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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Stanley Black and Decker (SWK) EQ Update 3Q '19

Current EQ Rating*	Previous EQ Rating
3-	4-

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 a more detailed explanation of the EQ Review Rating scale, please refer to the end of this report

We are lowering our earnings quality rating on SWK to 3- (Minor Concern) from 4- (Acceptable). While the company's inventory situation seems to be improving, we are concerned about the extension of the restructuring actions and the presence of some new red flags noted below.

- SWK announced its latest restructuring program after the third quarter which is expected to produce $200 million in annualized savings by reducing headcount and rationalizing operations. Management indicated this is a proactive response to headwinds from commodity costs, currency impacts, and tariffs. The company expects pretax restructuring charges of $150 million to be recognized primarily in 2019. The 9/19 quarter contained $74 million of restructuring charges, or about 20% of adjusted pretax earnings for the quarter. This is just the latest of the company's announced restructuring plans. While the company has had unusual charges over the last couple of years, we have been more patient than normal given the divestiture of the security business and integration of acquisitions. However, the size of the charges and their ongoing nature are raising our concern level regarding the quality of charge-adjusted earnings figures.

- We have been tracking the rising inventory levels at SWK for several quarters but have not assigned it a high level of concern given the credibility of management's explanation that it was building levels to support the Craftsman Tool rollout. The string of increases finally reversed in the current quarter with DSI declining by 2.4 days versus the year-ago quarter. This reduces our concern in this area.

- SWK's warranty provision increased by 9% in the 9/19 quarter versus the year-ago quarter. However, warranty usage increased at a much faster rate, causing the warranty allowance to fall to 0.68% of trailing sales versus 0.75% a year ago. Restoring the allowance to its previous level would require an approximate 6 cps in provision expense.

- In previous quarters, SWK had built up its accounts receivable allowance to 6.9% of gross receivables from the previous mid-4% range. However, this began to reverse in the 9/19 quarter as provision expense declined by $2.7 million (1.4 cps).

- Undesignated hedges provided a $2 million gain in the 9/19 quarter versus a $5.9 million loss in the year-ago period. These amounts represent hedges which are essentially marked to market every period as opposed to gains or losses reclassified from comprehensive income when the hedged item impacts earnings. We, therefore, consider this a non-operating item which added about 4 cps to earnings in the quarter.

- Pension expense was a $3.4 million expense versus a $1.3 million gain in the year-ago quarter. This swing was an approximate 2.5 cps *drag* on EPS growth in the period.

- Management cited improved working capital performance as a tailwind to cash flow growth in the year-to-date period. As we noted above, inventory DSIs improved by approximately 2.4 days. However, this was more than offset by a 15-day year-over-year decline in days payable. As we noted in previous reviews, the company restarted its accounts receivable sales program in the 12/18 quarter. Receivables sold but outstanding at the end of the quarter totaled $73 million which is a decent approximation of how much incremental cash was generated through the sales over the year-ago period. This alone accounted for a significant portion of the $222 million improvement in operating cash flow during the nine-month period. However, even after adjustment for the derecognized receivables, DSOs fell by approximately 8 days versus the 9/18 quarter. Management did not discuss the movements in payables or receivables in the 10-Q or conference call. We suspect the huge decline in payables was an unusual timing issue, which was offset by the company pushing to collect on receivables. We will be watching for these items to normalize in the next quarter.

Allowance for Warranties Down

SWK's provision expense for warranties rose by 9% in the three months ended 9/19. However, as the following table shows, warranty payments climbed at a much faster pace:

	9/28/2019	6/29/2019	3/30/2019	12/29/2018
Warranties and Guarantees Issued	$30.3	$34.3	$28.1	$28.7
Warranty Payments and Currency	-$36.4	-$32.5	-$28.8	-$30.8
Warranty Reserve Ending Balance	$97.1	$103.2	$101.4	$102.1
Warranty % of Trailing 12 Month Sales	0.68%	0.73%	0.72%	0.73%

	9/29/2018	6/30/2018	3/31/2018	12/30/2017
Warranties and Guarantees Issued	$27.8	$29.7	$24.2	$28.4
Warranty Payments and Currency	-$27.7	-$32.7	-$25.6	-$28.4
Warranty Reserve Ending Balance	$104.2	$104.1	$107.1	$108.5
Warranty % of Trailing 12 Month Sales	0.75%	0.76%	0.80%	0.84%

Typically, warranty provision and payments track closely in line. However, over the last several quarters, the allowance for warranties as a percentage of trailing 12-month revenue has been slowly declining. The jump in warranty payments in the 9/19 quarter left the allowance percentage at 0.68%. We estimate it would take about 6 cps in charges to boost the reserve back to the 0.75% level. This could represent and unexpected headwind for earnings in upcoming quarters.

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.

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