NEW RISK ALERT: (TTC)

Toro's Off-Balance Sheet Credit Exposure Spikes as Receivables Outpace Sales

Turf company's off-balance sheet arrangements signal potential earnings trouble that is currently hidden from investors.

By Nick Winkler
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This alert compares the language used in the company's latest filing with the period before. Research suggests changes in language, particularly in the risk factor section, are powerful indicators of future performance. Companies that change filing language and structure underperform those that don't by 30-50 basis points per month for the following year.

Toro's Off-Balance Sheet Credit Exposure Spikes

In its latest 10-Q, Toro, a turf and landscaping equipment manufacturer, appears to mislead investors by saying there were no material changes to its off-balance sheet arrangements ***except*** for those described later in the filing. What we found later in the filing, is a 33% increase in Toro's off-balance sheet credit exposure through its Red Iron joint venture with TCF Bank:

> *"The net amount of receivables financed for dealers and distributors under this arrangement for the six month period ended April 30, 2021 and May 1, 2020 was **$1,180.9 million and $886.4 million**, respectively."*

Through Red Irion, Toro provides inventory financing to some of its distributors and dealers to ensure plenty of the company's products appear on showroom floors. Toro accounts for the inventory as receivables.

A separate agreement with TCF provides inventory financing to Canadian dealers. Toro also partners with other financial institutions to finance inventory. Together, receivables financed via these arrangements increased 24.2%:

> *"These third-party financial institutions and TCFCFC financed **$216.1 million and $173.9** million of receivables for such dealers and distributors during the six month periods ended April 30, 2021 and May 1, 2020, respectively."*

Off-Balance Sheet Receivables Growth Significantly Outpacing Sales Growth

Investors should note off-balance sheet receivables growth— 33% for Red Iron and 24.2% for the other vehicles— is much greater than Toro's 19% sales growth. If dealers and distributors can't sell the inventory or repossess it from retail customers, Toro may be forced to repurchase some of the inventory it financed:

- Under the Red Iron and TCFCFC agreements, Toro may be required to repurchase up to **$7.5 million** in repossessed inventory per year
- Under its agreements with third-party financial institutions, Toro may be required to repurchase up to **$103.4 million** in repossessed inventory

To date, Toro says it has repurchased an immaterial amount and assures investors its exposure is limited to the difference between the amount paid to repurchase inventory and the amount for which it resells the product.

This understates the risk to investors on multiple fronts:

- Repurchasing repossessed inventory would immediately transfer off-balance sheet risk on-balance sheet and negatively impact operating results
- With off-balance sheet receivables growth far outpacing sales growth, if Toro is forced to repurchase repossessed inventory it would likely have to resell it— if the inventory can be sold at all—at prices that would pressure margins

In the near term, these risks seem muted. On its earnings call, Toro suggested it may not be able to meet demand due to supply chain constraints:

> *"Our biggest challenge for the remainder of the year will be our ability to produce at the desired rate, given the supply chain constraints we are facing. "*

Despite robust demand, Toro is currently financing dealer inventory at a much faster rate than it's growing sales. Even if demand is sustained at current levels, Toro's off-balance sheet inventory financing must cool or the company risks having too much inventory in its distribution channels.

Toro's Receivables Growing Double the Rate of Sales as Cracks Emerge in Red Iron Joint Venture

Our analysis, which moves Toro's hidden receivables onto the company's balance sheet, suggests the company's receivables growth rate is not sustainable at the current sales growth rate. The unseen risk is that Toro's off-balance financing vehicles— which can accelerate sales in the near term— may result in too much channel inventory once a post-pandemic world is no

longer supply constrained. Evidence is already emerging that the Red Iron joint venture is hurting Toro's results. In its 2020 10-K, Toro blamed a decline in Other Income, in part, on:

> *"...**lower income from our Red Iron joint venture**..."*

In its latest 10-Q, Toro posted another decline in Other Income and again points the finger, in part, at its Red Iron JV:

> *"...**lower income from our Red Iron joint venture**..."*

Here, Toro blames the Red Iron weakness on lower field inventory levels and increased inventory turnover due to strong retail demand. Field inventory levels are undoubtedly low coming out of the pandemic. Refilling field inventory is not a problem that should concern investors as Toro's management made clear in the earnings call:

> *"...the willingness to take inventory is very high. The field is hungry for inventory impact at this point."*

The real concern is whether end customers can absorb all of the inventory being pushed into the field. If not, expect more of Toro's off-balance sheet credit exposure to be transferred on-balance sheet.

If we add the $147.4 million in receivables outstanding from third-party financing companies and TCFCFC and the $17.1 million due from Red Iron to the balance sheet, Toro's receivables are actually $555.7 rather than the reported $391.2. It means that instead of receivables being down 2.3% from a year ago, Toro's receivables are actually up 38.8%. This is double the company's quarterly sales growth of 19% and foreshadows future earnings trouble that is currently hidden from investors.