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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Ritchie Brother Auctioneers (RBA) EQ Review

Current EQ Rating*	Previous EQ Rating
4+	na

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 initiate earnings quality coverage of RBA with a 4+ (Acceptable) rating

Overall, while we are somewhat concerned about the degree to which growth is dependent on rising fees which will see some tailwinds expire after the June quarter, we consider RBA's earnings quality to be solid.

- While the gross transaction volume (GTV) generated by RBA's auctions has been growing in the low single-digit range, the company has seen a boost to profit growth from charging higher fees. Some of the increase in fees has been the result of the company's 2017 acquisition of IronPlanet which led to different buyer fees across geographic markets. To remove the incentive to trade in one market over another. The last set of fee changes occurred in June of 2019 so that benefit to year-over-year growth will be gone after the current quarter. Fee growth has also benefitted from an increase in the portion of lower-sized lots which carry higher buyer's fees relative to transaction volume. While this is not an earnings quality issue, we view this as a low-quality source of growth investors should be considering.

- RBA utilizes the declining balance method to depreciate a significant portion of its asset base. This method results in significantly more depreciation being recognized in the early years of an asset's life compared to the more common straight-line method and has contributed to the company reporting depreciation expense more than twice that of capex. Overall, this implies more conservative earnings. However, we do note that capital spending has fallen to about 1.1% of sales from 1.4% a year ago and the company has cut capital spending for 2020 in light of the current crisis. If the company has to increase capex in future periods to "catch up", it could result in a quick jump in depreciation expense compared to companies that use the straight-line method. We also note that the computer software and leasehold improvement categories (which are depreciated on the straight-line method) are over 80% depreciated which could indicate a need to accelerate spending in those areas.

- RBA did not disclose allowance for bad debts on a quarterly basis prior to the 3/20 quarter. In addition, it did not break out trade receivables from consumption tax receivables making an analysis of receivables and allowance trends difficult. We are able to see that the allowance balance fell from $5.2 million in the 12/19 quarter to $3.7 million in the 3/20 quarter and the company wrote off $1.5 million more in receivables in the quarter than it expensed back to the allowance. These two factors could indicate the company is somewhat under reserved despite its claim that it is not seeing a negative impact on receivables from COVID-19. We do not see this as a huge problem given receivables are largely secured by the equipment sold. However, changes in the reserve have the potential to move EPS 1-2 cps in a quarter. The new disclosure is an improvement although we would prefer to see a breakout of the receivables quarterly given the material consumption tax receivable component.

- Lower stock-based compensation added about 1.5 cps to earnings in the quarter.

- To RBA's credit, the company utilizes very minimal non-GAAP adjustments when presenting earnings. In fact, the 3/20 quarter and its year-ago comparable period did not feature any adjustments. The downside to this is that analysts must be aware of any unusual items impacting comparisons. In the case of the 3/20 quarter, the effective tax rate fell to 19.6% from 26.8% in the year-ago period due to a lower impact from US tax reform and a larger percentage of income taxed in lower-rate jurisdictions. Also, the quarter benefitted from the receipt of $1.7 million (1.5 cps) in contingent consideration from the sale of assets in 2019. Offsetting this was $2 million in nonrecurring depreciation and amortization and other expenses related to the termination of a UK business arrangement, the cancellation of a property transaction, and executive departures.

- RBA offers some contracts that guarantee a minimum amount of proceeds to sellers. In some cases, it also buys equipment from customers for inventory sales. Both of these "at risk" contract types expose the company to losses if auction proceeds fall below the company's cost. The mix of these contracts is volatile from period to period. At risk contracts rose to 20% of sales in 2019 from 17% the year before but fell to 15% in the 3/20 quarter from 16.5% a year-ago quarter. We see no increased dependence on these contracts for growth, the company's contract with the US Defense Logistics Agency does require it to purchase at least $11 million of surplus government inventory over the next year and RBA has little say in the equipment purchased. However, the company is set up well to sell these items through its GovPlanet business unit and we see the risk of a material loss as low.

Company Overview

RBA operates a leading network of live and online auctions that primarily focus on used and unused heavy equipment such as earthmoving equipment, trailers, governments surplus, and oil and gas machinery. In addition to conducting the auction, RBA inspects and appraises the equipment as well as offering full asset management services to customers. Customers include equipment dealers, construction firms, rental companies, and OEMs. RBA has over 40 permanent auction locations in 12 countries but has migrated much of its business online. Its 2017 acquisition of Iron Planet boosted its online equipment auction reach. Roughly 80% of the company's gross transaction volume (GTV) is generated at live auction sites with online auction sites generating the balance. However, buyers can submit bids to the on-site auctions from online and over 50% of winning bids now come from online. This has not diminished the importance of the on-site locations as many sellers still look to the company to move equipment to its sites to perform the appraisal and preparation services.

RBA earns a commission from the seller based on the auction proceeds as well as various fees from the buyer and seller as well as revenue from ancillary services such as asset management. The company also does guarantee contracts where the consignor is guaranteed a minimum amount plus additional amounts if proceeds exceed an agreed-upon level. Also, the company can purchase equipment from consignors. In such "inventory sales" RBA books the revenue and records a corresponding cost of inventory sales. Inventory sales as a percentage of total revenue is quite volatile but typically runs in the 30-40% range. Given the substantially lower margins on these deals, the mix of inventory sales significantly distorts the traditional total firmwide gross profit measure. Also note that prior to the 2018 adoption of ASC 606, RBA recorded inventory sales on a net basis in revenues with nothing reflected in cost of sales. Thus, analysts must be certain that historical data has been restated to reflect the accounting change.

Much of the Recent Growth Is Coming from Fee Increases

RBA's total revenue growth can be a misleading figure given the volatility in inventory sales from period to period. GTV gives a better idea of the growth in auction activity as it measures as it captures the total volume of lots sold through the company's auction platforms. Table 1 shows the growth in GTV for the last five years.

Table 1

	2019	2018	2017	2016	2015
Service GTV	$4,626	$4,544	$4,121	na	na
growth	*1.8%*	*10.3%*			
Inventory GTV	$515	$421	$347	na	na
growth	*22.4%*	*21.3%*			
Total GTV	$5,141	$4,964	$4,468	$4,335	$4,248
growth	*3.6%*	*11.1%*	*3.1%*	*2.1%*	

The spike in GTV growth in 2018 was driven by the 5/31/2017 acquisition of IronPlanet, a major online heavy equipment auction house. Absent that temporary boost, total GTV has been growing in the 2-3% range. However, much of the total GTV growth has been driven by a huge jump in inventory GTV while growth in the more important service GTV fell to under 2% in 2019. Table 2 shows the same measures on a quarterly basis for the last two years:

Table 2

	3/31/2020	12/31/2019	9/30/2019	6/30/2019
Service GTV	$1,056.893	$1,270.183	$973.022	$1,339.141
	1.3%	7.7%	1.8%	0.5%
Inventory GTV	$90.132	$113.725	$111.219	$158.616
	-31.2%	-28.1%	32.4%	68.4%
Total GTV	$1,147.025	$1,383.908	$1,084.241	$1,497.757
	-2.4%	3.5%	4.3%	5.0%

	3/31/2019	12/31/2018	9/30/2018	6/30/2018
Service GTV	$1,043.624	$1,179.421	$955.455	$1,332.228
Inventory GTV	$131.057	$158.193	$83.972	$94.184
Total GTV	$1,174.681	$1,337.614	$1,039.427	$1,426.412

Growth in GTV can be volatile based on the timing of auctions and equipment coming available. However, the company has been able to generate gross profit growth in excess of GTV growth in part due to growing fee revenue. This can be seen in the following table which shows the components of service revenue, inventory sales revenue, and total company gross profit for the last

Table 3

	2019	2018	2017	2016
Total GTV	$5,141	$4,964	$4,468	$4,335
Commissions	$432	$420	$394	$366
Fees	$372	$329	$230	$190
Total Service Revenue	$804	$750	$624	$556
Cost of Service Revenue	$165	$159	$133	$113
Service Gross Margin	$639	$590	$491	$443
Inventory Sales Revenue	$515	$421	$347	$571
Cost of Inventory Sales	$481	$374	$306	$513
Gross Inventory Profits	$34	$46	$40	$58
Total Gross Profit	$673	$637	$532	$500
Increase in:				
Commissions	$12	$26	$28	
Fees	$43	$99	$41	
Total Service Revenue	$55	$125	$69	
Total Gross Profit	$36	$105	$31	

Table 3 shows that the growth in fee revenue accounted for roughly 80% of the growth in service revenue in each of the last two years despite accounting for less than half of total service revenue. We also think it is informative to look at total gross profit rather than revenue as it helps to adjust for the mix of inventory sales. Not all fee revenue is purely based on GTV so it does not all pure profit. Still, incremental fee revenue is likely very profitable. As such, it is interesting to note that the absolute dollar growth in fee revenue has exceeded the growth in gross profit for the last three years.

The outsized growth in fee revenue can also be seen by looking at it as a percentage of service GTV:

Table 4

	2019	2018	2017
Service GTV	$4,626	$4,544	$4,121
Commissions	$432	$420	$394
% of Service GTV	9.3%	9.2%	9.6%
Fees	$372	$329	$230
% of Service GTV	8.0%	7.2%	5.6%

We see that commissions as a percentage of service GTV has remained fairly consistent over the last three years while fees as a percentage of service GTV have risen from 5.6% to 8.0%. The company attributed the jump in fee revenue in 2019 to higher total GTV, full buyer fee harmonization implemented in June 2019, and RBFS fee revenue growth… partially offset by lower RB Logistics revenue earned in the International region." Buyer fee harmonization is related to the 2017 acquisition of IronPlanet, which had different buyer fees that the company in various geographic markets. In 2018, RBA implemented changes to buyers fees to move them more towards parity across markets. A second round of fee changes was implemented in June of 2019 which resulted in an increase in average rates. This benefit will expire after the second quarter. We are in the process of obtaining historical rate data to allow us to quantify how much rate harmonization has boosted results.

The company also noted in the 3/20 10-Q that fee growth was boosted by a greater proportion of small lots. The company's website lists the current buyer fee schedule:

Successful bidders are required to pay a transaction fee:

- *Each purchased lot will be subject to a transaction fee of:* ***(a) 10% on all lots selling for 10,000 or less, (b) 3.85% on all lots selling for more than 10,000 up to 33,500, with a minimum fee of 1,000 per lot or, (c) 1,290 on all lots selling for over 33,500 (in the currency of the auction).*** *The transaction fee applies to on-site, online and proxy purchases and will be waived for purchases made in person at on-the-farm auctions.*

- *The following exceptions will apply to the foregoing. Each purchased lot will be subject to a transaction fee of:*
  - *Japan – (a) 10% on all Lots selling for JPY 1,000,000 or less, or (b) 3.85% on all Lots selling for over JPY 1,000,000 up to JPY 3,400,000, with a*

minimum fee of JPY 100,000 per lot, or (c) JPY 130,000 on all Lots selling for over JPY 3,400,000;

- *United Kingdom - (a) 10% on all Lots selling for GBP 5,000 or less or (b) 3.85% on all Lots selling for over GBP 5,000, with a minimum fee of GBP 500 per Lot*

We see that lots less that $10,000 draw a 10% buyers fee while the effective percentage gradually falls to 3.85% on lot sizes above $10,000. Average lot sizes have been declining for several quarters which helps to boost the growth in fee revenue as a percentage of GTV. Not all of this flows to profits as the higher fees are designed to compensate for the fact that a $5,000 trailer may take as much time to handle, store and process as a $50,000 bulldozer. While it may be true that the increase in fees driven by smaller lots may not all fall to the bottom line, we still suspect that the impact on profit growth is greater than the impact on GTV from the related transaction.

Fee growth is also being drive by the company driving higher use of services such as financing transactions, logistics services, and asset management services. These are helping to drive revenue growth above the low single-digit growth in service GTV. While these are legitimate sources of growth, the one-time fee harmonization and the temporary benefit from smaller lot sizes to be lower quality.

Accelerated Depreciation

RBA utilizes the declining balance method to depreciate much of its fixed asset base. The following table shows the deprecation method for each asset class along with the percentage of the gross balance that has been depreciated:

Table 5

	Dep. Method	Gross	Acc. Dep.	Net	% Depr.
Land and Improvements	Declining Balance- 10%	$361.623	-$77.015	$284.608	21%
Buildings	Straight Line- 15-30 yrs	$252.774	-$115.423	$137.351	46%
Yard and Automotive Equipment	Declining Balance- 20-30%	$66.871	-$40.686	$26.185	61%
Computer Software and Equipment	Straight Line- 3-5 yrs	$80.756	-$68.431	$12.325	85%
Office Equipment	Declining Balance- 20%	$31.760	-$21.776	$9.984	69%
Leasehold Improvements	Straight Line	$19.756	-$16.541	$3.215	84%
Assets Under Development		$10.814		$10.814	0%
		$824.354	-$339.872	$484.482	41%

Most companies utilize the straight-line method to depreciate assets where the depreciation for the asset each year is the gross balance divided by the estimated number of years of service. Since it is calculated on the gross balance, the periodic depreciation for the asset is the same every period. Under the declining balance method, the beginning net book value is multiplied by a percentage each period which results in depreciation expense declining rapidly throughout the life of the asset. This is a more realistic method for assets that have more utility early in their life cycle or in cases where the assets will require significant maintenance spending as they age. These would seem to apply to office equipment and yard equipment although this does not make as much sense to us for land and improvements.

To examine the difference in expense recognition under the two methods, let's look at the difference in depreciation on a $10,000 piece of office equipment with a residual value of $0 using RBA's policy of the declining balance with a 20% rate versus using the straight-line method over a typical period of ten years. The following table shows annual depreciation expense and the ending net book value for each method:

Straight Line- 10 years	Depreciation Expense	Ending Net
Year 1	$1,000	$9,000
Year 2	$1,000	$8,000
Year 3	$1,000	$7,000
Year 4	$1,000	$6,000
Year 5	$1,000	$5,000
Year 6	$1,000	$4,000
Year 7	$1,000	$3,000
Year 8	$1,000	$2,000
Year 9	$1,000	$1,000
Year 10	$1,000	$0

Declining Balance- 20%	Depreciation Expense	Ending Net
Year 1	$2,000	$8,000
Year 2	$1,600	$6,400
Year 3	$1,280	$5,120
Year 4	$1,024	$4,096
Year 5	$819	$3,277
Year 6	$655	$2,621
Year 7	$524	$2,097
Year 8	$419	$1,678
Year 9	$336	$1,342
Year 10	$268	$1,074

We see that RBA's declining balance method results in substantially higher depreciation expense in the early years which drops off dramatically by year ten. Note that while there is still a net book value under the declining balance method at the end of year ten, this would likely be below a reasonable residual value in the real world.

This accelerated recognition of depreciation is a contributing factor in RBA booking depreciation more than double that of capex which is shown in the following table:

	2019	2018	2017
Depreciation Expense	$29.112	$29.021	$28.337
Capital Spending	$13.589	$16.860	$10.812

The high depreciation expense relative to capex implies a stronger earnings quality. However, we also note that capex has declined to 1.1% of sales from 1.4% a year ago and the company has cut its capex spending plans for 2020 in response to the uncertain environment. As the asset base ages, the company may see a boost from lower depreciation expense more quickly than it would if it used the straight-line method for all asset classes. However, this will work in reverse if the company must ramp up spending after the crisis clears.

We would also note that Table 4 shows that purchased computer software and equipment and leasehold improvements (both depreciated under the straight-line method) are more than 80% depreciated as of the end of the year. This could be an indication that these assets are running out of useful life which will necessitate an acceleration in cash spending in that area. This is particularly true for computer equipment given the company's increasing reliance on technology for its on-line auction platforms. It is also worth noting that the company capitalizes internally developed software as a component of intangible assets (rather than PP&E) and amortizes those costs over 3-5 years which seems reasonable.

Receivables Allowance Disclosure Is Weak

RBA discloses "trade and other receivables" on its quarterly balance sheets. On an annual basis, it breaks that account down which shows that the account includes a sizable consumption tax receivable component:

	2019	2018	2017
Trade Receivables	$121.752	$112.680	$77.870
Consumption Tax Receivable	$12.108	$16.099	$13.592
Other Receivables	$3.542	$0.478	$0.643
Total Trade and Other Receivables	$137.402	$129.257	$92.105

Until the 3/20 quarter, RBA did not disclose the allowance for bad debts in its quarterly filings. Given that there is likely little of the allowance related to the consumption tax or other receivables portion of the balance, the most informative way to analyze the credit allowance is to compare it to only the trade receivables portion of the account:

	2019	2018	2017
Trade Receivables	$121.752	$112.680	$77.870
Allowance for Losses	$5.225	$5.942	$5.443
Allowance % of Gross Receivables	4.1%	5.0%	6.5%

We can see that the allowance percentage has fallen significantly in the last three years. Given that we don't know the components of the "trade and other receivables" account disclosed in the 3/20 10-Q, we can't calculate a comparable ratio for that quarter. However, we can look at the sequential trend in the allowance compared to the movement of the annual "trade and other receivable accounts" for the last three fiscal years:

	3/20	3/19	2019	2018	2017
Trade and Other Receivables	$245.727	$220.452	$137.402	$129.257	$92.105
Allowance	$3.727	na	$5.225	$5.942	$5.443
Allowance % of Gross Receivables	1.5%	na	3.7%	4.4%	5.6%

We suspect the jump in receivables and the fall in the allowance percentage from the 12/19 to the 3/20 quarter is related to the timing of consumption tax receipts which do not have an allowance associated with them. The company stated in the 10-Q that it has not seen a decline in receivables quality due to COVID-19. Regardless, the sequential decline in the allowance itself seems unusual and could be an indication that the allowance percentage was reduced. This is further indicated by the company's new disclosure as of the 3/20 10-Q which shows the movement in the allowance:

Allowance for Credit Losses	
Opening Balance 1/1/20	$5.2250
Current Period Provision	$0.6580
Write-off charged against allowance	-$2.1560
Balance 3/31/20	$3.7270

Despite more than $2 million in receivable write-offs, the company only incurred $658,000 in expense to replenish the reserve.

As the discussion above indicates, the company's receivable disclosures prior to the 3/20 quarter make it very difficult to get a clear picture of what is happening with receivables. The new disclosure in the 10-Q will give a clearer picture after a year passes and we can do YOY comparisons by quarter. It would be even better if the company provided a breakdown of receivables by quarter given the large and apparently volatile impact of consumption tax receivables. Overall, we do not have a large degree of concern related to receivables given they are largely secured by the equipment being sold. However, we note that a $2 million move in the provision expense could move EPS in any quarter by roughly 1.5 cps.

Other Items

To RBA's credit, the company utilizes very minimal non-GAAP adjustments when presenting earnings. In fact, the 3/20 quarter and its year-ago comparable period did not feature any adjustments. The downside to this is that analysts must be aware of any unusual items impacting comparisons. In the case of the 3/20 quarter, the effective tax rate fell to 19.6% from 26.8% in the year-ago period due to a lower impact from US tax reform and a larger percentage of income taxed in lower-rate jurisdictions. In addition, the quarter benefitted from the receipt of $1.7 million (1.5 cps) in contingent consideration from the sale of assets in 2019. Offsetting this was $2 million in nonrecurring depreciation and amortization and other expenses related to the termination of a UK business arrangement, the cancellation of a property transaction, and executive departures.

Guarantee and Inventory Contracts Carry Higher Risk

As we discussed above, some of the company's contracts involve RBA either buying the asset from the seller in an inventory sale, or guaranteeing a minimum amount of auction proceeds to the seller. These are referred to as "at risk" contracts given the company's exposure to a potential loss should the final auction price fall below the company's costs. The proportion of at risk contracts can vary significantly from period to period. At risk contracts jumped to 20% of total revenue in 2019 versus 17% in the previous year. However, at risk contracts fell to 15% in the 3/20 quarter from 16.5% a year-ago quarter.

While there is not an increasing reliance on at-risk contracts for growth, it is worth noting that in December of 2017, the company entered into a two-year contract with the US Government Defense Logistics Agency to acquire and sell non-rolling stock surplus assets. These contracts required RBA to purchase between $11 million and $51 million of property annually between 4/18 and 3/20. As of 3/31/20, the company had purchased $41 million of property. RBA elected to extend the contract another year to 3/21. Adding to the risk is the fact that the RBA has little control over the types of assets it may be required to buy, and much of the items purchased may not be equipment the company typically sells. However, the company is able to sell the product through its GovPlanet unit which specializes in government surplus and the company's election to reup the contract indicates success so far. If RBA chooses, it can limit its purchases to $11 million over the next year which would limit its loss exposure to a reasonable degree. As such, we do not see this as a material overhang.

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.

Disclosure

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