BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Church & Dwight (CHD) EQ Update-12/18 Quarter

Current EQ Rating*	Previous EQ Rating
3+	2+

*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)

- One of our concerns about CHD is that it does not disclose quarterly data on its receivables factoring program, making the quarterly analysis of revenue recognition trends difficult. For example, while DSOs declined by almost 4 days in the 9/18 quarter, one cannot tell if receivables being sold and removed from the balance sheet could have impacted the trend. However, CHD disclosed in its 2018 10-K that total receivables factored in 2018 fell to $7.5 million compared to $45.3 million in 2017. The lower activity indicates there was not a hidden increase in receivables and that cash flow did not receive an artificial boost. This prompts us to raise our EQ rating to 3+ (Minor Concerns)

- We noted in our review of the last quarter that inventory days (DSI) rose with most of the increase centered in finished goods. The trend continued in the 12/18 quarter as DSI rose to 58.2 from 54.7 a year ago. Finished goods as a percent of total inventory jumped from 64.8% last year to 69.0% at 12/18. Management has indicated that its Waterpik business requires a higher degree of working capital. However, the Waterpik deal already lapped in the last quarter so the year-over-year impact should be removed by now. Management also indicated on the call that its gross margin disappointment was partly due to faster than expected international sales of Waterpik which has built up increased costs in inventory from tariffs. Regardless, the jump in finished goods inventory at best indicates that there are pent-up costs still posed to hit the income statement in future periods. We therefore remain cautious on the inventory build.

- We recommend clients read last week's overview of goodwill at several companies including CHD for more detail regarding the makeup of the company's intangibles. Spoiler alert - we are not as concerned about a material negative surprise from a goodwill write-down at CHD as we are some other consumer products companies. CHD did warn that in 2017, a personal care trade name had deteriorated in value due to competition, but actions the company took in 2018 have increased the buffer between estimated and carrying value reducing the chance of a write-down at least for now.

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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