BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Contents

AT&T (T) 2Q19 Update
Maintain BUY

For over a year now, **AT&T (T -$33.80)** has been hit with negative news related to debt levels surrounding the Time-Warner acquisition and weakness in its TV operation. The company reported considerable progress on both fronts as well as other areas of the company that many investors have been ignoring in the last year.

We maintain our BUY recommendation even after yesterday's pop. The dividend yield is still 6% and well covered. Plus, the stock remains cheap at 9.5x trailing EPS, 6.7x trailing EBITDA, with several areas still pointing to growth in EPS and EBITDA for several years. The company hit EPS targets of $0.89 for 2Q19 and that was with the tax rate coming in higher than expected and cutting EPS by $0.02.

- **Debt targets are likely to be hit.** The Time Warner deal boosted Debt/EBITDA to 3.0x and the market has been skeptical of AT&T cutting it to 2.5x by the end of 2019.

After asset sales and improved cash flow, the company looks like it will comfortably reach that goal.

- **$9-$12 billion in debt reduction for 2H19 should be covered by multiple asset sales that are currently being worked on and over $6 billion in free cash flow after the dividend that should come in during 3Q and 4Q.** There is a potential for cash flow to come in higher based on current trends as well. EBITDA above $60 billion also would reduce the amount of debt needed to be paid down to hit a 2.5x target.

- **AT&T is discussing that share repurchases could start in 2019. After this year, the focus on debt reduction will be less intense and should allow repurchases regardless.** Capital spending should also decline as the 5G and FirstNet buildout is completed allowing free cash flow to rise. AT&T sees buying stock at a 6% post-tax dividend cost of capital as an attractive use of cash versus retiring 4%-5% pre-tax debt and investors will likely see some balance in capital allocation to those areas.

- **The TV unit is hitting forecasts of stabilizing EBITDA for early 2019. AT&T has allowed lower paying customers to churn off while retaining others at higher fees.** With half of the 2 million customers seeing an end to their discount fee lock-ups already, AT&T has actually started to grow EBITDA again in this area on fewer customers. Another million customers will be in a position to renew or leave in the 2H of 2019. **Wild cards remain regarding that next million customers and the success of the streaming network's rollout. We think investors should remain focused on the wireless side and less on TV as it is only about 7% of total EBITDA.**

- **Many other catalysts point to growth for EBITDA, FCF, and EPS. FirstNet and 5G are rolling out and should be nationwide during 2020. As it is completed, capital spending should fall and boost FCF for share repurchases and debt retirement.** It also opens AT&T up to millions of First Responders and their families as new customers. Currently, the company is not charging for the higher speeds of 5G Evolution, it should be able to boost fees as 5G turns on and drive growth at its largest unit.

Debt Targets Appear Likely to Be Met and Possibly Exceeded

The Time-Warner deal pushed the Debt to EBITDA ratio to 3.0x. Investors were skeptical that AT&T could reduce debt to 2.5x by the end of 2019 – a $30 billion reduction. Moreover, the concern was share repurchases would be off the table.

Flash forward to 2Q19, the debt reduction has already been $18 billion leaving only about $12 billion to go. EBITDA has increased too, which would allow the debt figure to remain higher than $150 billion and still hit 2.5x EBITDA. We think AT&T could declare victory if debt fell by $9-$10 billion in 2H19, but the $12 billion figure looks more than doable.

The company raised 2019 free cash flow guidance from $26 billion to $28 billion. Much of that increase is due to securitizing acquired Warner Media receivables in the 2Q19. That source of cash will not recur but has already been achieved. It is holding capital spending forecasts the same $23 billion, which excludes $1 billion from reimbursement from the FirstNet project and does assume vendor financing. So here is a 2H forecast vs 1H realized cash flow:

Cash Flow	2019e	2H 2019e	1H 2019
FCF	$28.0	$13.5	$14.5
Dividend	$14.8	$7.4	$7.4
Avail for Debt	$13.2	$6.1	$7.1

Even without another receivable securitization, the remaining capital spending is a bit lower ($12.6 billion in the 1H19 leaves $10.4 billion for 2H19), so AT&T should produce close to the same FCF in the 2H as 1H. Guidance has been that asset sales of $6-$8 billion would be achieved and $4 billion already has. The company has several more assets such as real estate, 2,300 cell towers, and investments to sell. It also believes it can find a bit more from working capital. Also, they think free cash flow could come in closer to $29 billion as well. Thus, it looks like $6 billion more debt will be paid down via free cash flow. Another $1.0-$1.5 billion could come from cash flow exceeding forecasts. Another $2-$4 billion could come from asset sales. Also, EBITDA appears likely to come in above $60 billion. It's been above $15 billion for 3 of the last 4 quarters and the one that came in below was $14.8 billion.

In summary, AT&T likely needs to retire another $9-$12 billion in debt in the 2H of 2019. It should get over $6 billion from Free Cash Flow. It hinted that the FCF forecast is likely light and it as much as $4 billion more of asset sales in the works.

Buying Shares Also Likely to Begin Earlier than Forecast

After 2019, the company has stated that over several more years, it wants to return the debt/EBITDA ratio to 2.0-2.2x. EBITDA should be growing during that time and debt would likely fall another $10-$20 billion by 2022-23.

Assuming $5-$7 billion of annual debt retirement, that should be easy to achieve looking at FCF less the dividend that is already at about $13 billion annually. On top of that, the capital spending has been elevated as AT&T rolled out the FirstNet network and built out the infrastructure for 5G at the same time. So capital spending levels should be falling off and boosting FCF by several billion dollars per year.

Thus, yesterday the company talked about using excess cash flow after the dividend and meeting debt ratio targets to repurchase shares. John Stephens the CFO mentioned this twice:

> *"Looking at the remainder of the year, we're confident that we'll hit our year-end leverage target.* ***To the extent, we can overachieve with that target you can expect will take a hard look at allocating capital to share buybacks in the back half of the year****."*
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> *"With regard to the balance sheet, I think, if you can think about as we talked about after – the fourth year after the close of the deal. We look to be – I'd expect, we'd be somewhere around the 2.0 range or below that gives us great flexibility to pay down debt and take advantage of what now is a higher cash cost of equity capital than the cash cost of our debt capital. So, when you look at out of very methodical basis, right now,* ***the cash flows of the overall operation on an after dividend basis can be enhanced by shifting some of your focus from debt repayment to buyback****."*

The TV Unit Is Hitting Targets But Still has Wildcards

We still think far too much emphasis at AT&T is on the TV unit which is only about 7% of EBITDA. However, investors focus on it and that is unlikely to change in the immediate future. Guidance was for stability to be achieved in 2019 and the results are now showing that. This has been generated by having 2 million customers on lower-priced deals roll-over with churn eliminating some, but others remaining at higher rates.

Ent. Unit	2Q19	1Q19	4Q18	3Q18	2Q18
Premium TV subs	22.9	23.9	24.5	25.1	25.4
OTT TV subs	1.3	1.5	1.6	1.9	1.8
Premium ARPU	$117.49	$114.98	$121.76	$114.90	$112.90
Ent. Rev	$11.4	$11.3	$12.0	$11.6	$11.5
Ent. EBITDA	$2.9	$2.8	$2.2	$2.4	$2.8

The DirecTV Now business is the OTT. It has been losing customers as cheap deal rolls off and not all customers renew at the higher rates. The premium TV has been seeing the same situation and another 1 million subscribers will see cheaper deals expire through the end of 2019. The company and expectations point to more customer decay in terms of number of subscribers. However, the belief is the higher ARPU will become more evident and hold profitability at these levels.

There is more going on here such as disputes with CBS which has several stations turned off on the various forms of DirecTV at this time. AT&T does not see much difference between the offers between the two companies and expects that to be resolved quickly. Another dispute with Nexstar involves carrying local channels in some markets. Nextstar wants a 100% increase in fees that AT&T is not willing to pay. People have work-arounds to receive those channels as they are available for free as over the air deliveries. That dispute does not sound close to being resolved at all as more customers deal with a "stay at a higher fee" decision during the rest of 2019.

Another wildcard is the AT&T streaming product that rolls out as a beta test in a few markets in the coming months and will roll out heavily in 2020. There are no numbers to really go on to evaluate this at the moment, other than to say streaming is becoming a very crowded area and content delivery will vary widely among the various providers. The sheer number of players could make customers more likely to shop around and change providers more frequently. It could also cause more to stick with current systems longer too.

What AT&T has found is that it is much more likely to win and retain customers when it can bundle wireless service and high-speed broadband with TV options. Given that it has faster wireless speeds now with 5G Evolution and will have 5G expanding in 2020 and beyond along with a sizeable broadband footprint and content via HBO and the rest of Warner – it should have some good selling points to make.

At this point we are going to simply say that AT&T is now reaching its goals in entertainment after an ugly 4Q18 and 3Q18. The wild cards related to churn and new product roll-out may have to be experienced for a couple quarters before determining a trend. Also, investors should keep in mind, Broadband is a larger part of Entertainment's EBITDA than TV. Of AT&T's total EBITDA above $60 billion – TV is about 7% of that. Thus, positive or negative – TV shouldn't be viewed as the key business, but it continually gets an overweighting in investor sentiment. The WSJ's headline on the quarter about 2Q19 results was about TV subscriber figures falling for example.

The Bigger Catalysts Should Start Turning On in 2020 and 2021

Beyond hitting the debt reduction targets and starting to repurchase stock at under 10x EPS. We believe there remain some sizeable catalysts here:

1) Capital spending has been elevated with the simultaneous rollout of the FirstNet and 5G infrastructure in the last two years. They are currently about 60% built out and are 9-months ahead of schedule. They expect to be 70% complete by the of this year and have nationwide coverage in the summer of 2020. The capital spending figure may start to decline by several billion dollars next year. That will enhance free cash flow and fuel more debt reduction, share repurchases, and/or dividend growth.

2) FirstNet enables them to add more wireless customers. They started with a low penetration into that market. They should become the largest provider to that area which has 3 million potential new people and are only now starting to see that grow. Some of those will have multiple phones/tablets to enroll. Add to that, second-tier emergency people such as people who restore power in a storm, relocate hospital patients, engage back-up systems for utilities, hospitals, government offices – that is 8 million more people that will have access to the FirstNet system. Then, AT&T can offer plans to the families of those users too. There is a fairly sizable base of new wireless customers from FirstNet that should be driving growth in the coming years.

3) 5G Evolution is up and running in many markets now. Customers with newer iPhones and Samsung phones are already seeing much faster speeds. That should

help hold back churn and lower customer acquisition costs. Actual 5G starts rolling out shortly. AT&T will be in a position to start offering faster speeds and charging for it. Wireless is by far AT&T's largest source of EBITDA at essentially half the total. They should be in a position to add customers from FirstNet and raise ARPU in this area. ARPU is essentially $50-55/post-paid customer per month. That's 76 million people. If they can add to the 76 million and add a few dollars of ARPU with 5G – that is growth that adds up quickly.

4) As the build-out is completed, much more of the remaining process requires software rather than hardware installation. The capital needs and cash operating costs should fall on a per unit basis as the revenue stream per new user is increasing.

We still look at this as the stock is under 10x EPS and 7x EBITDA paying 6% in cash to wait and compensate for wildcard news on one of the smallest parts of the AT&T business – TV. Current growth is for single-digit EPS growth, but that should accelerate with the new FirstNet and 5G operations gaining customers and revenue/user. Debt/EBITDA goals are being met and the ratio should continue to fall as EBITDA rises and FCF increases to reduce debt further, plus the company is focusing on future share buybacks of a cheap stock. If EPS grows with acceleration of the wireless unit and share repurchases, the P/E ratio should probably also rise.

Snap-on Inc. (SNA) – Update
Maintain SELL

Snap-On's (SNA-$154.11) 6/19 adjusted EPS beat the consensus by a penny. However, we continue to see warning signs in the company's results.

- Contract receivables days of Tool Group sales rose by 5.6 over the year-ago quarter. These balances include financing to franchisees to fund, among other things, purchases of tools from SNA. Past due contract receivables as a percentage of the total fell to 0.83% compared to 1.51% a year ago and essentially flat with the previous quarter. However, the charge-off rate jumped by 11 basis points which helped keep the past-due amount in the quarter down.

- While management noted that finance receivable originations declined due to lower big-ticket sales, days of total sales jumped by 5 versus the year-ago quarter. Past due finance receivables remained stable, but lower provision expense added about 2.3 cps to EPS.

- Inventory days continued to climb, jumping 8 days over the 6/18 quarter. Management blamed the rising inventories on multiple factors including new product introductions, increased project-based activity, and striving to improve service levels. However, the current DSI level in the 140 range has risen steadily from the low 100s seen in 2016. While tools to do not spoil and are not subject rapid obsolescence, we remain concerned that the buildup could lead to reduced production levels which could hurt margins in the future. We also note that the company utilizes FIFO inventory for about 61% of its total inventories and about 35% of US inventories. This makes us less concerned that results are artificially benefitting from expensing older, lower-cost inventory in recent periods.

- Lower pension expense added 3.2 cps to EPS in the quarter due to higher expected return on plan assets and lower amortization of prior loss.

- Lower amortization of intangibles added about 1.4 cps to EPS in the quarter. Gross internally developed software dropped significantly in the 12/18 quarter with a like decline in accumulated amortization although we saw no mention of an impairment or divestiture. At the same time, the average estimated life for internally developed software rose from 4 years to 6 years. The sudden jump in average lives makes it appear as if the company is using a significantly longer amortization period for its more recent internally developed software investments which would provide a mild boost to EPS. For perspective, $160 million of internally developed software amortized over 6 years amounts to $26.6 million in annual amortization expense while the same balance amortized over 4 years results in $40 million in expense.

Contract Receivable Days Still Rising

Contract receivables continued to climb on a days of Tool Group sales basis in the 6/19 quarter, rising 5.6 days over the year-ago quarter. As has been the trend, the increase was centered in long-term contract receivables which can be seen in the following table:

	6/29/2019	3/30/2019	12/29/2018	9/29/2018
Snap-on Tools Groups Sales	$405.8	$410.2	$407.4	$389.8
ST Contract Receivables	$91.5	$92.9	$98.3	$105.6
ST Contract Days	20.6	20.7	22.0	24.7
LT Contract Receivables	$347.5	$345.1	$344.9	$338.1
LT Contract Days	78.1	76.8	77.3	79.1
Total Contract Receivables	439.0	438.0	443.2	443.7
Total Contract Receivables Days	98.7	97.4	99.3	103.9

	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Snap-on Tools Groups Sales	$411.9	$404.7	$409.2	$392.7
ST Contract Receivables	$87.6	$92.0	$96.8	$99.8
ST Contract Days	19.4	20.7	21.6	23.2
LT Contract Receivables	$332.6	$326.1	$322.6	$310.4
LT Contract Days	73.7	73.5	71.9	72.1
Total Contract Receivables	420.2	418.1	419.4	410.2
Total Contract Receivables Days	93.1	94.3	93.5	95.3

Contract receivables include some financing to independent customers, but a large part includes business financing for the company's franchisees to fund, among other things, purchases of inventory from SNA. Below is the company's definition of contract receivables from its 10-K:

> *"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****."*

Therefore, we view increases in the extension of contract receivables as the company essentially financing its own sales. The average yield on these receivables was 9.1% during the quarter.

Below, we can see that the percentage of total past-due contract receivables was essentially flat sequentially and were substantially down from the year-ago level:

Contract Receivables	6/29/2019	3/30/2019	12/29/2018	9/29/2018
30-59 days past due	0.29%	0.29%	0.38%	0.40%
60-90 days past due	0.23%	0.20%	0.27%	0.31%
>90 days past due	0.32%	0.32%	1.16%	0.85%
Total past due	0.83%	0.81%	1.81%	1.56%
>90 Days and Still Accruing	0.07%	0.09%	0.04%	0.04%

Contract Receivables	6/30/2018	3/31/2018	12/30/2017	9/30/2017
30-59 days past due	0.47%	0.38%	0.28%	0.34%
60-90 days past due	0.21%	0.21%	0.14%	0.17%
>90 days past due	0.82%	0.57%	0.45%	0.41%
Total past due	1.51%	1.16%	0.87%	0.91%
>90 Days and Still Accruing	0.05%	0.09%	0.14%	0.14%

However, the company significantly ramped up its charge-off activity during the quarter. The charge-off rate essentially doubled from a year ago and was a significant increase compared to the previous three quarters as well, which can be seen in the following table:

Contract Receivables	6/29/2019	3/30/2019	12/29/2018	9/29/2018
Charge-Off Rate	-0.23%	-0.16%	-0.16%	-0.16%
Recovery Rate	0.05%	0.02%	0.02%	0.02%
Net Loss Rate	-0.18%	-0.14%	-0.13%	-0.13%

Contract Receivables	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Charge-Off Rate	-0.12%	-0.14%	-0.14%	-0.17%
Recovery Rate	0.02%	0.02%	0.02%	0.05%
Net Loss Rate	-0.09%	-0.12%	-0.12%	-0.12%

The increase in charge-offs would have made the past due data look better as these receivables would have certainly been counted as past-due if they had not been written off. If we add back the 11 basis point year-over-year increase in the charge-off rate to the 0.83% -total past due figure in the 6/19 quarter, get an adjusted past-due rate of approximately 0.94%, still a marked improvement over the 1.51% from a year ago, but a noticeable deterioration from the 0.83% posted in the 3/19 quarter.

We can see below that the provision for bad debt expense doubled in the quarter while the allowance for uncollectible contract receivables remained essentially flat.

	6/29/2019	3/30/2019	12/29/2018	9/29/2018
Contract Receivables Allowance %	1.06%	0.97%	1.03%	1.07%
Provision for Bad Debt Expense	$1.2	$0.9	$0.5	$0.4

	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Contract Receivables Allowance %	1.08%	1.09%	1.20%	1.16%
Provision for Bad Debt Expense	$0.6	$0.5	$0.0	$0.8

Finance Receivables Days Rising Despite Lower Originations

SNA's finance receivables installment loans mostly to external customers rather than loans for franchisees. Keep in mind that the yield on these receivables averaged over 17% in the quarter, so these customers likely have very little other access to credit to make the purchases.

Consider the company's description of its finance receivables contracts from the 10-K:

"Snap-on's finance receivables are comprised of extended-term installment payment contracts to both technicians and independent shop owners."

Management has emphasized that originations have been down which it largely attributed to slower big-ticket sales in the period:

"Total loan originations of $263.4 million decreased $12.7 million or 4.6%, primarily due to decrease in originations of finance receivables resulting from lower year-over-year Snap-on Tools Group sales of big-ticket items."

However, finance receivables continue to rise on a days sales basis as seen in the following table:

	6/29/2019	3/30/2019	12/29/2018	9/29/2018
Sales	$951.3	$921.7	$952.5	$898.1
ST Finance Receivables	$529.0	$525.9	$518.5	$519.0
ST Finance Receivables Days	50.7	52.1	49.7	52.7
LT Finance Receivables	$1,089.0	$1,077.1	$1,074.4	$1,058.3
LT Finance Receivables Days	104.5	106.6	102.9	107.5

	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Sales	$954.6	$935.5	$974.6	$903.8
ST Finance Receivables	$514.4	$512.2	$505.4	$505.8
ST Finance Receivables Days	49.2	50.0	47.3	51.1
LT Finance Receivables	$1,051.3	$1,035.9	$1,039.2	$1,018.6
LT Finance Receivables Days	100.5	101.0	97.3	102.8

We can see that total finance receivables days for the 6/19 quarter increased by 5 days over the year-ago quarter, so while originations may have stalled due to lower sales, the overall balance of receivables continues to outgrow revenues.

Meanwhile, credit metrics for the finance receivables portfolio continues to show improvement as past-due finance receivables remained stable:

Finance Receivables	6/29/2019	3/30/2019	12/29/2018	9/29/2018
30-59 days past due	0.95%	0.85%	1.17%	1.08%
60-90 days past due	0.61%	0.58%	0.73%	0.74%
>90 days past due	0.97%	1.17%	1.23%	1.19%
Total past due	2.53%	2.60%	3.13%	3.00%
>90 Days and Still Accruing	0.75%	0.90%	0.96%	0.94%

Finance Receivables	6/30/2018	3/31/2018	12/30/2017	9/30/2017
30-59 days past due	1.04%	0.82%	1.21%	1.01%
60-90 days past due	0.65%	0.62%	0.87%	0.73%
>90 days past due	1.00%	1.25%	1.26%	1.22%
Total past due	2.69%	2.70%	3.33%	2.97%
>90 Days and Still Accruing	0.76%	0.98%	0.96%	0.98%

..while charge offs slightly declined and allowances were flat:

Finance Receivables	6/29/2019	3/30/2019	12/29/2018	9/29/2018
Charge-Off Rate	-0.83%	-0.90%	-0.95%	-0.81%
Recovery Rate	0.12%	0.12%	0.11%	0.10%
Net Loss Rate	-0.71%	-0.78%	-0.84%	-0.71%

Finance Receivables	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Charge-Off Rate	-0.90%	-0.98%	-0.96%	-0.80%
Recovery Rate	0.10%	0.12%	0.11%	0.10%
Net Loss Rate	-0.79%	-0.87%	-0.85%	-0.70%

	6/29/2019	3/30/2019	12/29/2018	9/29/2018
Finance Receivables Allowance %	3.63%	3.67%	3.71%	3.64%

	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Finance Receivables Allowance %	3.63%	3.63%	3.53%	3.43%

The improvement in finance receivable credit metrics led to a decline in provision expense, as shown in the following table:

	6/29/2019	3/30/2019	12/29/2018	9/29/2018
Finance Receivables Allowance %	3.63%	3.67%	3.71%	3.64%
Provision for Bad Debt Expense	$11.9	$12.5	$16.0	$12.1

	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Finance Receivables Allowance %	3.63%	3.63%	3.53%	3.43%
Provision for Bad Debt Expense	$13.6	$15.8	$16.0	$12.8

The $1.7 million year-over-year decline in provision expense added about 2.3 cps to EPS growth in the quarter. While it could be argued that the improved metrics warranted a decline in the provision, we nevertheless view this as a non-operational benefit to earnings growth.

Inventory Is Still Climbing Rapidly

We remain concerned about the company's rising inventory levels which continued into the 6/19 quarter. Inventory days increased by 8.3 days over the year-ago level:

	6/29/2019	3/30/2019	12/29/2018	9/29/2018
Total Inventories	$725.8	$707.0	$673.8	$690.6
COGS	$477.5	$450.1	$495.1	$444.2
DSI	138.7	143.3	124.2	141.9

	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Total Inventories	$668.3	$678.8	$638.8	$649.9
COGS	$467.5	$463.9	$509.0	$455.0
DSI	130.4	133.5	114.5	130.3

In addition, the increase was focused in finished goods, which increased as a percentage of total FIFO value inventories on both a year-over-year basis and sequentially:

	6/29/2019	3/30/2019	12/29/2018	9/29/2018
Finished Goods %	77.2%	76.8%	76.7%	76.2%
Work in Process %	6.7%	7.0%	6.9%	7.0%
Raw Materials %	16.1%	16.2%	16.4%	16.8%

	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Finished Goods %	76.1%	76.5%	75.9%	76.8%
Work in Process %	6.8%	6.7%	6.9%	6.8%
Raw Materials %	17.1%	16.8%	17.2%	16.3%

Management indicated that the increase in inventory was to "support higher levels of demand across critical industries, including demand for U.S. manufactured hand tools, new products as well as to improve service levels to our customers." When asked about the increase on the conference call, management provided more color:

> *"The biggest increase is if you look at our divisions, **the biggest increase is inventory associated with the Snap-on Tools Group, our European-based hand tools operation and industrial.** Those are the ones that have been adding by the way the most, I'd say, across the range of most new products. **We have new product additions, it's certainly one of them. The industrial, more specifically, has been pleasantly engaged in more project-based activity in assembly of kits, and they've been compiling more inventory to service those customers. As an example, the U.S. military being a significant one.***
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> ***And we're trying to improve our service levels,** where when you have such a variety of SKUs that we offer across the board and you're somewhat dealing with an environment where people can use discretion to buy, maybe a little bit of an impulse element in there as well. Last thing you want to do is not being able to meet demand because you don't have the inventory on the shelf. So we are willing to err on the side of having adequate levels of inventory across those broad number of SKUs. And at least you got a couple of product ramp ups that are occurring. So for example, we're developing new leaps in some of our factories, and that requires some ramp-up investment. And our inventories are [indiscernible] as well. We're getting it a little low, we're trying to take advantage of the situation where we can and buy smartly. And that divestments is what drives the -- the operating variance, David, it's about $52 million. If you look year-over-year, you're taking out the effects of currency and acquisitions to give you a number."*

Investors should remember that the inventory on the company's balance sheet represents unsold tools in its warehouses, not the inventory on franchisee trucks which is owned by the franchisee.

We understand the explanation of new product launches and assuring service levels. However, the current DSIs are in the 140 range, but they have steadily increased from the low 100s in 2016. Sales of diagnostic systems and bigger ticket commercial and industrial systems have grown faster in the last few years than the company's flagship mechanics hand tools which could account for some of the increase in the dollar value of inventory. Nevertheless, the buildup in inventory is a concern. These tools do not spoil and are not subject to rapid obsolescence. Nevertheless, the buildup could lead to reduced production levels which could hurt margins in the future.

We also note that the company utilizes FIFO inventory for about 61% of its total inventories and about 35% of US inventories. This makes us less concerned that results are artificially benefitting from expensing older, lower-cost inventory in recent periods.

Lower Pension Expense Adds 3.2 CPS

We note that pension expense fell by $2.3 million during the quarter due to higher expected return on plan assets and lower amortization of prior loss. This added about 3.2 cps to EPS growth in the quarter.

Decline in Amortization Adds About 1.4 CPS

SNA's amortization expense fell by $1 million (1.4 cps) in the 6/19 quarter. While a small boost, it nonetheless accounted for more than 10% of the reported increase in adjusted EPS.

SNA discloses gross balances, accumulated amortization, and weighted average assumed life of each segment of its intangible assets. The following table shows this data for the last five quarters for the internally developed software component of intangibles:

	6/29/2019	3/30/2019	12/29/2018	9/29/2018	6/30/2018
Gross Internally Developed Software	$161.2	$158.0	$156.6	$182.9	$181.1
Accumulated Amortization	$120.3	$117.9	$116.6	$142.9	$139.8
Net Internally Developed Software	$40.9	$40.1	$40.0	$40.0	$41.3
Weighted Average Amortization Period (years)	6	6	5	4	4

We found it interesting that there was a sharp decline in gross internally developed software in the 12/18 quarter offset which was matched by a similar decline in accumulated amortization. At the same time, the weighted average assumed life for internally developed software jumped from 4 years to 6 years. The company did not mention impairments or divestitures which would have accounted for the sudden drop in internally developed software so we are uncertain of the nature of the decline. Regardless, the sudden jump in average lives makes it appear as if the company is using a significantly longer amortization period for its more recent internally developed software investments which would provide a mild boost to EPS. $160 million amortized over 6 years amounts to $26.6 million in annual amortization expense while the same balance amortized over 4 years results in $40 million in expense.

Netflix (NFLX) EQ Update-6/19 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).

NFLX hit a road bump after reporting new subscriber adds in the 6/19 quarter of roughly half of the original forecast. Our earnings quality rating on NFLX does not incorporate a projection of subscriber growth rates or competition but rather on how well current earnings reflect economic reality. The company's disclosures make it difficult to follow trends in estimated useful lives of produced and licensed content which are the single largest factor in determining what earnings the company reports. However, we have the following observations regarding the quarter:

- The nature of the company's business model requires it to make huge upfront cash payments when licensing and producing content while subscription revenue comes in over time. The company has made it clear that it will be "many years" before it is able to report positive free cash flow. As a result, trailing 12-month operating cash flow was a negative $2.85 billion compared to a negative $1.7 billion in the year-ago comparable period.

- NFLX suffered notable title losses during the quarter including losing the license for *Friends* and *The Office* and will soon lose its entire line of Disney content. Management appeared to almost spin this as a positive, implying it will free up cash to spend on its own produced content. However, the push to produced content requires even more upfront cash spending than licensing content which will delay the cash breakeven point even longer. The company's price increases and rising competition will make the stakes even higher for the company to produce its share of its own big hits.

- Marketing expense fell as a percentage of revenue to 12.3% in the 6/19 quarter compared to 15.2% in the 6/18 quarter. Management indicated that this was a timing issue in the supporting of new titles. *Stranger Things 3* was released subsequent to the end of the second quarter along with new international titles the company plans to invest in during the back half of the year. Marketing investment should increase in the second half and we will be concerned if that does not materialize.

Healthcare Services Group (HCSG)
Cancel SELL

After HCSG missed again yesterday on revenues and EPS, we are going to cancel our warning with the stock down from $40 to $23. The market cap is now under $2 billion and 30% of the float is short at this point. We were following it as a supplier to the assisted living market, which is an area we still consider overbuilt and in considerable transition among the industry participants. We're not certain how much value we can still add on HCSG by pointing out that the same problems continue to worsen.

However, we are not predicting a turn-around for this company by any means. It still has an SEC investigation ongoing for past EPS calculations. Nor do we think this can be a growth company based on what the company is touting as the plan of not extending credit to customers. Without credit, we think many customers will simply vacuum their own carpets and prepare their own food. Investors should still be concerned that the stock trades above 20x EPS for negative growth as well as the following problems:

- The tight labor market is likely hurting HCSG more than most companies. It hires the chronically unemployed to get WOTC (Worker Opportunity Tax Credits), but that also sets it up for considerable churn as the tax credits drop in year-2 and normally vanish in year-3. So HCSG has an incentive to replace the workers too. But, people may be tougher to find and pressure labor costs. They have had trouble hitting their labor cost targets and wages have been rising overall in the market already.

- The company has been calling out a lack of managers and higher training costs for those managers continually for several quarters now. In 2Q19, it was $4 million again – which is about 4-cents in EPS. Despite the word "Healthcare" in the company's name, it is vacuuming carpets, dusting, washing sheets, and running a small dining hall in some cases. The skills needed by the manager to oversee this operation shouldn't take 18-months to acquire. We would be skeptical of adding back these training costs as "one-time" items. We think churn within manager ranks is a more likely explanation for why the company wants to hire more.

- HCSG is not growing and has not been in many years in terms of number of customers. It operates in 47 states and has been around for decades. The idea that there are retirement homes that do not know who HCSG is far-fetched in our view.

Most are simply opting to use in-house staff to clean. This also calls into question how many managers HCSG really needs to be training with these "one-time" expenses because the business isn't expanding.

- The company is losing business faster than forecast. When a troubled customer started buying its own food and hired HCSG simply to prepare food, the company pointed out to expect approximately a $20 million y/y decline in revenues. In 2Q19, the drop was $40 million.

- Receivables actually went down in 2Q19 by $6.3 million. That is at least moving in the right direction. However, revenue fell $14.0 million and outstanding receivables remains a huge problem.

- HCSG touted again that it has moved 55% of the customers to accelerated collections. Yet, net A/R was over 68 days at the end of 2Q19 and net Notes Receivables added another 8 days. On top of that, we know reserves would boost that figure even higher by probably 11-15 days, based on recent quarters. After a year, this company should be seeing solid evidence that A/R is declining due to payments being received – not because they wrote them off and reclassified them as long-term notes.

- This company continues to be slow releasing full financial information with a press release containing only a consolidated income statement not broken out by division and a balance sheet with no reserve accounts listed.

- Having a customer base that was able to slow pay HCSG for years and essentially use its balance sheet for a 0% loan as their businesses were squeezed does not bode well going forward. Customers who cannot use HCSG's capital may leave and do the house-cleaning themselves. Other properties may simply not be viable longer term as new supply has exceeded demand in this industry for many years. The churn rate for assisted living centers is about 33%, so HCSG's customers have to add many new residents to post flat results. Many older properties may have a tougher time doing that in an industry with oversupply and many newer locations. We would expect credit quality to remain an issue for HCSG's receivable for a long time.

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.

Disclosure

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