BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Mohawk (MHK) EQ Update-3/19 Qtr.

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 maintain our earnings quality rating of 3- (Minor Concern).

- Allowance for doubtful accounts fell again to 4.2% of gross trade receivables versus 4.8% in the 12/18 quarter and 5.4% in the 3/18 quarter. The company does not disclose provision expense or utilization of the reserve, so we cannot determine the exact benefit to earnings from the decline in the reserve percentage. However, we estimate that it would have taken an additional 11 cps in expense in the 3/19 quarter to have maintained the reserve at the same level as the previous quarter (4.8%).

- Quarterly amortization of capitalized costs to obtain contracts declined sequentially and year-over-year. Contract cost amortization as a percentage of average capitalized contract costs fell to 18.9% in the 3/19 quarter from 21.0% in the 12/18 quarter and 32.9% in the 3/18 quarter. This implies anywhere from a 1-5 cps reduction in expenses. However, the rate at which the company is capitalizing costs relative to sales has levelled out in the last three quarters which implied the net benefit to expense was closer to the 1 cps figure.

- Inventory DSIs continued to climb, jumping 8 days over the year-ago quarter. Management attributed this to two new plants as well as higher raw materials costs and tariffs.

Amortization Costs to Obtain Contracts

MHK amortizes certain incremental costs related to obtaining contracts related to setting up marketing displays in customers' stores. These costs are capitalized when the amortization period is longer than one year. As the following table shows, quarterly amortization expense of capitalized contract costs declined by 25% year-over-year despite a 28% *increase* in the capitalized costs balance:

	3/30/2019	12/31/2018	9/29/2018	6/30/2018	3/31/2018
Beginning Balance of Capitalized Cont. Costs	$57.840	$57.051	$50.400	$46.224	$43.259
Amounts Capitalized (plug)	$12.242	$12.879	$14.280	$25.331	$17.679
Quarterly Amortization of Costs to Obtain Contracts	-$11.048	-$12.090	-$7.629	-$21.155	-$14.714
Ending Balance Capitalized Cont. Costs	$59.034	$57.840	$57.051	$50.400	$46.224
Average Capitalized Costs	$58.437	$57.446	$53.726	$48.312	$44.742
Amortization % of Average Capitalized Balance	18.9%	21.0%	14.2%	43.8%	32.9%
Quarterly Sales	$2,442.490	$2,448.618	$2,545.800	$2,577.014	$2,412.202
Amounts Capitalized % of Sales	0.50%	0.53%	0.56%	0.98%	0.73%

Likewise, quarterly amortization expense fell by almost 9% sequentially despite the 2% increase in the capitalized costs balance. Quarterly amortization expense has been very volatile over the last five quarters on an absolute basis and as a percentage of average capitalized costs. The recent initiation of the disclosure does not allow for a long-term analysis of the trend, but if we just assume that amortization expense as a percentage of the average capitalized cost balance had remained steady with the 12/18 quarter (21.0%), it would have taken almost a penny off of EPS in the quarter. Likewise, if the amortization percentage had remained comparable to the 32.9% from the year-ago first quarter, it would have resulted in amortization expense being over 5 cps higher.

Typically, earnings quality issues arise when the rate of capitalization increases. From this perspective, MHK's rate of capitalizing new costs relative to sales has actually flattened int eh last three quarters. Therefore, we believe any net artificial benefit to earnings per share is closer to the 1 cps than the 5 cps figure. Regardless, this is an area to watch closely in future quarters.

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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