BEHIND THE NUMBERS
Quality of Earnings Analysis

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

August 16, 2021

Mohawk Industries, Inc. (MHK)
Earnings Quality Update- 7/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are downgrading our earnings quality rating of MHK to 3- (Minor Concern).

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

Summary

MHK topped EPS estimates by 76 cps in the 7/21 quarter. Revenue came in over $200 million higher than expected as demand remains robust in the current housing and remodeling environment. However, we noted several one-time benefits to earnings growth in the period which totaled over 50 cps. While the earnings beat was still well intact, growth was not as strong as the headline numbers indicate.

- Accruals for product warranties declined sequentially despite an almost $300 million sequential increase in sales. This compares to the year-ago quarter where accruals rose sequentially on a decline in revenue. This drove warranty accruals on a days of sales basis down to 1.7 days from 2.4 days a year ago. We estimate this could have added over 25 cps to earnings growth in the period.

- The allowance for doubtful accounts fell to 4.2% of gross receivables compared to 4.8% a year ago and 4.8% in the 3/21 quarter. We estimate this could have added over 12 cps to earnings in the period.

- MHK's Other Expense (Income) line jumped to an income of $11.2 million in the 6/21 quarter from a $1.4 million expense in the year-ago quarter. The company stated in the 10-Q that this was "primarily attributable to the resolution of foreign non-income tax contingencies of $6.2 million and other miscellaneous items." The $6.2 million benefit was adjusted out of non-GAAP results. However, the "all other" category jumped to $6.1 million in income from virtually nothing last year, adding almost 7 cps to earnings in the quarter.

- Amortization of capitalized contract costs fell, adding about 5 cps to earnings growth in the quarter. The company has been capitalizing a smaller amount of contract-related costs which we suspect is due to fewer in-store display placements in the current environment. We expect these costs will increase as conditions return to normal.

Warranty Accruals Down Relative to Sales

The following table shows MHK's accruals for product warranty costs relative to revenue for the last eight quarters:

	7/03/2021	4/3/2021	12/31/2020	9/26/2020
Revenue	$2,953.833	$2,669.026	$2,641.764	$2,574.870
Warranty Accruals	$54.702	$55.024	$54.692	$53.520
Warranty Accruals Days of Sales	1.7	1.9	2.0	1.9

	6/27/2020	3/28/2020	12/31/2019	9/28/2019
Revenue	$2,049.800	$2,285.763	$2,424.512	$2,519.185
Warranty Accruals	$53.769	$51.983	$49.184	$46.984
Warranty Accruals Days of Sales	2.4	2.0	1.9	1.7

Warranty accruals on a days-of-sales basis fell to 1.7 days versus 2.4 days in the year-ago quarter. MHK does not disclose the actual warranty expense incurred. However, note that warranty accruals fell by $322K from the 4/21 quarter to the 7/21 quarter on a $284 million sequential increase in sales while warranty accruals rose by $1.8 million from the 3/20 quarter to the 6/20 quarter on a $236 million sequential sales increase. This seems to indicate that warranty expense was atypically high in the 6/20 quarter and atypically low in the 7/21 quarter. It would have taken approximately 26 cps in incremental warranty expense in the most recent quarter to boost the warranty accrual to 2.4 days of sales.

Decline in Allowance for Doubtful Accounts

The following table shows customer trade receivables and the allowance for discounts, claims, and doubtful accounts for the last eight quarters:

	7/03/2021	4/3/2021	12/31/2020	9/26/2020
Gross Customer Trade Receivables	$1,861.788	$1,716.072	$1,591.503	$1,696.515
Allowance for Discounts, Claims, and Doubtful Accounts	$82.165	$86.425	$83.682	$81.851
Allowance for Doubtful Accounts % of Gross Receivables	4.2%	4.8%	5.0%	4.6%

	6/27/2020	3/28/2020	12/31/2019	9/28/2019
Net Receivables	$1,563.110	$1,611.525	$1,491.592	$1,763.435
Allowance for Doubtful Accounts	$78.872	$64.745	$61.921	$70.457
Allowance for Doubtful Accounts % of Gross Receivables	4.8%	3.9%	4.0%	3.8%

Note that MHK nets the allowance against all receivables including tax and other receivables in its disclosures. However, we assume that virtually all the allowance is related to customer trade receivables. We can see that the company increased its allowance percentage in the 6/20 quarter to 4.8% of gross receivables to reflect increased risk from customers during the pandemic. The percentage remained at that level until the 7/21 quarter when the company cut it back to a more normal level of 4.2%. This makes sense given the improvement in credit conditions and we do not have a problem with the company reducing the allowance. However, investors should note that cutting the decline in the reserve percentage from 4.8% in the 4/3 quarter to 4.2% in the 7/21 quarter added about 12 cps to earnings growth that will not repeat.

Jump in Miscellaneous Other Income

MHK's Other Expense (Income) line jumped to an income of $11.2 million in the 6/21 quarter from a $1.04 million expense in the year-ago quarter. The company stated in the 10-Q that this was "primarily attributable to the resolution of foreign non-income tax contingencies of $6.2 million and other miscellaneous items." The $6.2 million resolution of foreign non-income tax contingencies is adjusted out of non-GAAP results. However, the "all other, net" category of Other Expense (Income) swung to a $6.1 million gain from just $193K in gains last year, adding over 6.5 cps to earnings in the period.

Decline in Amortization of Costs to Obtain Contracts

MHK capitalizes the cost to obtain contracts which namely includes the costs of in-store displays. These amounts are capitalized when the amortization period is more than one year. The following table shows the average capitalized contract cost outstanding during the quarter and the amortization of those amounts for the last eight quarters:

	7/03/2021	4/3/2021	12/31/2020	9/26/2020
Average Capitalized Balance During the Quarter	$56.278	$57.196	$61.222	$62.396
Amortization of Costs to Obtain Contracts	$14.615	$15.581	$17.091	$16.356
Amortization % of Average Capitalized Balance	26.0%	27.2%	27.9%	26.2%

	6/27/2020	3/28/2020	12/31/2019	9/28/2019
Average Capitalized Balance During the Quarter	$64.581	$68.002	$61.970	$61.400
Amortization of Costs to Obtain Contracts	$19.214	$15.540	-$0.070	$14.479
Amortization % of Average Capitalized Balance	29.8%	22.9%	-0.1%	23.6%

We see that amortization expense fell from $19.2 million in the year-ago quarter to $14.6 million in the most recent period. We have highlighted the unusual lumpiness in these amortization amounts in past reviews and the 6/20 amortization figure appears to be unusually high. The absolute decline in amortization expense added about 5.2 cps to growth in the quarter.

The average capitalized balance has been declining which we assume is due to the company placing fewer in-store displays during the pandemic despite strong revenue growth which would put pressure on amortization expense. However, even amortization expense as a percentage of the average outstanding contract balance declined from 29.8% to 26.0% YOY which we estimate by itself would have added about 2.4 cps to EPS growth in the period. We expect as conditions return to normal the company will to have to spend more on in-store displays which will drive up these costs.

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 Concern)- 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 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 upcoming quarters. 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.

Disclosure

Behind the Numbers, LLC is an independent research firm structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. All research is based on fundamental analysis using publicly available information including SEC filed documents, company presentations, annual reports, earnings call transcripts, as well as those of competitors, customers, and suppliers. Other information sources include mass market and industry news resources. These sources are believed to be reliable, but no representation is made that they are accurate or complete, or that errors, if discovered, will be corrected. Behind the Numbers, LLC does not use company sources beyond what they have publicly written or discussed in presentations or media interviews. Behind the Numbers does not use or subscribe to expert networks. All employees are aware of this policy and adhere to it.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.