BEHIND THE NUMBERS

EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Church and Dwight (CHD) EQ Update 12/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3+	2-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

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

We are raising our earnings quality rating to 3+ (Minor Concern) from 2- (Weak).

- Inventory DSIs rose by more than 3 days over the year-ago quarter which management blamed on the 6/19 quarter acquisition of Flawless. We expressed concern about the increase in inventory seen in the 6/19 quarter because the company did not originally book the Flawless inventory in that period but rather continued to buy inventory from Flawless during the five-month trial period. During the 12/19 quarter, the Flawless inventory hit CHD's balance sheet, so the jump in inventory being driven by the Flawless acquisition seems plausible. We are less concerned about inventory levels at this point but will be looking for the year-over-year increase in DSIs stabilize going forward.

- DSOs based on receivables on the balance sheet were down about a day from last year's fourth quarter. The 10-K indicated that CHD sold $138.9 million of receivables during 2019, up from $112.9 million in 2018. However, as we have criticized in the past, CHD does not disclose the amount of receivables sold but still outstanding at the end of the period, nor does it disclose any quarterly data on the program. This makes it impossible to calculate an adjusted period ending receivables balance to assess the extent to which sales could have been pulled into the end of the quarter through the extension of easier terms. Still, if we just assume that all of the year-over-year increase in receivables factored during the year ($138.9-$112.9) came at the end of the fourth quarter and was still outstanding at the end of the period, adjusted DSOs would have risen by only about a day. Therefore, we are not overly concerned about receivables at this 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 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 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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