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Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

Mohawk Industries (MHK) EQ Review- 6/18 Quarter

Current EQ Rating*	Previous EQ Rating
3-	NA

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

We initiate coverage of Mohawk Industries (MHK) with a 3- (Minor Concern) rating.

MHK had a disastrous second quarter, missing EPS targets by $0.39 per share. The stock, which has gradually declined all year, still fell over 15% on the news. Nevertheless, our review of the company's result turned up several apparent one-time benefits in the most recent quarter that seem unlikely to repeat. We remind clients that our rating does not constitute a sell recommendation. MHK sells for about 10 times EBITDA, has very manageable debt, strong free cash flow and should enjoy a macro tailwind from strong housing activity. Regardless, it appears to us that core second quarter results were even weaker than they appeared on the surface and there are several trends that should be monitored going into the next quarter.

- Bad debt reserve fell as a percentage of gross receivables. If the allowance percentage had remained even with the 3/18 quarter, we estimate it would have shaved over 15 cents per share off EPS in the 6/18 quarter.

- A sequential decline in the warranty reserve as a percentage of sales appeared to add another 4 cents to the quarter.

- Rising inventory levels have been a problem all year. While the year-over-year increase in days sales of inventory (DSI) moderated in the quarter, the company's use of FIFO accounting coupled with its relatively slow inventory turns mean that costs from later purchases of higher cost materials and the impact of decreased productivity could be a drain on profits well into the current quarter.

Background on the Quarter

MHK's second quarter was a huge disappointment for investors as several negative trends converged to cause the earnings shortfall. Management gave this summary of the problems in the conference call:

> *"In the second quarter, we had a stronger dollar and a delay of Godfrey Hirst [pending acquisition] closing, which impacted results by $0.10 a share. The results were also impacted by lower sales than we anticipated, input inflation, transportation costs, lower LVT supply and a tight labor market, which increased our costs. In addition, we had a lower product mix than we anticipated and we reduced our production volumes more than we had thought to begin with. We also had the timing of the price increases were later than we had anticipated."*

Bad Debt Allowance Down

The following table shows the company's allowance for bad debts as a percentage of customer trade receivables for the last 8 quarters:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Customer Trade Receivables	$1,716.75	$1,674.52	$1,538.35	$1,660.99
Allowance for Bad Debt	$78.14	$90.88	$86.10	$91.25
Allowance %	4.6%	5.4%	5.6%	5.5%

	7/01/2017	4/01/2017	12/31/2016	10/01/2016
Customer Trade Receivables	$1,651.77	$1,508.93	$1,386.31	$1,523.93
Allowance for Bad Debt	$91.47	$81.24	$78.34	$84.01
Allowance %	5.5%	5.4%	5.7%	5.5%

We can see the significant sequential and year-over-year drop off's both on an absolute basis and as a percentage of gross receivables. We did not see the decline in allowances discussed in either the conference call or the 10-Q, nor do we see how this measure would be impacted by any of the negative events in the quarter such as materials inflation or delayed price increases. MHK does not break out the development of the bad debt reserve account, so we do not know how much was actually expensed in the above periods. **However, for the allowance percentage to have remained even with the 3/18 quarter, it would have taken an additional expense of about $12 million or over 15 cents per share.**

We observe that the company reports an "other receivables" amount in its receivables disclosure. At this point, we are uncertain as to the nature of this account, but we show it below for reference:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Other Receivables	$91.37	$96.87	$96.08	$80.65

	7/01/2017	4/01/2017	12/31/2016	10/01/2016
Other Receivables	$69.18	$64.03	$59.56	$54.41

The account balance has been on the rise for the last 8 quarters with a noticeable jump in the 12/17 period. We will be following up with more on this account in a later note.

Warranty Reserve Declined

MHK offers warranties on certain of its flooring products and discloses the warranty reserve balance under the breakdown of its "accounts payable and accrued expenses" account. This amount is shown in the below table as a percentage of sales for the last 8 quarters:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Sales	$2,577.01	$2,412.20	$2,369.10	$2,448.51
Warranty Reserve	$38.97	$40.46	$39.04	$44.20
Allowance % of Sales	1.5%	1.7%	1.6%	1.8%

	7/01/2017	4/01/2017	12/31/2016	10/01/2016
Sales	$2,453.04	$2,220.65	$2,182.57	$2,294.14
Warranty Reserve	$45.08	$46.56	$46.35	$37.51
Allowance % of Sales	1.8%	2.1%	2.1%	1.6%

The reserve balance displays a noticeable year-over-year decline starting in the 12/17 period. While the company does not disclose the warranty provision expense for each period, **if we simply assume that the allowance percentage had remained constant as a percentage of sales with the 3/18 quarter, it would have taken over 4 cents per share off of EPS in the 6/18 quarter.**

Inventory Balances Coming Back in Line

MHK's inventories have been outstripping sales and cost of sales growth for the last several quarters resulting in large year-over-year jumps in inventory days of sales in the 9/17, 12/17 and 3/18 quarters.

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Inventory	$2,061.20	$2,044.96	$1,948.66	$1,911.03
COGS	$1,810.46	$1,707.51	$1,615.47	$1,665.21
DSI	103.9	109.3	110.1	104.7

	7/01/2017	4/01/2017	12/31/2016	10/01/2016
Inventory	$1,865.94	$1,740.88	$1,675.75	$1,673.24
COGS	$1,673.90	$1,540.29	$1,491.57	$1,567.58
DSI	101.7	103.1	102.5	97.4

The company admitted that it came into 2018 with higher inventory than it wanted to have, and it has been trying to work the balance down. This has involved selling off impaired inventory and reducing production levels which has negatively impacted productivity. In addition, rising costs have been pushing inventories up as well. Consider the following management comment from the second quarter conference call:

> *"In the second quarter, volumes did not increase as we anticipated and we produced less than we sold to reduce inventory. Our productivity declined as we manufactured new products that had higher production costs. These issues have been addressed, but some costs will flow through to our inventory. Our U.S. LVT sales in the period grew less than we forecast due to a delay in shipments of our sourced products. We anticipate a significant increase in LVT sales as our new U.S. production ramps up and the supply of sourced products increases in the third period."*

In short, the problems with inventory are well-known at this point, and management has been dealing with the issue. However, investors should keep in mind that the company turns its inventories relatively slowly and utilizes the FIFO method of inventory accounting. This means the impact of higher costs associated with more recent raw materials prices and lower productivity will be impacting the income statement well into the next quarter.

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 recent 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.

Disclosure

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