BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Colgate-Palmolive Company (CL)
Earnings Quality Update- 3/21 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 of 3- (Minor Concern)

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

CL's 3/21 quarter adjusted EPS of $0.80 beat consensus estimates by a penny. We are positive on the fact that the company has wound down its restructuring program and the quarter was free of any non-GAAP adjustments. However, we are reluctant to raise our earnings quality rating yet as organic revenue growth continues to benefit significantly from ignoring the negative FX impact in Latin America and inventory levels remain elevated.

- Similar to other companies we follow with a Latin American presence, CL's organic sales growth is receiving an artificial boost from removing the negative FX impact in the region but keeping the benefit of inflation-driven price increases that contributed to the negative FX decline. In the case of the 3/21 quarter, reported Latin American organic growth of 9.5% was the product of a 1% increase in volume and an 8.5% increase in pricing and trade incentive activity. However, the negative 7.5% impact of deteriorating Latin American currencies is not considered. If Latin American organic revenue growth had mirrored the 1% volume increase, total company organic growth would have fallen to 3.2% from the reported 5%.

- Inventory DSIs rose to 88 from 72 in the previous two March quarters. CL's inventories steadily tracked in the 70s before the pandemic but jumped to the high 80s/low 90s range to satisfy the COVID-driven demand for personal care products and pet food.

	3/31/2021	12/31/2020	9/30/2020	6/30/2020
Cost of Sales	$1,707	$1,681	$1,613	$1,528
Total Inventory	$1,676	$1,673	$1,578	$1,524
DSI	88.4	91.6	90.0	90.8

	3/31/2020	12/31/2019	9/30/2019	6/30/2019
Cost of Sales	$1,632	$1,601	$1,612	$1,558
Total Inventory	$1,301	$1,400	$1,371	$1,322
DSI	72.5	80.4	78.2	77.2

	3/31/2019	12/31/2018	9/30/2018	6/30/2018
Cost of Sales	$1,597	$1,558	$1,576	$1,585
Total Inventory	$1,278	$1,250	$1,245	$1,254
DSI	72.0	73.8	72.7	72.0

Management warned in the first quarter conference call that it is more cautious for the outlook in developed markets and that its categories had deteriorated more quickly than it anticipated. It expects that trend to continue in the short term. While it is more excited about emerging markets early in the year, the current COVID outbreaks in Brazil, Mexico, and India could change the outlook there. The company admitted that raw material prices were rising faster than it anticipated and it is raising prices to help offset this. For the first quarter, pricing added 170 bps to gross margin, but cost inflation was a 310 bp drag. CL indicated it will continue to drive pricing. The higher inventories coupled with the fact the company utilizes FIFO (first-in, first-out) accounting for 75% of its inventories could have delayed the worst of the impact of higher costs if CL was realizing higher prices in revenue while expensing older, lower historical cost inventories. This could catch up to the company as it begins to replenish inventories at higher costs and those goods work their way to the income statement.

- Other expense fell to $28 million from $40 million in the year-ago first quarter. Last year's amount included $2 million from acquisition-related costs. After that adjustment, the decline still added about a penny per share to EPS in the quarter. We saw no discussion of what drove the decline. While a small amount, we believe it is worth mentioning as without it the company would have not reported an earnings beat.

- On the positive side, CL's non-GAAP adjustments disappeared in the 3/21 quarter with only a minor adjustment for debt extinguishment in the 12/20 quarter. The Global Growth and Efficiency program wound down at the end of 2019 with only minor amounts charged in the 9/20 quarter. We view this as a positive development for earnings quality.

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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