BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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August 1, 2019 | www.btnresearch.com

Colgate-Palmolive (CL) EQ Update-6/19 Qtr.

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 earnings quality rating to 3- (Minor Concern)

CL reported EPS in-line with the consensus estimate while falling short of the revenue target. Analysts were initially excited by organic sales growth in North America of 3.5% exceeding the 3.2% estimate. Analysts also cheered the acceleration in organic sales growth to 4% from 3% in the 3/19 quarter which was driven by a 3% increase in prices. However, as we show below, much of this was a result of misleading FX adjustments in Latin America. Given this and the jump in inventory discussed below, we are lowering our earnings quality rating to 3- (Minor Concern) from 3+ (Minor Concern).

- We discussed CL in our theme piece on Latin American inflation artificially boosting non-GAAP FX-adjusted organic sales growth. Specifically, we noted that in the 3/19 quarter, Latin America accounted for more than 46% of organic FX-adjusted sales growth despite accounting for only 23% of total sales. This was driven by a 3.5% boost from pricing in Latin America which was almost certainly possible due to inflation in the region. However, a negative impact of currency of 10.5% from the region was removed from the organic growth figures. We estimated that the total company organic growth rate of 3% would have been closer to 2% without the benefit from Latin America. The phenomenon continued into the 6/19 quarter. CL reported total company organic sales growth (before FX) of 4% which was heralded by analysts as an accelerating from the 3% growth in the 3/19 quarter. However, reported sales growth was down 0.5% due to a negative 4.5% currency impact. Latin American pricing boosted the geographic segments' growth by 5.5%. Again, this rapid increase in prices was almost certainly enabled by high inflation in the region. However, this

benefit was more than offset by a 7.5% negative currency impact which was removed from the organic growth figures. We estimate that the 4% total company organic sales growth would have once again been closer to 2% if the Latin American impact was removed. Therefore, we do not see much acceleration in ex-Latin America organic growth.

- Inventory DSI resumed its climb, jumping by more than 5 days versus the year-ago second quarter with all of the increase coming from finished goods. Management did not offer an explanation for the increase in the 10-Q or the conference call. The 6/19 DSI figure of 77.4 compares to 72.2 and 71.7 in the 6/18 and 6/17 quarters, respectively which is more indication that the current inventory level is elevated. The fact that the raw materials and work-in-process components declined as a percentage of total inventories does not indicate that the company is gearing up for expected near-term demand. All these factors point to an increased risk that the company will have to discount inventories in future quarters to move them or cut production in the future to the detriment of future cost per unit.

- Operating cash flow for the twelve months ended 6/19 increased by 3.3% after adjustment for voluntary pension contributions. However, the company also saw its payable days spike by 6 days over the year-ago quarter. We estimate that this benefit could have accounted for all of the increase in operating cash flow in the period. Trailing 12-month capital spending fell to 2.4% of sales, the lowest level in several years. This provided all the observed increase in free cash flow. Meanwhile, the buyback continues to consume more than free cash after the dividend.

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.

Disclosure

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