

## Church & Dwight (CHD) EQ Update

Current EQ Rating*	Previous EQ Rating
3-	3+

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

**We lower our earnings quality rating to 3- (Minor Concern) from 3+ (Minor Concern).**

CHD's 3/19 quarter adjusted EPS of \$0.70 was 4 cps ahead of expectations. The rating reduction primarily reflects the continuing increase in inventory along with the cuts to marketing spending.

- Inventory DSI continues to climb, rising 4.7 days which is the fifth straight quarter of 3+ day jumps. As in previous quarters, the buildup was centered in finished goods. We remind clients that prior to the 6/18 quarter, the company accounted for a little less than 20% of its inventory under the LIFO method. However, beginning in the 6/18 quarter, it moved to 100% FIFO. This could be contributing some to the year-over-year increase in DSI. However, CHD recorded only \$4 million in *cumulative* benefit related to the accounting change in the 6/18 quarter and we estimate that the entire amount would only account for about a 1-day increase in DSI.
- We note that marketing spending fell 50 bps as a percentage of sales with 30 attributed to sales leverage and 20 from lower expenses. The slowdown in spending can also be seen in the drop in accrued marketing and promotion costs which fell to \$110.1 million at the end of the 3/19 quarter versus \$114.8 million a year ago. We view this as a low-quality source of margin expansion for a consumer products company.
- Days payable increased by 3 days over the year-ago period. Payables still stand under 70 days, so we are not as concerned that cash flow is being stretched as we are at some other consumer goods companies with payable days in excess of 90.

- CHD closed on its acquisition of the Flawless and Finishing Touch hair removal business on May 1. While this was subsequent to the end of the 3/19 quarter, the accounting for this deal is unusual. CHD paid \$475 million at closing and will make up to \$425 million in additional earn-out payments through December 31, 2021. Management expects a 4-month transition period during which Flawless management will continue to operate the business and the new cash received from acquired operations will be recorded as “other revenue.” Following the transition period, the company will purchase inventory and a one-time working capital build which will total another \$30 million.

# 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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