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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Mohawk Industries (MHK) EQ Review-6/19 Qtr.

Current EQ Rating*	Previous EQ Rating
2-	3-

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

We are lowering our earnings quality rating on MHK to 2- (Weak) from 3- (Minor Concern).

MHK's stock dropped as much as 17% after reporting a 2 cps earnings beat but a sizeable revenue disappointment. The real catalyst for the stock price decline was the huge reduction in guidance as management called for third-quarter EPS to fall in the range of $2.58-$2.68 which was well below the pre-quarter Street estimate of $3.01. Management cited weaker demand, tough market conditions, and excess channel inventory as reasons for the bleak outlook.

We remind clients that our earnings quality scores are an assessment of the quality of the earnings reported in the quarter being examined. They are not an implicit buy or sell recommendation. Our stocks with a rating of 2 (Weak) going into a quarter have shown a number of earnings misses and pre-announcements. In the current case of MHK, the stock has been sold down to under 10 times forward earnings and guidance has been greatly reduced. However, we do not consider these factors when assigning a score to the quality of the second-quarter earnings. We have noted many of the concerns below over the last few quarters. However, given the moderate jump in DSOs, the acceleration in the inventory buildup, the easy comparison against contract amortization costs, and the unusual jump in other income, we are lowering our earnings quality rating to 2- (Weak) as we believe the operational growth in the quarter was weaker than the reported EPS figure implies.

- Accounts receivable days jumped by 2.5 over the year-ago second quarter. This is the largest YOY jump in over two years and could be an indication that the extension of

more generous terms pulled sales forward into the second quarter at the expense of the third.

- In addition, allowance for doubtful accounts as a percentage of trade receivables continues to decline, falling to 4.1% from 4.6% a year ago. We estimate it would take a 10 cps charge to rebuild the allowance to the year-ago level.

- Inventory days climbed by 13 days versus the year-ago second quarter with 9 days coming from finished goods and the balance from raw materials. We have been highlighting the rising DSIs for the last few quarters and management has been attributing the increase to opening new plants, rising raw materials costs, and tariffs. However, management noted in the second-quarter conference call that it is carrying too much inventory and it would need to curtail production in upcoming quarters to bring its own inventories back in line. This will negatively impact per unit production costs and pressure profits.

- MHK's amortization of capitalized contract costs declined by approximately 5.2 cps in the 6/19 quarter due to an easy comparison against last year's second quarter. We view this as a non-operational benefit that will likely reverse in upcoming quarters.

- Other income took a favorable swing of $5.1 million (5.5 cps) due to the favorable foreign exchange transactions and an insurance settlement.

Receivables Days Up 2.5 Days While Allowances Decline

MHK breaks out the components of its accounts receivable in its footnotes which allows us to strip out tax receivables and other receivables. The below table shows that DSOs calculated from customer trade receivables at the end of the 6/19 quarter jumped by 2.5 days versus the year-ago second quarter:

	6/29/2019	3/30/2019	12/31/2018	9/29/2018
Customer Trade Receivables	$1,793.551	$1,716.927	$1,562.284	$1,726.925
Sales	$2,584.485	$2,442.490	$2,448.618	$2,545.800
DSO	63.3	64.1	58.2	61.9

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Customer Trade Receivables	$1,716.748	$1,674.518	$1,538.348	$1,660.987
Sales	$2,577.014	$2,412.202	$2,369.097	$2,448.510
DSO	60.8	63.3	59.3	61.9

MHK's DSOs have typically tracked very steadily over the last two years and the 2.5-day jump is the largest increase in that time frame. This leads us to question if the company could have offered more attractive terms late in the quarter to pull sales into the 6/19 period at the expense of the next quarter.

We have also highlighted how the company's allowance for bad debts as a percentage of gross trade receivables has been declining and that trend continued into the 6/19 quarter. (Note that we are assuming that all of the allowance is related to customer trade receivables rather than income tax or other receivables which we believe is a reasonable assumption.)

	6/29/2019	3/30/2019	12/31/2018	9/29/2018
Gross Customer Trade Receivables	$1,793.551	$1,716.927	$1,562.284	$1,726.925
Allowance	$72.782	$72.308	$74.718	$81.566
% of Gross Receivables	4.1%	4.2%	4.8%	4.7%

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Gross Customer Trade Receivables	$1,716.748	$1,674.518	$1,538.348	$1,660.987
Allowance	$78.141	$90.877	$86.103	$91.247
% of Gross Receivables	4.6%	5.4%	5.6%	5.5%

To put this in perspective, if the allowance percentage had remained constant, it would have taken almost 10 cps off of EPS in the quarter.

Inventory DSIs Spike

We have been following the ongoing climb in inventory at MHK the last several quarters and the year-over-year jump in DSIs actually worsened in the 6/19 quarter:

	6/29/2019	3/30/2019	12/31/2018	9/29/2018
COGS	$1,847.867	$1,817.563	$1,802.228	$1,825.367
Inventory	$2,367.631	$2,338.125	$2,287.615	$2,214.295
DSI	116.9	117.4	115.8	110.7

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
COGS	$1,810.459	$1,707.510	$1,615.473	$1,665.209
Inventory	$2,061.204	$2,044.962	$1,948.663	$1,911.029
DSI	103.9	109.3	110.1	104.7

In the past, management has attributed the rising inventory to new plants coming online, higher raw materials costs and the impact of tariffs. However, with the deterioration in outlook, management seems to now be admitting that it has too much inventory on hand. Consider the following comments from the conference call:

> *"Given the uncertainties in our markets, we are taking actions to improve our business. We are streamlining our operations, consolidating facilities and taking out higher cost assets.* ***We are reducing production to control inventory levels****, introducing new product categories and increasing promotions to address changing markets."*

> *"The general conditions in our flooring markets around the world have become more challenging, and competition is more intense. We are taking actions to improve our sales, reduce our costs,* ***manage our inventory and adjust our offerings****."*

A breakdown of DSIs into inventory components gives us more insight into the situation:

	6/29/2019	3/30/2019	12/31/2018	9/29/2018
Finished Goods DSI	81.8	81.6	80.1	76.9
In-Process DSI	7.7	8.4	8.4	8.3
Raw Materials DSI	27.4	27.4	27.3	25.5

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Finished Goods DSI	72.9	75.0	74.9	71.8
In-Process DSI	7.9	9.0	9.0	8.3
Raw Materials DSI	23.1	25.3	26.1	24.6

We see that of the 13-day YOY increase in DSIs, almost 9 days came from finished goods with the remainder coming from a buildup in raw materials. As the company admitted on the call, it will have to cut production in the upcoming quarters for the inventory levels to reduce its inventories and "adjust" its offerings. We take that to mean that it has more of certain products than customers want. This will almost certainly result in higher production costs per unit as production is cut and quite possibly discounting or write-downs to eliminate obsolete inventory. Either way, margins suffer.

Amortization of Costs to Obtain Contracts Down by 5 cps

MHK capitalizes the cost to obtain certain contracts such as in-store advertising displays when the amortization period is expected to be more than one year. We noted in the 3/19 quarter that the quarterly amortization expense fell versus the year-ago first quarter. While amortization expense increased sequentially in the 6/19 quarter, it was still almost $4.8 million (5.2 cps) lower than the year-ago figure:

	6/29/2019	3/30/2019	12/31/2018	9/29/2018	6/30/2018	3/31/2018
Beginning Balance of Capitalized Cont. Costs	$59.034	$57.840	$57.051	$50.400	$46.224	$43.259
Amounts Capitalized (plug)	$25.228	$12.242	$12.879	$14.280	$25.331	$17.679
Qtrly Amortization of Costs to Obtain Contracts	**-$16.362**	-$11.048	-$12.090	-$7.629	**-$21.155**	-$14.714
Ending Capitalized Contracts	$67.900	$59.034	$57.840	$57.051	$50.400	$46.224
Amortization % of Avg. Capitalized Contracts	25.8%	18.9%	21.0%	14.2%	43.8%	32.9%

The company's amortization as a % of average capitalized contract balances has been very volatile, but we can see in the table above that the almost 44% from the 6/18 quarter was substantially above recent experience. Both the amortization percentage as well as the absolute amount capitalized should be monitored carefully going forward.

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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