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Stanley Black & Decker (SWK) EQ Update 12/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3+	3-

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 are raising our earnings quality rating to 3+ (Minor Concern) from 3- (Minor Concern).

- Provision for doubtful accounts expense fell to $5.3 million in the 12/19 quarter versus $11.2 million in the 12/18 quarter. This added a little more than 3 cps to EPS growth in the period. However, this drove the allowance as a percentage of gross receivables to 7.8% versus 6.8% in the 9/19 quarter and 6.5% in the year-ago quarter. Looking forward, the 3/20 quarter faces an even easier comparison as the 3/19 quarter also contained an unusually high provision expense of $18.3 million. This, coupled with the high allowance percentage which could minimize the need for provision expense, will likely make for an even bigger tailwind from lower YOY provision in the upcoming quarter. This tailwind should disappear starting in the June 2020 quarter with a return to more normal provision expense comparisons.

- As noted in prior reviews, SWK restarted its receivables factoring program in the fourth quarter of 2018. At the end of the 12/19 quarter, the company had

$100 million in receivables sold (removed from the balance sheet) but still outstanding. This is essentially flat with the year-ago level which implies there was no masking of a receivables buildup. DSOs adjusted for the sold receivables declined by more than 4 days versus last year's fourth quarter. While this bodes well for conservative revenue recognition, the decline in receivables resulted in a boost to operating cash flow growth of $138 million in 2019 compared to a use of cash of $48.8 million in 2018. This $187 million beneficial swing from receivables accounted for well over half the reported $244.8 million increase in cash from operations in 2019. With trade/note receivable DSOs adjusted for factored receivables at 35 days, this source of cash flow growth, while very legitimate, is likely nearing an end.

- Inventory DSI levels fell by almost 7 days to approximately 80.5, continuing the decline started in the 9/19 quarter following the completion of the *Craftsman* rollout. We have discussed in previous reviews how the company had built inventory to support the *Craftsman* rollout and the support of new *Stanley* product introductions. Management accelerated the reduction in inventory in the 12/19 quarter by cutting production levels in the Tools & Storage business. This increased cost levels, putting pressure on gross margin in the quarter. While we view the normalization of inventory as a positive, we would caution that the company utilizes the LIFO method to account for its US inventories which account for about half the total. While total inventory balances declined by 5% year-over-year, the amount of inventory accounted for under LIFO declined by more than 8%. (SWK does not disclose the value of LIFO inventories quarterly.) While LIFO does provide a realistic matching of current sales with current costs, cutting production and eating into older LIFO layers of inventory can lead to expensing older, lower-cost inventory against current sales. With less than a quarter of inventories on hand, there is not much time for a buildup in older inventories to magnify that effect and the fact that the company is already citing the impact of higher costs from production cuts bears this out. However, there is still a possibility that a mild "LIFO liquidation" could have cushioned the blow from production cuts.

- SWK closed a deal to buy CAM, a leading provider of fasteners to the aerospace industry for $1.5 billion with $200 million contingent on the 737 returning to production. After an expected $185 million of cash tax benefits, the final deal is valued at $1.1-$1.3 billion. We will review the details of the transaction when available.

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 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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