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Church & Dwight (CHD) EQ Review Update-9/18 Quarter

Current EQ Rating*	Previous EQ Rating
2+	2+

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

We are maintaining our 2+ (Weak) rating on Church and Dwight (CHD).

CHD reported EPS of $0.58 in the 9/18 quarter, 4 cps ahead of the consensus estimate which the company attributed to a higher-than-expected top-line growth and lower-than-expected tax rate. Given the lack of visibility into receivables and rising inventories, we maintain our 2+ (Weak) rating.

- Accounts receivable days (DSO) fell by almost 4 days from the year-ago quarter. The year-ago DSO was elevated from last year's Pik Holdings acquisition. Still, the receivables balance itself declined year-over-year.

- However, the lack of visibility into the company's quarterly receivables securitization activity adds a degree of uncertainty to tracking trends in revenue recognition and cash flow growth.

- Inventory DSIs continued to increase, climbing almost 4 days above the year-ago level. While higher levels of inventory at the acquired Pik Holdings business may have influenced the increase seen in the last few quarters, that has now lapped and it is out of the comparison. In fact, the year-ago DSI was likely *inflated* by the impact of the acquisition which actually muted the reported increase in the DSI.

- Accounts payable DSPs showed a noticeable jump in the quarter as the company extends payment time on its suppliers.

DSOs Are Down but Lack of Visibility Still Clouds

Accounts receivable DSOs in the 9/18 quarter fell by almost 4 days compared to the year-ago quarter:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Sales	$1,038	$1,028	$1,006	$1,033
Accounts Receivable	$362	$349	$361	$346
Sales YOY growth	7.2%	14.5%	14.7%	15.3%
Accounts Receivable YOY growth	-4.3%	14.7%	18.3%	20.5%
Accounts Receivable DSOs	31.8	30.9	32.8	30.6

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Sales	$968	$898	$877	$896
Accounts Receivable	$378	$304	$305	$287
Sales YOY growth	11.2%	2.3%	3.3%	2.6%
Accounts Receivable YOY growth	42.4%	8.9%	10.2%	3.9%
Accounts Receivable DSOs	35.6	30.9	31.7	29.2

However, the year-ago DSO was inflated by the Pik Holdings acquisition during the final month of the 9/17 quarter. Nevertheless, the receivables balance itself declined implying the balance of the account is under control.

However, investors should still be mindful of the fact that the company maintains a receivables factoring program about which it discloses no quarterly detail. This leaves open the possibility that receivables could have been sold off and removed from the balance sheet which would cloud the real level of receivables at the end of the quarter as well as accelerate cash receipts. Admittedly, we would expect the company would disclose it if a meaningful quantity of receivables were sold off in the quarter. Still, we know the company factored over $100 million in receivables during 2017 which is more than capable of distorting a DSO analysis depending upon timing during a quarter. We will have more disclosure on this issue when the 2018 10-K comes out next year.

Inventories Continue to Climb with Buildup in Finished Goods

The following table shows that CHD's inventory days (DSI) continued to climb on a year-over-year basis.

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
COGS	$578	$573	$555	$552
Inventory	$391	$369	$357	$331
COGS YOY growth	9.1%	17.5%	16.0%	13.1%
Inventory YOY growth	16.2%	26.3%	27.5%	28.1%
Inventory DSIs	61.7	58.8	58.8	54.7

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
COGS	$529	$488	$478	$488
Inventory	$336	$292	$280	$258
COGS YOY growth	11.4%	3.9%	1.7%	2.5%
Inventory YOY growth	17.6%	0.7%	-3.7%	-5.8%
Inventory DSIs	57.9	54.7	53.5	48.3

	9/30/2016	6/30/2016	3/31/2016	12/31/2015
COGS	$475	$469	$470	$476
Inventory	$286	$290	$291	$274
Inventory DSIs	54.9	56.4	56.5	52.5

We can see that the Pik acquisition drove a 17.6% YOY increase in inventory in the 9/17 quarter. As with receivables, the company's 8/7/2017 acquisition of Pik Holdings would have inflated the DSI number in the 9/17 quarter by 1) only one month of cost of sales being included with the full amount of inventory impacting the calculation and 2) Pik likely carrying a higher level of inventory relative to cost of sales given the nature of the business. Still, in the quarters following the deal, inventory continued to grow at almost double the rate of cost of sales. In addition, the YOY increase in DSI was only three days from the 9/16 quarter to 9/17 quarter and that only widened in the following quarters. Now, in the 9/18 quarter, we still see a 16.2% increase in inventory on a 9.1% increase in cost of sales despite the fact that the 9/17 quarter included all of Pik's inventory and only about two-thirds of its cost of sales. We see this as an indication more of a buildup in inventory at the whole company rather than reflective of Pik having an intrinsically higher DSI.

We believe more evidence of this is still seen in the breakdown of inventory components seen below:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Raw Materials % of inventory	21.9%	23.7%	24.8%	25.9%
In-Progress % of inventory	8.5%	8.7%	9.8%	9.3%
Finished Goods % of inventory	69.6%	67.6%	65.4%	64.8%

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Raw Materials % of inventory	24.6%	25.6%	25.1%	27.0%
In-Progress % of inventory	10.1%	11.3%	10.0%	11.2%
Finished Goods % of inventory	65.2%	63.1%	64.9%	61.8%

Finished goods as a percentage of total inventory has been on the rise the last four quarters. Key to note once again is that the percentage jumped by more than 400 bps YOY in the 9/18 quarter and both periods included the acquired Pik inventory. The only comment we have seen from management on inventory was in the 9/18 10-Q:

> *"The increase in the cash conversion cycle is* ***primarily due to certain acquisitions, which currently require a higher level of working capital.*** *We continue to focus on reducing our working capital requirements."*

This seems to address why inventory is higher than it was prior to the Pik acquisition but not the increase from the 9/17 to 9/18 quarters.

We also remind investors that the company switched the 17% of its inventories accounted for under LIFO to the FIFO method at the beginning of the 6/18 quarter. Prior quarters have not been restated as the company has deemed the impact immaterial. Regardless, in a period of rising costs, FIFO will result in a higher ending inventory balance than under LIFO and this could be driving some of the increase we are seeing. As such, these are costs that are being delayed from hitting the income statement, although the company's DSI of 60 days limits the delay.

There are many factors impacting the company's inventory balance, but all things considered, we remain cautious on the company's inventory level.

Payables Are Now Rising

We noted in our review of CHD's 6/18 quarter that the company's account payable growth had been under control in the previous three quarters. However, payables growth accelerated relative to cost of sales in the 9/18 quarter:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
COGS	$578	$573	$555	$552
Accounts payable	$450	$420	$405	$399
COGS YOY growth	9.1%	17.5%	16.0%	13.1%
Accounts payable YOY growth	15.2%	11.9%	17.0%	20.3%
Accounts payable DSPs	71.0	66.9	66.7	66.0

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
COGS	$529	$488	$478	$488
Accounts payable	$390	$375	$346	$332
COGS YOY growth	11.4%	3.9%	1.7%	2.5%
Accounts payable YOY growth	22.1%	18.6%	13.0%	12.8%
Accounts payable DSPs	67.3	70.2	66.1	62.0

Once again, we see that days payable (DSP) was inflated in the 9/17 quarter by the Pik acquisition just like DSOs and DSIs. However, the 3.7-day YOY jump to 71 seen in the 9/18 quarter is a noticeable increase. Management noted in the 10-Q filing for the 9/18 quarter:

> *"The change in working capital is primarily due to an increase in accounts payable and accrued expenses as we continue to extend payment terms with our suppliers…"*

The increase in payables and the absolute level of DSPs has not reached the ridiculous proportions we have seen with some other companies, but the benefit from stretching payables will run out at some point.

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.

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