BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Behind the Numbers

Household Products Earnings Quality Comparison

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Performance Since Last Ranking

Our last consumer products industry earnings quality review was published on 8/9/2022 in which we ranked the companies from least to most likely to post disappointing results in the next 2-3 quarters based on an analysis of recent earnings quality trends. The following table shows the rankings and the performance of each since that time.

Performance Since 8/9/2022		
CLX	least likely	8.9%
CHD		11.1%
KMB		1.9%
PG		2.4%
CL	most likely	-3.7%

Below, we update our views of the earnings quality of each company and present a new risk outlook for the next 2-3 quarters.

Summaries of Outlooks Based on Earnings Quality, Fundamental Factors, and Valuation

The following table shows the expected fiscal ’23 and ’24 growth rates, PEs, and PE to Growth ratios for all five companies and is referenced in the summaries below:

Expected Growth and Valuation

	FY ended:	*23 gr*	*24 gr*	*PE23*	*PE24*	*PEG23*	*PEG24*
CHD	December	4.7%	8.7%	30.9	28.4	6.5	3.3
CL	December	6.1%	9.2%	24.1	22.0	4.0	2.4
CLX	June	9.7%	25.3%	34.3	27.4	3.5	1.1
KMB	December	11.0%	12.8%	21.6	19.2	2.0	1.5
PG	June	1.2%	8.5%	25.0	23.0	20.7	2.7

The Clorox Company (CLX) Summary

(See full review on page 9)

- We view CLX’s recent earnings quality as one of the highest in the group. A lack of massive, ongoing restructuring costs is one of the main reasons. The supply chain

financing program remains under control. A recent negative is an unusual decline in the accrual for trade spending which was established just a quarter ago. However, this did not appear to be a key to the earnings beat in the quarter.

- CLX has leaned the heaviest on price increases in recent quarters of all the companies in the group, increasing prices by 19% in the 3/23 quarter. This caused an 11% drop in volumes. Interestingly, management stated on the call that the 11% volume deterioration was better than it expected. Price increases are starting to roll off in the current quarter but the company is exposed to elasticity risk, particularly in its *Kingsford* brand which is facing increased competition and most of its sales are reported in the current June quarter.

- CLX is expected to grow the fastest over the next two years as its gross margins recover to pre-Covid levels which appears to be a reasonable goal.

- CLX was the top-ranked company in our last review and has performed the best in the group. Despite the price appreciation, the investors appear to still be paying a reasonable multiple for the expected growth.

- CLX was our top-rated company at the last review and was the leading performer for most of the time since then before falling behind CHD in the last week. While its PE is the highest in the group on the surface, the company is expected to provide the highest growth rate which results in the lowest PE to Growth ratio of the five. Still, the company is not as undervalued as it was at our last review.

Colgate-Palmolive Company Summary (CL)

(See full review on page 15)

- We believe CL's earnings quality remains the lowest in the group as the company continues to see unusual benefits which more than account for meeting or beating earnings estimates.

- Other risk factors include the degree to which recent growth is dependent on pricing in Latin America well beyond what is justified by currency depreciation as well as dependence on continued growth in high-end pet food.

- Management anticipates increasing competition as the year moves on as costs moderate, particularly from private label. Advertising jumped to a historically high level in the 3/23 quarter and this is expected to remain high or increase in the back half.

- CL was our lowest-rated company at the last review and has trailed the group since then, posting the only price decline of the five. While it has the second-lowest PE of the group, we can hardly label it "cheap" at this point as the PE to Growth ratio is still among the highest in the group which does not reflect the risks we see.

Church & Dwight Co., Inc. Summary (CHD)

(See full review on page 21)

- In our opinion, CHD's earnings quality remains one of the strongest in the group and it carries the highest EQ score of the five. We see the biggest risk factor as the company's acquisition strategy but we have yet to see signs that the company is reaching to generate short-term growth at the expense of returns.

- CHD posted flat volume growth in the 3/23 quarter which was the best performance of its peers. This came courtesy of an improvement in fill rates for key products. It is less dependent on pricing which rose by only 5.7% although this is distorted some by the trade down to its own value brands and demand trends in its higher-end products.

- 40% of its sales are from value brands which are reportedly benefitting from consumer trading down, but its higher-end products have suffered. Vitamin sales met targets in the quarter due to higher fill rates. Waterpik also met targets while the company made some cautious statements regarding retail inventories for its Flawless products. While these areas have shown signs of life, the recovery remains in question and they would likely suffer in an economic downturn.

- CHD was our second-highest-rated company at our last review and was the best performer over the last three quarters. It has typically carried the highest valuation in the group and after normalizing for CLX's depressed results, it still is the priciest of the group. Despite the positives here, CHD's valuation of 28 times 2024 earnings and PE to Growth of over 3 make it less of a compelling value at this price.

Kimberly-Clark Corporation (KMB)

(See full review on page 25)

- KMB's earnings quality has shown remarkable improvement. Our rating has gone from 2- (Weak) to now 4+ (Acceptable) in the last two years as the never-ending restructuring charges finally disappeared and we have seen no unusual movements in accruals that explain earnings beats.

- KMB has the second-highest expected growth rate over the next two years of the five in the group mostly from its gross margin returning to pre-Covid levels. While it priced aggressively and early and the benefits have started to anniversary in the current 6/23 quarter, even if gross margin remains sequentially flat the company will post significant improvement for the full year.

- KMB faces the same risk as others in the group of competitive pricing as costs moderate and even decline. The company stated in the call that it is beginning to see pockets of price/promotional competition in certain geographies. We see the risk coming from higher advertising as the company has expressed a clear aversion to promotional spending.

- KMB was ranked in the middle of the group at our last review and the stock has risen 1.9%. It is expected to post the second-highest growth in the group driven by gross margins returning to pre-Covid levels which appears well under way. While there are risks to the outlook, the company's PE remains the lowest in the group and the high expectations result in by far the lowest PE to Growth ratio. The valuation and the improvement in earning quality make the valuation more compelling in our view.

The Procter & Gamble Company (PG) Summary

(See full review on page 27)

- In the past, PG's results featured huge restructuring charges that seemed to never end. However, this has not been the case in some time and non-GAAP adjustments have become few and far between for several years which has vastly improved its earning quality, in our opinion.

- The company does lean on supply chain financing arrangements more than the other companies with roughly 40% of payables falling under such financing arrangements. The company warned in its 6/22 10-K that it may not be able to benefit from the expansion of these programs as much as it has in the past which could be an unexpected squeeze on cash flow growth.

- Further impairment of Gillette intangibles seems a possibility given rising rates and market conditions.

- PG's core gross margin improved by 150 bps in the 3/23 quarter which is the first quarterly improvement in some time. Gross margin still has 200 bps of room to get back to pre-Covid levels which is a potential source of growth.

- However, advertising investment is increasing and offsetting much of this improvement. We also are worried that the company may not be able to sustain all of its operating cost cuts given that operating expenses as a percentage of sales are now 300 bps lower than they were pre-Covid.

- PG tends to be one of the more expensive stocks in the group except for CHD which is supplementing its growth with acquisitions. We see the PE of 24 times 6/24 earnings as not being excessive, certainly when compared to CL which features lower-quality earnings and more risks, in our opinion.

New Ranking

Below is our ranking of the five companies from the least likely to most likely to post disappointing results in the next 2-3 quarters. The number one factor we consider is the quality of recent earnings and we believe companies that have been aggressive to meet recent earnings targets have an increased chance of posting an earnings disappointment in subsequent quarters. However, we also take into consideration fundamental items and valuation.

Ranking as of 6/26/2023	
KMB	least likely
CLX	
PG	
CHD	
CL	most likely

Price Elasticity Table

The following table breaks out the source of organic growth for each company for the last eight quarters between volume growth and price/mix. The company commentaries below make frequent references to this table:

	Q1 23	Q4 22	Q3 22	Q2 22	Q1 22	Q4 21	Q3 21	Q2 21
CLX								
Organic Vol Growth	-11.0%	-10.0%	-15.0%	-9.0%	2.0%	-10.0%	-2.0%	-8.0%
Pricing	19.0%	14.0%	13.0%	10.0%	0.0%	2.0%	-3.0%	-2.0%
Organic Sales Growth	8.0%	4.0%	-2.0%	1.0%	2.0%	-8.0%	-5.0%	-10.0%
CL								
Organic Vol Growth	-6.5%	-4.0%	-4.5%	0.5%	-1.5%	0.0%	1.5%	2.5%
Pricing	10.5%	12.5%	11.5%	8.5%	5.5%	3.0%	3.0%	2.5%
Organic Sales Growth	4.0%	8.5%	7.0%	9.0%	4.0%	3.0%	4.5%	5.0%
CHD								
Organic Vol Growth	0.0%	-3.8%	-8.5%	-2.9%	-5.1%	-1.7%	-1.5%	4.3%
Pricing	5.7%	4.2%	7.8%	6.3%	7.8%	6.0%	5.2%	0.2%
Organic Sales Growth	5.7%	0.4%	-0.7%	3.4%	2.7%	4.3%	3.7%	4.5%
KMB								
Organic Vol Growth	-5.0%	-7.0%	-5.0%	-1.0%	2.0%	0.0%	0.0%	-4.0%
Pricing	11.0%	11.0%	10.0%	10.0%	8.0%	3.0%	4.0%	2.0%
Organic Sales Growth	5.0%	5.0%	5.0%	9.0%	10.0%	3.0%	4.0%	-3.0%
PG								
Organic Vol Growth	-3.0%	-6.0%	-3.0%	-1.0%	3.0%	3.0%	2.0%	1.0%
Pricing	11.0%	11.0%	10.0%	8.0%	7.0%	3.0%	2.0%	3.0%
Organic Sales Growth	8.0%	5.0%	7.0%	7.0%	10.0%	6.0%	4.0%	3.0%

The Clorox Company (CLX)

Our current earnings quality rating of CLX is 4- (Acceptable)

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

Earnings quality observations:

- ***Lower trade spending accrual benefitted the 3/23 quarter.*** Management disclosed in the conference call that the reported 8% growth in sales benefitted by 2% from a combination of a competitor of its *Pine-Sol* brand being out of stock along with the company taking down its sales promotion accruals. We don't how much came from each source. Regarding the promotional accrual, management indicated on the call that it was not seeing promotional activity increase at the same rate it anticipated when it set the promotional accrual in the 12/22 quarter. It offered the following color:

  > *"before the pandemic, about 25% of our product was sold in some form of promotion. In our most recent quarter is at 20%. And if I look at Q3 a year it goes at 19%. So it is increasing. We expect that we get back to more of that pre-pandemic level faster. And so the reduction in accrual is just recognizing it's not as growing as fast as we had anticipated, but we do expect to continue to increase."*

  As discussed in the section on pricing, CLX has taken significant pricing and its advertising investment rose significantly in the quarter. This seems somewhat unusual that the rate of promotional spending would drop so much in one quarter that it warranted a meaningful cut to the accrual. We estimate that the combined 2% increase in sales from the Pine-Sol competitor benefit and the accrual cut amounted to almost 10 cps in one-time benefit to earnings. CLX topped estimates by 29 cps in the quarter so this was not integral to the beat.

- ***The recent goodwill impairment was sudden.*** CLX decided to "streamline investment levels" in its Vitamins, Minerals, and Supplements business in the 3/23 quarter. As part of this move, the company revised its estimates of the growth rate of future cash flows which led to it recording a $445 million pretax impairment charge to the value of goodwill

and indefinite-lived trademark intangible assets. There is no more goodwill associated with the reporting unit.

- ***CLX does not have a history of excessive, ongoing restructuring charges as many in this industry do.*** The company began a program to streamline its operating model in the first quarter of fiscal 2023. It forecast it would incur between $75 and $100 million in 2023 and 2024. So far, neither the forecast nor the estimated time to complete has gone up. Which we view as a positive. During the first three quarters of the program, the non-GAAP adjustments related to the plan have amounted to approximately 8% of adjusted EPS. While material, if the company sticks to its original forecast of the plan ending in 2024, we do not see it as a significant detractor from earning quality.

- ***Digital transformation spending rose in the quarter.*** In addition to the plan to streamline the operating model, CLX started a digital transformation plan at the beginning of fiscal 2022 which involves a complete replacement of its ERP systems which had become completely outdated. The plan is expected to run for five years at a cost of $500 million. So far, the company has spent $105 million (after tax) which it adds back to non-GAAP results. The quarterly amounts jumped to 17 cps in the most recent quarter which is up from 7-12 cps seen in the first year of the plan. Management stated on the call that this reflects the timing of spending and the forecast for $500 million remained intact. Given how out of date the old systems reportedly were and the focused nature of the spending, we do not have a significant problem with adding these amounts back to non-GAAP results. Nevertheless, analysts should be skeptical of any expansion of the scope of the plan.

- **The supply chain financing program remains under control.** CLX initiated a supply chain financing program (SCF) in the second half of fiscal 2020 under which its suppliers can sell their CLX receivables to collect their cash faster. This was done in connection with an extension of payment terms to improve the company's working capital position. CLX discloses its accounts payable balance only on an annual basis and since the beginning of the program, days payable has jumped from 50 to over 75. This is not nearly as dramatic as some companies we have seen like KDP. Additionally, the quarterly amount of payables in the SCF has remained around $200 million for the last few quarters which is about 20% of total payables. The lack of growth in the use of the program reduces our concern. However, investors should be aware that if the use of the program begins

to reverse, which is possible given the higher rate environment, it would become a headwind on cash flow growth in upcoming quarters.

CLX's Gross Margin Recovery Should Drive Highest Growth in Group but Highest Price Increases Give it the Highest Exposure to Negative Elasticities

CLX has leaned the heaviest on price increases in recent quarters of all the companies in the group, increasing prices by 19% in the 3/23 quarter (see Price Elasticity Table above). This caused an 11% drop in volumes. Interestingly, management stated on the call that the 11% volume deterioration was better than it expected:

> *"And then as it relates to Q3, probably the biggest benefit above what we expected is volume deleveraging. We went into the quarter expecting based on elasticities that we would see volumes down in the mid-teens range. And as you saw, our volume was down about 11%. So that stronger top line performance that really drove through the entire P&L."*

Management has indicated that it expects the impact from pricing to moderate going forward as price increases begin to lap. Meanwhile, it hopes that cost increases will moderate:

> *"We expect some moderation in cost inputs as we move from Q3 to Q4. The counterbalance of that is on pricing. We believe Q3 will be the strongest benefit from pricing. As we move into Q4, we're now lapping two price increases, the first two rounds we took. And so I would expect that we'll see less benefit from pricing in Q4, essentially offset by more moderating cost environment."*

Later in the call:

> *"And so as I said, short of any future pricing being taken, I think we've probably got a three more quarters or so, we're seeing price/mix driving the top line to a greater extent of volume. But I think that will level and balance out as we look further out into our fiscal year '24 and so I think that's when we get to a more steady state of volume."*

The biggest risk we see to near-term disappointment in elasticities is with its charcoal products. The company has aggressively raised prices on its Kingsford charcoal brand but competitors did not follow suit. The company planned to increase advertising support of the brand in the important 6/23 quarter in which the brand sees most of its annual sales occur. This is a potential source of disappointment for the upcoming quarter.

CLX's Gross Margin Goals Seem Reasonable and Will Provide Bulk of Growth

CLX's gross margins fell the most during Covid of any company in the group:

T12 Adjusted Gross Margin

	Q1 23	*Q1 22*	*Q1 21*	*Q1 20*	*Q1 19*
CLX	37.8%	35.8%	46.0%	45.1%	43.6%
CL	56.6%	59.0%	60.9%	59.8%	59.2%
CHD	42.1%	43.2%	44.9%	45.7%	44.5%
KMB	31.7%	30.6%	36.3%	35.9%	32.7%
PG	47.0%	48.3%	51.9%	50.6%	49.0%

Demand for bleach skyrocketed at the onset of the pandemic which drove a spike in sales. However, this quickly dwindled leading to drastically reduced sales leverage at the same time higher costs hit, forcing gross margin into a trough. Margins have been steadily recovering via the aggressive price increases and moderating costs. Gross margin for FY 23 is expected to be 38.5%-39.0%. As noted above, we believe the biggest risk threatening that goal is potential negative elasticities in the *Kingsford* brand. The company has stated it plans to return gross margin to the pre-Covid range of 44% although it has yet to declare that will happen in FY 24. Given that the company's sales are higher than pre-Covid levels, this seems like a very achievable goal. Note that CLX's earnings growth for FY 24 is the highest in the group:

	FY ended:	23 gr	24 gr
CLX	June	9.7%	25.3%
CL	December	6.1%	9.2%
CHD	December	4.7%	8.7%
KMB	December	11.0%	12.8%
PG	June	1.2%	8.5%

Gross margins returning to pre-Covid levels will be the key driver of this growth.

CLX's Advertising Spiked in the 3/23 quarter

CLX discloses its advertising costs as a separate line item on the income statement. We can see below that the company's advertising investment jumped significantly in the latest quarter:

	3/31/2023	12/31/2022	9/30/2022	6/30/2022
Adjusted Advertising Costs	$206	$156	$161	$207
Adjusted Advertising Costs %	10.8%	9.1%	9.3%	11.5%
	-	-	-	-
	3/31/2022	12/31/2021	9/30/2021	6/30/2021
Adjusted Advertising Costs	$153	$167	$182	$224
Adjusted Advertising Costs %	8.5%	9.9%	10.1%	12.4%
	-	-	-	-
	3/31/2021	12/31/2020	9/30/2020	6/30/2020
Adjusted Advertising Costs	$200	$187	$179	$214
Adjusted Advertising Costs %	11.2%	10.2%	9.3%	10.8%
	3/31/2020	12/31/2019	9/30/2019	6/30/2019
Adjusted Advertising Costs	$184	$140	$137	$167
Adjusted Advertising Costs %	10.3%	9.7%	9.1%	10.3%

Management noted on the call that advertising *"was significantly higher than other quarters and that's given innovation that we launch and timing of merchandising."*

Elsewhere, management noted:

> *"As you noted, Q3 [advertising] was significantly higher than other quarters and that's given innovation that we launch and timing of merchandising. And again, we don't manage quarter-to-quarter, but this was the right time to spend this money to support our brands. And coincides with having our fourth price increase in the market, which is good*

> *timing. We continue to believe that about 10% is the right spending, but we adjust that and look at that depending on what the businesses require. And we're not afraid to move or adjust that moving forward. But again, right now, about 10%, we're on track to do that for the year."*

As noted above, price increases have started to anniversary in the current quarter which may reduce the need to maintain advertising at an unusually high level relative to sales so we do not see an unexpected drain from higher-than-expected ad spending as a significant risk.

Colgate-Palmolive Company (CL)

Our current earnings quality rating of CL is 3- (Minor Concern)

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

Summary

CL reported non-GAAP EPS of 73 cps which was 3 cps ahead of guidance. We have observed before that CL seems to come in right at its EPS targets and this represents the largest beat in some time. However, stock compensation was lower by 1.4 cps which reduces the quality of the beat, in our opinion.

While the company raised its full-year revenue guidance as a result of the beat, it merely raised the low end of its EPS outlook, leaving the top end the same.

Earnings quality observations:

- **The 2022 Global Productivity Initiative charges remain under control, but analysts should keep an eye out for any expansion.** The plan outlook still calls for total pretax spending of $200-$240 million and for the plan to be complete by mid-2024 which is consistent with the outlook given at the end of 2022. So far, the company has expensed $115 million since its beginning in the 3/22 quarter which is less than 3% of non-GAAP pretax income reported over that time which is very reasonable. However, given CL's history of huge ongoing restructuring charges a few years ago, we believe analysts should be skeptical of any significant expansion of the plan.

- **Depreciation and amortization has declined in the last three quarters as a result of the Filorga writedown.** This was a 1 cps benefit in the 3/23 quarter which will be gone after the June quarter.

- ***Allowance for bad debts as a percentage of gross receivables finally increased.*** We have warned in the past that the company has been taking down its allowance for bad debts which fell to 4.5% of gross receivables in the 12/22 quarter compared to the pre-

pandemic norm above 5% which we estimated was adding 1.2-1.8 cps to earnings growth over the last few quarters. The 3/23 quarter saw the company increase the percentage to 4.85% which we estimate could have cost EPS growth about 0.6 cps. We remain concerned that the reserve percentage will need to keep rising which could be a small but material headwind in upcoming quarters.

- ***Newly-required FASB disclosures revealed that while the company does participate in supplier financing arrangements, they are immaterial to results***. CL's days payable stood at just over 70 days at the end of the 3/23 quarter which is not out of line with typical payment terms in the industry.

- ***CL disclosed in its 10-K that it has a $145 million unfavorable tax court ruling against it.*** While it is contesting the matter, it also disclosed that another company lost a similar case in US Tax Court in February, yet this amount was not included in the CL's uncertain tax positions as of the end of the 3/23 quarter.

> *"One such matter relates to the IRS assessment of taxes on the Company by imputing income on certain activities within one of our international operations, which is also under audit for the years 2014 through 2018. There was a U.S. Tax Court ruling in February 2023 in favor of the IRS against an unrelated party on a similar matter. Despite the recent U.S. Tax Court ruling, the Company continues to believe that the tax assessment against the Company is without merit. While there can be no assurances, the Company believes this matter will ultimately be decided in favor of the Company.* ***The amount of tax plus interest for the years 2010 through 2018 is estimated to be approximately $145, which is not included in the Company's uncertain tax positions."***

- ***Filgora is still at risk for more writedowns***. After the fourth quarter write-down of the *Filorga* brand, the company still had $375 million in intangible assets and $214 million in goodwill. It warned in the 10-Q that the fair value of those amounts is less than 10% above carrying value and changes in macroeconomic conditions or interest rates could force another impairment.

Pricing in Latin America Continued Much Faster Than Seems Justified by Currency Depreciation

Over time, pricing in Latin America has been more rapid than most segments to help offset rapid currency depreciation in the region. However, as the following table shows, in the 3/23 quarter, pricing in Latin America jumped by 18% while FX was only a 2% drain.

Latin America	3/31/2023	12/31/2022	9/30/2022	6/30/2022	3/31/2022	12/31/2021
Organic Volume	-3.5%	-7.0%	-8.5%	0.0%	-3.5%	-1.0%
Pricing, Coupons, Incentives	18.0%	19.0%	20.0%	12.5%	10.0%	7.0%
Organic Sales Change	14.5%	12.0%	11.5%	12.5%	6.5%	6.0%
Acquisitions and Divestitures	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
FX	-2.0%	-2.0%	-4.5%	0.0%	-1.0%	-2.5%
Reported Sales Change	12.5%	10.0%	7.0%	12.5%	5.5%	3.5%

Meanwhile, North American pricing was only 10.5%. If the company had increased prices on par with North America plus another 2% for FX, Latin America prices would have been only 12.5% higher. We estimate that if the company had not increased prices in Latin America by the extra 5.5%, it would have cut the company's total organic growth rate to 2.8% rather than the reported 4.0%.

Note that the Africa/Eurasia segment is seeing a similar outsized gain from price increases, but the segment is only about a fourth as large as Latin America so its impact on the total company is not as material:

Africa/Eurasia	3/31/2023	12/31/2022	9/30/2022	6/30/2022	3/31/2022	12/31/2021
Organic Volume	-5.0%	-7.0%	-6.5%	-17.0%	-6.5%	-5.5%
Pricing, Coupons, Incentives	21.5%	23.5%	26.5%	22.0%	14.0%	8.5%
Organic Sales Change	16.5%	16.5%	20.0%	5.0%	7.5%	3.0%
Acquisitions and Divestitures	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
FX	-8.5%	-7.5%	-9.0%	-8.5%	-9.5%	-1.0%
Reported Sales Change	8.0%	9.0%	11.0%	-3.5%	-2.0%	2.0%

Margin Recovery May Take a Little Longer

The following table shows CL's trailing 12-month margin for the last five calendar first quarters:

T12 Adjusted Gross Margin

	Q1 23	*Q1 22*	*Q1 21*	*Q1 20*	*Q1 19*
CL	56.6%	59.0%	60.9%	59.8%	59.2%

CL's gross margin peaked in 2021 as sales rebounded off lower levels posted during the pandemic. However, a combination of rapid cost inflation and the acquisition of the low-margin generic pet food business in the 9/22 quarter has driven down the company's gross margin below its pre-Covid levels. The company will have to continue to manufacture private-label pet food in the newly-acquired facilities under lower-margin contracts for the next couple of years which will be a damper on margins returning to pre-Covid levels quickly.

Management was also not optimistic on the call about seeing significant relief on the cost front in the next couple of quarters:

> *"…on the commodities, it's kind of across-the-board with most of the ag. So corn, wheat, soybean, the risk of the drought in the US and the effect on crops, even though some other areas of the world are a little bit better, the risk of Ukraine, all has been pushing pressure on that. Don't forget as well that the protein side of this, things like chicken livers, etc, with some of the impacts have been out there has all put pressure on Hill's that remains the real driver of that $300 million to $400 million [higher input costs] range."*

Advertising Is Rising Rapidly

As noted in Table 3 above, CL's organic sales benefited from a 10% increase in prices which drove a 6.5% drop in volumes. The volume decline would have presumably been worse if the company had not significantly ramped up its advertising investment as shown in the following table:

	3/31/2023	12/31/2022	9/30/2022	6/30/2022
Advertising	$579	$504	$486	$501
Advertising % of Sales	12.1%	10.9%	10.9%	11.2%

	3/31/2022	12/31/2021	9/30/2021	6/30/2021
Advertising	$506	$489	$503	$494
Advertising % of Sales	11.5%	11.1%	11.4%	11.6%

	3/31/2021	12/31/2020	9/30/2020	6/30/2020
Advertising	$535	$549	$476	$439
Advertising % of Sales	12.3%	12.7%	11.5%	11.3%

The company was very vocal about its plans to maintain and even increase advertising spending in the back half of the year. Management stated on the call:

> *"So overall, your observation is correct. We feel we've got a good handle of getting the gross margins and the operating profits up sequentially as we move through the back half of the year, and importantly, sustaining or increasing our advertising levels to continue to drive the topline."*

The company is expecting competition, particularly from private label, to increase as the year goes on. Consider the following comment from the call:

> *"The competitive environment will likely intensify, particularly as you see cost come down, and that will be a function of both local brands and private label getting more aggressive. The good news is our categories, if you take North America and private label, we're benign, no progress in private label shares, so to speak, with the exception of a little bit in liquid hand soap and a little bit in cleaners, a little bit more acute on private label growth in Europe. As you saw price discrepancies or the gap between private label and global brands increase, we'll see how that translates in the back-half as we expect them to have to take pricing in the first quarter as we did as well.*
>
> *So, we think local brands and private label likely to elevate in terms of their competitive nature in the back-half. And as cost stay flat in the back-half, which is what I think we're*

hearing from most, we expect the competitive environment to increase in that regard. Obviously, you'll see more promotional volumes probably come into the category, but it's been quite constructive so far, I will say that. But we need to anticipate that things could worsen based on where the costs are and we are well-prepared for that."

We see a risk of the company disappointing on volumes or profits as a result of the need to increase advertising in an increasingly competitive market.

Church & Dwight Co., Inc. (CHD)

Our current earnings quality rating on CHD is 4+ (Acceptable)

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

Summary

CHD's EPS of $0.85 per share for the first quarter topped estimates by 8 cps. Organic sales growth of 5.7% was remarkably better than the company's admittedly conservative outlook of 1%. We continue to regard CHD's earnings quality as one of the highest in the group. The improvement in inventory and rising advertising investments prompted us to recently raise our earnings quality rating to 4+ (Acceptable).

Earnings quality observations:

We view CHD as having one of the highest earnings quality profiles in the group.

- **The biggest big-picture risk we see with CHD versus its peers remains how much growth is generated via acquisition.** However, we have yet to see clear evidence that the return from acquisitions is not justifying the investments. It is therefore a noteworthy positive that TheraBreath and Hero, the two most recently acquired brands, are enjoying rapid growth and market share gains.

- **Inventory has improved as they have worked off excess discretionary product inventory.** DSI was 72.8 versus 72.4 last year. However, the company typically sees a 4 to 5-day sequential jump in DSI in the first quarter and this year it only rose by 1.4 days.

- **CHD's supply chain financing program appears under control.** Under new FASB guidelines, CHD disclosed in the 3/23 10-Q that $88.3 million of payables were to suppliers using third-party financing which accounts for just 13.6% of total payables. The company's days payable have tracked fairly consistently in the low to mid-70s range for

years so we are not worried that cash flow has received an artificial boost from a rapid expansion of these programs and the company is not at risk from a material cash flow drain from such programs unwinding.

- ***Flawless* remains something to watch.** The company noted on the call that *"[Flawless] Retail inventories are moving slower than we expected. That's partly had an impact on our inventory reserves for -- limiting inventory on our end, but we think we've appropriately captured that from here, and we're moving forward."* *Flawless* has already been the subject of a $441 million writedown in early 2022 so any more underperformance could result in more writedowns. However, there is only $46 million left on the books at this point so exposure is limited.

- ***Waterpik* also warrants scrutiny**. Management noted that *Waterpik* hit sales targets for the first quarter. However, the brands struggled during the pandemic and the company warned in the 10-Q that as of 10/22, the fair value of the intangibles of $644.7 million exceeded the carrying value by only 7%.

CHD Is Less Dependent on Price Increases Than Others

Referring back to the Price Elasticity Table above, we see that CHD posted flat volume growth in the 3/23 quarter after several quarters of significant volume declines. Its pricing is also rising at the slowest pace in the group at only 5.7% in the quarter compared to double-digit paces for its peers. Some of this is due to growth in value brands and different demand trends in the company's higher-end products such as *Waterpik* and *Flawless*.

Much of the sales outperformance was a result of organic volumes which were flat after being down several quarters. However, the company is expecting negative volumes in 2Q as fill rates in 1Q jumped to 93% versus only 72% a year ago whereas fill rates were up to 85% by 2Q22 leaving less room for improvement. CHD also stands to continue to benefit from 40% of its sale coming from value products and the company is seeing consumers trading down to these lower price points.

However, the risk remains for some of its higher-priced products as the company's *Waterpik, Flawless*, and vitamin products all saw poor sales growth during the pandemic. Management has blamed lagging vitamin sales on supply chain problems which have reportedly freed up and the sales plan was supposedly met in Q1. Likewise, *Waterpik* sales reportedly hit expectations in the quarter as well. However, the company made some seemingly cautious statements regarding *Flawless* on the conference call:

> *"[Flawless] Retail inventories are moving slower than we expected. That's partly had an impact on our inventory reserves for -- limiting inventory on our end, but we think we've appropriately captured that from here, and we're moving forward."*

While results in Q1 seemed positive overall, these higher-end brands are at risk of disappointing should the economy take a turn for the worse.

Advertising Is Rising

The following table shows advertising as a percentage of sales for the last 16 quarters:

	3/31/2023	12/31/2022	9/30/2022	6/30/2022
Adjusted Marketing Expenses	$122	$190	$141	$103
Adjusted Marketing Expenses %	8.6%	13.2%	10.7%	7.8%

	- 3/31/2022	- 12/31/2021	- 9/30/2021	- 6/30/2021
Adjusted Marketing Expenses	$102	$201	$161	$117
Adjusted Marketing Expenses %	7.9%	14.7%	12.3%	9.2%

	- 3/31/2021	- 12/31/2020	- 9/30/2020	- 6/30/2020
Adjusted Marketing Expenses	$99	$202	$171	$122
Adjusted Marketing Expenses %	8.0%	15.6%	13.8%	10.2%

	3/31/2020	12/31/2019	9/30/2019	6/30/2019
Adjusted Marketing Expenses	$96	$163	$125	$129
Adjusted Marketing Expenses %	8.3%	14.2%	11.5%	12.0%

Before the pandemic, advertising ran closer to 12% of sales. However, this fell as supply chain problems limited its ability to fill orders and the company cut its advertising investment as a result. In the 3/23 quarter, advertising showed its first YOY increase in years and was up to 8.6% of sales vs 7.9% last year which the company attributed to the higher fill rates. This higher advertising also likely added to the better-than-expected volume performance. The advertising percentage is lumpy from quarter to quarter with most occurring in 4Q. The company expects full-year 2023 advertising to hit 10.5%, up from 10% last year with a goal of reaching a more normal 11% in 2024.

Kimberly Clark Corporation (KMB)

We are upgrading our earnings quality rating of KMB to 4+ (Acceptable)

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

Earnings quality observations:

- We have been highly critical in the past of KMB's history of taking huge restructuring charges every quarter for many years at a time and unusual movements in reserve accounts that seemed to benefit earnings at just the right time. However, KMB has now gone five straight quarters with no restructuring charges added back to non-GAAP results and we have not seen evidence of unusual benefits from reserve takedowns. This greatly improves the company's earnings quality, in our opinion.

- Prompted by recent FASB requirements, KMB disclosed in its 3/23 10-Q for the first time that it maintains a supply chain finance program under which suppliers can sell their KMB receivables to third-party financing institutions to receive cash faster. Payables to suppliers using the programs amounted to 27% of total accounts payable as of 3/23. We do not have historical information to see how that has grown over the years, but we do know that KMB's days payable are currently 98 which is up from about 85 before the pandemic. This is not excessive when compared to CLX's 139 and PG's 119. Regardless, KMB could see an unexpected cash flow squeeze if higher rates force it to unwind some of its supply chain financing.

Pricing Will Begin Rolling Off, But Gross Margin Goals Seem Reasonable

As shown in Table 3 above, KMB's pricing has risen by double digits for the last four quarters as volumes have fallen from 5-7% over that time. Management noted in the conference call that it was among the first of its competitors to start raising prices and that the impact of these earlier price increases has started to anniversary in the current June quarter. While gross margin improved by 340 bps in the 3/23 quarter and 270 bps in the 12/22 quarter, the sequential improvement is expected to fade as the boost from pricing disappears at the same time

moderating costs begin helping. Like many companies, management indicated on the call that cost inflation has moderated for several quarters but remains above 2019 levels.

The following table shows the trailing 12-month adjusted gross margin for the last five first quarters:

T12 Adjusted Gross Margin

	Q1 23	*Q1 22*	*Q1 21*	*Q1 20*	*Q1 19*
KMB	31.7%	30.6%	36.3%	35.9%	33.2%

The company has a goal of getting back to its pre-Covid gross margin which was 35% on 12/19 although it is not forecasting that for 2023. Gross margin in the 3/23 quarter was 33.2% so even if there is no more sequential improvement in 2023, gross margin will show a marked improvement over 2022's gross margin of 30.2%. Note that management specifically stated on the call that while sequential gross margin improvement will fade, it does expect the 4Q23 gross margin to be above 1Q's 33.2%.

On the competitive front, management indicated on the call that it is seeing signs of price competition heating up which will be a problem faced by all consumer staples companies that have priced aggressively when costs being to come down. Consider the following comment:

> *"I mean we're seeing that in spots and so in Latin America, we're seeing a little ramp up promotion from both local players, and other multinationals, similarly in parts of Africa, for us and in a few categories in North America. Childcare pull-ups is one. Periodically, there's a secondary or tertiary brands that make a distribution push and we see that from time-to-time."*

The company also made clear again that it favors advertising investment which is expensed in operating costs versus promotional spending which is typically recorded as a reduction in the sales price. Therefore, gross margin may hold while the risk comes from higher operating expenses.

The Procter & Gamble Company (PG)

Our current earnings quality rating of PG is 4- (Acceptable)

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

Summary

Earnings quality observations:

- PG reported non-GAAP EPS of $1.37 which was 5 cps ahead of consensus. The top line also surprised to the upside by $750 million. While other income growth added about a penny per share to EPS in the quarter, the beat looked solid overall.

- In the past, PG's results featured huge restructuring charges that seemed to never end. However, this has not been the case in some time and non-GAAP adjustments have become few and far between for several years.

- We have been cautious of the fact that over time, 1.5-2.5% of PG's EPS growth comes from a reduction of the share counts via buybacks. Cash flow less capex, dividends, acquisitions, and buybacks is almost always negative as a result. While its strong returns and controlled acquisition spending have allowed it to keep debt under control (1.4x EBITDA), the ongoing nature of the buybacks indicates that the company is not waiting until its shares pose an uncommon value before buying.

- Since PG's fiscal year does not end until June, it has not had to quantify its exposure to supply chain finance programs quarterly yet under the new FASB requirements. However, it disclosed in its 6/22 10-K that payables due to suppliers participating in the programs it sponsors have risen from 33% of total payables in 2020 to over 40% on 6/22. This is the most aggressive use of supply chain financing of the companies in the group and has led to the second-highest days payable of the group at 119. The company warned in its 10-K that *"Although difficult to project due to market and other dynamics, we anticipate incremental cash flow benefits from the extended payment terms with suppliers could increase at a slower rate in fiscal 2023."* We estimate that declining payables in the first

nine months of fiscal 2023 were a drain on cash flow of over $1 billion versus a boost of $455 million in the comparable year-ago period. PG appears to be the most exposed of the consumer staples companies to its SCF program continuing to unwind as rates rise.

- PG's *Gillette* indefinite-lived intangible asset remains at risk for another writedown. The company again disclosed in the 3/23 10-Q that the fair value of the asset is only 5% above its current carrying value of $14.1 billion. It also disclosed that:

  > *"changes in the business or in the macroeconomic environment, including foreign currency devaluation, increasing global inflation, market contraction from an economic recession and the Russia-Ukraine War, could reduce the underlying cash flows used to estimate the fair value of the Gillette indefinite-lived intangible asset and trigger a future impairment charge. Further reduction of the Gillette business activities in Russia could reduce the estimated fair value by up to 5%."*

  We will add the impact of higher interest rates driving down the discount rate used to estimate the fair value of the assets to the list of possible items that could force another writedown.

Gross Margin Improved in the Latest Quarter

PG's core gross margin improved by 150 bps in the 3/23 quarter which is the first quarterly improvement in some time. The following table shows the company's trailing 12-month gross margin for the last five calendar first quarters:

T12 Adjusted Gross Margin

	Q1 23	*Q1 22*	*Q1 21*	*Q1 20*	*Q1 19*
PG	47.0%	48.3%	51.9%	50.6%	49.0%

We can see that the company's gross margin simply returning to its pre-Covid range will add 200 bps to margins. We see in the Price Elasticity Table above that while PG has been increasing its prices as rapidly as most of the group, its volume eroded by only 3% in the 3/23 quarter. This is partly because of its increasing investment in advertising which has allowed it to

drive growth in its premium brands. Pricing starts to anniversary in the current June quarter, but the company also pushed through mid-single-digit price increases in certain markets in the March quarter. On the call, the company echoed what we have heard from others about how private-label competitors in Europe have not moved to increase prices. PG, therefore, faces the same problem others do about more recent price increases resulting in elasticities finally becoming an issue.

How Much Further Can Productivity Be Pushed?

One concern we have is the extent to which results are benefitting from its productivity initiatives including its Supply Chain 3.0 program. Despite the 150 bps gross margin gain in the quarter, operating margin rose by only 40 bps. Consider the following quote from the call:

> *"Core operating margin increased 40 basis points, as 150 basis points of gross margin expansion were partially offset by SG&A investments and inflation impacts. Currency-neutral core operating margin increased 160 basis points.* ***Productivity improvements were a 290 basis point help to the quarter.****"*

Productivity improvements obviously helped drive the gross margin increase and still allow for margin improvement despite the increased advertising investment. However, look at adjusted trailing-12 operating expenses (non-COGS) for the last five first quarters:

T12 Operating Expenses % of Revenue

	Q1 23	*Q1 22*	*Q1 21*	*Q1 20*	*Q1 19*
PG	25.3%	26.0%	27.6%	28.1%	28.2%

Operating expenses are already 300 bps as a percentage of sales below where they were before Covid. We are somewhat skeptical that expenses can remain this low indefinitely and wonder if the company may have to recoup some of that spending at a later date.

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.

Disclosure

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