BEHIND THE NUMBERS
Quality of Earnings Analysis
March 8, 2022

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

Colgate-Palmolive Company (CL)
Earnings Quality Update- 12/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are maintaining our earnings quality rating of CL at 3- (Minor Concern).

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

Summary

CL reported non-GAAP EPS of $0.79 per share was in line with expectations. Results benefitted from a 1.5 cps decline in other expense although the cause of the decline is unclear. A decline in the adjusted tax rate added another 1.5 cps to EPS growth, but the rate was likely close to what most analysts had modeled given guidance so we do not view it as relevant to the company meeting EPS targets in the quarter. Nevertheless, we have several items of concern that may be pointing to CL having a difficult time hitting targets over the next couple of quarters.

- Gross margin in the 12/21 quarter declined by 300 bps YOY and was 210 bps below the pre-COVID 12/19 quarter. This was largely driven by a negative 670 bps impact of higher costs. This was in spite of the fact that the company utilizes FIFO accounting for 75% of its inventories. The company turns its inventories about 4 times per year, meaning sales in the 12/21 quarter were benefitting from price increases that were in effect in the fourth

quarter while costs which were rising during the fourth quarter were delayed from hitting the income statement.

- In addition, CL uses LIFO accounting for its 25% of inventories that are located in North America. However, plant closures and supply chain problems are prohibiting the company from rebuilding its inventories to keep pace with unit sales which may be resulting in gross margin benefitting from lower-cost LIFO layers being expensed on the income statement. Over the next couple of quarters, the company will be scrambling to rebuild its FIFO inventories at higher costs which will be recognized immediately at the same time any benefit from eating into lower-cost LIFO layers may be disappearing.

- CL implemented more price increases in developed markets to take effect in the 3/22 quarter and into the 6/22 quarter. It also hopes to drive sales of higher-priced, higher-margin products. However, it is unclear how successful the company will be at either given the degree to which rising food costs and higher gasoline prices are pressuring consumers' budgets.

- Advertising expense fell to 11.1% of sales in the 12/21 quarter which was down from last year's historical high of 12.7%. Unlike most companies, CL increased its advertising during Covid. It is understandable that advertising fell versus the 12/20 high, but it even declined noticeably from the 9/21 quarter's level. If advertising had remained flat sequentially, it would have taken roughly 1.5 cps off EPS in the quarter, causing the company to miss targets. Now the company is calling for an increase in advertising in 2022 as it tries to push through more price increases and drive customers to more innovative (high-priced) products. This may be a tall order in the current inflationary environment with consumer budgets facing more pressure by the day.

- The Hill's Pet Nutrition segment has been growing at a disproportionate rate and now is the company's largest profit contributor. Organic sales growth has been extremely strong in the last two years. In 2020, growth accelerated as people stuck at home during the pandemic prompted many to get pets as companions. So far, growth has remained strong in the last few quarters in part due to aggressive advertising. However, as people return to work and budgets are crimped by inflation, we wonder how long it will be before pet owners have to start trading down to lower-priced, non-premium pet foods and away from the company's premium brands.

- Latin America accounts for about 20% of CL's revenue. Like SEE and MDLZ, CL's organic revenue figures are benefitting from adding back the negative impact of foreign exchange while retaining the benefits of higher pricing being driven by inflation in those markets which is helping to drive the weakness in the currency. If we use organic volume growth as a proxy for organic sales in Latin America, the company's total organic growth rate fell to 3% in the 12/21 quarter to 1.6%.

- In late 2012, CL announced a restructuring plan that was originally forecast to last until 2016 and cost $1.1 billion to $1.25 billion. The plan eventually ran through 2019 and cost over $1.8 billion. In the most recent quarter, CL announced its latest plan which management said would only last one year and cost $200 million to $240 million. Such "one-time" charges always erode the quality of reported earnings given the chance for ongoing costs to be included in the charges and added back to non-GAAP results. Given the company's history, we are also very skeptical that 2021 will mark the end of this plan.

Gross Margin Disappointed Again- Despite Possible Inventory Accounting Benefits

CL's adjusted gross margin fell by 300 bps YOY in the 12/21 quarter. The following table shows gross margin for the last twelve quarters along with the basis point impact of pricing, raw materials prices, and productivity improvements for the last three periods.:

	12/31/2021	9/30/2021	6/30/2021	3/31/2021
Adjusted Gross Profit	$2,559	$2,623	$2,556	$2,637
Adjusted Gross Profit Margin	58.1%	59.4%	60.0%	60.7%
YOY Change	-300 bps	-180 bps	-80 bps	
Impact of Pricing	+120 bps	+110 bps	+90 bps	
Impact of Raw Materials	-670 bps	-510 bps	-370 bps	
Productivity	+250 bps	+210 bps	+200 bps	

	12/31/2020	9/30/2020	6/30/2020	3/31/2020
Adjusted Gross Profit	$2,643	$2,540	$2,369	$2,469
Adjusted Gross Profit Margin	61.1%	61.2%	60.8%	60.3%

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Adjusted Gross Profit	$2,416	$2,317	$2,305	$2,298
Adjusted Gross Profit Margin	60.2%	59.0%	59.6%	59.2%

Note that in 2020, gross margins were unusually high due to Covid-driven volumes. Therefore, it is more informative to compare to 2019. Gross margin in 2021 was above their comparable 2019 periods until the 12/21 quarter when it fell over 200 bps compared to the 12/19 period.

The impact of rising raw materials costs drained 670 bps of gross margin in the 12/21 quarter which is up from a 510 bps and 370 bps in the 9/21 and 6/21 quarters, respectively. However, CL utilizes FIFO accounting for its foreign inventories which amount to 75% of the total while it utilizes LIFO accounting for its US inventories which comprise about 25% of inventories. The following table shows inventory DSIs by component for the last twelve quarters:

	12/31/2021	9/30/2021	6/30/2021	3/31/2021
Raw Materials DSI	25.2	23.2	25.1	24.4
Work in Process DSI	1.9	2.3	2.6	2.5
Finished Goods DSI	62.3	64.8	68.1	66.6
Non-Current inventory DSI	-5.0	-4.4	-5.0	-5.2
Total DSI	84.4	85.8	90.8	88.4

	12/31/2020	9/30/2020	6/30/2020	3/31/2020
Raw Materials DSI	24.8	22.2	22.6	18.3
Work in Process DSI	2.5	2.7	2.9	2.6
Finished Goods DSI	68.7	67.9	68.2	54.4
Non-Current inventory DSI	-4.5	-2.9	-3.0	-2.8
Total DSI	91.6	90.0	90.8	72.5

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Raw Materials DSI	17.5	15.8	15.1	13.6
Work in Process DSI	2.8	2.5	2.5	2.4
Finished Goods DSI	60.7	59.9	59.7	56.0
Non-Current inventory DSI	-0.6	0.0	0.0	0.0
Total DSI	80.4	78.2	77.2	72.0

Under FIFO, the company expenses its older inventories first. We can see that the company's DSI approximate 90 days, meaning it takes a full quarter for inventories to work their way through to cost of sales. This should be providing a meaningful boost to gross margin in such a rampant period of inflation as the company's revenue figures will reflect the impact of increased prices before the higher costs are recognized in cost of sales.

However, the company utilizes LIFO accounting for its US inventories which comprise 25% of the total. Under LIFO, the company expenses the most recent inventories first which results in lower gross margins than it would report under FIFO during times of inflation.

However, notice that the company's inventory DSIs were down YOY in the last two quarters. We can see in the following table the trend if declining finished goods inventory in the last three two quarters:

CL stated in its 10-K the following regarding its LIFO inventories:

> *"Inventories valued under LIFO amounted to $410 and $439 at December 31, 2021 and 2020, respectively. The excess of current cost over LIFO cost at the end of each year was $60 and $65, respectively. The liquidations of LIFO inventory quantities had no material effect on income in 2021, 2020 and 2019."*

CL does not disclose its LIFO balances on a quarterly basis, but we can see from the statement above that LIFO inventories were indeed down by more than 6% in 2021. Volume sales in North American Oral Care fell by 4% in 2021. However, volume for the Hill's pet care business, which is also primarily in North American and comparable in size to the North American Oral Care segment, rose by 8% in 2021. Therefore, it is possible that North American unit volume growth was positive for 2021. However, remember that inventory replacement costs were skyrocketing during 2021. This points to LIFO units being down much more than 6% while North American volumes were flat to positive.

Without quarterly LIFO data, we can't get an exact picture of the flow of LIFO balances during the year, but it is still informative to look at the sequential trends in total inventory by component which is shown in the following table:

	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020	6/30/2020
Raw Materials	$505	$451	$470	$463	$454	$390	$380
Work in Process	$39	$44	$48	$48	$45	$48	$49
Finished Goods	$1,248	$1,261	$1,275	$1,264	$1,256	$1,190	$1,145
Non-Current inventory	-$100	-$86	-$93	-$99	-$82	-$50	-$50
Total Inventory	$1,692	$1,670	$1,700	$1,676	$1,673	$1,578	$1,524

While raw materials inventories showed recovery in the 12/21 quarter, both Finished Goods and Work in Process have gone straight down the last three quarters. Management has pointed to both supply chain problems and plant shutdowns related to Covid as factors keeping it from maintaining the desired inventory level and admitted that struggling to rebuild inventories will lead to cost increases.

With regard to the company's statement that results would not have been materially different if it had utilized 100% FIFO, we believe this statement pertains to all of 2021 and does not necessarily rule out the possibility that eating into LIFO layers could have provided one-time benefits to third or fourth-quarter results which would fade going forward as the company rebuilds LIFO inventories at higher costs. Keep in mind that $50 million in higher costs impacts

EPS by 5 cps. Therefore, we believe there is potential for increased costs to linger into the next couple of quarters more than some analysts are expecting.

How Much More Pricing Can the Company Push- Advertising Will Rise

Regardless of the degree to which inventory accounting may have delayed the full impact of raw materials cost increases, the company is counting on price increases to help it offset the rising costs. The company took pricing in emerging markets in the 12/21 quarter and will be rolling out more pricing in developed markets in the 3/22 quarter and into the 6/22 quarter. In addition, the company hopes to drive sales of its more innovative products (higher-priced) to help drive sales growth and margins.

This level of pricing aggressiveness will require an increase in advertising in the hopes to minimize volume loss. The following table shows advertising as a percentage of sales for the last twelve quarters:

	12/31/2021	9/30/2021	6/30/2021	3/31/2021
Advertising Expense	$489	$503	$494	$535
% of Sales	11.1%	11.4%	11.6%	12.3%

	12/31/2020	9/30/2020	6/30/2020	3/31/2020
Advertising Expense	$549	$476	$439	$484
% of Sales	12.7%	11.5%	11.3%	11.8%

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Advertising Expense	$426	$423	$416	$429
% of Sales	10.6%	10.8%	10.8%	11.0%

2020 saw an increased level of advertising as the company sought to build its brands with much of its focus on the Hill's pet nutrition business. However, advertising expense fell abruptly in the 12/21 quarter versus historically high levels in the 12/20 quarter. CL did not cut advertising during Covid as many companies did as it sought to support its brands. We understand that the 12/20 quarter was unusually high and would have expected advertising to come down some, on a YOY basis. However, advertising was not even flat with the first three 2021 quarters on an absolute or percentage of sales basis. If advertising had remained flat with the 9/21 quarter at 11.4% of sales, it would have taken almost 1.5 cps off EPS, causing the company to miss targets. Regardless of what analysts were expecting for advertising in the quarter, management noted in the conference call that it expects advertising in 2022 to increase both in absolute terms and as a percentage of sales as it seeks to push through price increases and drive customers to premium, higher-priced products. It is remarkable that CL not only saw advertising rise during Covid, but a return to pre-Covid levels does not appear to be in the cards anytime soon as getting customers to switch to premium products with inflation at 1970s levels may be tall order.

Pet Food Is Supplying the Bulk of the Growth

The Hill's pet food segment has been a key source of growth which was accelerated further by the pandemic as people stuck at home acquired pets for companionship. While most people associate CL with soap and toothpaste, the Pet Nutrition segment is now essentially tied with North America and Latin America as CL's largest segment in terms of sales and in 2021 accounted for the highest percentage of total company profits as shown in the following table:

% of Revenue by Segment	12/31/2021	12/31/2020	12/31/2019
North America	21.1%	21.7%	21.3%
Latin America	20.8%	20.5%	22.6%
Europe	15.9%	17.2%	16.2%
Asia Pacific	16.4%	16.7%	16.7%
Africa/Eurasia	5.7%	5.7%	6.2%
Pet Nutrition	20.1%	18.2%	16.9%

% of Segment Op Inc. (before corp)	12/31/2021	12/31/2020	12/31/2019
North America	15.9%	21.3%	21.3%
Latin America	22.5%	22.4%	22.5%
Europe	14.9%	15.4%	15.8%
Asia Pacific	19.3%	19.5%	17.6%
Africa/Eurasia	4.7%	2.9%	4.2%
Pet Nutrition	22.8%	18.6%	18.6%

The following table breaks out the source of organic growth in this segment between volume and pricing:

Pet Nutrition	12/31/2021	9/30/2021	6/30/2021	3/31/2021
Organic Volume	7.0%	11.0%	10.5%	3.0%
Pricing, Coupons, Consumer and Trade Incentives	6.0%	8.0%	4.5%	4.0%
Organic Sales Change	13.0%	19.0%	15.0%	7.0%

	12/31/2020	9/30/2020	6/30/2020	3/31/2020
Organic Volume	11.0%	6.5%	7.5%	17.0%
Pricing, Coupons, Consumer and Trade Incentives	3.5%	4.5%	4.0%	4.0%
Organic Sales Change	14.5%	11.0%	11.5%	21.0%

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Organic Volume	3.5%	6.5%	2.0%	2.0%
Pricing, Coupons, Consumer and Trade Incentives	5.0%	3.5%	4.0%	4.0%
Organic Sales Change	8.5%	10.0%	6.0%	6.0%

Prior to the pandemic, organic volume was running in the low single-digit range before rapidly accelerating at the onset of Covid. Despite difficult comps and rapidly increasing prices, organic volume growth has remained surprisingly strong in 2021 although volume growth did decelerate in the most recent quarter.

While many are viewing the increase in pet ownership from the pandemic as a new normal, this is a trend that, in our opinion, may be ripe for a reversal. We have read articles documenting the plight of new pet owners who have worked at home for two years who, upon returning to the office, are facing hundreds of dollars a month in pet daycare bills. In addition, their budgets are now being drained by rampant food cost inflation and $4+ per gallon gas. A key point is that Hill's produces pet food in the premium end of the market. Customers don't have to go as far as to get rid of their pets to negatively impact CL, they only have to trade down to a more affordable brand of food. As such, we would not be surprised to see a negative surprise from the Pet Care segment in the future, particularly given the tough comparisons of 2021.

Latin American Pricing Providing Bulk of Reported Organic Growth

We have documented with several other companies how the practice of removing the impact of foreign exchange can distort organic growth rate figures for companies with sizeable operations in Latin America. Latin America accounts for over 20% of CL's total sales so this phenomenon is particularly strong.

The following table shows the reconciliation of reported sales growth for the Latin American segment to organic sales growth for the last twelve quarters:

Latin America	12/31/2021	9/30/2021	06/30/2021	3/31/2021
Reported Sales Change	3.5%	11.0%	12.5%	2.0%
FX	-2.5%	3.0%	4.0%	-7.5%
Organic Volume	-1.0%	2.5%	2.5%	1.0%
Pricing, Coupons, Consumer and Trade Incentives	7.0%	5.5%	6.0%	8.5%
Organic Sales Change	6.0%	8.0%	8.5%	9.5%

	12/31/2020	09/30/2020	06/30/2020	03/31/2020
Reported Sales Change	-2.5%	-5.0%	-13.5%	0.0%
FX	-13.0%	-16.5%	-18.0%	-10.5%
Organic Volume	1.0%	2.0%	-4.5%	4.0%
Pricing, Coupons, Consumer and Trade Incentives	9.5%	9.5%	9.0%	6.5%
Organic Sales Change	10.5%	11.5%	4.5%	10.5%

	12/31/2019	09/30/2019	06/30/2019	03/31/2019
Reported Sales Change	2.0%	3.0%	-0.5%	-4.5%
FX	-4.5%	-5.0%	-7.5%	-10.5%
Organic Volume	3.0%	4.5%	1.5%	2.5%
Pricing, Coupons, Consumer and Trade Incentives	3.5%	3.5%	5.5%	3.5%
Organic Sales Change	6.5%	8.0%	7.0%	6.0%

As we have discussed extensively with MDLZ and SEE, the idea behind adding back FX to organic growth is that over time, the effects should roughly cancel each other out. In other words, one year the impact may be -2% and the next year a +1.5%. However, as we see in the table above, Latin America almost always is a negative impact. Despite this, the company's headline reported organic growth rate benefits from the rapid price increases in the Latin American markets that are mostly a result of this high inflation that is eroding the value of the currencies.

Also, note that organic volume growth in Latin America, which is a better indicator of true business activity, has been anemic for years. As a result of adding back the negative impacts of foreign exchange, Latin America regularly provides a disproportionate share of the company's total reported organic sales growth. CL's total organic sales growth in the 12/21 quarter was 3.0%. However, if we substitute organic volume as a proxy for organic sales in Latin America, CL's total organic sales growth rate falls to 1.6%.

New Restructuring Program Announced

At the end of 2012, CL announced its Global Growth and Efficiency Program which was intended to *“help the Company ensure sustained solid worldwide growth in unit volume, organic sales and earnings per share and enhance its global leadership positions in its core businesses.”* The original projections called for the plan to run through 2016 and cost between $1.10 billion and $1.25 billion. However, as is often the case, the size and scope of the plan grew over time. The Global Growth and Efficiency Program was extended multiple times and eventually ran through 2019 with a total cost of $1.85 billion. We also note that roughly half the total costs were classified as “other” costs and consisted of “charges resulting directly from exit activities and the implementation of new strategies as a result of the Global Growth and Efficiency Program.” The problem we have with such open-ended amounts is they can include items that should be viewed as ongoing in nature such as management time spent on restructuring. How does one decide how much time was spent on the restructuring versus other business functions? Such ambiguity opens the door for ongoing expenses to be lumped into the charge and written back into earnings as non-GAAP adjustments.

CL did not take another restructuring charge throughout 2020 and 2021 which we viewed as a positive for earnings quality. **However, with the close of 2021, the company announced a new round of restructuring which it described as follows:**

> *“In order to accelerate changes to our operating structure that will allow us to reallocate resources to our strategic priorities and faster growth businesses and channels, drive efficiencies in the company's operations and streamline our supply chain to reduce structural costs, this morning, we also announced the global productivity initiative. We intend to execute the majority of the productivity program in the current calendar year, and once the projects are implemented and finalized, is expected to result in cumulative pretax charges totaling between $200 million and $240 million in annualized pretax savings in the range of $90 million to $110 million. We would expect the benefits to begin to flow through in the second half of 2022 and then accelerate into 2023.”*

So far, the new plan is relatively limited in scope and cost. We seldom see a restructuring program that is expected to last just one year. This, plus the company’s history of expanding restructuring initiatives make us believe it is likely to expect the company to announce this plan will spill over into future years.

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 Concern)- 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 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 upcoming quarters. 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

Behind the Numbers, LLC is an independent research firm structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. All research is based on fundamental analysis using publicly available information including SEC filed documents, company presentations, annual reports, earnings call transcripts, as well as those of competitors, customers, and suppliers. Other information sources include mass market and industry news resources. These sources are believed to be reliable, but no representation is made that they are accurate or complete, or that errors, if discovered, will be corrected. Behind the Numbers, LLC does not use company sources beyond what they have publicly written or discussed in presentations or media interviews. Behind the Numbers does not use or subscribe to expert networks. All employees are aware of this policy and adhere to it.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.