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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Mohawk Industries (MHK) 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 3- (Minor Concern) rating on Mohawk (MHK).

MHK reported its second disappointing quarter in a row, missing EPS estimates by $0.29 as well as coming up short on the top-line. Management blamed weaker than expected sales, less effective price increases, higher inflation, higher transportation costs, manufacturing reductions from excessive inventory levels, product mix and competition.

- Bad debt allowance remains at relatively low levels compared to recent quarters.
- We warned that reserves for warranties declined in the 6/18 quarter. This reversed back to more normal levels and we speculate it could have contributed to the earnings shortfall in the quarter.
- Inventory continued to grow in the quarter with the buildup focused in finished goods. The company's use of FIFO inventory delays the impact of rising costs on the income statement. We believe risks remain from elevated inventories.
- Amortization of costs to obtain contracts fell sharply in the quarter which likely provided a material boost to profits in the period.

- Contract liabilities (deferred revenue) declined sequentially in the quarter. While not a huge concern given the lack of history to compare to, this is still something to be watchful of in upcoming quarters.

Bad Debt Allowances Remain Low

In our review of the 6/18 quarter, we noted that bad debt allowances had declined materially from the year-ago quarter on an absolute basis and as a percentage of trade receivables:

	9/29/2018	6/30/2018	3/31/2018	12/31/2017
Customer Trade Receivables	$1,726.93	$1,716.75	$1,674.52	$1,538.35
Allowance for Bad Debt	$81.57	$78.14	$90.88	$86.10
Allowance %	4.7%	4.6%	5.4%	5.6%

	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Customer Trade Receivables	$1,660.99	$1,651.77	$1,508.93	$1,386.31
Allowance for Bad Debt	$91.25	$91.47	$81.24	$78.34
Allowance %	5.5%	5.5%	5.4%	5.7%

We see that while the allowance increased slightly sequentially, the allowance percentage remains low compared to the last several quarters. As we noted in the last review, it would take a charge of well over 15 cps to raise the allowance percentage to a mid-5% level.

Warranty Reserve Increased and Was a Likely Drag on the Quarter

We warned in our 6/18 quarter review that the company's warranty reserve dropped noticeably in the second quarter:

	9/29/2018	6/30/2018	3/31/2018	12/31/2017
Sales	$2,545.80	$2,577.01	$2,412.20	$2,369.10
Warranty Reserve	$44.62	$38.97	$40.46	$39.04
Allowance % of Sales	1.8%	1.5%	1.7%	1.6%

	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Sales	$2,448.51	$2,453.04	$2,220.65	$2,182.57
Warranty Reserve	$44.20	$45.08	$46.56	$46.35
Allowance % of Sales	1.8%	1.8%	2.1%	2.1%

However, we see in the above table that the reserve showed a sharp sequential increase both absolutely and as a percentage of revenue. The sequential increase of $5.6 million by itself could have reduced EPS by approximately 6 cps in the 9/18 quarter.

Inventory Remains Elevated

MHK noted as far back as the beginning of 2018 that its inventories were too high and it was working to bring them down. We noted in our review of the 6/18 quarter that while inventory balances had moderated some, DSIs remained high and the company's use of FIFO (first-in, first-out) accounting coupled with its long inventory turns would delay the recognition of higher costs on the income statement. Not surprisingly, management cited reduced manufacturing due to excessive inventories and higher than expected inflation as key reasons for its large earnings miss in the quarter. Despite the reductions in production, inventories still appear elevated at the end of the 9/18 quarter:

	9/29/2018	6/30/2018	3/31/2018	12/31/2017
Inventory	$2,214.30	$2,061.20	$2,044.96	$1,948.66
COGS	$1,825.37	$1,810.46	$1,707.51	$1,615.47
DSI	110.7	103.9	109.3	110.1

	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Inventory	$1,911.03	$1,865.94	$1,740.88	$1,675.75
COGS	$1,665.21	$1,673.90	$1,540.29	$1,491.57
DSI	104.7	101.7	103.1	102.5

MHK closed the acquisition of Godfrey Hirst, Australia's largest floor manufacturer, on 7/2/2918. The acquisition price was $412 million but the company has yet to finalize its allocation of the purchase price so we do not know how much it booked in acquired inventory. Regardless, while the deal would have increased inventory levels, the fact that the quarter would have also contained virtually a full quarter of cost of sales for the acquired company means there would be a minimal impact on our calculation of quarterly DSI. Thus the 6-day YOY increase in DSI is likely indicating both a continued buildup in inventory as well as a reflation of the higher costs the company is citing. A look at inventory components shows that the buildup was centered in finished goods, further increasing the concern:

	9/29/2018	6/30/2018	3/31/2018	12/31/2017
Finished Goods % of inventory	69.5%	70.2%	68.6%	68.0%
In-Progress % of inventory	7.5%	7.6%	8.2%	8.2%
Raw Materials % of inventory	23.0%	22.2%	23.2%	23.7%

	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Finished Goods % of inventory	68.6%	69.7%	69.3%	67.3%
In-Progress % of inventory	7.9%	8.0%	8.4%	8.2%
Raw Materials % of inventory	23.5%	22.3%	22.2%	24.5%

We are therefore somewhat confused by management's comment in the conference call regarding the increase in inventory:

> *"What I'm saying also is that with the raw material inflation, you have the raw materials hitting the balance sheet before the sales prices have gone up. So the inventory turns get worse because the raw materials have increased, and it's showing up in the inventory dollars, in addition to having nothing to do with the units as the prices go up."*

While raw materials balances did increase by 14% in the period, finished goods jumped by 17% and was a much larger driver of the overall increase in inventory.

All of these factors make us think we have not seen the last of the negative impacts from the company's inflated inventory balances.

Amortization of Costs to Obtain Contracts

Under the new ASC 606 guidelines for revenue recognition, MHK began reporting its capitalized costs to obtain new contracts as well as periodic amortization of those costs in 2018. MHK describes its capitalized costs to obtain contracts as follows:

> *"The Company historically incurs certain incremental costs to obtain revenue contracts. These costs relate to marketing display structures and are capitalized when the amortization period is greater than one year, with the amount recorded in other assets on the accompanying condensed consolidated balance sheets."*

The company discloses the ending balance of capitalized contract costs and the YTD amortization of those costs by quarter. We utilized these amounts to construct the following table:

	9/29/2018	6/30/2018	3/31/2018
Beginning Balance of Capitalized Costs to Obtain Contracts	$50.400	$46.224	$43.259
Amounts Capitalized (Plug)	$14.280	$25.331	$17.679
Quarterly Amortization of Costs to Obtain Contracts	($7.629)	($21.155)	($14.714)
Capitalized Costs to Obtain Contracts	$57.051	$50.400	$46.224

We can see that the company's rate of capitalization dropped off dramatically in the 9/18 quarter which we assume indicates that it did not sign any new contracts requiring the placement of store marketing displays. Therefore, we would expect to see a slight decline in quarterly amortization, but certainly not for it to fall by more than 60%. It is difficult to imply much from just three quarters of data, but the huge decline in quarterly amortization expense looks unusually low and could represent a material headwind to results if it reverses in upcoming quarters.

Contract Liabilities (Deferred Revenue) Declined Sequentially

Under the new ASC 606 accounting for revenue recognition, MHK began reporting contract liabilities in 2018. These amounts are essentially deferred revenue, or revenue that the company has booked ahead of satisfying all its associated obligations. These amounts are shown for the last four quarters:

	9/29/2018	6/30/2018	3/31/2018	12/31/2017
Contract liabilities	$34.42	$42.94	$35.96	$29.12
Sales	$2,545.80	$2,577.01	$2,412.20	$2,369.10
Days of Sales	1.23	1.52	1.36	1.12

Any sequential decline in a deferred revenue account is noteworthy as it indicates revenue was recognized without a similar-sized future amount taking its place in the "pipeline." However, without a year-ago quarterly balance to compare to, these figures have limited analytical value. In addition, contracts spanning multiple quarters would not seem to be a major part of the company's business model which make this seem less relevant.

Explanation of EQ Rating Scale

Rating	Description
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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