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Worst is yet to come

Shares of Deere & Co. leapt by 13.5% in the waning seconds of the tractor maker's Aug. 19 earnings call. A ho-hum review of bland results closed with the not obviously electrifying news of a $500 million cost-cutting program. Before you knew it, some algorithm—or conceivably a person—had jumped to a bullish conclusion.

Grant's was not that convert. We stand by the bearish conclusions in our March 11 analysis. Following is an update on the facts. In its essentials, the story remains the same.

Aug. 30 brought an upward revision of estimated 2016 American farm income. It was much in the spirit of the Deere call. The headline looked OK: a 30% boost, to $71.5 billion from the February forecast of $54.8 billion. It was less hopeful on closer inspection. The boost came not from a rebound in grain prices but from a projected plunge in farm outlays. If the Department of Agriculture is on the beam, farmers will spend $27.7 billion less than the government economists had budgeted seven months earlier. Un-bullish for the implement makers, the farmers will buy fewer tractors and combines.

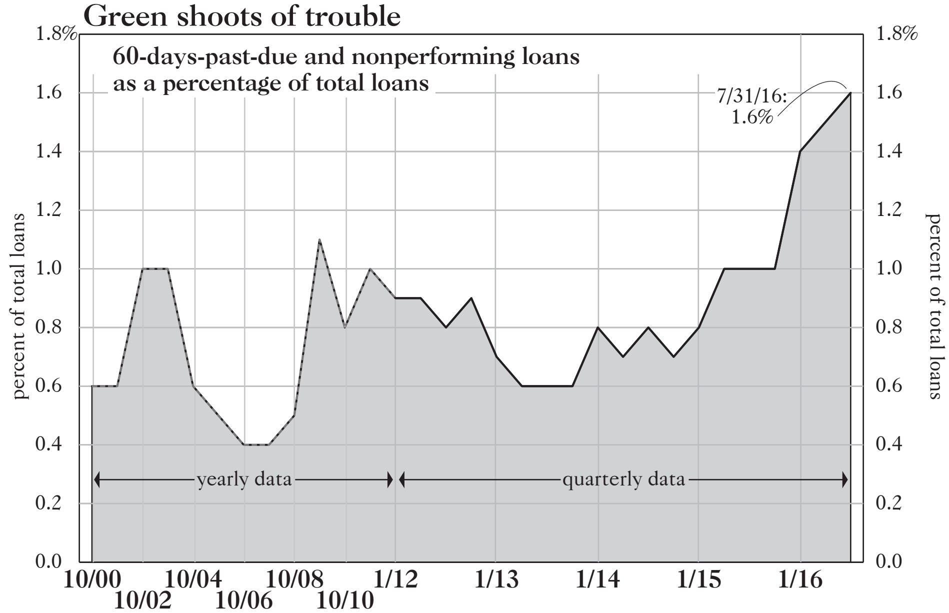
"In the three months ended July 31," colleague Even Lorenz relates, "Deere sold $5.9 billion worth of equipment, a 14% decline from a year earlier and $100 million below Street expectations. Despite flagging sales, management was able to report $1.55 in earnings per share, vs. $1.53 a share in the third fiscal quarter of 2015 and analyst expectations of $0.94 a share.

"One-offs were key to these pleasing results," Lorenz continues. "Thus, in May, Deere sold a 30% stake in its SiteOne Landscape subsidiary. The $75 million gain-on-sale in this transaction alone contributed to 11% of the $705.1 million in pre-tax quarterly profits. Pension expenses, too, contributed their mite. Owing to a change in how Deere tabulates its post-retirement costs, those outlays will come in $210 million lower in fiscal 2016, $10 million less than initially expected; the company recognized a $53 million benefit in the three months till July 31."

Lower steel prices helped, too—they generally make an impact in company results with a three- to six-month lag. "Given the mid-point of that lag, we estimate that steel prices were down about 25%–30% year-on-year," Jay Van Sciver, who rates Deere a best ideas short for Hedgeye Risk Management, writes in a Sept. 1 bulletin. "While we do not know the exact portion of steel in DE's [cost of goods sold], we know [Caterpillar, Inc.'s] is something like 20% including supplied components. A reasonable guess for DE is that ~15% of equipment COGS is steel costs. If so, the drop in steel prices may have made the difference between an equipment decremental margin in the mid-single digits and one in the high 20s/ low 30s. Without lower input costs, DE would likely have missed estimates in the quarter."

In the nature of things, one-time benefits are ephemeral, and the

Green shoots of trouble



source: Hedgeye Risk Management

price of steel has already rebounded. Underlying demand is another matter. On the conference call, Deere acknowledged that early orders for spring 2017 have registered single-digit declines. Greg Peterson, the founder of MachineryPete.com, tells Lorenz that dealers continue to make progress in clearing their lots of unwanted merchandise. But sales are falling faster than inventory positions are improving. Big tractors illustrate the adverse dealer inventory position. Thus, the ratio of machinery on the lot to trailing-12-month sales reached a historical high of 37% on July 31, up from 25% the year before. It's a sign that Deere may have to cut production rates further in coming quarters.

As noted here in March, the Deere financing engine is hitting on all cylinders. It contributed 32% of total operating earnings in the 12 months ended July 31, up from 15% in fiscal 2013 (year ends Oct. 31). Still, the farm income drought is making its mark at John Deere Capital Corp., too. Loans with payments 60 or more days late and loans marked nonperforming have increased to 1.6% of the total portfolio from 1% in the 12 months ended July 31. This is the highest level of past-due and nonperformers since 1993.

Deere is not unaware of this trend, of course. It has bumped up its provision for doubtful loans, expressed as a percentage of the credit portfolio, to 24 basis points in the third quarter from 12 basis points the year before. "Given the current level of past dues—where we are right now and not eventually where it goes—based on historical experience you are heading to something that will be more like 80 basis points," Van Sciver comments. "On a $480 million net income, this year's guidance on a roughly $30 billion portfolio, that hits your finance income quite heavily. That is not taking it to a loss, but it is taking away an incremental third of the profit from the finance subsidiary at least."

Still and all, Deere's stock jumped after that coda of a cost-cutting announcement on the Aug. 19 conference call. No details were divulged on how Deere intends to achieve the $500 million in savings. The program goes unmentioned in the company's earnings release and 10-Q report.

Analysts are, to say the least, befuddled. "When a manufacturer produces less, its cost per unit goes up," Van Sciver says. "They are not redesigning a tractor and components in a three-month period and changing the tooling, specs and engine. Designing costs out of a major platform is a very long process. It can happen over a couple of years, but it is not as though they are retooling and redesigning a new engine that has significantly less steel or fewer materials or whatever they are doing intra-quarter. Mostly, management is stuck with what they have and can only do a little reorganization while downsizing in the short run. I should caution that one can get that kind of short-term cost benefit at a really badly managed manufacturer. I don't think that Deere was very badly managed. I don't think there is a ton of waste in what is a competitive, large-scale manufacturer that is reasonably well-operated."

Bearish, we remain.

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