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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Stanley Black & Decker (SWK) EQ Review

Current EQ Rating*	Previous EQ Rating
4-	NA

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

We initiate coverage of Stanley Black& Decker (SWK) with a rating of 4- (Acceptable)

We do not have serious concerns with SWK's earnings, but there are several issues that are complicated by recent accounting changes and other items that need to be adjusted when reviewing results.

- Accounts receivable days of sales (DSO) have declined year-over-year in the last couple of quarters after adjustment for the derecognition of securitized receivables. The sequential increase in deferred revenue over the last three quarters also bodes well for the quality of revenue recognition.

- The company discontinued its receivables securitization program as of the beginning of the year. However, it also adopted ASU 2016-15 which requires that cash flows from the deferred purchase price receivable related to the securitization program be reported as an investing cash flow where it was previously recorded as an operating cash flow. This has the effect of understating operating cash flow of the year-ago period relative to the current period on recent cash flow statements. After this adjustment, operating cash flow is actually declining, largely due to the termination of the securitization program. Cash flow growth should normalize after the next two quarters.

- Inventory DSIs have been increasing but the increase has moderated, has been centered in raw materials, and is to be at least somewhat expected from rising costs.

We note that the company uses last-in, first-out (LIFO) accounting for about 45% of its inventories which provides a more accurate matching of costs with revenues than first-in, first out (FIFO), particularly in periods of rising prices.

- About $1.2 million shares were excluded from the diluted share count in the 6/18 quarter due to being anti-dilutive while none were excluded last year. While beyond the company's control, this non-operational benefit added almost 2 cents to adjusted EPS in the quarter. This was not material to SYK's 6 cents per share earnings beat.

Accounts Receivable: Lots of Moving Parts to Consider But Nothing of Concern

There are several factors that must be taken into consideration when analyzing SWK's receivables.

- Prior to January 1, 2018, SWK conducted an accounts receivable securitization program under which it sold receivables to a wholly-owned, consolidated special purpose subsidiary which in turn sold those receivables to a third-party financial institution. The company received cash up front for the receivables plus a deferred purchase price receivable. Receivables were derecognized from SWK's balance sheet at the time they were sold to the third-party financial institution. The company discloses the outstanding derecognized balances in a footnote to its 10-Q filings and these amounts must be added back to trade receivables on the balance sheet to analyze the trends in DSOs.

- On 4/2/2018, SWK acquired Nelson Fastener Systems. While the exact amount of receivables was not disclosed, the total allocation to working capital was valued at only $65 million. In addition, our calculation of days sales outstanding (DSO) utilizes quarterly sales, so with the acquisition occurring at the very beginning of the quarter, the impact on the comparability on DSOs between the 6/18 and the year-ago period should be minimal.

- On 3/9/2017, SWK acquired Newall Tools for $1.9 billion, but only $19.7 million was allocated to receivables. Also, on 3/8/201, SWK acquired the *Craftsman* brand from Sears Holdings for $916 million, but only $40.2 million was considered working capital. Given their size and purchase in the final third of the quarter, these acquisitions could have artificially inflated the calculated DSO in the 4/01/2017 quarter, but we believe the impact was relatively minor.

The following table shows the calculation of adjusted DSOs for the last eight quarters by adding back the derecognized receivables noted above.

	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Sales	$3,643.6	$3,209.3	$3,305.6	$3,298.6
Net Trade Accounts Receivable (balance sheet)	$2,151.4	$1,986.1	$1,628.7	$2,009.8
Securitized Receivables Derecognized	$0.0	$0.0	$100.8	$61.0
Adjusted Receivables	$2,151.4	$1,986.1	$1,729.5	$2,070.8
Adjusted DSOs	53.9	56.5	47.7	57.3

	7/01/2017	4/01/2017	12/31/2016	10/01/2016
Sales	$3,286.7	$2,856.3	$2,920.4	$2,882.0
Net Trade Accounts Receivable (balance sheet)	$1,927.9	$1,728.0	$1,302.8	$1,730.2
Securitized Receivables Derecognized	$100.8	$65.3	$100.5	$79.0
Adjusted Receivables	$2,028.7	$1,793.3	$1,403.3	$1,809.2
Adjusted DSOs	56.3	57.3	43.8	57.3

We see that adjusted DSOs as of 6/18 actually declined by more than 2 days compared to the year-ago quarter which does not indicate aggressive revenue recognition in the period. As we will discuss more in the next section, the elimination of the receivables securitization program has resulted in a slowdown in the rate of cash collection which will normalize after the next couple of quarters.

In accordance with ASC 606, the company has reported deferred revenue for the last three quarters which is shown in the following table:

	6/30/2018	3/31/2018	12/30/2017
Current Deferred Revenue	$93.3	$96.8	$95.6
Long-Term Deferred Revenue	$94.9	$24.4	$21.4
Total Deferred Revenue	$188.2	$121.2	$117.0

While it is difficult to draw much of a conclusion on deferred revenue trends without a year-over-year comparison, the strong upward trend in total deferred revenue is encouraging on the surface. More noticeable though, is the rapid increase in the long-term portion of deferred revenue. We plan to follow up with the company to understand the nature of the increase.

Impact of Change in Securitization Accounting on Cash Flow

As explained above, prior to 2018, SWK maintained a receivables securitization program under which it sold receivables to a wholly-owned, consolidated special purpose subsidiary which in turn sold those receivables to a third-party financial institution. The effect was to accelerate the flow of cash from its trade receivables. In the first quarter of 2018, the company adopted ASU 2016-15 which requires that cash flows from the deferred purchase price receivable related to the securitization program be reported as an investing cash flow where it was previously recorded as an operating cash flow. This has a materially negative impact on reported operating cash flow and is likely the reason that the company discontinued the securitization program when it did.

For the last two quarters, SWK's cash flow statement has shown operating cash flow in historical periods restated to reflect the new method. However, for a proper comparison, we must add back the cash flow from the deferred purchase price receivable to the year-ago period, which is shown in the following table:

	6/30/2018	7/1/2017
Reported Cash from Operations for 6 Months Ended:	-$151.4	-$162.3
Add Back Proceeds from Deferred Purchase Price Receivable	$0.0	$227.8
Adjusted Cash from Operations for 6 Months	-$151.4	$65.5

We can see that the reported cash from operations for the six months ended 6/18 shows a slight improvement. However, when we add back the proceeds from the deferred purchase price receivable, operating cash flow is a positive $65.5 million, considerably stronger than the -$151 million registered in the most recent six-month period. This is caused primarily by the termination of the securitization program which is no longer accelerating the cash flow from receivables. This is not a problem in itself, and operating cash flow growth should normalize in two quarters when the accounting change is lapped.

We note that Kellogg (K) faced a similar impact from the required accounting change. It responded by terminating the practice of selling the receivables through a wholly-owned special purpose subsidiary and increasing its pace of selling receivables straight to third-party financial institutions. This allowed it to get around the cash flows being designated coming from a deferred purchase price receivable and continue to report them in operating cash flows. In SWK's case, it has chosen to stop securitizing altogether, although we would not be shocked if the company chose to resume selling receivables through an amended method in the future.

Inventory DSIs Increasing

SWK's inventory days (DSI) have been increasing for the last several quarters, as shown below:

	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Cost of Sales	$2,361	$2,050	$2,055	$2,052
Inventory	$2,444	$2,350	$2,018	$2,247
DSI	94.5	104.6	89.6	100.0

	7/1/2017	4/1/2017	12/31/2016	10/01/2016
Cost of Sales	$2,079	$1,799	$1,850	$1,800
Inventory	$2,078	$1,977	$1,478	$1,720
DSI	91.2	100.3	72.9	87.2

We refer readers to the section on accounts receivable for a more detailed discussion of the impact of acquisitions on the various quarters. In short, the acquisition of Nelson in the 6/18 quarter did not likely have a material impact on our calculated DSI for that period. We can see in the table that after three straight quarters of significant year-over-year increases in DSIs, the 6/18 quarter showed a much more moderated increase. Given that the company's raw materials are increasing in price, we would expect to see some increase in inventory levels. The following table shows a breakdown of inventory components as a percentage of sales for the last eight quarters:

	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Finished Goods % of inventory	71.0%	72.1%	72.4%	73.3%
In-Progress % of inventory	8.1%	7.5%	7.7%	7.4%
Raw Materials % of inventory	21.0%	20.4%	19.9%	19.3%

	7/1/2017	4/1/2017	12/31/2016	10/01/2016
Finished Goods % of inventory	72.3%	73.6%	70.6%	72.5%
In-Progress % of inventory	8.0%	8.0%	9.0%	7.5%
Raw Materials % of inventory	19.7%	18.3%	20.3%	20.0%

The table shows that SWK's finished goods inventory has fallen as a percentage of the total while raw materials has increased as a percentage for the last two quarters, a trend we have noted with several companies. While this alleviates the concern that the DSI increase indicates a buildup of excessive finished inventories that will have to be discounted later, it can be taken as a sign of increasing prices that will we recognized later.

Investors should also note that SWK utilizes the last-in, first-out (LIFO) method of accounting for most of its US inventories. Consider the disclosure regarding inventory accounting from its 10-K:

> *"U.S. inventories are primarily valued at the lower of Last-In First-Out ("LIFO") cost or market because the Company believes it results in better matching of costs and revenues. Other inventories are primarily valued at the lower of First-In, First-Out ("FIFO") cost and net realizable value because LIFO is not permitted for statutory reporting outside the U.S."*

According to disclosures in the 10-K, about 45% of inventories are accounted for under LIFO, We agree with the company's conclusion that the LIFO method results in better cost-matching, particularly in an environment of rising costs. However, it is worth noting that LIFO can cause distortions if inventories are reduced and older, lower-cost inventories are matched against current sales prices on the income statement.

Impact of Exclusion of Anti-Dilutive Shares

Diluted earnings per share is calculated with the outstanding numbers of shares in the denominator, adjusted for the number of options or other securities which could dilute the share count. However, when options are considered to be anti-dilutive, they are excluded from the diluted share count. SWK excluded 1.2 million shares from its diluted share count in the 6/18 quarter while none were excluded in the year-ago quarter. The following table shows the impact of this on adjusted EPS:

	6/30/2018	7/1/2017
Reported Diluted Shares Outstanding	152.494	152.226
Antidilutive Shares Excluded from Count	1.161	0
Adjusted Diluted Shares Outstanding	153.655	152.226
Adjusted Net Income	$392	$307
Reported Diluted EPS	$2.569	$2.017
Adjusted Diluted EPS	$2.550	$2.017
difference	-$0.019	$0

We see that the exclusion of the anti-dilutive shares added almost 2 cents to adjusted EPS in the quarter. Usually an exclusion of shares due to being anti-dilutive is related to the difference in current security price versus the strike price of options or convertible securities. Therefore, the decision to exclude the shares was not something the company could have controlled, nor what is material to the company's 6 cents per share earnings beat in the quarter. We nonetheless view this as a non-operational benefit investors should be aware of.

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.

Disclosure

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