BEHIND THE NUMBERS

EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

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Stanley Black Decker (SWK) EQ Update- 12/18 Quarter

Current EQ Rating*	Previous EQ Rating
4-	4-

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

We maintain our earnings quality rating of 4- (Acceptable) pending release and review of the 10-K.

SWK reported adjusted EPS of $2.11, a penny ahead of the consensus estimate. However, the stock was pummeled over guidance for full year 2019 of $8.45-8.65, well short of Wall Street's $8.80. While we do have some skepticism of the dramatic improvement in the SG&A percentage in the same quarter as a larger restructuring charge, we are maintaining our 4- (Acceptable) rating until we have the 10-K.

- Gross margins adjusted for charges fell by 280 bps which management blamed on higher raw materials costs and unfavorable FX. However, SG&A as a percentage of sales fell by 260 bps which management attributed to cost management. As previously announced, the company took a $102 million restructuring charge in the 12/18 quarter which represented the bulk of the full year $160 million charge. Large charges call into question the quality of near-term profit improvement given the possibility that ongoing expenses have been included in the "one-time" amounts. Management noted that its current restructuring action is largely complete.

- Management indicated it will be in deleveraging mode in 2019 with regards to usage of free cash flow. On a trailing-12 month basis, free cash flow of $769 million was not sufficient to cover the $385 million dividend and the $527 million buyback. The 2018 buyback was focused in the 6/18 and 9/18 quarters which resulted in a more than 2%

reduction in the average share count used to calculate adjusted EPS figure in the 12/18 quarter. While the buyback will be pared in 2019, the company still expects an approximate 10 cps tailwind in 2019 from the residual effect of the buybacks.

- Accounts receivable days (DSO) fell by approximately 5 days versus the year-ago quarter after adjustment for factored receivables in last year's period. Keep in mind that SWK ended its receivable factoring program beginning in 2018. DSOs were up two days in the 9/18 quarter, so some of the 12/18 decline in DSO could have been related to the timing of collections. Regardless, the fact that DSOs are trending downward in the quarters following the cancellation of a factoring program implies a disciplined collection approach. We noted in our previous review that the shift in sales to new channels from the Craftsman rollout and the introduction of new products in the superstore channel could have impacted the receivables trends. Still, we wonder if the company has room to negotiate with better payment terms in the future.

- Inventory days (DSIs) rose by over 6 days versus the year-ago fourth quarter. This continues the trends seen in previous quarters which is being driven by the rollout in new Craftsman products as well as new Stanley products in new channels. We are therefore not very concerned that this represents an unexpected increase that will result in future discounting. However, management has noted that inventory will likely remain a drag on earnings in the foreseeable future as it seeks to ensure availability of new products.

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.

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