BEHIND THE NUMBERS
Quality of Earnings Analysis
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Mohawk Industries, Inc. (MHK)
Earnings Quality Update- 9/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are maintaining our earnings quality rating of 3- (Minor Concern) and our On-Deck Sell rating.

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

Summary

MHK reported non-GAAP EPS of $3.95 for the 9/21 quarter which was 15 cps ahead of consensus. However, revenue missed targets by almost $90 million, and the company guided to 12/21 quarterly EPS of $2.80-$2.90, well below the $3.22 consensus. This led to an eventual 10%+ stock price decline.

While revenue grew by 9%, this was driven by pricing and mix as volumes were essentially flat which the company attributed to problems with the availability of materials. Higher raw materials costs including natural gas as well as availability and absenteeism drove costs higher than expected. The company noted that while inventories increased (about 12 days YOY on a DSI basis), this was driven by higher costs and transportation delays.

The non-GAAP tax rate of 21.4% was significantly higher than last year's 16.9%, but this was actually at the low end of the company's full-year guided range of 21.5%-22.5% so we do not consider this an unusual headwind.

We noted several unusual benefits to earnings in the quarter:

- Warranty accruals continued to decline despite increasing sales. MHK increased the warranty reserve during the pandemic and is now bringing it down which appears to be causing an artificial boost to earnings. Warranty accruals on a days-of-sales basis are at 1.5 which is below both year-ago levels of 1.9-2.5 and even pre-pandemic levels of 1.7-1.8. The reserve balance itself fell to $43.3 million from $53.5 million a year ago despite the 9% increase in revenue. While we don't have provision and usage data to calculate an exact earnings impact, we estimate it would have taken about 14 cps off earnings growth to move the warranty reserve to the year-ago level relative to sales.

- Like many companies, MHK built allowances for bad debts during the pandemic and it is now seeing those decline which is providing an artificial tailwind to earnings growth. The allowance for bad debts as a percentage of gross receivables fell to 4.3% from 4.8% in the year-ago quarter. The 4.3% is more in-line with pre-pandemic experience. While we don't have the provision expense and usage data to be able to calculate the exact impact on earnings, we estimate that if the reserve percentage had remained the same as the year-ago level it would have shaved about 11 cps off of earnings growth. Assuming the reserve percentage levels out in the low 4% range, the earnings tailwind still has a couple of quarters left to run after which it will play out as comps normalize.

- MHK capitalizes costs to obtain contracts which include the cost to install in-store displays and it amortizes these costs over the expected time of benefit. It has been capitalizing less since the pandemic began which is likely due to the pandemic limiting the placement of new in-store displays. However, amortization as a percentage of average capitalized balances has been declining and fell from 26.2% last year to 24.1% in the most recent quarter. If the percentage had remained constant, we estimate it would have taken about 1.5 cps off of earnings in the 9/21 quarter. This also highlights that the company will likely see these contract costs rise as conditions normalize post-Covid.

Warranty Accruals Continue Falling

We noted in our review of the June quarter that the revenue growth was outrunning the growth in the company's accruals for product warranties. In the October quarter, warranty accruals declined by 13% from the year-ago quarter despite a 9% increase in revenue. The following table shows revenue and warranty accruals for the last 12 quarters.

	10/2/2021	7/03/2021	4/3/2021	12/31/2020
Revenue	$2,817.017	$2,953.833	$2,669.026	$2,641.764
Warranty Accruals	$46.346	$54.702	$55.024	$54.692
Warranty Accruals Days of Sales	1.5	1.7	1.9	2.0

	9/26/2020	6/27/2020	3/28/2020	12/31/2019
Revenue	$2,574.870	$2,049.800	$2,285.763	$2,424.512
Warranty Accruals	$53.520	$53.769	$51.983	$49.184
Warranty Accruals Days of Sales	1.9	2.4	2.0	1.9

	9/28/2019	6/29/2019	3/30/2019	12/31/2018
Revenue	$2,519.185	$2,584.485	$2,442.490	$2,448.618
Warranty Accruals	$46.984	$47.873	$46.129	$47.511
Warranty Accruals Days of Sales	1.7	1.7	1.7	1.8

We can see that during the pandemic, the company appears to have built up the warranty reserve both absolutely and relative to sales. The company does not disclose actual warranty provisions and usage so we can't tell the exact impact on earnings. However, the fact the ending reserve amount is declining despite rising sales indicates that earnings are artificially benefitting. We estimate that it would have taken approximately 14 cps in expenses to keep the reserve at the same level relative to sales that it was in the year-ago quarter. With the accrual days of sales at a 12-quarter high, we are skeptical that this tailwind can continue and believe it is likely to reverse in upcoming quarters.

Amortization Percentage of Costs to Obtain Contracts Falling

As we also noted in the June quarter review, MHK capitalizes the cost to obtain contracts which includes the cost to install in-store displays and it amortizes these costs over the expected time of benefit. The following table shows the average capitalized cost balance for the last eight quarters and the amortization of the associated balances.

	10/2/2021	7/03/2021	4/3/2021	12/31/2020
Average Capitalized Balance During the Quarter	$57.539	$56.278	$57.196	$61.222
Amortization of Costs to Obtain Contracts	$13.846	$14.615	$15.581	$17.091
Amortization % of Average Capitalized Balance	24.1%	26.0%	27.2%	27.9%

	9/26/2020	6/27/2020	3/28/2020	12/31/2019
Average Capitalized Balance During the Quarter	$62.396	$64.581	$68.002	$61.970
Amortization of Costs to Obtain Contracts	$16.356	$19.214	$15.540	-$0.070
Amortization % of Average Capitalized Balance	26.2%	29.8%	22.9%	-0.1%

We have discussed in the past how lumpy these amortization amounts tend to be. There was even an unusual credit in the 12/19 quarter where the company apparently reversed prior charges. In addition, the capitalized balance has been declining which we believe has to do with Covid limiting the company's placement of in-store displays. Still, amortization expense as a percentage of capitalized balances has consistently declined both YOY and sequentially the last several quarters. We estimate that it would have taken about 1.5 cps off earnings if the amortization percentage had remained even with the year-ago quarter.

Bad Debt Allowance Declining

Like many companies, MHK built allowances for bad debts during the pandemic and it is now seeing those decline which is providing an artificial tailwind to earnings growth. The following table shows the reserve for bad debts as a percentage of gross receivables for the last eight quarters.

	10/2/2021	7/03/2021	4/3/2021	12/31/2020
Gross Customer Trade Receivables	$1,820.757	$1,861.788	$1,716.072	$1,591.503
Allowance for Discounts, Claims, and Doubtful Accounts	$78.221	$82.165	$86.425	$83.682
Allowance for Doubtful Accounts % of Gross Receivables	4.3%	4.4%	5.0%	5.3%

	9/26/2020	6/27/2020	3/28/2020	12/31/2019
Net Receivables	$1,696.515	$1,563.110	$1,611.525	$1,491.592
Allowance for Doubtful Accounts	$81.851	$78.872	$64.745	$61.921
Allowance for Doubtful Accounts % of Gross Receivables	4.8%	5.0%	4.0%	4.2%

The reserve percentage of 4.3% is more in-line with pre-pandemic experience. While we don't have the provision expense and usage data to be able to calculate the exact impact on earnings, we estimate that if the reserve percentage had remained the same as the year-ago level it would have shaved about 11 cps off earnings growth. Assuming the reserve percentage levels out in the low 4% range, the earnings tailwind still has a couple of quarters left to run after which it will play out as comps normalize.

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 Concern)- 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 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 upcoming quarters. 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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