	$0.276	$0.125	$0.216	$0.077

3Q EPS	2018	2017	2016	2015	2014	2013
Reported EPS	$0.35	$0.31	$0.27	$0.24	-$0.31	$0.20
Non-Rounded EPS	$0.350	**$0.315**	$0.268	$0.235	-$0.314	$0.196

2Q EPS	2018	2017	2016	2015	2014	2013
Reported EPS	$0.35	$0.30	$0.26	$0.23	$0.20	$0.19
Non-Rounded EPS	$0.347	$0.304	$0.256	$0.225	$0.196	$0.186

1Q EPS	2018	2017	2016	2015	2014	2013
Reported EPS	$0.00	$0.30	$0.26	$0.22	$0.21	$0.22
Non-Rounded EPS	$0.001	$0.298	$0.255	$0.215	$0.206	$0.218

This is a company that was accustomed to beating by a penny and having a high P/E ratio. Look at how often they rounded up 0.4-0.5 cents in a given quarter to report higher EPS. Suddenly in 3Q 2017, they rounded 31.5 cents DOWN to 31-cents as the SEC asked questions.

We think there's another issue too. If you add up the four reported quarterly EPS totals for each year – it has routinely been 2-full cents higher than the reported 12-month EPS. For

example, in 2016 – Quarterly EPS was reported as 26 cents, 26 cents, 27 cents and 28 cents. Adding that up, annual EPS should be $1.07. However, because HCSG rounded up every quarter, dividing the full year's income by shares one time resulted in reported 2016 annual EPS of only $1.05.

Annual	2018	2017	2016	2015	2014	2013
Add EPS for Q's 1-4	$1.12	$1.18	$1.07	$0.82	$0.32	$0.69
HCSG reported EPS	$1.12	$1.19	$1.05	$0.80	$0.31	$0.67
HCSG Non Rounded	$1.119	$1.187	$1.053	$0.800	$0.306	$0.673

We shall see how this turns out or if there are more issues being looked at by the SEC. In the 10-K, HCSG is showing the reported annual EPS figures in Item 6 – the 5-year summary of results. The math is correct on that figure, it just does not match up with the rounded quarterly EPS totals reported throughout several years.

Credit Quality of Receivables Is Growing More Suspect

HCSG does not fully report the various data points needed to review receivables in its press releases and we need to wait for SEC documents. The picture is getting uglier. First, the clients in financial trouble are rising:

$ in mm	2018	2017	2016
A/R from clients in BK/Lit	$115.7	$30.0	$15.9
Bad Debt Exp.	$51.4	$6.3	$4.6
Write-offs	$6.2	$1.2	$2.3
Bad Debt Allowance	$57.2	$12.0	$6.9

HCSG has always said that clients in trouble are a small percentage – yet saw a surge in receivables in bankruptcy, litigation, or otherwise in financial difficulty to over $115 million. It claims that when a client falls behind, HCSG converts their Accounts Receivable to a Long Term Notes Receivable and then charges interest income that is booked when cash is received. The amount of troubled receivables is much larger than the number reclassified as Notes Receivable:

$ in mm	4Q18	3Q18	2Q18	1Q18	4Q17
Notes Receivable	$53.0	$55.9	$37.4	$38.8	$15.5
Allowance	$10.0	$10.0	$0.0	$0.0	$0.0
Net Notes Rec.	$43.0	$45.9	$37.4	$38.8	$15.5

Only 46% of the receivables in trouble have become Notes Receivable. We believe that a customer who falls behind in payments is unlikely to see business improve enough to pay new receivables and older notes. In our opinion, the Notes should have had a substantial allowance from the start, but only in the last two quarters has HCSG recognized a loss allowance against these Notes. The key point is we do not believe the bad debt expense is going to decline going forward. With troubled receivables rising almost 400% in 2018, the allowance for bad debt reserves could still increase in 2019.

Receivables Are Not Falling

The company has been touting its faster collections process. They claim to have moved over one-third of clients to a shorter payment cycle that is less than 30 days. It claims many are paying in 7 and 14 days. If that is the case, receivables should be falling noticeably, and they are not:

$ in mm	4Q18	3Q18	2Q18	1Q18	4Q17
Gross A/R	$389.0	$392.1	$393.4	$383.9	$390.7
Allowance	$47.2	$38.6	$49.7	$48.9	$12.0
Net A/R	$341.8	$353.5	$343.7	$335.0	$378.7
Notes Rec.	$53.0	$55.9	$37.4	$38.8	$15.5
Allowance	$10.0	$10.0	$0.0	$0.0	$0.0
Net Notes	$43.0	$45.9	$37.4	$38.8	$15.5
Total Gross A/R	**$442.0**	**$448.0**	**$430.8**	**$422.7**	**$406.2**
Total Net	$384.8	$399.4	$381.1	$373.8	$394.2

Total gross receivables are up $36 million in 2018 after a year speeding up collections. At the same time, sales are down – coming in at $496.4 million in 4Q18 vs. $499.4 million in 4Q17.

Naturally, the DSOs are still increasing too and sit at a record level of over 80 days.

	4Q18	3Q18	2Q18	1Q18	4Q17
Gross A/R	$442.0	$448.0	$430.0	$422.7	$406.2
DSO	81.0	80.4	77.7	76.7	74.0

We pointed out in our original report that since 2000, the DSOs have been 50-60 days for most years other than when they topped 75 days in 2000, 68 in 2002, 65 in 2016 and 77 in

2017. 81 is the highest we have seen. But, remember, HCSG is accelerating collections according to management.

The only way to get it lower is to ignore the total moved to Notes Receivable and focus only on Net Current A/R after subtracting the growing allowance – even then it would remain far above the average:

	4Q18	3Q18	2Q18	1Q18	4Q17
Net A/R and Notes	$384.8	$399.4	$381.1	$373.8	$394.2
DSO	70.5	71.7	68.9	67.8	71.8
Net current A/R	$341.8	$332.9	$321.7	$312.9	$357.6
Notes Rec.	62.7	59.8	58.1	56.7	65.2

Even after boosting allowances from 12.0 million in 4Q17 to $57.2 million in 4Q18 to reduce the net receivables, the DSOs on net A/R and Notes would still be near a record high at over 70 days. Only when taking out all allowances and moving another $37.5 million out of current to Notes Receivable does the DSO fall much at all by 2.5 days. It has also been rising every quarter throughout 2018 and would remain above the historical range for gross receivable DSOs. So, we see no evidence that the company has successfully sped up collections.

But, let's try one last method. We'll take the gross receivables and notes from 4Q17 $406.2 million and subtract $30.0 million of clients in bankruptcy/litigation for $376.2 million. That would be a DSO of 69.6 on the rest of the non-troubled receivables.

Now, by 4Q18, the company says that one-third of customers are paying multiple times per month. Of the 376.2 million, one-third is $125.4 million. Let's cut the DSOs for that one-third to 12 days. That would mean that $125.4 million should decline to $21.6 million. We should be seeing evidence that receivables are down by at least $100 million between 4Q17 and 4Q18. It's not here. Receivables are up!

Let's subtract the full surge of bankrupt/litigation accounts of $115.7 from the $448.0 in gross receivables for $332.3 million in current accounts. It declined $43.9 million from $376.2 in current accounts at 4Q17. That's still less than half what we should be seeing and likely the huge increase in problem accounts still skewed that favorably like when HCSG touts falling DSOs because they wrote-off receivables. The last way to look at this would be to say that the faster-paying accounts are still one-third of receivables after subtracting the problem accounts. That would show a decline from $125.4 million to $110.7 million –

basically $15 million. Again, far short of the $100 million that should be closer to reality if one-third of accounts are being collected multiple times a month in 2018 vs 2017.

We also know that A/R was helped in 2018 by pushing the costs of food on the Genesis contract back to the customer. Genesis will now buy the food directly and HCSG will provide the labor. It is expected to reduce sales by $20 million per quarter, which should be about $3 million every two weeks in lower A/R and should be reflected by the end of 4Q18.

The still sizeable and rising receivable total continues to be a drag on cash flow. Three years ago, as DSOs really took off and broke out of the 50-60 day range – cash from operations began to lag net income:

	2018	2017	2016	2015	2014
Net Income	$83.5	$88.2	$77.4	$58.0	$21.9
CFO	$80.0	$7.6	$41.4	$63.6	$57.7
A/R drag	-$44.4	-$121.6	-$65.6	-$18.9	-$13.5

Depreciation is essentially a $7-9 million benefit for cash flow from operations. In 2018, the company even had a non-cash charge of $51.4 million for bad debt expense that gets added back to cash flow and HCSG still couldn't get CFO above Net Income.

The Is Still No Growth Here

HCSG is considered a growth business because of the aging of America. We have noted that many of the senior housing operators are reporting weak occupancy and the general view is that supply exceeds demand and that should be the case for many more years. The stock has dropped from $55 to $33 and yet the P/E ratio is still 30 based on the $1.12 in EPS in 2018. Last year, EPS was hurt by the $51 million bad debt expense. Every $10 million that does not recur would add about 10-cents back to EPS. If investors want to argue that $30 million of bad debt expense won't recur – then EPS is $1.42, and the P/E is still 23. We still think 2019 could see a large bad debt expense because the receivables to troubled customers rose 400% in 2018 and the reserve on Notes Receivable, which represent customers who already announced they can't pay is only 19%.

Customer totals remain flat:

Clients	2018	2017	2016	2015	2014
House Keeping	3500	3500	3500	3500	3500
Dietary	1500	1500	1000	1000	900

The company has not added any new customers in years and we believe its surge in dietary in 2017 was owed to HCSG giving customers extended payment terms and essentially a 2-month loan. That growth has vanished too. We know HCSG wants to be valued as a growth stock and when we see the flat customer totals – we understand more why the company does not fire customers and keeps trying to extend them credit despite a rising problem in payments. If there is a day of reckoning where clients leave as they liquidate or are acquired by another group that does not outsource housekeeping and meal service – what is HCSG going to do? They already have 95% of the outsourced market. Perhaps the outsourced market may be shrinking if larger firms take over more of these retirement homes.

The company has now lapped the increase in customers who added dietary food preparation to their contract and revenue growth has vanished:

	4Q18	4Q17	3Q18	3Q17
Total Revenues	$496.4	$499.4	$506.9	$491.4
Housekeeping	$239.7	$245.0	$242.2	$247.4
Dietary	$256.8	$253.5	$264.7	$244.0

Housekeeping revenue has been lower y/y the last two quarters. Dietary was essentially flat in 4Q18 and had only a $7 million hit from switching food costs back to Genesis. Going forward, that will be a $20 million negative to quarterly Dietary revenue. We see negative revenue growth going forward at this point.

The tax cuts helped drive EPS in recent years too. The company's tax rate had been 34%-36% in prior years, dropped to 16.4% in 2018 and is expected to be 21%-23% in 2019 going forward. So that change has run its course in our view as a source of earnings growth. Simply bouncing to a 22% rate this year is an 8-cent headwind on EPS.

Other Earnings Headwinds

HCSG has said repeatedly that it has a labor problem. It wants to grow its customer base but lacks enough trained managers and employees to do this. They assured investors that

it has been changing this situation in 2018 and has been adding more staff. The 10-K shows little evidence of a change here:

	2018	2017	2016	2015	2014
Hourly Employees	48,400	48,300	43,100	37,300	37,100
Managers	6,600	6,700	5,800	8,600	8,600

Both employees and manager levels are flat. Manager levels remain far below levels seen in 2014 and 2015 when the company had one-third fewer food-prep clients. They aren't growing the number of clients so the only way a manager can advance is through having other managers quit. HCSG does not match 401(k) plan contributions. Employees can receive some stock-based incentive pay if they hit goals and remain, but the stock has gone from $55 to $33 and we've seen that drive many people out of tech companies as they can't rely on the stock rising to $100 vs. their option strikes at $40. HCSG wants a 14% margin at both units and blames weakness at dietary on the surge of 500 new contracts in 2017 – but it wasn't close to that goal in 2016 either or 2018:

	2018	2017	2016
Dietary Margin	8.4%	7.3%	8.2%

So, are managers getting bonus pay here? On top of that, the labor market is tight, so the managers have other options available.

The hourly employees are likely to churn rapidly also. They have a tight labor market helping them. More importantly, HCSG likes to hire people who come with a tax credit (WOTC – Work Opportunity Tax Credit). This incentive for employers to hire people recently out of prison, chronically unemployed, past military personnel only lasts for two years. HCSG has an incentive to let them leave and find the next person who will have some of their pay offset by the tax credit. High churn among employees also does not attract managers as easily in our view.

By the company's own admission for over a year – it needs to hire and train more managers. If they do that, it would seem they would be unproductive and duplicate wages for a period of time as they learn and study under an experienced manager. If that happens, that's a headwind on wages. If they don't do that, the lack of managers is a headwind on growth.

HCSG self-insures for workman's comp expense for accidents on the job. It has been cutting this cost noticeably in recent years which it attributes to better training, better emphasis on prevention, and being more proactive in dealing with claims. Since 2014, this has added 360bp to margin:

	2018	2017	2016	2015	2014
Self-Insurance % Sales	1.9%	2.4%	3.0%	3.4%	5.5%

This looks like another catch-22 situation. Even HCSG believes that its primary source of growth will be converting more clients to add food preparation to the contact. Knives, stoves, hot coffee, walking among many people with hands full – this sounds like an area likely to see more claims, not fewer. Also, add in more new managers and high churn of hourly employees. So, if they grow at all, this cost could become a headwind. If they don't grow, employee and manager churn may rise further and still hurt this metric. 1% of sales in this area is 21-cents in EPS.

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