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Johnson Controls (JCI) EQ Review Update- 6/18 Quarter

Current EQ Rating*	Previous EQ Rating
3-	NA

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

We initiate coverage of Johnson Controls (JCI) with a 3- (Minor Concern)

We note the unusual benefit from warranty reversals in the quarter which we estimate accounted for all of the upside in adjusted EPS in the quarter. We also are concerned by the sequential decline in deferred revenue in the period which we will be monitoring closely going forward. Should such one-time benefits continue or any revenue recognition trends worsen, we will likely reduce the company's EQ Review Rating.

Warranty Reversals Add Over a Penny to EPS in the Quarter

JCI discloses information on its warranty accruals in the footnotes of its SEC filings. The table below shows information on expense accruals for warranties issued during the current period as well as accruals/(reversals) of warranties issued in previous periods:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017	6/30/2017	3/31/2017
Accruals for Warranties for Current Period	$66	$75	$84	$91	$69	$70
Accruals (Reversals) of Pre-Existing Warranties	-$16	-$5	-$3	$1	-$3	$4

We note that despite an increase in revenues, the accrual for warranties made in the current period declined by $3 million. It is reasonable for such amounts to fluctuate some over time. However, what stands out is the unusually large reversal of previously accrued warranties in the 6/18 quarter. **We estimate the $13 million increase in reversals of pre-existing**

warranties would have added over a penny to EPS in the period. According to Zacks, JCI's $0.81 adjusted EPS number was one cent above the consensus estimate in the quarter, implying that all of this upside could have been accounted for by this unusual reversal.

Receivables and Deferred Revenue

We noted in our review of the 3/18 quarter that JCI's accounts receivable days of sale jumped 5 days over the year-ago quarter, with much of the increase coming from the jump in the "earnings in excess of billings" component of receivables. Our concern was reduced by the fact that deferred revenue was increasing. However, while the growth in accounts receivable moderated in the quarter, deferred revenue posted a significant sequential decline. We refer to data in the table below:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017	6/30/2017	3/31/2017
Sales	$8,120	$7,475	$7,435	$8,136	$7,683	$7,267
Reported Accounts Receivable	$6,895	$6,679	$6,731	$6,666	$6,443	$6,094
Reported DSOs	77.5	81.5	82.6	74.8	76.5	76.5
Earnings in Excess of Billings (in A/R)	$1,025	$1,065	$975	$908	$951	$863
Days of Sales	11.5	13.0	12.0	10.2	11.3	10.8
Trade Receivables DSOs	66.0	68.5	70.6	64.6	65.2	65.7
Deferred Revenue	$1,317	$1,543	$1,368	$1,279	NA	NA
Days of Sales	14.8	18.8	16.8	14.3	NA	NA
Billings in Excess of Earnings (in Def.Revenue)	$545	$565	$567	$451	$448	$472
Days of Sales	6.1	6.9	7.0	5.1	5.3	5.9
DSO-Deferred Revenue Days	62.7	62.7	65.8	60.4	NA	NA

We can see in the first three lines of the table that total reported receivable days of sales increased just one day over the year-ago period, which is not a concern. We can also see that the growth in the "earnings in excess of billings" component of accounts receivable also fell in-line with revenue growth, alleviating our concern with that aspect of revenue recognition.

However, the deferred revenue account showed a significant sequential decline. JCI did not break out deferred revenue in the 6/17 and 3/17 quarters, so we can not get a year-over-year comparison which would help in analyzing the trend. We note that the billings in excess of earnings component of deferred revenue only fell by $20 million sequentially, meaning that the remainder of deferred revenue fell by more than $200 million. This implies that there was either an acceleration in the recognition of previously deferred revenue in the quarter, or the pace of signing new contracts slowed considerably. Either way, this could be signaling a slowdown in revenue growth in upcoming quarters.

Inventory DSIs Down…

We noted in previous quarters that the company's inventories were rising which it attributed to preparation of increased order activity. As seen in the following table, inventory growth has moderated as inventory days of sales (DSIs) declined by over 2 days from the year-ago period.

	6/30/2018	3/31/2018	12/31/2017	9/30/2017	6/30/2017	3/31/2017
Cost of Sales	$5,648	$5,255	$5,266	$5,623	$5,252	$4,986
Inventory	$3,509	$3,565	$3,459	$3,209	$3,384	$3,138
DSIs	56.7	61.9	59.9	52.1	58.8	57.4

…While Payables Increase

We also noted in the previous review that accounts payable days (DSPs) increased in the 3/18 quarter, which seemed in-line with the increase in inventories. However, the current quarter saw a continuation in the trend of rising DPS which rose by more than five days compared to the year-ago quarter:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017	6/30/2017	3/31/2017
Cost of Sales	$5,648	$5,255	$5,266	$5,623	$5,252	$4,986
Accounts Payable	$4,410	$4,250	$4,020	$4,271	$3,764	$3,720
DSPs	71.2	73.8	69.7	69.3	65.4	68.1

Given the decline in inventory days, it appears that the company may have extended the time it took pay suppliers to the benefit of cash flow. We are not overly concerned about this, as DSPs remain in a reasonable range from a historical perspective.

Explanation of EQ Rating Scale

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

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

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