BEHIND THE NUMBERS
Quality of Earnings Analysis
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Stanley Black & Decker, Inc. (SWK) Earnings Quality Update 12/20 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We maintain our earnings quality rating of 3+ (Minor Concern)

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

Summary

SWK's fourth-quarter non-GAAP earnings of $3.29 topped the consensus by 27 cps. We did identify in excess of 15 cps of one-time boosts to the quarter, but the earnings beat remains well intact without them.

What improved?

- Cash flow growth was strong and free cash flow conversion was over 130%.
- Factored receivables fell to 1.9 days of sales from 2.5 in the year-ago quarter. Factoring remains under control and did not impact the quality of cash flow growth.

What eroded?

- The company's tax rate adjusted for charges was 13.6% in the 12/20 quarter versus 15.8% in the year-ago fourth quarter. We saw no discussion about the rate or the cause of its decline in the press release or call. On the 9/20 quarter conference call, the company was projecting a 16-17% tax rate for full-year 2020. This would have required the tax rate in the fourth quarter to be more than 17% which would imply an earnings boost of 13 cps for analysts expecting that rate. This could account for about half the reported earnings beat.

- The provision for warranties during the quarter fell to 0.78% of sales compared to 0.95% in the year-ago quarter. We estimate that this could have added over 3 cps to earnings in the quarter.

What to watch

- SWK regularly adds back "Merger and Acquisitions Related and Other Charges" to arrive at its non-GAAP results. These are typically presented as a single line item in its press release reconciliations of GAAP to Non-GAAP results. The 10-Qs and 10-Ks offer a little more insight into the makeup of the charges. For the 12/20 quarter, we estimate that roughly $75 million of pre-tax add-backs were related to cost reduction plans, facility-related costs, and business transformation costs. This amounted to about 12% of adjusted pre-tax earnings. Charges of such size are common which we believe erodes the quality of non-GAAP results. This is the major factor preventing us from giving the company a 4 (Acceptable) rating.

- 2021 will be very front-loaded. Management is forecasting full-year organic growth of 4-8% with 27-32% growth in the first half being partly offset by -12% to -7% growth in the second half. The incredibly strong recent growth is being driven by 1) a pandemic-driven DIY surge, 2) a push to e-commerce where the company has an advantage, and 3) a surge in new and pre-owned home sales. 1Q and 2Q 2020 sales were certainly weak, posting -6% and -16% growth rates, respectively. However, 1Q trends should be watched carefully for any signs sequential growth is weaker than expected.

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 Concern)- 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 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 upcoming quarters. 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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