BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Church & Dwight (CHD) EQ Update- 6/20 Qtr.

Current EQ Rating*	Previous EQ Rating
3+	3+

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 maintain our earnings quality rating at 3+ (Minor Concern)

- Accounts receivable DSOs in the 6/20 quarter fell by 6 days versus the year-ago period. This follows a similar YOY decline posted in the 3/20 quarter. Management attributed the decline in receivables to "sales timing and increased receivable factoring." We have criticized the company in the past for its minimal disclosure regarding its receivables factoring program. CHD discloses only the amount of receivables factored on an annual basis and does not reveal outstanding factored balances at the end of the period. This makes it impossible to calculate a DSO adjusted for receivables that have been factored but not collected at the end of the quarter. The concern in such a situation is that accelerated factoring is masking an increase in DSOs. We do not believe that is the case in the 6/20 quarter given the magnitude of the DSO decline, but the situation warrants continued scrutiny going forward and lowers the quality of the company's reported results.

- Inventory DSIs rose by 4 days YOY in the 6/20 quarter. This follows an almost 6-day YOY decline in the 3/20 quarter driven by the initial COVID pantry-stuffing wave. The company has experienced strong demand for laundry and cleaning products, cat

litter, baking products, and gummy vitamins have gone from the problem child of the portfolio to superstar growth-driver overnight. At the same time, personal products such as WATERPIK and condoms have experienced strong declines. While management did not address the buildup of inventories in the 10-Q or the conference call, it did indicate that inventory levels at retailers had normalized. Management also has indicated that it expects its cleaning and wellness brands, gummy vitamins included, to be at a new permanent plateau. This makes us wonder if the buildup in inventory was a combination of expectations for second-quarter sales as well as unsold WATERPIK and condoms. To the extent it is the latter, we would expect DSIs to wind back down in the second half. We will become more concerned about the inventory levels if the increase continues into 3Q.

- CHD warned investors in the 10-Q that the *TROJAN* condom tradename ($176.4 million) was "susceptible to impairment risk" due to recent declines in sales and profits. However, as of the 12/19 quarter, fair value exceeded carrying value by 26%. This is a fairly big buffer and the COVID-related hit to demand should decline in upcoming quarters. However, it is worth noting that the company has also warned that competition has increased and the category has seen secular growth pressures. The 10-Q states "Condom usage has declined, as a result of a lower 18 to 24-year old population, alternate birth control options, less fear of HIV, decreased sexual activity, and increased competition, all of which have contributed to lower demand for our products in the condom category." These long-term secular trends pose more of a worry that the company could eventually face a write-down in the *TROJAN* intangibles. Also remember that prior to the COVID boost, the company was warning that the gummy vitamin category was vulnerable to a write-down, so if the company's permanent plateau of demand for its vitamin products does not materialize, we could be seeing those warnings again.

- Given the artificially strong demand in the 6/20 quarter, the company cut advertising and promotional spending which was a 180 bps boost to operating margins. The company expects this to reverse in the back half as conditions normalize and to support new product introductions. For reference, the decline in marketing expense as a percentage of revenue added about 6.5 cps to earnings growth in the quarter.

Explanation of EQ Rating Scale

Rating	Description
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.

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