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Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

Colgate-Palmolive (CL) EQ Review Update-9/18 Quarter

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 are lowering our rating on Colgate-Palmolive (CL) to a 3- (Minor Concern).

CL's 9/18 adjusted EPS of $0.72 was in-line but its revenue came up short of estimates as its results were weighed down by both unfavorable FX and rising costs. It is interesting to note that the company has not hit a consensus revenue target since second quarter 2015 yet has recorded only one earnings miss in the same time frame.

We noted deterioration in a couple of areas in the 9/18 quarter:

- Inventory days (DSI) at the end of the 9/18 quarter jumped by 3 days over the year-ago period. Additionally, finished goods as a percentage of total inventories increased by 150 basis points over last year, a marked acceleration from the previous three quarters. These factors coupled with the lower than expected revenue in the quarter could be pointing to an unexpected buildup in product that could require discounting to move in the fourth quarter.

- Management had forecast that advertising would increase as a percentage of sales in 2018 and it has finally started happening. While absolute advertising spend declined slightly, it rose 10 bps as a percentage of sales. This drag on margins should continue as the company seeks to push through price increases, in some cases reportedly ahead of its competition.

Inventory DSIs Up 3 Days

CL's inventory days (DSI) were up by 3 days over the 9/17 quarter as shown in the table below:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
COGS	$1,576	$1,585	$1,594	$1,564
Inventory	$1,245	$1,254	$1,312	$1,221
COGS YOY growth	-0.9%	3.9%	6.8%	6.1%
Inventory YOY growth	3.3%	4.6%	10.3%	4.3%
Inventory DSIs	72.1	72.2	75.1	71.2

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
COGS	$1,591	$1,526	$1,493	$1,474
Inventory	$1,205	$1,199	$1,189	$1,171
COGS YOY growth	3.1%	-1.0%	-1.4%	-8.2%
Inventory YOY growth	1.0%	-2.7%	-3.6%	-0.8%
Inventory DSIs	69.1	71.7	72.7	72.5

This is the largest year over year increase seen in two years. We can also see from the table below that all of the increase was focused in finished goods:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Raw Materials % of inventory	19.9%	20.0%	19.7%	21.9%
In-Progress % of inventory	3.2%	3.6%	3.7%	3.4%
Finished Goods % of inventory	76.9%	76.4%	76.6%	74.7%

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Raw Materials % of inventory	20.7%	20.1%	20.3%	22.7%
In-Progress % of inventory	3.9%	3.9%	3.7%	3.6%
Finished Goods % of inventory	75.4%	76.0%	76.0%	73.7%

Finished goods as a percentage of total inventory rose to 76.9% at the end of the 9/18 quarter from 75.4% a year ago. The finished goods percentage has been rising for several quarters, but this 150 bps increase is a marked acceleration and coincides with the spike in DSIs. The company is experiencing rising costs which could give an uplift to inventories. However, the sudden jump in DSIs and finished goods percentage increases coupled with lower than expected sales increases the concern level that there was an unintended buildup in product at the end of the 9/18 quarter. Such a buildup would increase the risk of discounting to move older product.

Advertising % Increased

CL has been saying it would increase advertising as a percentage of sales for the last couple of quarters and it finally happened. While absolute advertising declined, it rose as a percentage of sales by 10 bps. We would expect to see advertising continue to be a drag on margin growth as the company is increasing prices and is moving ahead of its competition in doing so. As such, it will likely have to continue the emphasis on advertising in order to minimize market share loss.

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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