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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Mohawk Industries (MHK) EQ Update 9/19 Qtr.

Current EQ Rating*	Previous EQ Rating
2-	2-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

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

We are maintaining our earnings quality rating on MHK of 2- (Weak).

MHK's 9/19 quarter EPS of $2.75 trounced the consensus target by 11 cps. However, we remind investors the consensus target for the 9/19 quarter was $3.01 prior to management's huge reduction in its outlook after the 6/19 quarterly results. Nevertheless, the stock is higher now than prior to the downgraded outlook. We continue to see a number of red flags and one-time benefits to the company's EPS.

- We noted in the last review that management stated in the 6/19 quarter that inventories were too high and it would have to cut production in the second half to bring them back in-line. DSIs in the 9/19 were flat sequentially and still higher by 6 days versus the year-ago period. The company is continuing efforts to reduce its inventory levels which could represent a headwind to margins in the next quarter.

- Other expenses rose to $52.7 million versus just $706,000 a year ago. Management noted in the 10-Q that the change in other expense was *"primarily attributable to an impairment charge of $65.2 million related to the Company's net investment in a manufacturer and distributor of ceramic tile in China, partially offset by foreign* *exchange rates on transactions in the current year."* However, the $65 million charge was taken out of adjusted non-GAAP earnings. This leaves a $13 million (14.3 cps) swing in other income which would have benefitted adjusted earnings. While the company indicates that the non-China portion of the other expense account was due to foreign currency change, the detailed line items in the footnotes indicates that only $3.6 million of the swing came from "foreign currency losses (gains)" while $8.9 million of the swing was labeled as "all other." We are uncertain of the source of the movement in the "all other" category, but we are inclined to view it as non-operational in nature.

- Accounts receivable allowances for doubtful accounts once again declined, falling over $11 million from the year-ago level despite a rise in receivables. This drove the allowance percentage down to 3.8% from 4.5% a year ago and 3.9% in the 6/19 quarter. We estimate it would now take more than 13 cps in provision charges to bring the allowance back in line with the year-ago level.

- Amortization of costs to acquire contracts rose by almost $7 million (7.5 cps) in the 6/19 quarter. In addition, our estimated capitalization of costs to acquired new contracts fell to $1.5 million from $14.3 million a year ago, implying lower spending on setting up in-store fixtures at new customers.

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.

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