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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Mohawk (MHK) EQ Update 12/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3+	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 an explanation of the EQ Review Rating scale, please refer to the end of this report

We are raising our earnings quality rating to 3+ (Minor Concern) from 2- (Weak).

MHK reported adjusted EPS of $2.25 which topped the Street estimate by 5 cps. We see both positive and negative one-time items in the quarter. We are concerned by amortization of contract costs falling to zero (+13 cps), but rising stock-based compensation expense (-2 cps) and a rise in "all other" expense (-8 cps) offset much of this benefit. Inventory remains elevated and it will take a couple of quarters to resolve during which time there could be some negative surprises as higher costs from lower production rates work their way through the FIFO layers. Nevertheless, the buildup in inventory seems to have peaked.

We note the following impacts on the quarter:

On the downside:

- MHK capitalizes the cost to obtain new contracts (store fixtures, displays, etc) and amortizes that amount over the time frame of the contract. We noted after our review of the 9/19 quarter that MHK saw a material increase in

amortization expense related to contract costs. However, this situation reversed dramatically in the 12/19 quarter as the company recorded a slight credit in amortization versus $12 million of expense in the year-ago quarter. The estimated amount of capitalized costs in the quarter was in-line with the quarterly trend rate for the last several quarters. The swing in amortization expense added over 13 cps to EPS in the quarter which we would expect to reverse in upcoming periods. (See full report for more details)

- The allowance for bad debts as a percentage of gross receivables rose slightly on a sequential basis to 3.9% from 3.8%. However, it remains well below the year-ago level of the mid-4% range and we estimate it would take approximately 9 cps in charges to return it to that level.

- The company incurred another $50 million in restructuring charges "*for restructuring and integration costs of which most was non-cash and divided relatively evenly among completing US carpet realignment and rightsizing the Company's wood manufacturing footprints in Flooring North America and Flooring Rest of the World..*"

On the upside:

- Rising inventories have been a concern for several quarters. However, this situation is improving as DSIs rose by only one day over the year-ago quarter. However, the steps to correct the problem (reduced production) have led to higher costs as expected. Also, on a related inventory matter, pre-buying ahead of tariff increases earlier in the year led to a buildup of rebates which will result in a 15 cps benefit to be recognized over the first three quarters of 2020. This is expected to offset recent price reductions.

- We noted after the review of the 9/19 quarter that the "all other" component of other income/expense was a material positive boost to growth in the quarter. However, this reversed sharply in the 12/19 period draining almost 8 cps of earnings growth from earnings. We are not certain of what drove the increase in the line item.

- Rising stock-based compensation was a 2 cps headwind in the quarter.

- In the 12/19 quarter, the company recorded a $5.2 million recovery from a previous impairment of its net investment in a manufacturer and distributor of ceramic tile in China. This added about 7 cps to GAAP EPS but was adjusted out of the non-GAAP numbers.

Amortization of Costs to Obtain Contracts Falls to Zero

MHK capitalizes the cost of setting up a new contract with a customer and amortizes them over the term of the contract. These costs can include new displays and other in-store items. We noted after our review of the 9/19 quarter that MHK saw a material increase in amortization expense related to contact costs. However, this situation reversed dramatically in the 12/19 quarter as seen in the following table:

	12/31/2019	9/28/2019	6/29/2019	3/30/2019	12/31/2018	9/29/2018
Beginning Balance of Capitalized Contract Costs	$54.900	$67.900	$59.034	$57.840	$57.051	$50.400
Quarterly Amortization of Capitalized Contract Costs	$0.070	-$14.479	-$16.362	-$11.048	-$12.090	-$7.629
Amount Capitalized (Plug)	$14.069	$1.479	$25.228	$12.242	$12.879	$14.280
Ending Balance of Capitalized Contract Costs	$69.039	$54.900	$67.900	$59.034	$57.840	$57.051

We see that the company recorded a slight credit in the 12/19 quarter compared to a $12 million amortization expense in the 12/18 period. This would have added over 13 cps to EPS in the period. While MHK does not disclose the amount capitalized in a quarter, we can estimate that amount as a plug number using the beginning and ending balances and the disclosed amortization expense. We can see that there was a heavy period of capitalization in the 6/19 quarter and very little in the 9/19 quarter. The rate of capitalizing costs returned to a more normal level in the 12/19 quarter. We see no reason for the sudden drop off in amortization expense and expect it will experience a bounce in the next quarter. Therefore, we view the decline in expense as a very material, non-recurring benefit.

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 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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