BEHIND THE NUMBERS
Quality of Earnings Analysis

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Colgate-Palmolive (CL)

Update after 3/22 Quarter Results and 10-Q Review

CL missed non-GAAP EPS estimates by a penny for the 3/22 quarter. It also cut its guidance for the full year. It now expects raw materials costs will rise 22% for the year compared to previous forecasts for 13%.

- We previously warned that inventory trends were pointing to higher than expected costs. While DSIs increased in the 3/22 quarter, inventory growth adjusted for inflation still seems to be lagging unit sales growth meaning the company will have to stock inventory with even higher-priced items.
- A drop in other expense/income added 1.9 cps from a VAT refund while lower advertising added over 3 cps. Neither benefit is sustainable.
- CL announced its latest restructuring charge- right on schedule
- The company is still pricing aggressively in Latin America despite the FX headwind almost disappearing.

Inventory Increased but Is Still Low- More Pressure Likely Ahead

CL saw gross margin decline in the 12/21 quarter from rising costs. We warned then that CL uses FIFO inventory accounting for 75% of its inventory balances and LIFO for the rest. Gross margin should have been getting help from price increases boosting revenue while rising costs on FIFO inventories were delayed from hitting the income statement. Meanwhile, inventories were declining on a unit basis implying that the quarter could have benefitted from liquidating lower-cost LIFO layers. Our concern was that as the company began to rebuild inventories at higher costs, this benefit would go away. Let's look at where inventory DSIs stand now:

	3/31/2022	12/31/2021	9/30/2021	6/30/2021
Raw Materials DSI	27.1	25.2	23.2	25.1
Work in Process DSI	2.5	1.9	2.3	2.6
Finished Goods DSI	71.5	62.3	64.8	68.1
Non-Current inventory DSI	-6.3	-5.0	-4.4	-5.0
Total DSI	94.8	84.4	85.8	90.8

	3/31/2021	12/31/2020	9/30/2020	6/30/2020
Raw Materials DSI	24.4	24.8	22.2	22.6
Work in Process DSI	2.5	2.5	2.7	2.9
Finished Goods DSI	66.6	68.7	67.9	68.2
Non-Current inventory DSI	-5.2	-4.5	-2.9	-3.0
Total DSI	88.4	91.6	90.0	90.8

We see that DSIs are beginning to rise both sequentially and year-over-year. However, look at the inventory component growth rates:

Inventory Component Growth Rates	3/31/2022	12/31/2021	9/30/2021
Raw Materials	18.8%	11.2%	15.6%
Work in Process	4.2%	-13.3%	-8.3%
Finished Goods	14.8%	-0.6%	6.0%
Non-Current inventory	28.3%	22.0%	72.0%
Total Inventory	14.8%	1.1%	5.8%

Remember that cost inflation was running well into the double-digit range at the end of 2021, meaning that the 11% growth in raw materials inventories in the 12/21 quarter which represented a decline on a unit basis. Now consider some of management's color on the outlook for inflation in 2022 given in the 3/22 quarter conference call:

> *"**What that means is that material costs will be up over 20%** for the full year on a year-on-year basis. So we put some context a little bit underneath what's happening in those commodities. **Natural gas is up over 60%.** And natural gas is used to power many of our plants and importantly, many of our suppliers' plants, which puts pressure on their costs and timing. **Soybean and corn are up by over 1/3; palm is up 25% and increasing**. So as we said earlier, what that means for the year, **fats and oils, including palm will be up over 60% year-to-year and doubled since 2020.***
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> ***Resins are up over 20%.** And these two categories combined, fats and oils and resins make up a significant portion of the material spend and on a combined basis are up nearly 40%. Take Listerine, another important material, and that's more than doubled year-to-year. So as we've looked at logistics, we saw similar cost inflation. And since we've seen that increase, we've over $150 million since our expectations in January, that translates*

to logistics being up nearly 20% for the full year. And -- some of this increase is because we prioritize meeting clients' needs."

The company will still be rebuilding significant unit inventory during the next couple of quarters with higher-cost units. They are already seeing the benefits from raising prices on the revenue line, but the cost of sales line has yet to feel the full brunt of these higher-cost inventories. We continue to worry that this lead to even more pressure on margins ahead.

Other Income Jumped Due to a VAT Refund

Other (income)/expense fell to $8 million after adjustments for restructuring charges versus $28 million in last year's first quarter. This added 1.9 cps to EPS growth in the period. The company does not specifically cite what drove this improvement although it does mention that the operating margin in the Latin American segment received a 70 bps boost primarily from a value-added tax refund which was recorded in other (income)/expense.

Advertising Fell

CL spent an unusually high amount of advertising in the 12/20 and 3/21 quarters and has now enjoyed two quarters of easy comparisons as shown in the following table.

	3/31/2022	12/31/2021	9/30/2021	6/30/2021
Advertising	$506	$489	$503	$494
Advertising % of Sales	11.5%	11.1%	11.4%	11.6%
	3/31/2021	12/31/2020	9/30/2020	6/30/2020
Advertising	$535	$549	$476	$439
Advertising % of Sales	12.3%	12.7%	11.5%	11.3%
	3/31/2020	12/31/2019	9/30/2019	6/30/2019
Advertising	$484	$426	$423	$416
Advertising % of Sales	11.8%	10.6%	10.8%	10.8%

Advertising fell sharply, both on an absolute and percentage of sales basis, adding 80 bps to operating margin and over 3 cps to EPS in the 3/22 quarter. This benefit will wane going into the 6/22 period when the company faces a more normalized level of spending. While advertising was below 11% of sales before the pandemic, we are skeptical that it can return to that level soon given the degree to which the company is increasing prices.

Another Restructuring Charge- Right on Schedule

It seems CL can't live long without restructuring. Its 2018 plan just ended last year and it started 2022 by announcing its latest "2022 Global Productivity Initiative" which is "*intended to reallocate resources towards the Company's strategic priorities and faster growth businesses, drive efficiencies in the Company's operations and streamline the Company's supply chain to reduce structural costs.*" The plan is expected to be completed by mid-2023 and result in $200-240 million in charges before tax. CL incurred $82 million of charges under the plan in the 3/22 quarter which, of course, were added back to non-GAAP results. Roughly 75% of the charges are expected to be related to severance and pension termination. While the components of the charges seem less open-ended than many plans, we still question why expenses that seem to be incurred almost every year should be considered one-time in nature. We also will be very surprised if the company doesn't end up expanding the scope of this plan before mid-2023 which will increase the likelihood that ongoing expenses are being included in the charges and added back to adjusted results.

Latin American Pricing Impact Still Disproportionate

At 21% of sales, Latin America is CL's largest segment. However, the segment continues to generate a disproportionate, and in our mind, unsustainable source of organic growth due to the impact of adding back negative FX impact. The following table shows year-over-year organic growth in Latin America broken down by the volume, pricing, and foreign exchange impact.

	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020
Reported Sales Change	5.5%	3.5%	11.0%	12.5%	2.0%	-2.5%
Organic Volume	-3.5%	-1.0%	2.5%	2.5%	1.0%	1.0%
Pricing, Coupons, Incentives	10.0%	7.0%	5.5%	6.0%	8.5%	9.5%
FX	-1.0%	-2.5%	3.0%	4.0%	-7.5%	-13.0%
Organic Sales Change	6.5%	6.0%	8.0%	8.5%	9.5%	10.5%

A few quarters ago, the company was increasing prices in its Latin American segment near 10% to offset the impact of high inflation in the region. This was essentially offsetting a huge negative FX impact. Now, the company continues to price aggressively in Latin America but the FX penalty has declined dramatically. The aggressive pricing led to a 3.5% fall in volumes in Latin America and we are skeptical about how long the company can continue to price this aggressively in Latin America

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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.

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