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Church & Dwight (CHD) EQ Review

Current EQ Rating*	Previous EQ Rating
2+	NA

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

We initiate coverage of Church & Dwight (CHD) with a rating of 2+ (Weak).

CHD reported adjusted EPS of $0.49 in the 6/18 quarter which was 2 cents ahead of the Zack's consensus number. However, we see several red flags with the company's recent results including:

- Accounts Receivable DSOs have been tracking relatively in-line with the year-ago numbers the last few quarters. However, the company disclosed in its 10-K that it maintains a receivables factoring program under which it sells receivables to third parties. Unfortunately, the company does not disclose any information regarding the factoring program on a quarterly basis and only shows the total amount of receivables sold during the year in its annual disclosure. This minimal disclosure leaves no visibility into the amount of receivables sold and still outstanding at the end of each period from which an adjusted receivables balance can be calculated. This leaves open the possibility that actual DSOs could be materially different than the receivables on the balance sheet indicate. Reported operating cash flow growth could be clouded as well.

- Inventory days (DSIs) have been rising over the last several quarters. This is made more concerning by the fact that the bulk of the increase came from finished goods inventory.

- CHD historically accounted for about 17-20% of its inventories under the LIFO (last-in, first-out) method of accounting with the balance reported under the FIFO (first-in, first-out) method. However, beginning in the 6/18 quarter, the company began utilizing the FIFO method for all of its inventories. This change results in an increase in the matching of older, lower-cost inventory against current sales. The impact of switching to FIFO added $4 million to gross profit in the quarter and a boost to gross margin by about 40 basis points. However, this benefit was not mentioned in the company's discussion of margins, nor was it adjusted out of non-GAAP results. We estimate this added about 1.3 cents to EPS in the period and accounted for the bulk of the earnings beat.

- The company has dramatically increased its commodity hedges in the last four quarters, yet it still stated that higher raw materials costs weighed down gross margin by 120 bps in the 6/18 quarter. While details about its hedging program are limited, management comments seem to indicate that the current hedges will unwind by the end of the year, which could leave the company more exposed to higher costs.

- Accounts payable days (DSPs) have declined year-over-year in each of the last two quarters. Management stated in the last conference call that it is working to improve its payables experience. While DSPs are already more than two months, we note that the company does not appear to utilize structured payables arrangements like some of its peers in the consumer goods and packaged foods industries are doing. It is possible the company could boost its cash flow on a short-term basis by stretching payables further.

Receivables Factoring

On the surface, CHD's accounts receivable balances look very stable with days of sales (DSOs) remaining relatively in line on a year-over-year basis for the last three quarters as seen in the following table:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Sales	$1,028	$1,006	$1,033	$968
Accounts Receivable	$349	$361	$346	$378
Accounts Receivable DSOs	30.9	32.8	30.6	35.6

	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Sales	$898	$877	$896	$871
Accounts Receivable	$304	$305	$287	$265
Accounts Receivable DSOs	30.9	31.7	29.2	27.8

Note that the 9/17 quarter DSO was elevated from the acquisition of Pik Holdings (Waterpik) 8/7/2017 which resulted in only two months of revenue from Pik being recorded in that quarter.

However, the company discloses the following in its 10-K regarding factored receivables:

> *"The Company entered into a factoring agreement with a financial institution to sell certain customer receivables at discounted rates in 2015. Transactions under this agreement are accounted for as sales of accounts receivable and were removed from the Consolidated Balance Sheet at the time of the sales transaction. The Company factored an additional $45.3 in 2017, resulting in a total of $105.4 and $60.1 as of December 31, 2017 and 2016, respectively."*

The disclosed amounts seem to indicate the total amount of receivables that were sold during the periods, but there is no mention of the amount of receivables sold but still uncollected as of the end of the period. In addition, CHD only discloses the above figures annually with no mention of the factoring program in its quarterly 10-Q filings. We find this disclosure to be less than adequate to understand the true trends in trade receivables. If we assume that the additional $45.3 million in receivables factored in 2017 were done so evenly across the four quarters, this comes to $11.3 million in receivables that were generated but kept off the balance sheet. This would have resulted in DSOs being over 1 day higher in the 12/17 quarter, for example. If the factoring was concentrated in a particular quarter, the impact could have been even greater. The current level of disclosure does not allow us to see if the last couple of quarters could have benefitted from the extension of more generous credit terms.

In addition, cash flow growth could be receiving a material boost from the increased use of factoring. For reference, reported cash from operations rose by just over $26 million in 2017. An increase of $45.3 million in the use of factoring could have been a very material contributor to that growth depending on the timing of the receivables sales.

Jump in Inventory DSIs and Finished Goods

CHD's inventory days (DSIs) have been registering a year-over-year increase for the last several quarters, as shown in the table below:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
COGS	$573	$555	$552	$529
Inventory	$369	$357	$331	$336
Inventory DSIs	58.8	58.8	54.7	57.9

	6/30/2017	3/31/2017	12/31/2016	9/30/2016
COGS	$488	$478	$488	$475
Inventory	$292	$280	$258	$286
Inventory DSIs	54.7	53.5	48.3	54.9

CHD closed on the Passport Food Safety deal on 3/8/2018, but this would have had a very minimal impact on the DSIs above. However, the 8/7/2018 acquisition of Pik Holdings was large enough to impact the above figures. While CHD discloses that it booked $95 million in current assets at the close of the deal, it does not offer a further breakdown showing inventory and receivables balances. Since we calculate our DSIs on a quarterly basis, the 9/17 quarter DSI was most likely the most inflated since it would have incorporated only two months of sales from Pik but reflected the entire balance of acquired inventory. However, the comparisons in the last three quarters would have only been impacted to the degree that the Pik business carries a higher level of inventory than CHD's base business. While it is possible this has had some impact on year-over-year comparisons of DSIs, it is concerning that the year-over-year increase has only widened in the quarters since the close of the Pik acquisition. Even more concerning is that the increase has been more focused in finished goods, which has risen noticeably as a percentage of total inventory in the last two quarters:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Raw Materials % of inventory	23.7%	24.8%	25.9%	24.6%
In-Progress % of inventory	8.7%	9.8%	9.3%	10.1%
Finished Goods % of inventory	67.6%	65.4%	64.8%	65.2%

	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Raw Materials % of inventory	25.6%	25.1%	27.0%	25.3%
In-Progress % of inventory	11.3%	10.0%	11.2%	10.7%
Finished Goods % of inventory	63.1%	64.9%	61.8%	63.9%

The finished goods inventory percentage rose to a historically high level in the 6/18 quarter which increases our level of concern that CHD might be experiencing an unexpected buildup in product despite the relatively strong sales growth the company has been posting. This could also be a reflection of rising raw materials costs which the company has been citing in recent quarters. This brings us to another inventory-related concern- the company's recent change in inventory accounting method which we discuss in the next section.

Change in Inventory Accounting Method

As of the end of 2017, CHD utilized the last-in, first-out (LIFO) method of accounting for certain of its inventories as disclosed in its 10-K filing:

> *"Inventories are valued at the lower of cost or market (net realizable value, which reflects any costs to sell or dispose). Approximately 17% and 20% of the inventory at December 31, 2017 and 2016, respectively, including substantially all inventory in the Company's Specialty Products Division ("SPD") segment as well as domestic inventory sold primarily under the ARM & HAMMER trademark in the Consumer Domestic segment, was determined utilizing the last-in, first-out ("LIFO") method."*

However, on April 1, 2018, the company converted all of its inventories to the first-in, first-out (FIFO) method as disclosed in the 10-Q filing for the 6/18 quarter:

> *"On April 1, 2018, the Company changed its method of accounting for inventories from last-in-first-out ("LIFO") to first-in-first-out ("FIFO") for the approximately 17% of consolidated inventory not previously valued using FIFO. Substantially all of the Company's Specialty Products Division segment inventory as well as domestic inventory sold primarily under the ARM & HAMMER trademark in the Consumer Domestic segment was previously determined using LIFO. After this change, all the Company's inventory will be determined by the FIFO method. The Company believes this change is preferable as the predominant method to value inventory has been FIFO, which will provide a uniform costing method across all inventory. Prior financial statements have not been retroactively adjusted due to immateriality.* ***The cumulative effect of the change in accounting principle of approximately $4.0 pre-tax was recorded as a decrease to cost of goods sold for the quarter ending June 30, 2018."***

There are several things to take away from this. First, if we adjust the 6/18 quarter DSI calculation by adding $4 million back to cost of sales and subtracting it from inventory, we get we get an adjusted DSI figure of 57.8 which is still a 3.1-day increase over the year-ago period. Likewise, if we take the $4 million increase in inventory out of finished goods, the adjusted finished goods inventory percentage is 66.5% which is still noticeably higher than recent quarters. Note that since the $4 million is as cumulative adjustment, the maximum impact on inventory would be $4 million or it could have been less. Still, we see that taking the full $4 million out of inventory leaves the above ratios at high levels.

More importantly, the move to FIFO inventory will benefit CHD in a rising cost environment as older, lower-cost inventory is matched against current sales on the income statement. We find it interesting that the company stated that prior financial statements have not been restated for the change "due to immateriality." However, cost of sales was $4 million lower in the 6/18 quarter than it would have been if it had continued using the LIFO method on some of its inventory. Let's take a look at the impact on reported gross margin by taking out the $4 million of incremental gross profit created by the switch to all-FIFO inventory accounting:

Reported 6/18 Sales	$1,028
Reported 6/18 Gross Profit	$455
Reported 6/18 Gross Margin	44.3%

Reported 6/18 Sales	$1,028
Adjusted 6/18 Gross Profit	$451
Adjusted 6/18 Gross Profit	43.9%

We see in the above table that reported gross profit benefitted by 40 basis points from the switch to FIFO. However, consider the company's discussion of its gross margin from the Management's Discussion and Analysis of Results" section of its 6/18 10-Q:

> *"Our gross profit was $454.9 for the three months ended June 30, 2018, a $44.5 increase as compared to the same period in 2017. Gross margin decreased 140 basis points ("bps") in the second quarter of 2018 compared to the same period in 2017, primarily due to higher commodity costs of 120 bps, higher transportation costs of 40 bps, the impact of lower margins on acquired businesses of 30 bps, unfavorable price/mix of 20 bps, and other manufacturing cost increases of 10 bps, partially offset by productivity programs of 80 bps. The impact of acquired businesses and price/mix includes charges associated with a voluntary recall and a FDA mandated withdrawal for certain oral care products."*

Noticeably absent from the commentary is the 40-basis point boost to margins from the accounting change. Likewise, we saw no discussion of it in the second quarter conference call transcript, nor is it accounted for in the company's non-GAAP earnings figure.

According to Zack's, CHD's adjusted EPS of $0.49 was 2 cents ahead of the consensus average. For reference, the $4 million pretax benefit translates to about 1.3 cents per share which represents the majority of the upside surprise.

Increased Use of Commodities Contracts

The company's primary raw materials include soda ash (used to make sodium bicarbonate), surfactants (cleaning agents), paper products and resin-based molded components. CHD does not disclose much about its commodity derivate contracts on a quarterly basis other than the following regarding the number of pounds hedged:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Commodities Contracts (million lbs.)	161.1	89.7	28.3	31.9

	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Commodities Contracts (million lbs.)	0.0	0.0	0.0	0.0

We see that from 9/16 to 6/17, the company was completely unhedged on the commodity front, yet that has rapidly increased in the last four quarters. CHD describes its commodities hedging program as follows in its 2017 10-K filing:

> *Commodity Hedges*
> *"The Company is subject to exposure due to changes in prices of commodities used in production. To limit the effects of fluctuations in the future market price paid and related volatility in cash flows, the Company enters into Over-the-Counter commodity forward swap contracts. These hedges are designated as cash flow hedges for accounting purposes and, therefore, changes in the fair value of the contracts are recorded in Other Comprehensive Income (Loss) and reclassified to earnings when the hedged transaction affected earnings. The fair value of these commodity hedge agreements is reflected in the Consolidated Balance Sheet within Other Current Assets and Accounts Payable and Accrued Expenses."*

There is no description of the current value of these contracts in the 10-Q, so we will rely on an exchange in the second quarter conference call to gauge their current impact on earnings:

> *Richard Dierker*
> *"Really, the biggest hedges we have out there are really for and you'll see this in the 10-Q are for surfactants or ethylene for HTPE for resin and for diesel, and net-net as they're close to washing. I mean it's nice to have certainty and now we're 88% hedged and we're already hedging 2019 in some cases in order to again have predictable movements on our cost structure. But in general, I'd say those net differences aren't that material."*

For clarification, the company's diesel contracts are disclosed separately from commodities and have actually declined significantly for the last four quarters. Management's statement above seems to indicate that the hedges are not having a material impact on its results at the moment. It also seems to indicate that the bulk of the current contracts will unwind prior to 2019. Should there be a spike in commodity prices over the next couple of quarters, the company would appear to be more protected than in the past. However, management has already cited rising costs as being a 120 bps drag on margins in the 6/18 quarter. A concern would be if the company has actually been shielded from rising costs and this protection could fade as the current contracts unwind over the next couple of quarters.

Payables Are Declining

CHD lumps accounts payable in with other accrued liabilities on the balance sheet. However, it discloses trade payables in a footnote which we use to calculate days payable (DSPs) in the following table:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
COGS	$573	$555	$552	$529
Accounts payable	$420	$405	$399	$390
Accounts payable DSPs	66.9	66.7	66.0	67.3

	6/30/2017	3/31/2017	12/31/2016	9/30/2016
COGS	$488	$478	$488	$475
Accounts payable	$375	$346	$332	$320
Accounts payable DSPs	70.2	66.1	62.0	61.4

After expanding for several quarters on a year-over-year basis, DSPs declined in the last two quarters. This runs contrary to what we are seeing with many consumer goods and packaged foods companies that are boosting cash flow (albeit temporarily) by leaning hard on suppliers and increasing the utilization of structured payable arrangements. CHD does not disclose any such arrangements whereby it facilitates financing for suppliers to get their money up front so the company can capture early-pay discounts while taking longer to actually pay supplier invoices. Management admitted in the conference call that it has room for improvement on payables. We note that a DSP exceeding two months hardly seems excessive and doubt it could sustain a long-term number much if any higher than that. However, we admit that if the company began to pull some of the same levers we have seen other companies utilizing, it does appear to have some room to expand DSP to the benefit of short-term cash flow growth.

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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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