

Colgate-Palmolive (CL) EQ Update- 6/18 Quarter

Current EQ Rating*	Previous EQ Rating
3+	NA

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

We initiate coverage of Colgate-Palmolive (CL) with an EQ Rating of 3+ (Minor Concern).

Colgate (CL) has significant problems generating growth due to increasing competition from generics, consolidating retail customers and rising raw materials costs. While we are not positive on the outlook for the company and do not believe its valuation is compelling, we nonetheless consider the company's earnings and cash flows to be of sound quality. Were it not for the fact that the company cannot internally fund the buyback with free cash flow, we would likely give the company an EQ rating of 4 (Acceptable).

Our observations about the quarter include:

- Free cash flow after buyback is negative.
- We noted a minor concern in our last review that inventory DSIs had jumped over 2 days in the 3/18 quarter. However, DSI fell back in line in the 6/18 quarter removing this point of concern.
- Advertising as a percentage of sales was flat in the quarter. The company has committed to increasing advertising spend as a percentage for the year, implying there is still a headwind to margins in the back half of the year.
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Cash Flow Negative After Buyback

As the following table shows, free cash flow is not adequate to cover both the company's dividend and buyback leaving an approximate \$500 million shortfall on a trailing basis.

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
T12 Operating Cash Flow	\$3,046	\$2,979	\$3,054	\$3,119
T12 Capex	\$540	\$550	\$553	\$583
T12 Free Cash Flow	\$2,506	\$2,429	\$2,501	\$2,536
T12 Dividends	\$1,569	\$1,536	\$1,529	\$1,525
Dividend % of FCF	63%	63%	61%	60%
T12 Stock Repurchases	\$1,435	\$1,417	\$1,399	\$1,477
Cash After Buyback	-\$498	-\$524	-\$427	-\$466

	6/30/2017	3/31/2017	12/31/2016	9/30/2016
T12 Operating Cash Flow	\$3,126	\$3,218	\$3,141	\$3,158
T12 Capex	\$574	\$600	\$593	\$624
T12 Free Cash Flow	\$2,552	\$2,618	\$2,548	\$2,534
T12 Dividends	\$1,520	\$1,513	\$1,508	\$1,513
Dividend % of FCF	60%	58%	59%	60%
T12 Stock Repurchases	\$1,513	\$1,439	\$1,335	\$1,268
Cash After Buyback	-\$481	-\$334	-\$295	-\$247

Of the 7% reported increase in adjusted EPS in the 6/18 quarter, almost 2% came from a lower share count. CL's current net debt/EBITDA of 1.4 gives the company cushion to continue this rate of spend for a while, but nonetheless, the trend is unsustainable in the long term.

Inventory DSI Falls Back In-Line

We noted in a previous EQ Review of CL that the company's inventory DSI jumped to 75.1 in the 3/18 quarter from 72.7 in the year-ago period. However, the 6/18 quarter's DSI of 72.2 was only a half a day higher than the 6/17 reading of 71.7. This alleviates any concern we currently have with the company's inventory levels. However, we do observe that CL's inventory DSIs are notably higher than the other major household products companies which have DSIs in the mid-to-high 50s range, implying CL may have some room for improvement in this area which could potentially be used to boost cash flow growth.

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 as 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 score 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.

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