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BTN Earnings Quality Review

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EQ Review- Colgate-Palmolive Company (CL)

We are initiating a regular review of Colgate's (CL) earnings given its popularity and the fact that like many of its consumer products peers, it is considered by many to be a premium dividend stalwart, destined to maintain and increase its dividend forever because it always has and because people will always brush their teeth.

While CL's recent earnings do not contain much in the way of accounting red flags such as rising inventories or receivables, we do note several items of concern with its results:

- **CL struggles to maintain positive unit growth.** Recent 3% unit growth took price cuts to produce which resulted in a gross margin decline. The company plans to increase prices again in 2018 which could hit unit growth as it has in the past.

- **Recent unit growth also required a huge increase in advertising which contributed to an 80 bps decline in operating margin**. With advertising expected to increase again in 2018 and the likelihood of higher raw materials costs, we do not see how meaningful margin improvement can be achieved in 2018.

- **Cash from operations has not grown in 5 years.** The dividend consumes over 60% of free cash and rising. The dividend and the buyback consume more than free cash flow. While recent results have benefitted from cash from stock option exercises, this is not a reliable source of cash. While not an immediate concern, unless something changes dramatically, the company cannot continue to maintain the buyback and grow the dividend without taking on additional debt.

- **CL has been incurring regular restructuring charges for years** amounting to 6-9% of pre-charge operating profit each year calling into question the quality of non-GAAP earnings.

- **Return on investment adjusted for stock buybacks is about 14% and has actually declined** over the course of the company's restructuring program.

Unit Growth Only Comes with Price Cuts

All of the consumer products companies are faced with the same obstacles to growth including increasing price competition, consumers' acceptance of private label brands, rising raw materials costs, and a retailer customer base that grows stronger by the year. CL management addressed the slowing growth in all of its categories in the fourth quarter conference call:

> *"Now before this year, we have consistently delivered against our 4% to 7% long-term organic revenue growth target, although as we have seen more towards the lower end since the financial crisis.* ***You may recall that, that range was determined when global growth for our categories was around 4% to 5% per year on a fairly consistent basis. Of course, if you look at our categories over the last 12 to 18 months, they've been growing at roughly a 2% rate,*** *slightly up, as I commented earlier, in the fourth quarter.* ***But the 2% we've been operating in was developed markets moving closer to 0 with developing markets coming down from a high single-digits to the mid single-digits. Now while we believe these growth rates are beginning to improve, we think it's appropriate to plan with an assumption that category growth rate will be below those heavy historical levels even if it's greater than what we've seen in the most recent past. So as we look forward, starting with 2018, we think it more probable that our categories will grow in a 2% to 4% range.*** *And on top of this growth, we believe that we will return to consistent market share growth behind the strength of our brands, our increased investment, our ability to innovate and in our market execution. And we believe, from a consumption point of view, we're already seeing signs of that.* ***So, this combination of category growth and market share growth should put us in the range of 3% to 5% top line organic growth rate, and that's the stance we are taking for 2018 and beyond."***

Management noted that in the fourth quarter its categories saw some improvement and it was gaining share in most areas, but it admitted that sales were less robust than it had hoped. The following table shows a breakdown of sales growth for the last eight quarters:

	12/31/2017	9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016	6/30/2016
Unit Volume	3.0%	1.5%	-1.0%	-2.0%	-1.0%	1.5%*	1.5%*
Pricing	-1.0%	0.0%	1.0%	2.5%	2.5%	3.0%	3.0%
Currency	2.5%	1.5%	-0.5%	-0.5%	-1.5%	-2.5%	-5.5%
Organic Growth	2.0%	1.5%	0.0%	0.5%	1.5%	4.5%	4.5%
Reported Sales Growth	4.5%	3.0%	-0.5%	0.0%	1.5%	-3.5%	-5.5%

*9/16 and 6/16 unit volume growth adjusted for divestiture of Venezuela operations.

While unit volume did turn positive in the last two quarters, it has taken two profit margin-busting moves to do it - lower pricing and higher advertising. After several periods of rising prices and lackluster unit growth, CL lowered prices in the back half of the year. The lower prices were seen across almost all geographies:

	12/31/2017	9/30/2017	6/30/2017	3/31/2017
North America (21% of sales)				
Unit Volume	4.5%	3.0%	-2.0%	-5.0%
Pricing	-3.5%	-4.0%	-1.5%	-0.5%
Latin America (25% of sales)				
Unit Volume	4.0%	3.0%	2.5%	0.0%
Pricing	-1.5%	2.5%	4.5%	7.0%
Europe (16% of sales)				
Unit Volume	6.0%	3.0%	-1.0%	0.5%
Pricing	-2.0%	-2.0%	0.5%	-1.0%
Asia Pacific (17% of sales)				
Unit Volume	1.0%	0.0%	-2.0%	-1.0%
Pricing	1.5%	0.0%	-1.5%	0.0%
Africa/Eurasia (6% of sales)				
Unit Volume	-0.5%	-4.5%	-7.5%	-6.5%
Pricing	0.0%	2.5%	4.5%	7.0%
Hill's Pet Nutrition (15%)				
Unit Volume	0.0%	1.0%	-1.5%	-4.0%
Pricing	0.5%	0.0%	2.0%	4.0%

While the US has seen the most prominent decline in prices, Latin America and Europe have also seen declines. Not surprisingly, those markets are the only ones that have

registered unit growth greater than 1% in those periods. This perfectly illustrates the balancing act faced by the consumer products companies in what remains a very price sensitive market. To achieve unit growth and maintain market share, they must cut prices, but doing so destroys gross margins:

	12/31/2017	9/30/2017	6/30/2017	3/31/2017
Sales	$3,892	$3,974	$3,826	$3,762
Adjusted Gross Margin	60.4%	60.4%	60.7%	60.7%
Adjusted Operating Margin	25.9%	25.0%	26.3%	25.0%
Advertising Expense	$369	$405	$399	$400
% of sales	9.5%	10.2%	10.4%	10.6%

	12/31/2016	9/30/2016	6/30/2016	3/31/2016
Sales	$3,721	$3,867	$3,845	$3,762
Adjusted Gross Margin	60.8%	60.4%	60.2%	60.0%
Adjusted Operating Margin	27.9%	26.4%	26.3%	24.7%
Advertising Expense	$297	$339	$394	$398
% of sales	8.0%	8.8%	10.2%	10.6%

CL's gross margin fell in the 12/17 quarter as lower prices and higher raw materials costs more than offset the benefits of its ongoing restructuring program (which we will discuss in a later section).

Management has predicted that adjusted gross margin will improve substantially in 2018 as it will apparently try to push through higher pricing again:

> *"…we expect our gross margin to be up 50 to 75 basis points as a combination of pricing and productivity from our funding-the-growth initiatives should more than offset higher raw material costs."*

Given the rising costs of oil and other raw materials and the obvious price sensitivity of the market, it seems a daunting enough task to maintain gross margin let alone show that type of improvement absent a dramatic change in market conditions.

As we explore in the next section, pricing is not the only margin-killing lever the company has pulled to produce unit growth.

Advertising Expense is Skyrocketing

The low single-digit unit growth seen in the last couple of quarters has taken more than gross margin-compressing price cuts to achieve. As the table above shows, the company also ramped up its advertising spend by 150 bps as a percentage of sales and an eye-popping 24% on a year-over-year dollar basis. Management has indicated that the rising advertising spend will continue in 2018:

> *"We expect another year of increased advertising spending in 2018, both on an absolute basis and as a percentage of net sales."*

Between price cuts, raw material price increases and higher advertising, adjusted operating income margin fell by 80 bps in 2017. It is difficult to see how meaningful expansion can occur in 2018 given this headwind.

Dividend Is Consuming an Increasing Percentage of Cash

Given the pressures discussed above, it is not surprising that CL has been unable to show meaningful growth in cash from operations over the last five years. However, the company's dividend has continued to grow and consequently consume an increasing amount of cash flow:

	12/31/2017	12/31/2016	12/31/2015	12/31/2014	12/31/2013
Operating Cash Flow	$3,054	$3,141	$2,949	$3,298	$3,204
Capex	$553	$593	$691	$757	$670
Free Cash Flow	$2,501	$2,548	$2,258	$2,541	$2,534
Dividends	$1,529	$1,508	$1,493	$1,446	$1,382
Dividend % of Free Cash Flow	61.1%	59.2%	66.1%	56.9%	54.5%
Buyback	$1,399	$1,335	$1,551	$1,530	$1,521
Cash After Dividend and Buyback	($427)	($295)	($786)	($435)	($369)
Shares outstanding	887.8	898.4	909.7	924.3	939.9
Proceeds from Exercise of Stock Options	$507	$446	$347	$371	$339

Note that capital spending has declined partly from lower spending on the company's restructuring initiatives. However, this benefit to growth cannot continue as the company

will have to eventually spend to grow and maintain its capital base, and if history is any guide, future restructurings are highly likely.

In addition, we note that the company regularly spends large sums buying back shares. Cash after spending on dividend and buybacks has been substantially negative for the last five years. However, this has been offset by cash provided by the exercise of stock options. We do not see this as a reliable source of cash, as the amount in any given year will depend on the company's stock price. Even after factoring in the cash inflow from stock options, the company is essentially spending all its available cash flow on the buyback and dividend. **This can't continue at the rate it is going without the company either cutting the buyback, slowing the dividend growth, or taking on debt. This is not an immediate problem, but it is one more example of how the consumer products companies cannot be relied upon by dividend investors to be the sure-fire source of never-ending dividend growth that they have been in the past.**

Restructuring Charges

Like all the consumer products companies, CL seems to be perpetually engaged in restructuring activities. Its latest program, the "Global Growth and Efficiencies Program", began in the fourth quarter of 2012. It was later expanded in 2014, 2015 and 2017 and is expected to run through 2019. Amounts spent so far are shown below:

	12/31/2017	12/31/2016	12/31/2015	12/31/2014	12/31/2013	12/31/2012
Pretax Restructuring Charges	$333	$228	$254	$286	$371	$89
Pre-Charge Operating Income	$3,922	$4,065	$3,043	$3,843	$3,927	$3,978
% of Pre-Charge Op. Inc	8.5%	5.6%	8.3%	7.4%	9.4%	2.2%

These charges have regularly been a meaningful part of pre-charge income. They are recorded in cost of sales, SG&A and other (income) expense on the income statement, but CL presents non-GAAP results in which these amounts are added back. The size and regularity of the charges increases the likelihood that expenses that should be considered operating in nature are being lumped in to the charges, thus overstating the non-GAAP profits. Consider the company's disclosure on the makeup of the cumulative charges from 2012-2017:

Employee-Related Costs	50%
Incremental Depreciation & Asset Impairments	10%
Implementation costs from exit activities (including contract termination)	20%
Implementation of new strategies	20%

Employee-related costs pertain to severance costs resulting from headcount reductions and facility relocations. However, costs such as implementation costs from exit activities and the cost of implementing new strategies are much less defined and seem likely to include costs that the company would have incurred as a normal part of its business. We admit that in our analysis of margins in sections above, we utilized the non-GAAP numbers to account for the volatile nature of these charges from period-to-period. However, ignoring these charges as if they never occurred is giving a false sense of the true profitability of the company. Note that the company estimates that 80% of the charges will result in cash expenditures. The balance is made up of asset write-offs that represent shareholder capital spent at some time in the past, even if they are not resulting in cash spending in the current periods.

The company's current target for the end of the program is 2019. Investors should view the expansion of the program or announcement of a new one with a large degree of skepticism.

Actual Returns Are Less Than Stellar

The headline return numbers of over 60% ROI are impossibly high and are a result of the exhaustion of shareholders' equity from a long history of buybacks. However, if we adjust shareholders' equity for the treasury shares balance, we can get a better idea of the real returns CL is generating. In keeping with the spirit of our contention that restructuring charges are real expenses, we will amortize the restructuring charges incurred since 2012 over the last five years.

	12/31/2017	12/31/2016	12/31/2015	12/31/2014	12/31/2013
Pre-Charge Operating Income	$3,922	$4,065	$3,043	$3,843	$3,927
Amortized Restructuring Costs Since 2012	$294	$294	$294	$294	$294
Adjusted Return	$3,628	$3,771	$2,749	$3,549	$3,633
Total Debt	$6,577	$6,533	$6,548	$6,148	$5,657
Cash	$1,535	$1,315	$970	$1,089	$962
Net Debt	$5,042	$5,218	$5,578	$5,059	$4,695
Reported Shareholders' Equity	$243	$17	-$44	$1,385	$2,536
Treasury Stock	$20,181	$19,135	$18,102	$16,862	$15,633
Adjusted Equity	$20,424	$19,152	$18,058	$18,247	$18,169
Adjusted Capital	$25,466	$24,370	$23,636	$23,306	$22,864
Adjusted pretax ROI	14%	15%	12%	15%	16%

CL's sub15% pretax ROI is certainly not remarkable, and we question whether it justifies the company's multiple of almost 16 times EBTIDA.

In addition, it is worth noting that despite the restructuring efforts, the company's return on investment is actually down from five years ago.

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