BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

November 1, 2018 | www.btnresearch.com

Stanley Black & Decker (SWK) EQ Review Update- 9/18 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 are maintaining our 4- (Acceptable) rating on Stanley Black & Decker (SWK).

SWK reported adjusted EPS of $2.08 in the 9/18 quarter which beat the consensus targets by 4 cps. However, revenue was a slight miss largely owing to negative currency. The company lowered its guidance for the full year by $0.25 per share due to tariffs, rising commodity costs, currency impacts and lower than expected organic growth partially offset by lower tax rate and other "below the line" items.

- Inventory DSIs continued to rise, jumping almost 10 days over the 9/17 quarter. The company contends that this is in preparation for the massive rollout of new Craftsman products. The fact that the buildup was across all inventory components and not concentrated in finished goods lends credibility to this and reduces our concern.

- Accounts receivable days (DSO) rose by a little over 2 days in the quarter which the company attributed to higher core growth. We are not especially concerned with the increase in receivables but it is an item to be watching in the next quarter.

- Management announced it will be taking $125 million in charges related to a plan to reduce costs by $250 million to combat tariff, commodity and FX headwinds.

Inventory Up

SWK's increase in inventory days of sale (DSI) accelerated noticeably in the 9/18 quarter. DSIs now stand at a recent historical high:

	9/29/2018	6/30/2018	3/31/2018	12/30/2017
Cost of Sales	$2,262	$2,361	$2,050	$2,055
Inventory	$2,650	$2,444	$2,350	$2,018
DSI	106.9	94.5	104.6	89.6

	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Cost of Sales	$2,112	$2,079	$1,799	$1,850
Inventory	$2,247	$2,078	$1,977	$1,478
DSI	97.1	91.2	100.3	72.9

However, as we have noted before, there does not appear to be a disproportionate increase in finished goods inventory typically associated with an unintended buildup in product, as shown in the following table:

	9/29/2018	6/30/2018	3/31/2018	12/30/2017
Finished Goods % of inventory	72.6%	71.0%	72.1%	72.4%
In-Progress % of inventory	7.4%	8.1%	7.5%	7.7%
Raw Materials % of inventory	20.0%	21.0%	20.4%	19.9%

	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Finished Goods % of inventory	73.3%	72.3%	73.6%	70.6%
In-Progress % of inventory	7.4%	8.0%	8.0%	9.0%
Raw Materials % of inventory	19.3%	19.7%	18.3%	20.3%

Finished goods actually fell as a percentage of total inventory. This adds credibility to the company's explanation that it will be carrying more inventory to support the upcoming launch of new *Craftsman* tools. Consider this quote from the 9/18 quarter conference call:

> *"We are, however, revising our outlook to deliver a free cash flow conversion rate of approximately 90%.* ***This recognizes our expectation to carry higher inventory due to continued growth in the business and the ongoing Craftsman rollout"***

SWK has plans to release more than 1,200 new *Craftsman* products over the next year including hand tools and lawn and garden equipment to be sold through major retailers including Lowe's and Amazon. This reduces the concern of the inventory spike.

In addition, we note that accounts payable days increased by about three days above the year-ago quarter, but this is to be expected given the ramp-up in inventories.

Receivables Up

As the following table shows, accounts receivables days of sale (DSO) at the end of the 9/18 quarter climbed by about two days over the year-ago quarter. Note that previous periods have been adjusted for the derecognition of accounts receivable sold under the company's discontinued securitization program.

	9/29/2018	6/30/2018	3/31/2018	12/30/2017
Sales	$3,494.8	$3,643.6	$3,209.3	$3,305.6
Net Trade Accounts Receivable (balance sheet)	$2,236.2	$2,151.4	$1,986.1	$1,628.7
Securitized Receivables Derecognized	$0.0	$0.0	$0.0	$100.8
Adjusted Receivables	$2,236.2	$2,151.4	$1,986.1	$1,729.5
Adjusted DSOs	58.4	53.9	56.5	47.7

	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Sales	$3,359.4	$3,286.7	$2,856.3	$2,920.4
Net Trade Accounts Receivable (balance sheet)	$2,009.8	$1,927.9	$1,728.0	$1,302.8
Securitized Receivables Derecognized	$61.0	$100.8	$65.3	$100.5
Adjusted Receivables	$2,070.8	$2,028.7	$1,793.3	$1,403.3
Adjusted DSOs	56.2	56.3	57.3	43.8

Management noted in its liquidity discussion in the 10-Q filing for the 9/18 quarter that receivables consumed more cash due to strong organic growth. Organic growth was 5% in the quarter. While this is not stellar growth, the timing of sales in the quarter could have driven the increase in receivables. In addition, the company is beginning to sell *Craftsman* into new channels we speculate could distort the timing of receivables collections. We are therefore not overly alarmed by the receivables increase, but this is certainly something to watch in the next quarter.

New Cost Reduction Program

Management announced during the conference call that it is initiating a new restructuring program due to "external headwinds, including commodity inflation, currency and tariffs,

as well as a somewhat slower U.S. residential housing and automotive markets related to continued upward pressure on U.S. short-term interest rates." A charge of $125 million is expected in the 12/18 quarter and will provide for $250 million in pre-tax cost savings in 2019. There was not much detail in the call regarding the components of the charge, but management did state the following:

> *"On the cost reduction side, I mean, we will go through a process that we've done many times before as a company. We haven't done one of these in a while. However, the discipline in structure on the process is very much focused on, what are the types of costs that we can take out that would not impact growth initiatives within the short-term and the midterm? How do we ensure that we don't slow momentum in some of these great growth catalysts that both Jeff and Jim talked about this morning? And so it will be very much targeted to activities that are removed from the customer in that regard, removed from the innovation categories, et cetera, that really do impact growth in the timeframe of the next one to three years."*

For perspective, the company has taken the following restructuring charges in the last four years which are largely related to mergers and acquisitions:

	2017	2016	2015	2014
Restructuring Charges	$51.5	$49.0	$47.6	$18.8

We certainly would not label the company as a "serial acquirer" that takes regular charges that are large percentages of profits. However, we do note that the $125 million in charges is close to what the company has spent in the last three years combined. We have an overall cynical view of restructuring charges and raise our eyebrows when a company announces it has hundreds of millions in excess costs it can eliminate without negative repercussions for operations. More importantly, we are skeptical of the quality of charge-adjusted earnings that add back all of these costs given the potential for expenses that should be viewed as ongoing being lumped into the charges.

Sears Bankruptcy Impact

It is worth noting that the company addressed the Sears bankruptcy in the conference call. SWK has only about $50 million in annual sales to Sears, so the impact of lost revenue is not material especially in light of the fact that Sears stores will effectively be removed from competition as an alternative supplier of *Craftsman* tools. SWK will continue to make its

contractual payments related to its acquisition of the Craftsman brand as planned and it will continue to honor the lifetime warranty on *Craftsman* tools as planned from the beginning. SWK does have a deferred revenue liability related to a royalty-free liability which will be reversed into profits but this will be largely offset by an increase to warranty liabilities as the company steps in to honor Sears' portion of the lifetime warranty on all *Craftsman* tools.

Explanation of EQ Rating Scale

Rating	Description
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

BTN Research is a research publication 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. Information included in this report is derived from many sources believed to be reliable (including SEC filings and other public records), but no representation is made that it is accurate or complete, or that errors, if discovered, will be corrected.

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.