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Johnson Controls (JCI) EQ Review Update-9/18 Quarter

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 are maintaining our rating on Johnson Controls (JCI) at 3- (Minor Concern).

JCI reported adjusted EPS of $0.93 in the 9/18 quarter, in-line with consensus expectations.

We continue to see minor non-operational benefits to earnings in the fourth fiscal quarter:

- Warranty accruals fell again in the quarter, adding about a penny to EPS.

- Unbilled receivable DSOs rose to 11.5 from 10.2 last year. Given that unbilled receivables are subject to a great deal of management estimation any increase should always be noted. However, given this increase was not out-of-line with recent experience we are not overly concerned and will continue to monitor going forward.

- While deferred revenue declined sequentially on an absolute and days of sales basis, the year-over-year trend remains intact. Again, this account should be monitored for indications of a decline.

- The annual allowance for doubtful accounts fell 30 bps to 2.4% largely due to a reserve adjustment. However, last year's amount was lifted by an acquisition and the adjustment could have been impacted by bringing the acquired reserves in-line with existing operations. It would take about 1.5 cps to bring the allowance percentage back up to the year-ago level which is not material to annual EPS. Given we can't tell

if any one quarter received a material boost, we are not overly concerned by the decline.

Warranty Accruals Still Declining

In our review of the 6/18 quarter, we pointed out that JCI reversed an unusually large amount of the warranty accrual back into earnings and estimated this added a little over a penny to EPS in the quarter. However, this amount was key, as it accounted for all of the reported upside in adjusted EPS versus the consensus. While warranty expense in the 9/18 quarter did not register as dramatic a decline as the 6/18 quarter, it still fell by about $9 million year-over-year as shown in the following table:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Beginning Warranty Balance	$399	$400	$415	$409
Accruals for warranties during the period	$84	$66	$75	$84
Accruals from acquisitions & divestitures	-$1	$1	$0	$0
Accruals from pre-existing warranties	-$2	-$16	-$5	-$3
Settlements made in cash	-$85	-$47	-$88	-$77
Currency translation	-$3	-$5	$3	$2
Ending Warranty Balance	$392	$399	$400	$415
Warranty Reserve % of T 12 Sales	1.2%	1.3%	1.3%	1.4%

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Beginning Warranty Balance	$392	$371	$370	$374
Accruals for warranties during the period	$91	$69	$70	$82
Accruals from acquisitions & divestitures	$5	$7	-$4	-$1
Accruals from pre-existing warranties	$1	-$3	$4	-$6
Settlements made in cash	-$81	-$53	-$73	-$73
Currency translation	$1	$1	$4	-$6
Ending Warranty Balance	$409	$392	$371	$370
Warranty Reserve % of T 12 Sales	1.4%	1.4%	1.4%	1.6%

Due to lower warranty accruals and recent accrual reversals, the warranty reserve as a percentage of sales has now fallen to 1.2% at the end of the 9/18 quarter, down from 1.4% a year ago and down 40 bps from the 8-quarter high of 1.6%. We note that on a trailing 4-quarter basis, the cash outflow for warranty payments was $297 million versus net accruals of $284 million. This does not indicate that the company is grossly under-reserving for warranties. However, the timing of warranty accruals and reversals in the last two quarters has benefitted reported EPS. In the case of the 9/18 period, the $10 million decline in net accruals added about a penny to EPS.

Receivables and Deferred Revenues Growth Rates Look Reasonable

We have noted in previous reviews that JCI's deferred revenue balance was declining sequentially. However, we were not overly concerned given that it was still increasing on a year-over-year basis. Deferred revenue includes not only amounts that were collected prior to being recognized on the income statement, but also other items including warranty reserves and battery core returns. The company does not itemize the deferred revenue account but does break out "billings in excess of costs and earnings" which is the true deferred revenue component relating to percentage-of-completion accounting. We show trends in this account along with accounts receivable and costs and earnings in excess of billings (unbilled receivables) in the table below:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Sales	$8,370	$8,120	$7,475	$7,435
Reported Accounts Receivable	$7,065	$6,895	$6,679	$6,731
Reported DSOs	77.0	77.5	81.5	82.6
Costs & Earnings in Excess of Billings (in A/R)	$1,054	$1,025	$1,065	$975
Days of Sales	11.5	11.5	13.0	12.0
Billings in Excess of Costs & Earnings (in Deferred Revenue)	$535	$545	$565	$567
Days of Sales	5.8	6.1	6.9	7.0

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Sales	$8,136	$7,683	$7,267	$7,086
Reported Accounts Receivable	$6,666	$6,443	$6,094	$6,057
Reported DSOs	74.8	76.5	76.5	78.0
Costs & Earnings in Excess of Billings (in A/R)	$908	$951	$863	$812
Days of Sales	10.2	11.3	10.8	10.5
Billings in Excess of Costs & Earnings (in Deferred Revenue)	$451	$448	$472	$462
Days of Sales	5.1	5.3	5.9	5.9

Observations:

- Accounts receivables DSOs jumped by 2.2 days in the period. This by itself is not a major concern. The company notes in its liquidity section in the 10-K filing that receivable increased due to strong organic sales growth.

- However, over half the increase in the overall DSO was due to a 1.3-day increase in the “costs & earnings in excess of billings” component of receivables. This amount represents unbilled receivables resulting from the company recognizing revenue under longer-term contracts that it has not been contractually allowed to bill. These amounts warrant particular scrutiny given their reliance on estimates and the potential for manipulation. The jump from 10.2 days of sales to 11.5 indicates growth out-of-line with revenue but is not yet alarming when considering the volatility of the measure over time. Nevertheless, this remains a key trend to watch going forward.

- “Billings in excess of costs & earnings” is reported in the deferred revenue account. While it has declined on a sequential basis, the trend of year-over-year increases remained intact. We will continue to monitor this going forward as well.

Allowance for Doubtful Accounts Down

JCI does not disclose the allowance for bad debt on a quarterly basis. However, balance sheet in the 9/18 10-K shows that the allowance fell to $177 million at 9/18 from $182 million on 9/17. The allowance as a percentage of gross receivables fell to 2.4% from 2.7% a year ago. We can get a little more clarity from the company’s 10-K disclosure showing the development of the account over the last three years which we show in the table below:

	2018	2017	2016
Beginning Balance	$182	$173	$70
Provision Charged to Expenses	$40	$39	$45
Reserve Adjustments	-$24	-$9	-$8
Charged Off	-$21	-$41	-$25
Acquisition		$18	$91
FX		$2	
Ending Balance	$177	$182	$173

We see the reason the account declined was not a cut to provision expense, but rather a reserve adjustment which wrote $24 million of the reserve back into earnings during the year. However, we also see that not only did charge-offs improve during the year, but last year’s allowance was boosted from an acquisition. Therefore, some of the reserve adjustment was likely due to bringing reserves at the acquired business in-line with the company’s current reserve level.

It would take about 1.5 cps in accruals to bring the reserve back up to the year-ago level. Regardless, we would not consider this to be material on an annual basis and it is impossible to tell if a particular quarter could have benefitted from a cut. As such, we are not overly alarmed by this.

Explanation of EQ Rating Scale

Rating	Explanation
6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's recent reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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