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Consumer Products Earnings Quality Comparison

Companies covered:

- The Clorox Company (CLX)
- Colgate-Palmolive Company (CL)
- Church & Dwight, Inc. (CHD)
- Kimberly-Clark Corporation (KMB)
- The Procter & Gamble Company (PG)

Insights to Gain from this Report

Comparing earnings quality risks of similar companies side-by-side can be very informative. It makes material differences in accounting choices easy to see. Issues such as drastically different allowances for bad debts, inventory accounting methods, use of factoring, marketing, and R&D spending all come more clearly into focus when examining companies with competing products and similar customer bases that are all being impacted by the same macro factors.

Key earnings quality factors we see as relevant to the consumer products industry include:

Inventory trends- In the current inflationary environment, the inventory accounting method a company uses has become more important than it has been in decades. Also, investors should be watching for companies whose inventories are lagging as it could be a sign the company will have to replenish inventories at higher prices resulting in higher-than-expected costs being recognized later.

Advertising cost trends- Consumer products companies are raising prices at a rate not seen in decades to offset rampant cost inflation. However, many in the group were cutting their advertising budgets and promotional spending over the last several quarters despite the need to offset pushback from consumers who can trade down to cheaper products or trade away to private label. This cost is expected to rise for all of them over the next year.

Restructuring charges- Several companies in the group have a long history of taking massive restructuring charges which greatly erodes the quality of non-GAAP results as ongoing costs are potentially lumped into these charges and ignored. We examine the longer-term history of each company in the group.

Goodwill and intangibles impairments- Many of these companies carry significant intangible asset balances as a result of past or current acquisition strategies. Some have taken sizeable impairment charges in the past so the carrying value of these assets should be regularly reviewed.

Other one-time items- Aside from the above industry-common earnings quality items, we evaluated recent one-time non-operating benefits for each company

Summary Points Section

This section includes the main summary points for each company reviewed. ***Full reviews of each company follow this with extensive data supporting each point.***

The Clorox Company (CLX)

Summary

CLX has been one of the worst performing stocks in the group recently. It faces challenges on the top line as demand for its cleaning products is still looking for a new normal after the pandemic. We see the company's overall earnings quality as one of the highest in the group largely based on its historical lack of large charges plaguing many of its peers. However, we are skeptical of the company's newly-announced restructuring plan which prompted us to lower our EQ rating to 4- (Acceptable).

Key Points

- CLX does not take the huge, never-ending restructuring charges that KMB and CL are fond of. However, it has added 7-10 cps in digital and productivity enhancement costs in each of the last three quarters which do weaken the quality of non-GAAP earnings somewhat. We note that in the 3/22 and 12/21 quarters, the company beat or missed earnings by a much wider margin than 7-10 cps so adding these expenses back was not a material factor in those results. However, in the latest quarter, the company reported in-line results so adding back 10 cps could have had an impact.

- More of a concern is the company's announcement of a restructuring charge after the 6/22 quarter. It will begin next quarter and is expected to cost between $75-$100 million over fiscal 2023 and 2024 and is expected to result in annual savings of $75-$100 million. Management indicated that it will be recorded mostly in other income and expense. We do not know if the company plans to add these costs back to non-GAAP earnings. CLX has not abused restructuring charges as much as some others in the group. Also, the high end of the expected cost range is about $0.64 cps, considerably less than the $4.27 EPS estimate for all of FY 2023. Still, investors should be very watchful for signs the company is going to expand this plan in size or duration and eventually winds up regularly adding back "one-time" charges to earnings.

- The company started a payables factoring program in 2020 under which its suppliers can sell their receivables to third-party financing institutions. This helped drive days payable from about 50 to 74. This is still a reasonable level compared to its peers although this was an artificial boost to cash flow growth in the last two years. CLX only reports its payables balance annually so this disclosure should be checked for unusual expansion of payables when the 10-K comes out in the next few days.

- CLX values its inventories using both the First-In, First-Out (FIFO) and the Last-In, First-Out (LIFO) methods. According to the FY 2021 10-K, the LIFO method was used to value approximately 34% of inventories as of June 30, 2021, with the balance accounted for under FIFO.

- Unlike some of the companies in the group, CLX saw its inventories rise significantly from the 6/21 through the 12/21 quarters on both an absolute and DSI basis. This was partly a function of the company replenishing inventories that were depleted by the Covid-driven demand. We won't have component data until the FY2022 is released, but we can see that total DSIs are currently several days higher than pre-Covid levels. We still do not see CLX as exposed to having to replenish inventories at higher costs like we do some of the other players. In fact, the company could be in a position to sell older, lower-cost basis inventory in an environment of rising prices which could help with its goal of rebuilding its gross margins.

- CLX's gross margin began plummeting in 2021 as sales began to normalize after the first wave of the pandemic and the company was hit by lower expense leverage and rising costs. The company initiated a price increase in the fall of 2021, followed by price increases in April and then July. It forecasted a 200 bps improvement in gross margin for FY 2023 but this was well below what the Street was expecting. The forecast is also very back-end-loaded as it is calling for gross margin to decline to 35% in the 9/22 quarter, a stark decline from 9/21's 37.1%. It expects gross margin to improve to 40% by year-end.

- CLX enjoyed a 90 bp YOY boost to operating margin from a decline in advertising expense. However, management indicated on the call that it expects the advertising expense percentage to rise to 10% for the fiscal year ended 6/23 which will be flat with FY22. This means that the tailwind the company has been enjoying from a decline in the advertising percentage will disappear. As with all the companies in the group, we also worry that higher price elasticities will force the company to increase its advertising spending above plan to maintain volumes at an acceptable level.

Other Items to Note

- The bulk of CLX's Health and Wellness revenue comes from cleaning supplies while roughly one-third of Household is grilling products. Both areas experienced huge boosts during Covid. Weak results in this segment reflect inventory levels at retailers normalizing after the Delta surge, particularly in wipes and the company noted it expects to see cleaning products continue to normalize (trend down) in the near term.

- The company noted that ex-Health and Wellness, the portfolio experienced 5% organic growth in the 6/22 quarter driven by 8 points of pricing more than offsetting a 3% decline in volumes.

- Consistent with what other consumer products companies are saying, CLX saw better than expected elasticities in the first half of the year but expects that to return to the normal level in the back half.

See Full CLX report on page 18

Colgate-Palmolive Company (CL)

Summary

CL has been one of the strongest performing stocks in the group in recent months and seems to have the favor of the Street after the 6/22 quarter. However, we view CL's earnings quality as one of the weakest of the group due to multiple low-quality benefits to recent results and a history of large restructuring charges with a new one beginning. Gross margins have experienced a significant decline despite some help from utilizing FIFO accounting for 75% of inventories. We also cite dependence on outsized growth from Latin America and premium pet food. It has also benefitted from improved FX experience in Latin America but this may be reversing.

Key Points

- CL has a long history of huge, ongoing restructuring charges which erodes the quality of non-GAAP results when these charges are added back. We also note that there has been little in the way of sustainable margin improvement after the billions of dollars that have been spent. After a two-year break from such charges, CL announced a new plan in the 3/22 quarter and added back 8 cps in charges to non-GAAP EPS. We observe that CL's EPS has been a penny above or below targets for several quarters in a row while its peers fluctuated significantly in the same time frame. We are always skeptical of such a pattern, particularly when it is accompanied by much larger add-backs of expenses characterized as non-operating. The current plan should be monitored for expansion of its scope and size.

- Other minor non-operational benefits to earnings include a change in other income from a VAT resolution which added 1.4 cps to EPS in the 6/22 quarter. Also, the allowance for bad debts as a percentage of gross receivables has been declining from its pandemic peak which we estimate has added about 1.5 cps to the last few quarters. This tailwind will begin to disappear going forward.

- One of the biggest concerns we have with CL's recent growth is how it is centered in Latin America. Latin America accounts for 25% of revenue but was 50% of sales growth in the 6/22 quarter. This came courtesy of 12.5% organic revenue growth that featured no volume growth and 12.5% in price increases. The company was increasing prices in Latin America by 9-10% a couple of years ago to offset rapidly deteriorating FX rates. Now the company is pushing through 12% price increase when FX has turned to a tailwind. We have seen similar disproportionate contributions from Latin America in PEP's results and are skeptical that this geography can sustain such strength for long. When asked about the dynamics of Latin America on the conference call, CL was curiously silent.

- We also observe that CL has benefitted from improving FX rates in Latin America while FX rates in its other markets have turned sharply against it. Now, Latin America FX may be reversing as well.

- The other concerning source of growth is Hill's which accounts for only 20% of sales but over 50% of sales growth in the 6/22 quarter. Organic growth jumped to 18% on top of 15% growth in the year-ago period. Pricing growth of an eye-popping 12.5% did not stunt volume growth which accelerated to 5.5%. So far, the contention that people who bought pets during the pandemic will continue to spend on premium food has held up which has been good for CL as it is a key driver of the company's growth.

- Approximately 75% of the company's inventories are accounted for under the FIFO method with the remainder accounted for under LIFO. CL turns its inventories the slowest in the group- roughly every 90 days. This means revenues reflect products sold this quarter at higher prices while cost of sales reflects the cost basis of inventory purchased last quarter. Therefore, margins are aided in a scenario where prices are rising.

- We have been watching for staples companies that have benefitted from a delay in replenishing inventories at higher costs. However, CL's inventory DSIs have now risen YOY for the last two quarters and are now above pre-pandemic levels which puts it in a better position to sell older, lower-cost inventory into rising prices than some of its peers who will be replenishing more inventories at current, higher costs.

- We were previously concerned by the fact that CL's operating margins received a material boost from lower advertising spending in the 12/21 and 3/22 quarters. However, this situation improved some in the 6/22 quarter which featured an absolute increase in advertising spending although it still fell 40 bps as a percentage of sales. Advertising is expected to be flat as a percentage of sales in the back half which will take away that margin tailwind.

See full CL report on page 29

Church & Dwight, inc. (CHD)

Summary

CHD is the worst performing stock of the group over the last few months due largely to disappointing guidance after the 6/22 quarter although we do note it is still one of the highest valuations of the group. Overall, we see CHD's earnings quality as at the higher end of the group owing to an absence of unusual benefits and non-GAAP adjustments although we would prefer to see more disclosure on its receivables and payables financing programs. Nevertheless, we are somewhat concerned by indications of an inventory buildup of *Waterpik* and Vitamins and Minerals products. Lower than expected advertising added 4 cps to the quarter and will be turning to a headwind as well. FIFO will be a problem as inflation issues subside – but not immediately. They also face some headwinds in vitamins and *Waterpik*. However, this may be offset by consumers trading down to value brands which are 40% of its product line. They are still showing reasonable volume stats and have easy comps coming.

- CHD has little in the way of non-GAAP adjustments and they almost always relate to adjustments to contingent consideration from acquisitions which is reasonable.

- Important to note is that CHD is the only company in the group that makes regular material acquisitions. Acquisitions typically account for 2-3% of the company's reported revenue growth. However, we are not currently concerned by the company's acquisitions program as it has solid organic growth without acquisitions, its margins and returns have held up over time, debt is not accumulating, and it does not take regular restructuring and acquisition charges.

- CHD maintains a receivables securitization program but provides little disclosure. Still, the amount of receivables securitized has remained relatively small and flat so we have minimal concern at this point.

- The company also supports a payables financing program for its suppliers under which they can sell their CHD receivables to third-party financers. CHD offers little detail on the program and does not even give the amount of payables in the program. The company's DPOs have been rising and are currently at 77 days. We are not overly alarmed by the level of payables at this point but view the associated growth in cash flow to be low quality and note that investors should be watching payables growth in upcoming quarters.

- CHD, along with PG, are the only two companies in the group to utilize FIFO inventory accounting for all of their inventories. This means they have received the largest benefits from expensing older, lower-cost inventories against revenues that are being boosted by higher prices. This has limited the pressure on margins relative to peers that utilize LIFO for a portion of inventories. However, when inflation does subside and its ability to increase prices disappears or prices even decline, it will be expensing higher-cost inventories still on the balance sheet. This is not a problem for the next quarter or two, but something to keep in mind.

- We have been watchful for staples companies that have benefitted from a delay in replenishing inventories at higher costs. However, CHD's inventory DSIs have increased year-over-year in each of the last two quarters and are now well above pre-Covid levels. Management noted in the press release that higher inventory was due to stocking *Waterpik* products, vitamins and mineral supplements, and raw materials to ensure supply. Management indicated that inventories would fall to "normalized levels" by the end of the year. We are not overly alarmed by the increase in inventories, particularly on the raw materials side. Management indicated that the increase in *Waterpik* products was a result of building stock ahead of the Chinese lockdowns that has not worked its way through yet. However, there is some concern here given that management cited consumer trade-down impacting *Waterpik* oral care products as well as the decline in do-it-yourself projects post-Covid negatively impacting *Waterpik* showerheads. Investors should keep an eye on inventory levels in the third quarter for any more signs of unexpected buildup in product that the company might have to discount to move.

- Vitamins and Minerals is another inventory item to watch for signs of a buildup. Management indicated that category growth has decelerated from 16% three quarters ago to 5% in the 6/22 quarter and is expected to turn negative in the third quarter. This is due to easy comps from 2-3 quarters ago as the company compared to quarters with vitamin sales adjusting down post-Covid. However, the 9/22 quarter will compare to a year-ago period which saw a spike in vitamin demand from the Delta variant surge.

- Lower advertising spending accounts for the bulk of the earnings beat. Management blamed this on lower fill rates and expects advertising to pick up in the second half. We note that advertising as a percentage of sales was unusually high in the third and fourth quarters a year ago which will make an increase in advertising less of a drain on margin growth.

See full CHD report on page 42

Kimberly-Clark Corporation (KMB)

Summary

KMB has the lowest valuation of the group which reflects the disastrous quarters the company has posted over the last couple of years. We have rated KMB a Top Risk in the recent past due to its history of never-ending restructuring charges and one-time benefits although we recently raised our EQ rating to 2+ (Weak) due to two straight quarters of no charges. We are skeptical this trend will continue and want to see another clean quarter or two before upgrading. We observe that much of the air seems to be out of the stock at this point and it may perform better in the foreseeable future as a result.

Key Points

- KMB has been facing easier comps by comparing to year-ago quarters hurt by inventory destocking post-Covid in the Consumer Tissue segment. These comps get more difficult moving forward from here.

- KMB is pricing aggressively to counter inflation. In addition to pricing taken earlier in the year, the company put in place price increases in Europe and America in late May which did not have much time to impact the quarter. Management indicated on the call that volumes held up better than they expected. However, it also stated that “given the overall level of pricing we expect to achieve, we anticipate some negative volume impacts in the balance of the year.”

- Management raised its guidance for full-year organic sales growth to 5-7% from the previous range of 4-6%. When asked on the call if that reflected more volume or pricing, management stated that it was a reflection of both. However, given the admission that it expects volume erosion in the second half makes us believe it is more weighted towards higher prices.

- KMB uses LIFO inventory accounting for about 37% of its inventories with the balance recorded under FIFO or Average Cost. KMB turns its inventory in less than 60 days which is among the lowest in the group. This means that regardless of inventory method used, inflation will be reflected in its results sooner.

- Inventory DSIs declined from the year-ago June quarter despite rapid cost inflation. Management specifically cited a sharp increase in tissue prices in the June quarter. In spite of this, finished goods DSIs fell by almost two days YOY. We believe KMB may be benefitting from a delay in replenishing inventories at higher costs as any new purchases of higher-cost inventories accounted for under Average Cost would immediately impact the cost of sales regardless of whether they were sold in the period or not. Delaying replenishment would be a boost to margins for inventories accounted for under LIFO as well since the company could dip into lower-cost layers of LIFO inventories rather than replenish with higher-cost inventories which would be expensed immediately.

- Gross margin fell by 170 bps in the 6/22 quarter as margin was negatively impacted by cost inflation of 800 bps partially offset by pricing and cost savings. On the bright side, this was the first sequential improvement in some time. However, the company raised its forecast for input cost inflation for the year to $1.4 to $1.6 billion from the previous estimate of $1.1 to $1.3 billion. It also guided towards the low end of its previously guided EPS range which sounds like margins will not come in as expected in the second half.

- We also note that the company had previously forecast FORCE savings to be $300-$350 million for the full year. FORCE savings were only $45 million in the 6/22 quarter which management admitted was lower than expected. Maintaining the forecast implies it is expecting to accelerate savings in the second half. We are always skeptical when we see the company ramp up its expectations for FORCE savings which are essentially ongoing efforts to cut costs. Accelerating cost cuts could simply be borrowing from future quarters when the spending must catch up.

- KMB does not disclose its advertising spend by quarter. We do know that for the year ended 12/21, advertising fell to $893 million (4.6% of sales) versus $956 million (5.0% of sales.) The company indicated that in the 6/22 quarter that marketing expense was higher but we don’t know if it increased as a percentage of revenue or not. Increased advertising as a percentage of sales will likely be necessary to limit volume erosion from higher pricing in the second half.

- KMB is the worst company in the group for incurring huge restructuring charges which are added back to non-GAAP results. Despite the billions spent in the name of cost efficiencies, we have seen no real evidence of improvement in profitability. While KMB has not taken a charge in two quarters, we would not be surprised to see them resurface in some form in the foreseeable future.

- The 6/22 quarter appeared to be free of many of the unusual gains we have cited in the past. These include credits for stock compensation expense last year due to changes in assumptions surrounding awards. This has now turned into a significant headwind as was the case in the 6/22 quarter which featured $52 million in expense compared to only $20 million of expense in the year-ago second quarter.

- We saw no material unusual benefits in the 6/22 quarter. However, given the history of ongoing charges, we are waiting to see another couple of clean quarters before raising our earnings quality rating on KMB.

See full KMB report on page 56

The Proctor & Gamble Company (PG)

Summary

Despite being a Wall Street perennial favorite, PG has been one of the poorer 6-month performances of the group. This wasn't helped by its recent FY 2023 outlook which was well below consensus. We view PG's earnings quality as being "middle of the pack." While recent non-GAAP adjustments have been clean, a longer-term view of the company's history reveals it has often been dependent on huge, ongoing restructuring charges. It squeezes its suppliers harder than any other company in the group but this low-quality cash flow boost appears to be ending. It is already experiencing the biggest FX headwinds of any in the group, margins are falling significantly despite utilizing 100% FIFO inventories, and it has yet to experience much elasticity which may be reversing. Advertising is likely to rise and more impairments look like a real possibility.

Key Points

- PG has the highest days payable ratio of the group at 125 days. This is partly due to the company's supply chain financing arrangement under which its suppliers can sell PG receivables to third-party financing companies. As of the fiscal year ended 6/22, about 40% of the company's payables were to suppliers participating in the program, up from 36% the year before. However, days payable actually declined YOY in the 6/22 quarter for the first time. The increase in payables added roughly $1.5 billion to cash flow growth in FY 2022 but this source of growth may be set to reverse.

- PG has a sizeable goodwill and intangibles balance as a result of large acquisitions made years ago. Together, the accounts amount to about 54% of total assets. The company has incurred significant write-downs in the past including an $8 billion charge to write down the value of the Gillette brand in 2019. While PG has not taken such a large charge since then, the company disclosed in the 2022 10-K that the fair value of the Gillette name only exceeded its carrying value by 5%. The company also disclosed a 25 bps increase in the discount rate used in valuing the Gillette name would result in a 6% decline in the value of the asset. This is more than the 5% cushion the company cited which would seemingly result in an impairment. With the Gillette asset still carried at $11.4 billion, there seems to be a material risk of another charge in the event of more interest rate increases or a prolonged recession.

- PG has not taken a large restructuring charge in some time but this has not always been the case as large charges were a regular feature of its results before 2020. Despite all the charges, we saw little evidence of real improvement in the company's profitability. As such, we will be skeptical of the company announcing any new plans anytime soon.

- We also note that the company contends that it always has an ongoing restructuring program with annual spending in the $250-$500 million range. The charges added back in the past were considered "incremental". The company used to disclose the amount of the charges on a quarterly basis until the 9/21 quarter. In the 10-K for the fiscal year ended 6/22, PG simply disclosed that total restructuring charges for 2022 were $253 million versus $330 million in 2021. This represents a 2.4 cps tailwind to annual EPS in 2022. That's not a big deal for the year, but it's a big deal if it all came in one of the last four quarters where the company beat or missed by one or two pennies. We encourage the company to return to disclosing the ongoing restructuring spending quarterly to improve visibility in this area.

- All of PG's product-related inventories are accounted for under the FIFO method. FIFO expenses older, lower-cost inventories first which benefits margins when prices are rising.

- We also note that PG turns its inventories in the mid-50-day range, one of the lowest in the group. This means that regardless of inventory method used, it will be impacted by inflation faster than others with higher turns.

- PG's DSIs have increased YOY for the last two quarters and are now slightly above pre-Covid levels. We do not see any hidden risks with PG's inventory at this point.

- PG does not quantify its advertising or promotional spending quarterly. We know that for FY 2022, advertising fell by more than 3.5% despite a 5.3% increase in revenue.

- Management offers little color on advertising and promotion. It stated on the call that it is not planning to increase promotional spending significantly and contended it is becoming more productive on its advertising spending. However, with the company increasing prices and looking to push consumers to higher performing products with higher price tags, we would expect upward pressure on both advertising which will show up as higher SG&A expenses and promotional spending which will show up as a reduction of net pricing.

See full PG report on page 66

Overall Risk Rankings

Taking overall earnings quality, valuation, and expectations into account, we rank the likelihood of meaningful disappointment stemming from overstated earnings over the next 2-3 quarters ***from lowest to highest*** among the consumer products companies we reviewed as follows.

- The Clorox Company (CLX)
- Church & Dwight, Inc. (CHD)
- Kimberly-Clark Corporation (KMB)
- The Procter & Gamble Company (PG)
- Colgate-Palmolive Company (CL)

This is not a short-term trading recommendation.

We admit we are not traders and some of these companies may delay an outright disappointment by becoming more aggressive in their accounting choices. However, in our experience, this simply makes the reckoning worse.

But what about the earnings quality scores?

Some readers may observe that some companies on the bottom of the list have higher EQ scores than some on the top. This stems from the fact that the EQ score takes a longer-term look at the company's reporting quality. For example, in our view, KMB has a long history of restructuring charges and unusual benefits so we are waiting to upgrade KMB from a 2+ (Weak) until we see a lasting pattern of improvements. Likewise, we downgraded PG from a 4+ (Acceptable) to a 4- (Acceptable) given deterioration but want to see more in the way of returning charges or unusual benefits before downgrading to a lower level.

Individual Company Reviews Below

Clorox (CLX)

CLX reported EPS in line for the fourth quarter ended June while missing the top line forecasts by $59 million. However, the stock reacted negatively to the company's guidance for EPS of $3.85-$4/22 for the fiscal year ended 6/23 which fell far short of the Street consensus which was looking for north of $5.26.

Note that the 10-K has not been filed yet. We will update with any meaningful changes.

We are lowering our earnings quality rating on CL to 4- (Acceptable) from a 4+ (Acceptable) largely as a result of the announcement of a new restructuring program.

Key Earnings Quality Items and Other Risks to Note:

- CLX does not take the huge, never-ending restructuring charges that KMB and CL are fond of. However, it has added 7-10 cps in digital and productivity enhancement costs in each of the last three quarters which does weaken the quality of non-GAAP earnings somewhat. We note that in the 3/22 and 12/21 quarters, the company beat or missed earnings by a much wider margin than 7-10 cps so adding these expenses back was not a material factor in those results. However, in the latest quarter, the company reported in-line results so adding back 10 cps could have had an impact.

- More of a concern is the company's announcement of a restructuring charge after the 6/22 quarter. It will begin next quarter and is expected to cost between $75-$100 million over fiscal 2023 and 2024 and is expected to result in annual savings of $75-$100 million. Management indicated that it will be recorded mostly in other income and expense. We do not know if the company plans to add these costs back to non-GAAP earnings. CLX has not abused restructuring charges as much as some others in the group. Also, the high end of the expected cost range is about $0.64 cps, considerably less than the $4.27 EPS estimate for all of FY 2023. Still, investors should be very watchful for signs the company is going to expand this plan in size or duration and eventually winds up regularly adding back "one-time" charges to earnings.

- The company started a payables factoring program in 2020 under which its suppliers can sell its receivables to third-party financing institutions. This helped drive days payable from about 50 to 74. This is still a reasonable level compared to its peers although it was an artificial boost to cash flow growth in the last two years. CLX only reports its payables balance annually so this disclosure should be checked for unusual expansion of payables when the 10-K comes out after the 6/22 quarter.

- CLX values its inventories using both the First-In, First-Out (FIFO) and the Last-In, First-Out (LIFO) methods. According to the FY 2021 10-K, the LIFO method was used to value approximately 34% of inventories as of June 30, 2021, with the balance accounted for under FIFO.

- Unlike some of the companies in the group, CLX saw its inventories rise significantly from the 6/21 through the 12/21 quarters on both an absolute and DSI basis. This was partly a function of the company replenishing inventories that were depleted by the Covid-driven demand. We won't have component data until the FY2022 is released, but we can see that total DSIs are currently several days higher than pre-Covid levels. We still do not see CLX as exposed to having to replenish inventories at higher costs as we do some of the other players. . In fact, the company could be in a position to sell older, lower-cost basis inventory into an environment of rising prices which could help with its goal of rebuilding its gross margins.

- CLX's gross margin began plummeting in 2021 as sales began to normalize after the first wave of the pandemic and the company was hit by lower expense leverage and rising costs. The company initiated a price increase in the fall of 2021, followed by price increases in April and then July. It forecasted a 200 bps improvement in gross margin for FY 2023 but this was well below what the Street was expecting. The forecast is also very backend-loaded end as it is calling for gross margin to decline to 35% in the 9/22 quarter, a stark decline from 9/21's 37.1%. It expects gross margin to improve to 40% by year-end.

- CLX enjoyed a 90 bp YOY boost to operating margin from a decline in advertising expense. However, management indicated on the call that it expects the advertising expense percentage to rise to 10% for the fiscal year ended 6/23 which will be flat with FY22. This means that the tailwind the company has been enjoying from a decline in the advertising percentage will disappear. As with all the companies in the group, we also worry that higher price elasticities will force the company to increase its advertising spending above plan to maintain volumes at an acceptable level.

Other Items to Note

- The bulk of CLX's Health and Wellness revenue comes from cleaning supplies while roughly one-third of Household is grilling products. Both areas experienced huge boosts during Covid. Weak results in this segment reflect inventory levels at retailers normalizing after the Delta surge, particularly in wipes and the company noted it expects to see cleaning products continue to normalize (trend down) in the near term.

- The company noted that ex-Health and Wellness, the portfolio experienced 5% organic growth in the 6/22 quarter driven by 8 points of pricing more than offsetting a 3% decline in volumes.

- Consistent with what other consumer products companies are saying, CLX saw better than expected elasticities in the first half of the year but expect that to return to the normal level in the back half.

Valuation and Outlook

Relative Valuations and Sentiment

	Price	52 week High	Decline from High	1-Mo. Return	6-Mo. Return	Fwd PE	Cal 2023 PE	Avg Price Target	Implied Upside	avg Rec	Short Interest
CLX	**144.58**	**$186.86**	**-22.6%**	**2.3%**	**0.9%**	**33.82**	**38.0**	**$135.27**	**-6.4%**	**3.5**	**6.1%**
CL	80.81	$85.61	-5.6%	3.1%	-0.1%	26.69	26.4	$81.94	1.4%	2.7	1.3%
CHD	87.63	$105.28	-16.8%	-7.5%	-13.1%	29.03	28.6	$92.93	6.0%	2.9	1.7%
KMB	134.29	$145.79	-7.9%	0.1%	0.8%	23.67	23.0	$133.21	-0.8%	3.1	2.1%
PG	145.27	$165.35	-12.1%	0.2%	-9.2%	24.44	25.0	$156.38	7.6%	2.4	0.6%

Recent earnings beats and misses:

	Q-0	Q-1	Q-2	Q-3	Q-4	Q-5	Q-6	Q-7	Q-8	Q-9
CLX	$0.00	$0.35	($0.19)	$0.19	($0.36)	$0.16	$0.28	$0.97	$0.42	$0.26

Historical EPS and projections by quarter:

	Q+3	Q+2	Q+1	Q-0	Q-1	Q-2	Q-3	Q-4	Q-5	Q-6	Q-7	Q-8
CLX	*$1.34*	*$0.76*	*$0.77*	$0.93	$1.31	$0.66	$1.21	$0.95	$1.62	$2.03	$2.63	$2.41

CLX's Dependence on Pricing to Drive Organic Growth

The following table shows CLX's sales by segment and the components of growth for each for the last eight quarters:

CLX Segment Sales

	6/30/2022	03/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Health and Wellness	$635.0	$662.0	$648.0	$745.0	$670.0	$680.0	$817.0	$813.0
Household	$580.0	$539.0	$423.0	$442.0	$560.0	$510.0	$411.0	$500.0
Lifestyle	$292.0	$306.0	$324.0	$331.0	$290.0	$293.0	$317.0	$318.0
International	$294.0	$302.0	$296.0	$288.0	$282.0	$298.0	$297.0	$285.0
Total	$1,801.0	$1,809.0	$1,691.0	$1,806.0	$1,802.0	$1,781.0	$1,842.0	$1,916.0

Growth Breakout

Total Company	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Organic Volume	-9.0%	2.0%	-10.0%	-2.0%	-8.0%	-5.0%	23.0%	22.0%
Price/Mix/Other	10.0%	0.0%	2.0%	-3.0%	-2.0%	4.0%	3.0%	5.0%
Organic Sales Growth	1.0%	2.0%	-8.0%	-5.0%	-10.0%	-1.0%	26.0%	27.0%
Acquisitions and Divestitures	0.0%	0.0%	0.0%	0.0%	1.0%	1.0%	1.0%	1.0%
FX	-1.0%	0.0%	0.0%	-1.0%	0.0%	0.0%	0.0%	-1.0%
Reported Sales Growth	0.0%	2.0%	-8.0%	-6.0%	-9.0%	0.0%	27.0%	27.0%

Health and Wellness	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Organic Volume	-18.0%	1.0%	-18.0%	-1.0%	-12.0%	-11.0%	36.0%	26.0%
Price/Mix/Other	13.0%	-4.0%	-3.0%	-7.0%	-5.0%	3.0%	6.0%	2.0%
Organic Sales Growth	-5.0%	-3.0%	-21.0%	-8.0%	-17.0%	-8.0%	42.0%	28.0%
Acquisitions and Divestitures	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
FX	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Reported Sales Growth	-5.0%	-3.0%	-21.0%	-8.0%	-17.0%	-8.0%	42.0%	28.0%

Household	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Organic Volume	-4.0%	2.0%	-2.0%	-8.0%	-3.0%	4.0%	18.0%	25.0%
Price/Mix/Other	8.0%	4.0%	5.0%	-4.0%	-5.0%	2.0%	2.0%	14.0%
Organic Sales Growth	4.0%	6.0%	3.0%	-12.0%	-8.0%	6.0%	20.0%	39.0%
Acquisitions and Divestitures	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
FX	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Reported Sales Growth	4.0%	6.0%	3.0%	-12.0%	-8.0%	6.0%	20.0%	39.0%

Lifestyle	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Organic Volume	-3.0%	6.0%	1.0%	5.0%	-1.0%	-1.0%	8.0%	17.0%
Price/Mix/Other	4.0%	-2.0%	1.0%	-1.0%	-2.0%	1.0%	1.0%	0.0%
Organic Sales Growth	1.0%	4.0%	2.0%	4.0%	-3.0%	0.0%	9.0%	17.0%
Acquisitions and Divestitures	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
FX	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Reported Sales Growth	1.0%	4.0%	2.0%	4.0%	-3.0%	0.0%	9.0%	17.0%

International	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Organic Volume	-1.0%	2.0%	-5.0%	-1.0%	-8.0%	-3.0%	15.0%	9.0%
Price/Mix/Other	13.0%	4.0%	8.0%	4.0%	7.0%	7.0%	3.0%	8.0%
Organic Sales Growth	12.0%	6.0%	3.0%	3.0%	-1.0%	4.0%	18.0%	17.0%
Acquisitions and Divestitures	0.0%	0.0%	0.0%	0.0%	7.0%	7.0%	9.0%	9.0%
FX	-8.0%	-5.0%	-3.0%	-2.0%	-1.0%	-2.0%	-4.0%	-8.0%
Reported Sales Growth	4.0%	1.3%	0.0%	1.0%	5.0%	9.0%	23.0%	18.0%

- The bulk of CLX's Health and Wellness revenue comes from cleaning supplies while roughly one-third of Household is grilling products. Both areas experienced huge boosts during Covid. Weak results in this segment reflect inventory levels at retailers normalizing after the Delta surge, particularly in wipes and the company noted it expects to see cleaning products continue to normalize (trend down) in the near term.

- The company noted that ex-Health and Wellness, the portfolio experienced 5% organic growth in the 6/22 quarter driven by 8 points of pricing more than offsetting a 3% decline in volumes.

- Consistent with what other consumer products companies are saying, CLX saw better than expected elasticities in the first half of the year but expect that to return to the normal level in the back half.

CLX's Inventory Status

The following tables show inventory components, their growth rates, and DSIs (days sales) for the last twelve quarters:

Inventory Component Data	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Finished Goods	NA	$602.00	$626.00	$594.00
Raw Materials & Packaging	NA	$206.00	$220.00	$220.00
Work in Process	NA	$37.00	$14.00	$13.00
LIFO Reserve	NA	-$42.00	-$42.00	-$42.00
Total Inventory	$755.00	$803.00	$818.00	$785.00

Inventory Component Growth	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Finished Goods	NA	15.3%	38.2%	50.0%
Raw Materials & Packaging	NA	9.6%	23.6%	36.6%
Work in Process	NA	270.0%	40.0%	44.4%
LIFO Reserve	NA	31.3%	31.3%	31.3%
Total Inventory	0.4%	16.7%	34.3%	47.0%

DSI by Inventory Component	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Finished Goods DSI	NA	46.7	50.8	48.1
Raw Materials & Packaging DSI	NA	16.0	17.9	17.8
Work in Process DSI	NA	2.9	1.1	1.1
LIFO Reserve DSI	NA	-3.3	-3.4	-3.4
DSI	60.0	62.3	66.4	63.6
	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Finished Goods DSI	43.6	46.7	41.5	36.6
Raw Materials & Packaging DSI	18.4	16.8	16.3	14.9
Work in Process DSI	0.9	0.9	0.9	0.8
LIFO Reserve DSI	-2.5	-2.9	-2.9	-3.0
DSI	60.3	61.5	55.7	49.3
	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Finished Goods DSI	29.4	34.6	47.1	44.7
Raw Materials & Packaging DSI	12.1	11.8	14.4	13.5
Work in Process DSI	0.6	0.7	0.8	0.7
LIFO Reserve DSI	-2.8	-3.3	-4.0	-3.9
DSI	39.2	43.7	58.4	55.0

- CLX values its inventories using both the First-In, First-Out (FIFO) and the Last-In, First-Out (LIFO) methods. According to the FY 2021 10-K, the LIFO method was used to value approximately 34% of inventories as of June 30, 2021, with the balance accounted for under FIFO.

- Unlike some of the companies in the group, CLX saw its inventories rise significantly from the 6/21 through the 12/21 quarters on both an absolute and DSI basis. This was partly a function of the company replenishing inventories that were depleted by the Covid-driven demand. We won't have component data until the FY2022 is released, but we can see that total DSIs are currently several days higher than pre-Covid levels. We still do not see CLX as exposed to having to replenish inventories at higher costs as we do some of the other players.

Gross Margin Outlook

CLX's gross margin began plummeting in 2021 as sales began to normalize after the first wave of the pandemic and the company was hit by lower expense leverage and rising costs.

	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Gross Profit Margin	37.1%	35.9%	33.0%	37.1%
	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Gross Profit Margin	37.1%	43.5%	45.4%	48.0%
	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Gross Profit Margin	46.8%	46.7%	44.1%	44.0%

Management gave the following color on gross margin movement in its prepared remarks for the 6/22 quarter:

> *"Gross margin for the quarter was 37.1%, flat versus the prior year and a sequential improvement of 120 basis points compared to the prior quarter. The year-over-year change in gross margin benefited from 330 basis points of pricing and 160 basis points of cost savings. This was offset by 350 basis points of higher commodity costs and 290 basis points of higher manufacturing and logistics costs."*

CLX initiated a price increase in the fall of 2021, followed by price increases in April and then July, and forecasted a 200 bps improvement in gross margin for FY 2023. This was well below what the Street was expecting. The forecast is also very backend-loaded end as it is calling for gross margin to decline to 35% in the 9/22 quarter, a stark decline from 9/21's 37.1%. It expects gross margin to improve to 40% by year-end.

CLX's Advertising Spend

Most of the staples companies are attempting to offset the impact of higher raw materials and labor costs with other operating cost cuts including advertising. This is especially dangerous when they are increasing prices as it threatens to make volume declines even worse.

CLX is one of three companies in this comparison that discloses advertising expense quarterly. Advertising expense as a percentage of sales is shown below for the last twelve quarters:

	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Adjusted Advertising Costs	$207	$153	$167	$182
Adjusted Advertising Costs %	11.5%	8.5%	9.9%	10.1%

	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Adjusted Advertising Costs	$224	$200	$187	$179
Adjusted Advertising Costs %	12.4%	11.2%	10.2%	9.3%

	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Adjusted Advertising Costs	$214	$184	$140	$137
Adjusted Advertising Costs %	10.8%	10.3%	9.7%	9.1%

We see that CLX enjoyed a 90 bp YOY boost to operating margin from a decline in advertising expense. However, management indicated on the call that it expects the advertising expense percentage to rise to 10% for the fiscal year ended 6/23 which will be flat with FY22. This means that the tailwind the company has been enjoying from a decline in the advertising percentage will disappear. As with all the companies in the group, we also worry that higher price elasticities will force the company to increase its advertising spending above plan to maintain volumes at an acceptable level.

CLX's Non-GAAP Spread

The following table shows a reconciliation between CLX's GAAP and non-GAAP EPS for the last eight quarters:

	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020	6/30/2020
GAAP Diluted EPS	$1.21	$0.56	$1.14	$0.78	-$0.49	$2.03	$3.22	$2.41
VMS Impairment	$0.00	$0.00	$0.00	$0.00	$2.11	$0.00	$0.00	$0.00
Professional Products Supplier Charge	$0.00	$0.00	$0.00	$0.17	$0.00	$0.00	$0.00	$0.00
Saudi JV Acquisition Gain	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	-$0.59	$0.00
Digital Cap. &Prod. Enhancements Investment	$0.10	$0.10	$0.07	$0.00	$0.00	$0.00	$0.00	$0.00
Adjusted Diluted EPS	$1.31	$0.66	$1.21	$0.95	$1.62	$2.03	$2.63	$2.41

CLX does not take the huge, never-ending restructuring charges that seem to plague the results of KMB and CL, and overall, its overall number of adjustments has been low with only four line items over the last eight quarters. However, there have been some items worth noting in the last four quarters. We will take at each below:

Digital Capabilities and Productivity Enhancement Investments plus New Restructuring Charge

The company has added back 7-10 cps for the last three quarters for investments in digital capabilities and productivity enhancements. In our minds, enhancing productivity is a regular part of doing business and we consider adding back such charges as questionable, especially in the current environment.

More of a concern is the company's announcement of a restructuring charge after the 6/22 quarter. It will begin next quarter and is expected to cost between $75-$100 million over fiscal 2023 and 2024 and is expected to result in annual savings of $75-$100 million. Management indicated that it will be recorded mostly in other income and expense. We do not know if the company plans to add these costs back to non-GAAP earnings. CLX has not abused restructuring charges as much as some others in the group. Still, investors should be very watchful for signs the company is going to expand this plan in size or duration and eventually winds up regularly adding back "one-time" charges to earnings.

VMS Impairment

The 3/21 quarter contained a charge for the impairment of intangible assets associated with the company's vitamin and mineral supplements business unit due to deteriorating business conditions. The company has not warned of any other intangibles being in danger of becoming impaired and while this note should be reviewed in the upcoming 10-K, we are not overly concerned by the matter.

Professional Products Supplier Charge

The 6/21 quarter included a 17-cps charge related to the company writing off an investment to scale up a supplier during the pandemic. The company described the charge as follows in its 4Q21 conference call:

> *"So as we mentioned, we took a $28 million charge in the fourth quarter, and this was related to a PPD supplier. And what this is related to is very early in the pandemic, we saw the unprecedented increase in demand. We invested to help scale this supplier up*

to help increase their ability to supply product. And so what we've done now is, as they've done that, they've had some challenges more recently and we've made a decision we're going to move away from them. And so what we're doing here is we wrote off the investments we made in that supplier, which was really done to help scale them back when the pandemic first began. And at this point, we've moved our business away to other suppliers. So we think we're in good shape going forward from a production perspective. And then we excluded this as a nonrecurring noncash item in terms of the charge we took in Q4."

We view the investment made in the supplier as a strategic investment decision and question whether it is appropriate to add this back to profits. However, the company does not make a habit of adding similar charges back to earnings so we do not see this as a concerning source of earnings quality erosion.

Other Earnings Quality Items for CLX

Accounts Payable Factoring

CLX only discloses its accounts payable balance annually and lumps in accrued liabilities with payables for quarterly disclosure. This makes it impossible to track payables trends closely. On an annual basis, DPOs are about 74 days which seems reasonable compared to the group. However, this was up from 50 days the previous year due to the introduction of a payables factoring program it started in 2020 under which suppliers may sell their receivables due from CLX to third-party institutions. The company describes its supply chain finance program as follows:

"The Company initiated the extension of its payment terms with its suppliers in the second half of fiscal year 2020 in order to improve working capital as part of and to fund the IGNITE strategy and in keeping with evolving market practices. As part of those efforts, the Company has arranged for a global financial institution to offer a voluntary supply chain finance (SCF) program for the benefit of the Company's suppliers. Leveraging the Company's credit rating, the SCF program enables suppliers to directly contract with the financial institution to receive payment from the financial institution prior to the payment terms between the Company and the supplier, by selling the Company's payables to the

> *financial institution. The participation in the program is at the sole discretion of the supplier and the Company has no economic interest in a supplier's decision to enter into the agreement and has no direct financial relationship with the financial institution. Once a supplier elects to participate in the SCF program and reaches an agreement with the financial institution, the supplier elects which individual Company invoices to sell to the financial institution. The terms of the Company's payment obligations are not impacted by a supplier's participation in the program."*

Payables in the factoring program accounted for about 16% of total payables as of 6/21. This disclosure should be checked for unusual increases when the 10-K for the 6/22 fiscal year is released.

Colgate Palmolive (CL)

CL beat estimates by a penny in the 6/22 quarter. It raised its guidance for organic sales for the year to 5-7% from the previous 4-6%. However, it increased its estimated headwind from FX by 1% and is calling for GAAP sales growth near the high end of its previous estimated range of 1-4%. It also raised its outlook for raw material inflation which will result in a non-GAAP EPS decline in the "mid-single digits." Wall Street liked the results and bid the price up after the news. However, we noted the one-cent beat included 1.4 cps from higher adjusted other income and about 1.5 cps from a decline in the allowance for bad debt percentage.

We are maintaining our earnings quality rating of 3- (Minor Concern) on CL.

Key Earnings Quality Items and Other Risks to Note:

- CL has a long history of huge, ongoing restructuring charges which erodes the quality of non-GAAP results when these charges are added back. We also note that there has been little in the way of sustainable margin improvement after the billions of dollars that have been spent. After a two-year break from such charges, CL announced a new plan in the 3/22 quarter and added back 8 cps in charges to non-GAAP EPS. We observe that CL's EPS has been a penny above or below targets for several quarters in a row while its peers fluctuated significantly in the same time frame. We are always skeptical of such a pattern, particularly when it is accompanied by much larger add-backs of expenses characterized as non-operating. The current plan should be monitored for expansion of its scope and size.

- Other minor non-operational benefits to earnings include a change in other income from a VAT resolution which added 1.9 cps to EPS in the 3/22 quarter. Also, the allowance for bad debts as a percentage of gross receivables has been declining from its pandemic peak which we estimate has added about 1.5 cps to the last few quarters. This tailwind will begin to disappear going forward.

- One of the biggest concerns we have with CL's recent growth is how it is centered in Latin America. Latin America accounts for 25% of revenue but was 50% of the growth. This came courtesy of 12.5% organic revenue growth that featured no volume growth and 12.5% in price increases. The company was increasing prices in Latin America by 9-10% a couple of years ago to offset rapidly deteriorating FX rates. Now the company is pushing through a 12% price increase when FX has turned to a tailwind. We have seen similar disproportionate contributions from Latin America in PEP's results and are skeptical that this geography can sustain such strength for long. When asked about the dynamics of Latin America on the conference call, Cl was curiously silent.

- We also observe that CL has benefitted from improving FX rates in Latin America while FX in its other markets has turned sharply against it. Now, Latin America FX may be reversing as well.

- The other concerning source of growth is Hill's which accounts for only 20% of sales but over 50% of sales growth in the quarter. Organic growth jumped to 18% on top of 15% growth in the year-ago period. Pricing growth of an eye-popping 12.5% did not stunt volume growth which accelerated to 5.5%. So far, the contention that people who bought pets during the pandemic will continue to spend for premium food has held up which has been good for CL as it is a key driver of the company's growth.

- Approximately 75% of the company's inventories are accounted for under the FIFO method with the remainder accounted for under LIFO. CL turns its inventories the slowest in the group- roughly every 90 days. This means revenues reflect products sold this quarter at higher prices while cost of sales reflects the cost basis of inventory purchased last quarter. Therefore, margins are aided in a scenario where prices are rising.

- We have been watching for staples companies that have benefitted from a delay in replenishing inventories at higher costs. However, CL's inventory DSIs have now risen YOY for the last two quarters and are now above pre-pandemic levels which puts it in a better position to sell older, lower-cost inventory at higher prices than some of its peers who will be replenishing more inventories at current, higher costs.

- We were previously concerned by the fact that CL's operating margins received a material boost from lower advertising spending in the 12/21 and 3/22 quarters. However, this situation improved some in the 6/22 quarter which featured an absolute increase in advertising spending although it still fell 40 bps as a percentage of sales. Advertising is expected to be flat as a percentage of sales in the back half which will take away that margin tailwind.

- In short, CL has been enjoying a tailwind from FIFO margins, lower advertising, and beneficial FX trends and all may be losing steam.

Valuation and Outlook

Relative Valuations and Sentiment

	Price	52 week High	Decline from High	1-Mo. Return	6-Mo. Return	Fwd PE	Cal 2023 PE	Avg Price Target	Implied Upside	avg Rec	Short Interest
CLX	144.58	$186.86	-22.6%	2.3%	0.9%	33.82	38.0	$135.27	-6.4%	3.5	6.1%
CL	**80.81**	**$85.61**	**-5.6%**	**3.1%**	**-0.1%**	**26.69**	**26.4**	**$81.94**	**1.4%**	**2.7**	**1.3%**
CHD	87.63	$105.28	-16.8%	-7.5%	-13.1%	29.03	28.6	$92.93	6.0%	2.9	1.7%
KMB	134.29	$145.79	-7.9%	0.1%	0.8%	23.67	23.0	$133.21	-0.8%	3.1	2.1%
PG	145.27	$165.35	-12.1%	0.2%	-9.2%	24.44	25.0	$156.38	7.6%	2.4	0.6%

Recent earnings beats and misses:

	Q-0	Q-1	Q-2	Q-3	Q-4	Q-5	Q-6	Q-7	Q-8
CL	$0.01	($0.01)	$0.00	$0.01	$0.00	$0.01	$0.01	$0.09	$0.05

Historical EPS and projections by quarter:

	Q+3	*Q+2*	*Q+1*	Q-0	Q-1	Q-2	Q-3	Q-4	Q-5	Q-6	Q-7	Q-8
CL	*$0.78*	*$0.81*	*$0.75*	$0.72	$0.74	$0.79	$0.81	$0.80	$0.80	$0.77	$0.79	$0.74

CL's Dependence on Pricing to Drive Organic Growth

The following table shows CL's sales by segment and the components of growth for each for the last eight quarters:

CL Segment Sales

	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
North America	$965.0	$926.0	$930.0	$931.0	$912.0	$923.0	$940.0	$923.0
Latin America	$1,019.0	$954.0	$917.0	$931.0	$907.0	$907.0	$886.0	$837.0
Europe	$639.0	$654.0	$698.0	$718.0	$709.0	$717.0	$743.0	$712.0
Asia Pacific	$696.0	$726.0	$724.0	$731.0	$673.0	$739.0	$721.0	$722.0
Africa/Eurasia	$256.0	$267.0	$249.0	$258.0	$265.0	$272.0	$245.0	$255.0
Total Oral, Personal, and Home Care	$3,575.0	$3,527.0	$3,518.0	$3,569.0	$3,466.0	$3,558.0	$3,535.0	$3,449.0
Pet Nutrition	$909.0	$872.0	$885.0	$845.0	$794.0	$786.0	$789.0	$704.0
Total Net Sales	$4,484.0	$4,399.0	$4,403.0	$4,414.0	$4,260.0	$4,344.0	$4,324.0	$4,153.0

Growth Breakout

Total Company	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Organic Volume	0.5%	-1.5%	0.0%	1.5%	2.5%	0.5%	5.0%	3.0%
Pricing, Coupons, Incentives	8.5%	5.5%	3.0%	3.0%	2.5%	4.5%	3.5%	4.5%
Organic Sales Change	9.0%	4.0%	3.0%	4.5%	5.0%	5.0%	8.5%	7.5%
Acquisitions and Divestitures	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	1.0%	2.0%
FX	-3.5%	-2.5%	-1.0%	2.0%	4.5%	1.0%	-2.0%	-4.0%
Reported Sales Change	5.5%	1.5%	2.0%	6.5%	9.5%	6.0%	7.5%	5.5%

North America	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Organic Volume	3.0%	1.5%	-1.0%	0.0%	-8.5%	-7.0%	5.0%	1.5%
Pricing, Coupons, Incentives	3.0%	-1.0%	-0.5%	0.5%	4.0%	5.5%	3.5%	3.5%
Organic Sales Change	6.0%	0.5%	-1.5%	0.5%	-4.5%	-1.5%	8.5%	5.0%
Acquisitions and Divestitures	0.0%	0.0%	0.0%	0.0%	0.0%	0.5%	1.5%	1.5%
FX	0.0%	0.0%	0.5%	0.5%	0.5%	0.5%	0.0%	0.0%
Reported Sales Change	6.0%	0.5%	-1.0%	1.0%	-4.0%	-0.5%	10.0%	6.5%

Latin America	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Organic Volume	0.0%	-3.5%	-1.0%	2.5%	2.5%	1.0%	1.0%	2.0%
Pricing, Coupons, Incentives	12.5%	10.0%	7.0%	5.5%	6.0%	8.5%	9.5%	9.5%
Organic Sales Change	12.5%	6.5%	6.0%	8.0%	8.5%	9.5%	10.5%	11.5%
Acquisitions and Divestitures	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
FX	0.0%	-1.0%	-2.5%	3.0%	4.0%	-7.5%	-13.0%	-16.5%
Reported Sales Change	12.5%	5.5%	3.5%	11.0%	12.5%	2.0%	-2.5%	-5.0%

Europe	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Organic Volume	-3.0%	-5.0%	-3.0%	-1.0%	7.0%	-3.5%	5.5%	2.5%
Pricing, Coupons, Incentives	3.5%	2.0%	-0.5%	0.0%	-2.0%	1.5%	-1.0%	0.5%
Organic Sales Change	0.5%	-3.0%	-3.5%	-1.0%	5.0%	-2.0%	4.5%	3.0%
Acquisitions and Divestitures	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	3.0%	9.5%
FX	-10.5%	-6.0%	-2.5%	2.0%	10.0%	8.0%	6.5%	4.5%
Reported Sales Change	-10.0%	-9.0%	-6.0%	1.0%	15.0%	6.0%	14.0%	17.0%

Asia Pacific	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Organic Volume	3.0%	-3.5%	0.5%	-1.0%	3.5%	10.5%	4.0%	2.5%
Pricing, Coupons, Incentives	6.0%	4.5%	1.0%	0.5%	-2.5%	0.5%	1.0%	2.0%
Organic Sales Change	9.0%	1.0%	1.5%	-0.5%	1.0%	11.0%	5.0%	4.5%
Acquisitions and Divestitures	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
FX	-5.5%	-2.5%	-1.0%	1.5%	6.5%	5.5%	2.0%	0.0%
Reported Sales Change	3.5%	-1.5%	0.5%	1.0%	7.5%	16.5%	7.0%	4.5%

Africa/Eurasia	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Organic Volume	-17.0%	-6.5%	-5.5%	-4.5%	9.5%	5.0%	4.5%	5.5%
Pricing, Coupons, Incentives	22.0%	14.0%	8.5%	3.5%	3.5%	8.0%	3.5%	6.5%
Organic Sales Change	5.0%	7.5%	3.0%	-1.0%	13.0%	13.0%	8.0%	12.0%
Acquisitions and Divestitures	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	1.0%
FX	-8.5%	-9.5%	-1.0%	2.0%	2.5%	-4.5%	-9.5%	-10.5%
Reported Sales Change	-3.5%	-2.0%	2.0%	1.0%	15.5%	8.5%	-1.5%	2.5%

Hill's	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Organic Volume	5.5%	4.0%	7.0%	11.0%	10.5%	3.0%	11.0%	6.5%
Pricing, Coupons, Incentives	12.5%	9.0%	6.0%	8.0%	4.5%	4.0%	3.5%	4.5%
Organic Sales Change	18.0%	13.0%	13.0%	19.0%	15.0%	7.0%	14.5%	11.0%
Acquisitions and Divestitures	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
FX	-3.5%	-2.0%	-1.0%	1.0%	3.0%	2.5%	1.5%	0.0%
Reported Sales Change	14.5%	11.0%	12.0%	20.0%	18.0%	9.5%	16.0%	11.0%

- After the 6/22 quarter, CL raised its guidance for organic sales growth for the year ended 12/22 to 5-7% from the previous 4-6%. However, it increased its estimated headwind from FX by 1% and is calling for GAAP sales growth near the high end of its previous estimated range of 1-4%.

- One of the biggest concerns we have with CL's recent growth is how it is centered in Latin America. Latin America accounts for 25% of revenue but was 50% of the growth. This came courtesy of 12.5% organic revenue growth that featured no volume growth and 12.5% in price increases. The company was increasing prices in Latin America by 9-10% a couple of years ago to offset rapidly deteriorating FX rates. Now the company is pushing through a 12% price increase when FX has turned to a tailwind. We have seen similar disproportionate contributions from Latin America in PEP's results and are skeptical that this geography can sustain such strength for long. When asked about the dynamics of Latin America on the conference call, Cl was curiously silent.

- The other concerning source of growth is Hill's which accounts for only 20% of sales but over 50% of sales growth in the quarter. Organic growth jumped to 18% on top of 15%

growth in the year-ago period. Pricing growth of an eye-popping 12.5% did not stunt volume growth which accelerated to 5.5%. So far, the contention that people who bought pets during the pandemic will continue to spend for premium food to feed them has held up which has been good for CL as it is a key driver of the company's growth.

CL's Inventory Status

The following tables show CL's inventory components, their growth rates, and DSIs (days sales) for the last twelve quarters:

Inventory Table- durable formulas

Inventory Component Data	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Raw Materials	$559.00	$550.00	$505.00	$451.00
Work in Process	$53.00	$50.00	$39.00	$44.00
Finished Goods	$1,510.00	$1,451.00	$1,248.00	$1,261.00
Non-Current Inventory	-$110.00	-$127.00	-$100.00	-$86.00
Total Inventory	$2,012.00	$1,924.00	$1,692.00	$1,670.00
	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Raw Materials	$470.00	$463.00	$454.00	$390.00
Work in Process	$48.00	$48.00	$45.00	$48.00
Finished Goods	$1,275.00	$1,264.00	$1,256.00	$1,190.00
Non-Current Inventory	-$93.00	-$99.00	-$82.00	-$50.00
Total Inventory	$1,700.00	$1,676.00	$1,673.00	$1,578.00
	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Raw Materials	$380.00	$329.00	$305.00	$277.00
Work in Process	$49.00	$46.00	$49.00	$44.00
Finished Goods	$1,145.00	$976.00	$1,056.00	$1,050.00
Non-Current Inventory	-$50.00	-$50.00	-$10.00	$0.00
Total Inventory	$1,524.00	$1,301.00	$1,400.00	$1,371.00

Inventory Component Growth	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Raw Materials	18.9%	18.8%	11.2%	15.6%
Finished Goods	18.4%	14.8%	-0.6%	6.0%
Non-Current Inventory	18.3%	28.3%	22.0%	72.0%
Total Inventory	18.4%	14.8%	1.1%	5.8%

DSI by Inventory Component	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Raw Materials DSI	26.4	27.1	25.2	23.2
Work in Process DSI	2.5	2.5	1.9	2.3
Finished Goods DSI	71.2	71.5	62.3	64.8
Non-Current inventory DSI	-5.2	-6.3	-5.0	-4.4
Total DSI	94.9	94.8	84.4	85.8
	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Raw Materials DSI	25.1	24.4	24.8	22.2
Work in Process DSI	2.6	2.5	2.5	2.7
Finished Goods DSI	68.1	66.6	68.7	67.9
Non-Current inventory DSI	-5.0	-5.2	-4.5	-2.9
Total DSI	90.8	88.4	91.6	90.0
	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Raw Materials DSI	22.6	18.3	17.5	15.8
Work in Process DSI	2.9	2.6	2.8	2.5
Finished Goods DSI	68.2	54.4	60.7	59.9
Non-Current inventory DSI	-3.0	-2.8	-0.6	0.0
Total DSI	90.8	72.5	80.4	78.2

- Approximately 75% of the company's inventories are accounted for under the FIFO method with the remainder accounted for under LIFO. CL turns its inventories roughly every 90 days meaning revenues reflect products sold this quarter at higher prices while cost of sales reflects the cost basis of inventory purchased last quarter. Therefore, margins are aided in a scenario where prices are rising.

- We have been watching for staples companies that have benefitted from a delay in replenishing inventories at higher costs. However, CL's inventory DSIs have now risen YOY for the last two quarters and are now above pre-pandemic levels which puts it in a better position to sell older, lower-cost inventory at higher prices than some of its peers who will be replenishing more inventories at current, higher costs.

CL's Gross Margin Outlook

CL has seen significant declines in non-GAAP gross profit margins for the last three quarters:

	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Adjusted Gross Profit Margin	57.0%	58.5%	58.1%	59.4%

	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Adjusted Gross Profit Margin	60.0%	60.7%	61.1%	61.2%

	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Adjusted Gross Profit Margin	60.8%	60.3%	60.2%	59.0%

The company blamed the 300 bps decline in gross margin on 800 bps of higher raw materials and packaging partially offset by higher pricing of 310 bps and cost savings from the company's funding-the-growth initiatives of 190 bps.

After the 12/21 quarter, management was expecting non-GAAP gross margin to expand for the year ended 12/22. However, after the 3/22 quarter, the company changed its guidance to include a gross margin decline for the year due to a higher-than-expected increase in costs which it blamed largely on the Ukrainian crisis. After the 6/22 quarter, the company increased its outlook for higher raw materials costs from $12 billion to $1.3 billion and it still expects a gross margin decline for the year.

Given the extent to which the company is expecting to rely on more price increases, shifting to premium products, and continued strength in premium pet food, we see CL at risk for more disappointment in the area of gross margins.

CL's Advertising Spend

We were previously concerned by the fact that CL's operating margins received a material boost from lower advertising spending in the 12/21 and 3/22 quarters. However, this situation improved some in the 6/22 quarter which featured an absolute increase in advertising spending:

	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Advertising	$501	$506	$489	$503
Advertising % of Sales	11.2%	11.5%	11.1%	11.4%

	- 6/30/2021	- 3/31/2021	- 12/31/2020	- 9/30/2020
Advertising	$494	$535	$549	$476
Advertising % of Sales	11.6%	12.3%	12.7%	11.5%

	- 6/30/2020	- 3/31/2020	- 12/31/2019	- 9/30/2019
Advertising	$439	$484	$426	$423
Advertising % of Sales	11.3%	11.8%	10.6%	10.8%

Management stated in the conference call:

> *"Relative to advertising, obviously, given the strong topline, the percentage of sales came down. Our absolute dollar was a little bit up. We expect our dollar increase to be up in the back half of the year as we continue to support our strong innovation plans and* ***as a percentage of sales, we are estimating that, that will come in more or less in line with where we were last year."***

It appears the advertising percentage will have a neutral impact on operating margins in the back half. CL cannot afford to skimp on advertising given its aim to continue increasing prices while pushing consumers to higher-priced premium options to offset higher costs.

CL's Non-GAAP Spread

The following table shows a reconciliation between CL's GAAP and non-GAAP EPS for the last eight quarters:

	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
GAAP Diluted EPS	$0.72	$0.66	$0.18	$0.75	$0.83	$0.80	$0.75	$0.81
Global Growth and Efficiency	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	-$0.02
Acquisition -Related Costs	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00
Subsidiary and Op.Structure Initiatives	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00
Value Added Tax Matter in Brazil	$0.00	$0.00	$0.00	$0.00	-$0.03	$0.00	$0.00	$0.00
Swiss Income Tax Reform	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00
Loss on Early Extinguishment of Debt	$0.00	$0.00	$0.00	$0.06	$0.00	$0.00	$0.02	$0.00
Goodwill and Intg Impairment Charge	$0.00	$0.00	$0.61	$0.00	$0.00	$0.00	$0.00	$0.00
2022 Global Productivity Inititaive	$0.00	$0.08	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00
Adjusted Diluted EPS	$0.72	$0.74	$0.79	$0.81	$0.80	$0.80	$0.77	$0.79

CL's non-GAAP spread has not been very wide when viewed over the last eight years. The goodwill but there are two important things to take away.

Restructuring Charges

First is the 2022 Global Productivity Initiative Charge from the 3/22 quarter. The company announced that the plan 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." It is expected to be completed by mid-2023 and result in $200-240 million in charges before tax. If viewed in isolation, this would not be that big a concern. However, CL has a pattern of large restructuring charges that run for many years. It is helpful to look further back in time to examine the company's longer-term history with restructuring plans.

The following table shows the charges on a per-share basis along with the company's non-GAAP operating margin for the last ten years:

	GAAP EPS	Restructuring	Non-GAAP EPS	Sales	Adj Op Inc	Op Margin
2021	$2.55	$0.00	$3.21	$17,421	$3,877	22.3%
2020	$3.14	-$0.02	$3.06	$16,471	$3,875	23.5%
2019	$2.75	$0.12	$2.83	$15,693	$3,673	23.4%
2018	$2.75	$0.15	$2.97	$15,544	$3,846	24.7%
2017	$2.28	$0.28	$2.87	$15,454	$3,922	25.4%
2016	$2.72	$0.19	$2.81	$15,195	$3,985	26.2%
2015	$1.52	$0.20	$2.81	$16,034	$3,988	24.9%
2014	$2.36	$0.23	$2.93	$17,277	$4,215	24.4%
2013	$2.38	$0.30	$2.84	$17,420	$4,140	23.8%
2012	$2.57	$0.07	$2.68	$17,085	$4,023	23.5%

We see that the company's 2012 Restructuring Plan, which turned into the 2018 Restructuring Plan, cost many billions of dollars (most of it in cash) which the company asked investors to add back to non-GAAP earnings as if they didn't cost anything. Further, the goals of the plan included "expanding commercial hubs", extending shared business service and streamlining global functions", and "optimizing global supply chain and facilities." These sound a lot like normal business activities to us. Yet despite all these charges taken to cut costs, the company's non-GAAP operating margins did not show much in the way of sustainable improvement. This history is why we are skeptical that the 2022 Global Productivity Initiative will end on time and believe that it casts doubt on the quality of charge-adjusted earnings.

Goodwill and Intangible Impairment Charges

In the 12/21 quarter, CL wrote off $518 million (after tax) of the value of goodwill and trade name intangibles related to its Filorga skin health business. The company attributed the decline in the value to the pandemic reducing consumer mobility and the consumption in the duty-free, travel retail, and pharmacy channels. However, before the pandemic, CL stated in its 2019 10-K:

> *"**The estimated fair value of the Company's intangible assets substantially exceeds the recorded carrying value, except for the intangible assets acquired in the Sanex acquisition in 2011 and the Filorga acquisition in 2019,** which were recorded at fair value. Except for recently acquired businesses where there is inherently a lower surplus of fair value over carrying value, the estimated fair value of the Company's reporting units also substantially exceeds the recorded carrying value. Therefore, it is not reasonably likely that significant changes in these estimates would occur that would result in an impairment charge related to these assets.*
>
> ***The Company determined that the fair value of the Sanex intangible assets exceeded their carrying value by more than 10% and concluded that such excess was reasonable considering the brand's relatively recent acquisition. Based on this, the brand's recent performance and the Company's future plans for the brand, the Company does not believe there is a significant risk of impairment related to the Sanex intangible assets. Given the recent acquisition of Filorga, its performance since its acquisition and the Company's future plans for Filorga, the Company does not believe there is a significant risk of impairment related to the Filorga intangible assets."***

By the 2020 10-K, the company's mention of Sanex was dropped from its discussion of goodwill and intangibles values while Filgora remained:

> ***"As of the date of the annual goodwill impairment test, the fair value of the Filorga reporting unit exceeded its carrying value by approximately 10%.** Either a reduction in the long-term growth rate of 50 basis points or an increase in the discount rate of 25 basis points would result in the fair value of the Filorga reporting unit exceeding its carrying value by less than 5%. As of the date of the annual impairment test, the fair value of the Filorga indefinite-life intangible assets exceeded their carrying value by less than*

10%. Either a reduction in the long-term growth rate of 50 basis points or an increase in the discount rate of 25 basis points would result in the fair value of the Filorga indefinite-life intangible assets approximating their carrying value. Given the inherent uncertainties in estimating the future impacts of the COVID-19 pandemic on global macroeconomic conditions and interest rates in general and on the Filorga business in particular, actual results may differ from management's current estimates and could have an adverse impact on one or more of the assumptions used in our quantitative models related to the Filorga reporting unit and the related indefinite-life intangible assets, resulting in potential impairment charges in subsequent periods. Given the recent acquisition of Filorga, where there is inherently a lower surplus of fair value over carrying value, management will continue to assess triggering events that may necessitate additional qualitative or quantitative analyses of our reporting units and indefinite-life intangible assets in future periods.

Except for the recently acquired Filorga business, as described above, where there is inherently a lower surplus of fair value over carrying value, the estimated fair value of the Company's reporting units substantially exceeds the recorded carrying value. The fair value of the Company's indefinite-life intangible assets other than Filorga exceeds their recorded carrying value by at least 20%. *Therefore, it is not reasonably likely that significant changes in these estimates would occur that would result in an impairment charge related to these assets."*

Goodwill and intangibles account for approximately 36% of CL's total assets which is below average for the group. Given the above discussion, we do not see a significant risk of more material impairments soon.

CL's Miscellaneous Earnings Quality Items

We note several recent benefits to CL's earnings that appear non-operational and one-time in nature.

Other (Income)/Expense Change

Other (Income)/Expense went from $8 million of income in the 6/21 quarter to $13 million of expense in the 6/22 quarter. However, after non-GAAP adjustments last year for a $26 million benefit from a VAT settlement and adjusting this year for $10 million in restructuring expenses, other (income) expense fell from an expense of $18 million last year to $3 million this year. The company did not give an explanation for the decline, but it added almost 1.5 cps to non-GAAP earnings that only beat estimates by a penny per share.

Allowance for Doubtful Accounts Percentage

The following table shows CL's allowance for doubtful accounts for the last twelve quarters:

	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Gross Receivables	$1,561	$1,612	$1,375	$1,504
Allowance for Doubtful Accounts	$71	$80	$78	$80
Allowance %	4.5%	5.0%	5.7%	5.3%

	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Gross Receivables	$1,528	$1,491	$1,353	$1,380
Allowance for Doubtful Accounts	$85	$89	$89	$88
Allowance %	5.6%	6.0%	6.6%	6.4%

	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Gross Receivables	$1,316	$1,635	$1,516	$1,581
Allowance for Doubtful Accounts	$85	$84	$76	$86
Allowance %	6.5%	5.1%	5.0%	5.4%

We see that CL's allowance for doubtful accounts as a percentage of gross receivables rose to a peak of 6.5% during the pandemic and was trending back down to its pre-pandemic level. However, the reserve fell to its lowest level in several years on both an absolute and percentage of sales level in the 6/22 quarter. While we don't have actual provision expense, we can observe that if the allowance percentage for the 6/22 quarter had remained level with the 6/21 quarter's 5.6%, it would have shaved bout 1.5 cps off earnings growth. This impact will wane going forward and is likely to even reverse as provision expense normalizes, particularly if the company has to increase the reserve level if the economy weakens.

Church and Dwight (CHD)

CHD beat EPS targets by 4 cps in the 6/22 quarter and slightly missed on the top line. However, the company guided full-year EPS to be flat, down from its previous guidance for 4% growth due to $50 million in additional inflation and an increased currency headwind. Management admitted that 4 cps of the beat came from lower-than-expected advertising which it attributed to low fill rates delaying promotional programs.

We are maintaining our earnings quality rating of 3+ (Minor Concern) on CHD.

Key Earnings Quality Items and Other Risks to Note:

- CHD has little in the way of non-GAAP adjustments and they almost always relate to adjustments to contingent consideration from acquisitions which is reasonable.

- Important to note is that CHD is the only company in the group that makes regular material acquisitions. Acquisitions typically account for 2-3% of the company's reported revenue growth. However, we are not concerned by the company's acquisitions program as it has solid organic growth without acquisitions, its margins and returns have held up over time, debt is not accumulating, and it does not take regular restructuring and acquisition charges.

- CHD maintains a receivables securitization program but provides little disclosure. Still, the amount of receivables securitized has remained relatively small and flat so we have minimal concern at this point.

- The company also supports a payables financing program for its suppliers under which they can sell CHD receivables to third-party finance companies. CHD offers little detail on the program and does not even give the amount of payables in the program. The company's DPOs have been rising and are currently at 77 days. We are not overly alarmed by the level of payables at this point but view the associated growth in cash flow to be low quality and note that investors should be watching payables growth in upcoming quarters.

- CHD, along with PG, are the only two companies in the group to utilize FIFO inventory accounting for all of their inventories. This means they have received the largest benefits from expensing older, lower-cost inventories against revenues that are being boosted by higher prices. This has limited the pressure on margins relative to peers that utilize LIFO for a portion of inventories. However, when inflation does subside and its ability to increase prices disappears or prices even decline, it will be expensing higher cost inventories still on the balance sheet. This is not a problem for the next quarter or two, but something to keep in mind.

- We have been watchful for staples companies that have benefitted from a delay in replenishing inventories at higher costs. However, CHD's inventory DSIs have increased year-over-year in each of the last two quarters and are now well above pre-Covid levels. Management noted in the press release that higher inventory was due to stocking *Waterpik* products, vitamins and mineral supplements, and raw materials to ensure supply. Management indicated that inventories would fall to "normalized levels" by the end of the year. We are not overly alarmed by the increase in inventories, particularly on the raw materials side. Management indicated that the increase in *Waterpik* products was a result of building stock ahead of the Chinese lockdowns that has not worked its way through yet. However, there is some concern here given that management cited consumer trade-down impacting *Waterpik* oral care products as well as the decline in do-it-yourself projects post-Covid negatively impacting *Waterpik* showerheads. Investors should keep an eye on inventory levels in the third quarter for any more signs of unexpected buildup in product that the company might have to discount to move.

- Vitamins is another inventory item to watch for signs of a buildup. Management indicated that category growth has decelerated from 16% three quarters ago to 5% in the 6/22 quarter and is expected to turn negative in the third quarter. This is due to easy comps from 2-3 quarters ago as the company compared to quarters with vitamin sales adjusting down post-Covid. However, the 9/22 quarter will compare to a year-ago period which saw a spike in vitamin demand from the Delta variant surge.

- Lower advertising spending accounts for the bulk of the earnings beat. Management blamed this on lower fill rates and expects advertising to pick up in the second half. We note that advertising as a percentage of sales was unusually high in the third and fourth quarters a year ago which will make an increase in advertising less of a drain on margin growth.

- In short, the valuation is high, FIFO will be a problem as inflation issues subside – but not immediately. They also face some headwinds in vitamins and Waterpik. However, this may be offset by consumers trading down to value brands that are 40% of its product line. They are still showing reasonable volume stats and have easy comps coming.

Valuation and Outlook

Relative Valuations and Sentiment

	Price	52 week High	Decline from High	1-Mo. Return	6-Mo. Return	Fwd PE	Cal 2023 PE	Avg Price Target	Implied Upside	avg Rec	Short Interest
CLX	144.58	$186.86	-22.6%	2.3%	0.9%	33.82	38.0	$135.27	-6.4%	3.5	6.1%
CL	80.81	$85.61	-5.6%	3.1%	-0.1%	26.69	26.4	$81.94	1.4%	2.7	1.3%
CHD	**87.63**	**$105.28**	**-16.8%**	**-7.5%**	**-13.1%**	**29.03**	**28.6**	**$92.93**	**6.0%**	**2.9**	**1.7%**
KMB	134.29	$145.79	-7.9%	0.1%	0.8%	23.67	23.0	$133.21	-0.8%	3.1	2.1%
PG	145.27	$165.35	-12.1%	0.2%	-9.2%	24.44	25.0	$156.38	7.6%	2.4	0.6%

Recent earnings beats and misses:

	Q-0	Q-1	Q-2	Q-3	Q-4	Q-5	Q-6	Q-7	Q-8
CHD	$0.04	$0.06	$0.04	$0.09	$0.06	$0.02	$0.01	$0.03	$0.14

Historical EPS and projections by quarter:

	Q+3	*Q+2*	*Q+1*	Q-0	Q-1	Q-2	Q-3	Q-4	Q-5	Q-6	Q-7	Q-8
CHD	*$0.87*	*$0.75*	*$0.68*	$0.76	$0.83	$0.64	$0.80	$0.76	$0.83	$0.53	$0.70	$0.77

CHD's Dependence on Pricing to Drive Organic Growth

The following table shows CHD's sales by segment and the components of growth for each for the last eight quarters:

CHD Segment Sales

Sales by Segment	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Household Products	$572.8	$520.5	$549.3	$535.5	$523.0	$495.2	$498.1	$501.4
Personal Care Products	$431.9	$474.6	$492.4	$462.6	$436.7	$447.2	$492.8	$453.2
Consumer International	$230.5	$214.6	$242.0	$227.0	$226.8	$216.4	$228.5	$213.6
Specialty Products Division	$89.9	$87.5	$85.0	$86.3	$84.6	$80.1	$75.9	$72.8
Total Net Sales	$1,325.1	$1,297.2	$1,368.7	$1,311.4	$1,271.1	$1,238.9	$1,295.3	$1,241.0

Growth Breakout

Total Company	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Product Volume Sold	-2.9%	-5.1%	-1.7%	-1.5%	4.3%	3.1%	10.3%	10.2%
Pricing/Product Mix	6.3%	7.8%	6.0%	5.2%	0.2%	1.8%	0.5%	-0.3%
Organic Sales	3.4%	2.7%	4.3%	3.7%	4.5%	4.9%	10.8%	9.9%
Acquired Product	1.8%	2.3%	1.2%	1.3%	0.2%	0.5%	2.1%	3.8%
FX	-1.0%	-0.3%	0.2%	0.7%	1.7%	0.9%	0.3%	0.2%
Net Sales Increase	4.2%	4.7%	5.7%	5.7%	6.4%	6.3%	13.2%	13.9%

Consumer Domestic	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Product Volume Sold	-4.4%	-6.0%	-3.4%	-3.2%	2.5%	3.3%	10.5%	11.1%
Pricing/Product Mix	6.8%	8.7%	7.0%	6.0%	0.3%	1.8%	0.5%	-0.4%
Organic Sales	2.4%	2.7%	3.6%	2.8%	2.8%	5.1%	11.0%	10.7%
Acquired Product	2.3%	0.0%	1.5%	1.8%	0.3%	0.7%	2.8%	4.6%
FX	0.0%	2.9%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Net Sales Increase	4.7%	5.6%	5.1%	4.6%	3.1%	5.8%	13.8%	15.3%

Consumer international	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Product Volume Sold	3.6%	-3.6%	4.2%	1.7%	12.5%	3.5%	14.7%	11.7%
Pricing/Product Mix	2.9%	3.9%	0.5%	0.6%	-2.1%	-0.3%	0.2%	-0.1%
Organic Sales	6.5%	0.3%	4.7%	2.3%	10.4%	3.2%	14.9%	11.6%
Acquired Product	0.7%	0.8%	0.0%	0.0%	0.0%	0.0%	-0.4%	1.6%
FX	-5.6%	-1.9%	1.2%	4.0%	10.6%	5.8%	1.7%	1.4%
Net Sales Increase	1.6%	-0.8%	5.9%	6.3%	21.0%	9.0%	16.2%	14.6%

Specialty Products	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Product Volume Sold	-4.1%	1.1%	9.0%	10.8%	6.3%	-1.6%	-2.5%	-3.8%
Pricing/Product Mix	10.4%	8.1%	3.0%	7.7%	5.5%	7.6%	1.3%	0.4%
Organic Sales	6.3%	9.2%	12.0%	18.5%	11.8%	6.0%	-1.2%	-3.4%
FX	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Acquired Product	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Net Sales Increase	6.3%	9.2%	12.0%	18.5%	11.8%	6.0%	-1.2%	-3.4%

Note that the company combines the Household Products and Personal Care Products segments under "Consumer Domestic" when breaking out the components of growth rate.

- Much of the company's product line is built around its *Arm and Hammer* baking soda brand. Household Products include the company's *Arm and Hammer* baking soda and related cleaning, laundry products, and cat litter, as well as its *Oxiclean* and *Kaboom* cleaning brands. Personal Care products include dental hygiene products, deodorant, *Trojan* condoms, *Waterpik* dental care products, and gummy supplements. SPD includes specialty animal care products and industrial bicarbonate products.

- Difficult comps led to negative volume growth in the 9/21 quarter which has only worsened due to volume losses from price increases and lower fill rates from supply chain problems. We observe that CHD's management seems more candid about price elasticity than most. It noted on the conference call that it is seeing consumers trading down, particularly in the *Waterpik* and *Flawless* brands and certain oral care products like electric toothbrushes. However, management points out that 40% of the company's products are considered value in nature which will benefit it in the event of continued trading down by consumers if conditions continue to tighten.

- Note that vitamins face a tough comp in the 9/22 quarter as they compare to a year-ago period that saw a spike in demand from the Delta variant.

- Fill rates have improved from the 80% range in the 3/22 quarter to 90% in June and are expected to be back to normal by end of year which could be a tailwind to growth.

- However, the company lowered its guidance for full-year organic sales growth to 3-4% from its previous range of 3-6%.

- A key difference to note is that CHD is the only one of the staples companies that still gets a meaningful part of its growth via acquisitions. Acquisitions regularly account for 2-3% of the company's reported revenue growth. We are not currently concerned with the company's acquisition program.

CHD's Inventory Status

The following tables show inventory components, their growth rates, and DSIs (days sales) for the last twelve quarters:

Inventory Component Data	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Raw Materials & Suppliers	$141.90	$122.20	$116.20	$117.10
Work in Process	$43.50	$41.30	$40.00	$41.10
Finished Goods	$477.60	$435.30	$379.20	$394.50
Total Inventory	$663.00	$598.80	$535.40	$552.70
	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Raw Materials & Suppliers	$120.00	$114.00	$112.90	$108.60
Work in Process	$39.30	$34.30	$33.00	$31.60
Finished Goods	$396.50	$393.00	$349.50	$357.50
Total Inventory	$555.80	$541.30	$495.40	$497.70
	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Raw Materials & Suppliers	$104.40	$85.00	$85.90	$82.50
Work in Process	$28.20	$30.40	$29.00	$31.10
Finished Goods	$322.90	$280.30	$302.50	$275.20
Total Inventory	$455.50	$395.70	$417.40	$388.80

Inventory Component Growth	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Raw Materials & Suppliers	18.3%	7.2%	2.9%	7.8%
Work in Process	10.7%	20.4%	21.2%	30.1%
Finished Goods	20.5%	10.8%	8.5%	10.3%
Total Inventory	19.3%	10.6%	8.1%	11.1%

DSI by Inventory Component	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Raw Materials & Suppliers DSI	16.6	14.8	13.6	14.7
Work in Process DSI	5.1	5.0	4.7	5.2
Finished Goods DSI	55.7	52.6	44.3	49.6
DSI	77.4	72.4	62.5	69.4
	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Raw Materials & Suppliers DSI	15.2	14.9	14.1	14.8
Work in Process DSI	5.0	4.5	4.1	4.3
Finished Goods DSI	50.2	51.4	43.6	48.7
DSI	70.4	70.8	61.8	67.8
	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Raw Materials & Suppliers DSI	15.0	12.2	12.7	13.0
Work in Process DSI	4.0	4.4	4.3	4.9
Finished Goods DSI	46.3	40.3	44.9	43.5
DSI	65.3	56.9	61.9	61.5

- CHD, along with PG, are the only two companies in the group to utilize FIFO inventory accounting for all of their inventories. This means they have received the largest benefits from expensing older, lower-cost inventories against revenues that are being boosted by higher prices. This has limited the pressure on margins relative to peers that utilize LIFO for a portion of inventories. However, when inflation does subside and its ability to increase prices disappears or prices even decline, it will be expensing higher cost inventories still on the balance sheet. *This is not a problem for the next quarter or two, but something to keep in mind.*

- We have been watchful for staples companies that have benefitted from a delay in replenishing inventories at higher costs. However, CHD's inventory DSIs have increased year-over-year in each of the last two quarters and are now well above pre-Covid levels. Management noted in the press release that higher inventory was due to stocking *Waterpik* products, vitamins and mineral supplements, and raw materials to ensure supply. Higher prices almost certainly added to the increase as well. Management indicated that inventories would fall to "normalized levels" by the end of the year.

- We are not overly alarmed by the increase in inventories, particularly on the raw materials side. Management indicated that the increase in *Waterpik* products was a result of building stock ahead of the Chinese lockdowns that has not worked its way through yet. However, there is some concern here given that management cited consumer trade-down impacting *Waterpik* water flossers as well as the decline in do-it-yourself projects post-Covid negatively impacting *Waterpik* showerheads. Investors should keep an eye on inventory levels in the third quarter for any more signs of unexpected buildup in product that the company might have to discount to move.

- Vitamins is another inventory item to watch for signs of a buildup. Management indicated that category growth has decelerated from 16% three quarters ago to 5% in the 6/22 quarter and is expected to turn negative in the third quarter. This is due to easy comps from 2-3 quarters ago as the company compared to quarters with vitamin sales adjusting down post-Covid. However, the 9/22 quarter will compare to a year-ago period which saw a spike in vitamin demand from the Delta variant surge.

CHD's Gross Margin Outlook

The following table shows CHD's non-GAAP gross margin for the last twelve quarters:

	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Adjusted Gross Profit Margin	41.2%	42.6%	42.5%	44.2%
	06/30/2021	3/31/2021	12/31/2020	9/30/2020
Adjusted Gross Profit Margin	43.4%	44.5%	43.0%	45.5%
	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Adjusted Gross Profit Margin	46.9%	45.7%	45.8%	46.6%

CHD's 6/22 gross margin was down by 220 basis points. This was ahead of the company's forecast for a 200 bps decline. The company increased its full-year forecast for higher raw materials costs by $50 million.

Higher manufacturing cost it 600 bps mostly from higher commodity costs, distribution, and labor. Currency was another 10 bps drain. This was only partly offset by a 270 bp boost from higher prices, 20 bps from acquisitions, and 100 bps from improved productivity. The company expects gross margin to improve sequentially in the 9/22 quarter and be up year-over-year in the 12/22 quarter as price increases take effect and fill rates improve further. As noted above, the company has instituted a second round of price hikes in laundry and cat litter which will take effect in the back half.

CHD's Advertising Spend

The following table shows CHD's advertising expense as a percentage of sales for the last twelve quarters:

	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Adjusted Marketing Expenses	$103	$102	$201	$161
Adjusted Marketing Expenses %	7.8%	7.9%	14.7%	12.3%
	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Adjusted Marketing Expenses	$117	$99	$202	$171
Adjusted Marketing Expenses %	9.2%	8.0%	15.6%	13.8%
	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Adjusted Marketing Expenses	$122	$96	$163	$125
Adjusted Marketing Expenses %	10.2%	8.3%	14.2%	11.5%

Year-over-year marketing spending has been trending down as a percentage of sales for the last several quarters. CHD's 2Q EPS of $0.76 was 6 cps ahead of expectations and management said that 4 cps was due to lower advertising due to continued lower fill rates which the company has been blaming on supply constraints:

> *"So Q2 was a solid quarter for us. Reported revenue was up 4.2%. Organic sales grew 3.4%. And this was in line with our 3% to 4% outlook. The adjusted EPS was $0.76. Now this was $0.06 higher than our outlook, but that was due to lower marketing…*
>
> *…lower marketing spend due to below normal fill rates in our personal care business. The market impact was about $0.04 in the quarter."*

About two-thirds of the company's marketing spend occurs in the second half of the year and CHD expects advertising to accelerate as fill rates improve in the back half. However, advertising as a percentage of sales was unusually high in the year-ago back-half so advertising has room to increase considerably before becoming a material drain on operating margin growth.

Note that management is calling for adjusted EPS in the 9/22 quarter to fall by 19% due to higher advertising but more so due to harder comps versus last year's third quarter which featured much lower-than-normal incentive compensation.

CHD's Non-GAAP Spread

The following table shows a reconciliation of CHD's GAAP and non-GAAP EPS for the last eight quarters:

	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
GAAP Diluted EPS	$0.76	$0.83	$0.64	$0.92	$0.87	$0.88	$0.59	$0.85
Passport Earn-Out Reversal	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00
Flawless Earn-Out Adjustment	$0.00	$0.00	$0.00	-$0.12	-$0.11	-$0.05	-$0.06	-$0.15
Brazil Loss on Sale	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00
Gain on Sale of International Brand	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00
Adjusted Diluted EPS	$0.76	$0.83	$0.64	$0.80	$0.76	$0.83	$0.53	$0.70

CHD's non-GAAP adjustments are almost always minimal and relate to acquisition earn-out adjustments. We agree with adjusting these amounts out although investors should examine recurring gains resulting from earn-out adjustments given the fact profits increasing from an earn-out adjustment implies that the results of the acquired company are not doing exceptionally well. The presence of so many earn-out adjustments also highlights one of the differentiating factors about CHD- the fact that it relies on acquisitions to generate its growth more so than the other companies in the comparison. We will examine this in the next section.

CHD's Other Earnings Quality Items

Frequent acquisitions

CHD is the only company in the group that generates a meaningful part of its growth from acquisitions. Major acquisitions made in the last four years include:

- 12/24/2021- Dr. Harold Katz, LLB and HK-IP International, Inc. (Therabreath)- $556 million
- 12/1/2020- Consumer Health Holdco LLC (Zicam)- $512.7 million with an additional contingent consideration of $20 million related to indemnification by the seller.
- 5/1/2019- Flawless and Finishing Touch- $475 million with contingent consideration of an additional $425 million

- 3/8/2018- Passport Food Safety Solutions- $50 million with contingent consideration of another $25 million

A key red flag to look for with an acquisitive company is if it is regularly buying the bulk of its growth. With that in mind, let's revisit the components of CHD's revenue growth rate on an annual basis for the last five years:

	2021	2020	2019	2018	2017
Product Volume Sold	1.0%	8.1%	1.0%	3.7%	5.0%
Pricing/Product Mix	3.3%	1.5%	3.4%	0.6%	-2.3%
Organic Sales	4.3%	9.6%	4.4%	4.3%	2.7%
FX	0.9%	-0.1%	-0.5%	0.1%	0.0%
Acquired Products	0.8%	2.8%	1.2%	5.4%	5.4%
Net Sales Increase	6.0%	12.3%	5.1%	9.8%	8.1%

While CHD did generate a meaningful part of its growth through acquiring other companies and product lines, it still has generated solid organic growth without them. Still, some of its organic growth in any given year is likely coming from expanding distribution on products acquired two and three years ago and the law of big numbers will erode this over time. Regardless, we give CHD good marks for generating a decent organic growth rate.

The second item to consider is the trend in its profitability and return figures looking for signs that the company's acquisitions are destroying shareholder value. The following table shows the calculation of CHD's operating profit margin and return on capital for the last five years:

	2021	2020	2019	2018	2017
Sales	$5,190.1	$4,895.8	$4,357.7	$4,145.9	$3,776.2
Adjusted Operating Income	$981.1	$932.7	$850.5	$791.7	$734.0
	18.9%	19.1%	19.5%	19.1%	19.4%
Short-term debt	$952.2	$351.4	$252.9	$598.3	$270.9
Long term debt	$1,610.7	$1,812.5	$1,810.2	$1,508.8	$2,103.4
Cash & Equivalents	$240.6	$183.1	$155.7	$89.3	$278.9
Shareholders' equity	$3,233.2	$3,020.4	$2,667.8	$2,453.8	$2,218.0
Total Investment	$5,796.1	$5,184.3	$4,730.9	$4,560.9	$4,592.3
Pretax Return on Capital	16.9%	18.0%	18.0%	17.4%	16.0%

We can see that before the inflation of 2021 and the pandemic in 2020-2021, the company was seeing its returns improving. While we do not take this as definitive evidence the company is unlocking a treasure trove of value with its deals, we do not see an indication that it is destroying value either. We also note that the company is generating enough cash to handle the debt it takes on with its acquisitions which is a good sign.

All things considered, we do not see any of the classic red flags associated with acquisitions and would not label CHD a "growth through acquisitions" story.

Goodwill and intangibles value

CHD's string of acquisitions has left it with a large goodwill and intangibles balance which stands at over 70% of total assets, the highest of all the companies in our comparison. The return data above would indicate that the company's acquired brands and companies are generating adequate cash flow to justify their purchase price. However, the company did write off $11.3 million of the value of its Passport Food Safety business in the fourth quarter of 2021 due to erosion of the business caused by Covid.

It is also worth noting that the company has expressed some concern with the underlying fundamental of its *Trojan* condom business. Consider the following quote from the 2021 10-K

> *"Fair value for indefinite lived intangible assets was estimated based on a "relief from royalty" or "excess earnings" discounted cash flow method, which contains numerous variables that are subject to change as business conditions change, and therefore could impact fair values in the future. We determined that the fair value of all intangible assets for each of the years in the three-year period ended December 31, 2021 exceeded their respective carrying values based upon the forecasted cash flows and profitability.* ***However, in recent years our TROJAN business, specifically the condom category, has not grown and competition has increased resulting in a reduction in expected future cash flows. In addition, the COVID-19 pandemic has further negatively impacted condom sales due to social distancing. As a result, the TROJAN business has experienced sales and profit declines that has eroded a significant portion of the excess between the fair and carrying value of the tradename, which, if these trends continue, could potentially result in an impairment. However, the condom category began to recover in 2021 as fewer social restrictions led to an increase in sexual activity with less shutdowns and governmental restrictions.*** *While*

> *management can and has implemented strategies to address the risk, significant changes in operating plans or adverse changes in the future could reduce the underlying cash flows used to estimate fair values and could result in a decline in fair value that could trigger future impairment charges of these assets."*

We consider this warning to be very conservative given that the company's estimate of fair value exceeded carrying value by 70% as of 12/31/2021. Typically, we would not see such warnings until the cushion was below 10-20%. We also note that the company has stated that the easing of social restrictions has led to a recovery in growth for this brand.

However, we also note that the company disclosed that "*the key assumptions used in the projections from the Company's October 1, 2021 impairment analysis include discount rates of 7.0% in the U.S. and 8.5% internationally, revenue assumptions based on recent trends, and an average royalty rate of approximately 10%."* These discount rates seem quite low and will be pushed upward with the increase in market interest rates. This could eat away a significant portion of the estimated fair value of the business in future impairment reviews.

The carrying value of the *Trojan* tradename is $176.4 million, so a write-off, while not the end of the world, could be a material amount. Therefore, it is worth keeping an eye on future management commentaries on the *Trojan* business.

Receivables factoring program

In 2015, CHD began a receivables factoring program under which it sells certain customer receivables. Regrettably, it does not disclose the amount of receivables factored quarterly and gives minimal disclosure in its 10-K. Regardless, the company has only factored an incremental $21.0 million, $21.1 million, and $26.0 million over the last three fiscal years, respectively. Those amounts are small and steady which eases any concern the company is unsustainably boosting cash flow or keeping a jump in receivables off the balance sheet.

Supply Chain Finance Program

Also in 2015, CHD started a Supply Chain Finance Program under which its suppliers can sell their CHD receivables to third-party financing firms, allowing them to obtain their cash faster than they would otherwise. Again, we are disappointed by CHD's disclosure in this area as it does not report how much of its payables are currently in the program. However, it is helpful to examine the trend in days payable (DPOs):

Days Payables	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Trade Accounts Payable	$667	$655	$664	$618
Trade Accounts Payable Days	77.9	79.2	77.5	77.6
	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Trade Accounts Payable	$567	$547	$588	$581
Trade Accounts Payable Days	71.7	71.6	73.3	79.1
	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Trade Accounts Payable	$517	$460	$473	$449
Trade Accounts Payable Days	74.1	66.1	70.2	71.0

Note that when a payable enters the program, it still stays on CHD's balance sheet. CHD just owes the bank, not the supplier. A large increase in payables could be an indication of an expansion of the program. CHD has recently noted that payables have increased due to an extension of payable terms. As we have covered in reviews of KDP that factoring will become more expensive for suppliers as short-term rates rise and they may push back in the form of charging more or demanding sooner payment. We are not overly concerned by the current level of DPOs, but view the growth in cash flow generated by the increase in payables over the last few quarters as low quality.

Kimberly-Clark Corporation (KMB)

KMB beat non-GAAP EPS targets by 2 cps in the 6/22 quarter with revenue topping estimates by about $75 million. While the company raised its guidance for organic sales growth for the year ended 12/22, a deteriorating FX outlook resulted in it leaving GAAP sales growth the same at 4-6%. Also, higher costs resulted in it reducing its estimate for operating profit growth to "down mid-single digit" from "down low to mid-single digit" and leaving its EPS forecasted range at $5.60-$6.00 but now guiding to the low end of that range.

Key Earnings Quality Items and Other Risks to Note:

- KMB has been facing easier comps by comparing to year-ago quarters hurt by inventory destocking post-Covid in the Consumer Tissue segment. These comps get more difficult moving forward from here.

- KMB is pricing aggressively to counter inflation. In addition to pricing taken earlier in the year, the company put in place price increases in Europe and America in late May which did not have much time to impact the quarter. Management indicated on the call that volumes held up better than they expected. However, it also stated that "given the overall level of pricing we expect to achieve, we anticipate some negative volume impacts in the balance of the year."

- Management raised its guidance for full-year organic sales growth to 5-7% from the previous range of 4-6%. When asked on the call if that reflected more volume or pricing, management stated that it was a reflection of both. However, given the admission that it expects volume erosion in the second half makes us believe it is more weighted towards higher prices.

- KMB uses LIFO inventory accounting for about 37% of its inventories with the balance recorded under FIFO or Average Cost. KMB turns its inventory in less than 60 days which is among the lowest in the group. This means that regardless of inventory method used, inflation will be reflected in its results sooner.

- Inventory DSIs declined from the year-ago June quarter despite rapid cost inflation. Management specifically cited a sharp increase in tissue prices in the June quarter. In spite of this, finished goods DSIs fell by almost two days YOY. We believe KMB may be benefitting from a delay in replenishing inventories at higher costs as any new purchases of higher cost inventories accounted for under Average Cost would immediately impact the cost of sales regardless of whether they were sold in the period or not. Delaying replenishment would be a boost to margins for inventories accounted for under LIFO as well since the company could dip into lower cost layers of LIFO inventories rather than replenish with higher cost inventories which would be expensed immediately.

- Gross margin fell by 170 bps in the 6/22 quarter as margin was negatively impacted by cost inflation of 800 bps partially offset by pricing and cost savings. On the bright side, this was the first sequential improvement in some time. However, the company raised its forecast for input cost inflation for the year to $1.4 to $1.6 billion from the previous estimate of $1.1 to $1.3 billion. It also guided towards the low end of its previously guided EPS range which sounds like margins will not come in as expected in the second half.

- We also note that the company had previously forecast FORCE savings to be $300-$350 million for the full year. FORCE savings were only $45 million in the 6/22 quarter which management admitted was lower than expected. Maintaining the forecast implies it is expecting to accelerate savings in the second half. We are always skeptical when we see the company ramp up its expectations for FORCE savings which are essentially ongoing efforts to cut costs. Accelerating cost cuts could simply be borrowing from future quarters when the spending must catch up.

- KMB does not disclose its advertising spend by quarter. We do know that for the year ended 12/21, advertising fell to $893 million (4.6% of sales) versus $956 million (5.0% of sales.) The company indicated that in the 6/22 quarter that marketing expense was higher but we don’t know if it increased as a percentage of revenue or not. Increased advertising as a percentage of sales will likely be necessary to limit volume erosion from higher pricing in the second half.

- KMB is the worst company in the group for incurring huge restructuring charges which are added back to non-GAAP results. Despite the billions spent in the name of cost efficiencies, we have seen no real evidence of improvement in profitability. While KMB has not taken a charge in two quarters, we would not be surprised to see them resurface in some form in the foreseeable future.

- The 6/22 quarter appeared to be free of many of the unusual gains we have cited in the past. These include credits for stock compensation expense last year due to changes in assumptions surrounding awards. This has now turned to a significant headwind as was the case in the 6/22 quarter which featured $52 million in expense compared to only $20 million of expense in the year-ago second quarter.

- We saw no material unusual benefits in the 6/22 quarter. However, given the history of ongoing charges, we are waiting to see another couple of clean quarters before raising our earnings quality rating on KMB.

Valuation and Outlook

Relative Valuations and Sentiment

	Price	52 week High	Decline from High	1-Mo. Return	6-Mo. Return	Fwd PE	Cal 2023 PE	Avg Price Target	Implied Upside	avg Rec	Short Interest
CLX	144.58	$186.86	-22.6%	2.3%	0.9%	33.82	38.0	$135.27	-6.4%	3.5	6.1%
CL	80.81	$85.61	-5.6%	3.1%	-0.1%	26.69	26.4	$81.94	1.4%	2.7	1.3%
CHD	87.63	$105.28	-16.8%	-7.5%	-13.1%	29.03	28.6	$92.93	6.0%	2.9	1.7%
KMB	134.29	$145.79	-7.9%	0.1%	0.8%	23.67	23.0	$133.21	-0.8%	3.1	2.1%
PG	145.27	$165.35	-12.1%	0.2%	-9.2%	24.44	25.0	$156.38	7.6%	2.4	0.6%

Recent earnings beats and misses:

	Q-0	Q-1	Q-2	Q-3	Q-4	Q-5	Q-6	Q-7	Q-8	Q-9
KMB	$0.02	$0.12	$0.05	($0.03)	($0.24)	($0.12)	$0.07	($0.01)	$0.43	$0.17

Historical EPS and projections by quarter:

	Q+3	*Q+2*	*Q+1*	Q-0	Q-1	Q-2	Q-3	Q-4	Q-5	Q-6	Q-7	Q-8
KMB	*$1.54*	*$1.47*	*$1.49*	$1.34	$1.35	$1.30	$1.62	$1.47	$1.80	$1.69	$1.72	$2.20

KMB's Dependence on Pricing to Drive Organic Growth

The following table shows KMB's sales by segment and the components of growth for each for the last eight quarters:

KMB Segment Sales

	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Personal Care	$2,710.0	$2,729.0	$2,632.0	$2,656.0	$2,517.0	$2,462.0	$2,349.0	$2,339.0
Consumer Tissue	$1,537.0	$1,568.0	$1,559.0	$1,541.0	$1,424.0	$1,510.0	$1,727.0	$1,623.0
K_C Professional	$802.0	$780.0	$758.0	$797.0	$765.0	$752.0	$742.0	$705.0
Corporate and Other	$14.0	$18.0	$16.0	$16.0	$16.0	$19.0	$18.0	$16.0
TOTAL	$5,063.0	$5,095.0	$4,965.0	$5,010.0	$4,722.0	$4,743.0	$4,836.0	$4,683.0

Growth Breakout

TOTAL	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Volume	-1.0%	2.0%	0.0%	0.0%	-4.0%	-10.0%	2.0%	2.0%
Price	9.0%	6.0%	2.0%	3.0%	1.0%	1.0%	3.0%	1.0%
Mix/Other	1.0%	2.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%
Organic	9.0%	10.0%	3.0%	4.0%	-3.0%	-8.0%	5.0%	3.0%
Acquisition	0.0%	0.0%	0.0%	2.0%	2.0%	2.0%	2.0%	0.0%
FX	-2.0%	-2.0%	0.0%	1.0%	3.0%	0.0%	-1.0%	-2.0%
Total	7.0%	7.0%	3.0%	7.0%	2.0%	-5.0%	6.0%	1.0%

Personal Care	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Volume	-1.0%	3.0%	5.0%	3.0%	4.0%	-3.0%	3.0%	4.0%
Price	9.0%	8.0%	4.0%	4.0%	0.0%	0.0%	1.0%	0.0%
Mix/Other	1.0%	3.0%	2.0%	2.0%	2.0%	1.0%	1.0%	1.0%
Organic	9.0%	13.0%	11.0%	9.0%	6.0%	-2.0%	5.0%	5.0%
Acquisition	1.0%	0.0%	1.0%	3.0%	4.0%	4.0%	3.0%	0.0%
FX	-2.0%	-2.0%	0.0%	1.0%	3.0%	-1.0%	-3.0%	-4.0%
Total	8.0%	11.0%	12.0%	14.0%	13.0%	2.0%	5.0%	1.0%

Consumer Tissue	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Volume	3.0%	2.0%	-7.0%	-7.0%	-15.0%	-14.0%	9.0%	10.0%
Price	7.0%	5.0%	-1.0%	1.0%	0.0%	0.0%	6.0%	0.0%
Mix/Other	1.0%	0.0%	0.0%	0.0%	-1.0%	-1.0%	-1.0%	-1.0%
Organic	11.0%	7.0%	-9.0%	-6.0%	-17.0%	-14.0%	14.0%	10.0%
Acquisition	0.0%	-1.0%	-1.0%	0.0%	0.0%	0.0%	0.0%	0.0%
FX	-3.0%	-2.0%	0.0%	1.0%	3.0%	1.0%	0.0%	0.0%
Total	8.0%	4.0%	-10.0%	-5.0%	-13.0%	-12.0%	14.0%	9.0%

K-C Professional	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Volume	-3.0%	0.0%	-2.0%	6.0%	-4.0%	-21.0%	-13.0%	-21.0%
Price	9.0%	4.0%	4.0%	5.0%	5.0%	7.0%	2.0%	3.0%
Mix/Other	2.0%	1.0%	0.0%	0.0%	1.0%	2.0%	2.0%	3.0%
Organic	7.0%	6.0%	2.0%	12.0%	2.0%	-13.0%	-9.0%	-15.0%
Acquisition	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
FX	-3.0%	-2.0%	0.0%	1.0%	3.0%	1.0%	0.0%	0.0%
Total	5.0%	4.0%	2.0%	13.0%	6.0%	-11.0%	-9.0%	-16.0%

- KMB has been facing easier comps by comparing to year-ago quarters hurt by inventory destocking post-Covid in the Consumer Tissue segment. These comps get more difficult moving forward from here.

- KMB is pricing aggressively to counter inflation. In addition to pricing taken earlier in the year, the company put in place price increases in Europe and America in late May which did not have much time to impact the quarter. Management indicated on the call that volumes held up better than they expected. However, also stated that "given the overall level of pricing we expect to achieve, we anticipate some negative volume impacts in the balance of the year."

- Management raised its guidance for full-year organic sales growth to 5-7% from the previous range of 4-6%. When asked on the call if that reflected more volume or pricing, management stated that it was a reflection of both. However, given the admission that it expects volume erosion in the second half makes us believe it is more weighted towards higher prices.

KMB's Inventory Status

The following tables show KMB's inventory components, component growth rates, and DSIs by component:

Inventory Component Data	6/30/2022	03/31/2022	12/31/2021	9/30/2021
Raw Materials	$533	$514	$493	$483
Work in Process	$265	$249	$242	$234
Finished Goods	$1,413	$1,438	$1,442	$1,321
Supplies and Other	$292	$290	$280	$276
LIFO Reserve	-$225	-$226	-$218	-$216
Total Inventory	$2,278	$2,265	$2,239	$2,098

	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Raw Materials	$442	$393	$394	$375
Work in Process	$235	$196	$189	$199
Finished Goods	$1,354	$1,253	$1,202	$1,116
Supplies and Other	$276	$270	$263	$242
LIFO Reserve	-$197	-$156	-$145	-$145
Total Inventory	$2,110	$1,956	$1,903	$1,787

	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Raw Materials	$383	$292	$321	$314
Work in Process	$181	$177	$206	$221
Finished Goods	$1,127	$952	$1,147	$1,149
Supplies and Other	$277	$265	$271	$263
LIFO Reserve	-$143	-$147	-$155	-$168
Total Inventory	$1,825	$1,539	$1,790	$1,779

Inventory Component Growth	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Raw Materials	20.6%	30.8%	25.1%	28.8%
Finished Goods	4.4%	14.8%	20.0%	18.4%
Supplies and Other	5.8%	7.4%	6.5%	14.0%
LIFO Reserve	14.2%	44.9%	50.3%	49.0%
Total Inventory	8.0%	15.8%	17.7%	17.4%

DSI by Inventory Components	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Raw Materials DSI	13.7	12.9	12.9	12.6
Work in Process DSI	6.8	6.3	6.3	6.1
Finished Goods DSI	36.4	36.2	37.6	34.5
Supplies and Other DSI	7.5	7.3	7.3	7.2
LIFO Reserve DSI	-5.8	-5.7	-5.7	-5.6
Total DSI	58.7	57.0	58.4	54.7

	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Raw Materials DSI	12.4	11.2	11.4	11.2
Work in Process DSI	6.6	5.6	5.5	5.9
Finished Goods DSI	38.0	35.8	34.9	33.2
Supplies and Other DSI	7.7	7.7	7.6	7.2
LIFO Reserve DSI	-5.5	-4.5	-4.2	-4.3
Total DSI	59.2	55.8	55.2	53.2

	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Raw Materials DSI	12.3	8.3	9.8	9.4
Work in Process DSI	5.8	5.0	6.3	6.6
Finished Goods DSI	36.2	26.9	35.0	34.3
Supplies and Other DSI	8.9	7.5	8.3	7.8
LIFO Reserve DSI	-4.6	-4.2	-4.7	-5.0
Total DSI	58.6	43.5	54.6	53.1

- According to inventory disclosures, about 37% of KMB's inventories were measured under the LIFO method as of 12/31/2021 with the balance measured under either FIFO or Average Cost. FIFO will benefit margins in times of rising prices as older, lower-cost inventories are expensed first.

- KMB turns its inventory in less than 60 days which is among the lowest in the group. This means that regardless of inventory method used, inflation will be reflected in its results sooner.

- We see that inventory DSIs declined from the year-ago June quarter despite rapid cost inflation. Management specifically cited a sharp increase in tissue prices in the June quarter. We do see a rise in raw materials but finished goods and overall inventory DSIs fell which implies a material drop in unit inventories. We believe KMB may be benefitting from a delay in replenishing inventories at higher costs as any new purchases of higher cost inventories accounted for under Average Cost would immediately impact the cost of sales regardless of whether they were sold in the period or not. Delaying replenishment would be a boost to margins for inventories accounted for under LIFO as well since the company could dip into lower cost layers of LIFO inventories rather than replenish with higher cost inventories which would be expensed immediately.

KMB's Gross Margin Outlook

The following table shows KMB's non-GAAP gross margin for the last twelve quarters:

	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Adjusted Gross Profit Margin	30.2%	29.8%	30.1%	30.6%

	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Adjusted Gross Profit Margin	31.9%	34.0%	35.4%	36.2%

	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Adjusted Gross Profit Margin	39.8%	37.2%	36.0%	35.8%

Gross margin fell by 170 bps in the 6/22 quarter as margin was negatively impacted by cost inflation of 800 bps partially offset by pricing and cost savings. On the bright side, this was the first sequential improvement in some time. However, the company raised its forecast for input cost inflation for the year to $1.4 to $1.6 billion from the previous estimate of $1.1 to $1.3 billion.

It also guided towards the low end of its previously guided EPS range which sounds like margins will not come in as expected in the second half.

We also note that the company had previously forecast FORCE savings to be $300-$350 million for the full year. FORCE savings were only $45 million in the 6/22 quarter which management admitted was lower than expected. Maintaining the forecast implies it is expected to accelerate savings in the second half. We are always skeptical when we see the company ramp up its expectations for FORCE savings which are essentially ongoing efforts to cut costs. Accelerating cost cuts could simply be borrowing from future quarters when the spending has to catch up.

KMB's Advertising Spend

KMB does not disclose its advertising spend by quarter. We do know that for the year ended 12/21, advertising fell to $893 million (4.6% of sales) versus $956 million (5.0% of sales.) The company indicated that in the 6/22 quarter that marketing expense was higher. But we don't know if it increased as a percentage of revenue or not. Increased advertising as a percenate3 of sales will likely be necessary to limit volume erosion from higher pricing in the second half.

KMB's Non-GAAP Adjustments

The following table shows a reconciliation of KMB's GAAP and non-GAAP EPS for the last eight quarters:

	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
GAAP Diluted EPS	$1.29	$1.55	$1.06	$1.39	$1.19	$1.72	$1.58	$1.38
2018 Global Restructuring Plan	$0.00	$0.00	$0.24	$0.23	$0.28	$0.08	$0.21	$0.31
Softex Acquisition-Related Costs	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.05	$0.03
Brazil Business Tax Credits	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	-$0.15	$0.00
Acquisition of Cont Interest in Thinkx	$0.00	-$0.20	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00
Pension Settlement	$0.05	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00
Adjusted Diluted EPS	$1.34	$1.35	$1.30	$1.62	$1.47	$1.80	$1.69	$1.72

KMB's non-GAAP adjustments appear reasonable over the last eight quarters at first glance. However, KMB's history clearly shows it to be a serial restructurer. While it has not taken a large charge in the last two quarters, the company's history is littered with a trail of regular large restructuring charges which are added back to non-GAAP results. The 2018 Global

Restructuring Plan just ended in the 12/21 quarter. Before the 2018 Plan, there was the 2014 Global Restructuring Plan which followed other plans. The following table shows the per share restructuring charges relative to non-GAAP EPS as well as the company's adjusted operating margins since 2011.

	GAAP EPS	Restructuring	Non-GAAP EPS	Sales	Adj Op Inc	Op Margin
2021	$5.35	$0.83	$6.18	$19,440	$2,836	14.6%
2020	$6.87	$0.94	$7.74	$19,140	$3,582	18.7%
2019	$6.24	$0.72	$6.89	$18,450	$3,281	17.8%
2018	$4.03	$2.24	$6.61	$18,486	$3,138	17.0%
2017	$6.40		$6.23	$18,348	$3,381	18.4%
2016	$5.99	$0.07	$6.03	$18,202	$3,341	18.4%
2015	$2.77	$0.11	$5.76	$18,591	$3,210	17.3%
2014	$4.04	$0.33	$5.51	$19,724	$3,184	16.1%
2013	$5.53	$0.17	$5.24	$19,561	$3,020	15.4%
2012	$4.42	$0.83	$5.25	$21,063	$3,120	14.8%
2011	$3.99	$0.73	$4.80	$20,846	$2,889	13.9%

We can see that almost every year in the periods examined included a material amount of expenses (the bulk of which were cash) that were added back to non-GAAP earnings. In addition, we call attention to the adjusted operating margin during the restructurings. At first glance, it appears there has been considerable improvement in profitability. However, keep in mind that the company spun off its health care business in 2014 and deconsolidated its disastrous Venezuelan operations in 2016 which accounted for much of the improvement in those periods. After that, we see that adjusted operating margins actually declined until the pandemic led to a rush on toilet paper and diapers that fueled a temporary expansion. Our conclusion is that there has been little in the way of real improvement at KMB to show for all the billions of dollars it asked investors to add back to profits over the years.

While KMB has not taken a charge in two quarters, we would not be surprised to see them resurface in some form in the foreseeable future.

KMB's Other Earnings Quality Items

The 6/22 quarter appeared to be free of many of the unusual gains we have cited in the past. These include credits for stock compensation expense last year due to changes in assumptions surrounding awards. This has now turned into a significant headwind as was the case in the 6/22 quarter which featured $52 million in expense compared to only $20 million of expense in the year-ago second quarter.

We saw no material unusual benefits in the 6/22 quarter. However, given the history of ongoing charges, we are waiting to see another couple of clean quarters before raising our earnings quality rating on KMB.

Procter & Gamble (PG)

PG's missed consensus non-GAAP EPS estimates by 2 cps in the fiscal fourth quarter ended 6/22. Sales beat by $104 million. However, the company's FY 2023 outlook for EPS of $5.93 at the midpoint fell short of the consensus which was expecting closer to $6.10. Management is forecasting $3.3 billion in headwinds from higher commodity and freight costs and unfavorable foreign currency impact.

We are downgrading our earnings quality rating on PG to 4- (Acceptable).

Key Earnings Quality Items and Other Risks to Note:

- PG has the highest days payable ratio of the group at 125 days. This is partly due to the company's supply chain financing arrangement under which its suppliers can sell PG receivables to third-party financing companies. As of the fiscal year ended 6/22, about 40% of the company's payables were to suppliers participating in the program, up from 36% the year before. However, days payable actually declined YOY in the 6/22 quarter for the first time. The increase in payables added roughly $1.5 billion to cash flow growth in FY 2022 but this source of growth may be set to reverse.

- PG has a sizeable goodwill and intangibles balance as a result of large acquisitions made years ago. Together, the accounts amount to about 54% of total assets. The company has incurred significant write-downs in the past including an $8 billion charge to write down the value of the Gillette brand in 2019. While the company has not taken such a large charge since then, the company disclosed in the 2022 10-K that the fair value of the Gillette name only exceeded its carrying value by 5%. The company also disclosed a 25 bps increase in the discount rate used in valuing the Gillette name would result in a 6% decline in the value of the asset. This is more than the 5% cushion the company which would seemingly result in an impairment. With the Gillette asset still carried at $11.4 billion, there seems to be a material risk of another charge in the event of more interest rate increases or a prolonged recession.

- PG has not taken a large restructuring charge in some time but this has not always been the case as large charges were a regular feature of its results before 2020. Despite all the charges, we saw little evidence of real improvement in the company's profitability. As such, we will be skeptical of the company announcing any new plans anytime soon.

- We also note that the company contends that it always has an ongoing restructuring program with annual spending in the $250-$500 million range. The charges added back in the past were considered "incremental". The company used to disclose the amount of the charges quarterly until the 9/21 quarter. In the 10-K for the fiscal year ended 6/22, PG simply disclosed that total restructuring chargers for 2022 were $253 million versus $330 million in 2021. This represents a 2.4 cps tailwind to annual EPS in 2022. That's not a big deal for the year, but it's a big deal if it all came in one of the last fourth quarters where the company beat or missed by one or two pennies. We encourage the company to return to disclosing the ongoing restructuring spending quarterly to improve visibility in this area.

- All of PG's product-related inventories are accounted for under the FIFO method. FIFO expenses older, lower cost inventories first which benefits margins when prices are rising.

- We also note that PG turns its inventories in the mid-50-day range, one of the lowest in the group. This means that regardless of inventory method used, it will be impacted by inflation faster than others with higher turns.

- PG's DSIs have increased YOY for the last two quarters and are now slightly above pre-Covid levels. We do not see any hidden risks with PG's inventory at this point.

- PG does not quantify its advertising or promotional spending on a quarterly basis. We know that for FY 2022, advertising fell by more than 3.5% despite a 5.3% increase in revenue.

- Management offers little color on advertising and promotion. It stated on the call that it is not planning on increasing promotional spending significantly and contended it is becoming more productive on its advertising spending. However, with the company increasing prices and looking to push consumers to higher performing products with higher price tags, we would expect upward pressure on both advertising which will show up as higher SG&A expenses, and promotional spending which will show up as a reduction of net pricing.

- In short, PG is already experiencing the biggest FX headwinds of any in the group, margins are falling significantly despite utilizing 100% FIFO inventories, and it has yet to experience much elasticity which may be reversing. Advertising must also rise and more impairments look like a real possibility.

Relative Valuations and Sentiment

	Price	52 week High	Decline from High	1-Mo. Return	6-Mo. Return	Fwd PE	Cal 2023 PE	Avg Price Target	Implied Upside	avg Rec	Short Interest
CLX	144.58	$186.86	-22.6%	2.3%	0.9%	33.82	38.0	$135.27	-6.4%	3.5	6.1%
CL	80.81	$85.61	-5.6%	3.1%	-0.1%	26.69	26.4	$81.94	1.4%	2.7	1.3%
CHD	87.63	$105.28	-16.8%	-7.5%	-13.1%	29.03	28.6	$92.93	6.0%	2.9	1.7%
KMB	134.29	$145.79	-7.9%	0.1%	0.8%	23.67	23.0	$133.21	-0.8%	3.1	2.1%
PG	**145.27**	**$165.35**	**-12.1%**	**0.2%**	**-9.2%**	**24.44**	**25.0**	**$156.38**	**7.6%**	**2.4**	**0.6%**

Recent earnings beats and misses:

	Q-0	Q-1	Q-2	Q-3	Q-4	Q-5	Q-6	Q-7	Q-8
PG	($0.02)	$0.04	$0.01	$0.02	$0.04	$0.07	$0.13	$0.21	$0.15

Historical EPS and projections by quarter:

	Q+3	*Q+2*	*Q+1*	Q-0	Q-1	Q-2	Q-3	Q-4	Q-5	Q-6	Q-7	Q-8
PG	*$1.35*	*$1.67*	*$1.58*	$1.21	$1.33	$1.66	$1.61	$1.13	$1.26	$1.64	$1.63	$1.16

PG's Dependence on Pricing to Drive Organic Growth

The following table shows PG's sales by segment and the components of growth for each for the last eight quarters:

PG Segment Sales

	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Beauty	$3,461.0	$3,389.0	$3,926.0	$3,964.0	$3,510.0	$3,316.0	$3,806.0	$3,786.0
Grooming	$1,608.0	$1,481.0	$1,811.0	$1,687.0	$1,666.0	$1,438.0	$1,735.0	$1,601.0
Health Care	$2,510.0	$2,662.0	$2,976.0	$2,676.0	$2,383.0	$2,356.0	$2,746.0	$2,471.0
Fabric & Home Care	$6,876.0	$6,699.0	$6,972.0	$7,009.0	$6,597.0	$6,275.0	$6,498.0	$6,644.0
Baby, Feminine, & Family Care	$4,821.0	$4,935.0	$5,116.0	$4,864.0	$4,665.0	$4,604.0	$4,858.0	$4,723.0
Corporate	$239.0	$215.0	$152.0	$138.0	$125.0	$120.0	$102.0	$93.0
Total Revenue	$19,515.0	$19,381.0	$20,953.0	$20,338.0	$18,946.0	$18,109.0	$19,745.0	$19,318.0

Growth Breakout

Total Company	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Volume	-1.0%	3.0%	3.0%	2.0%	1.0%	0.0%	5.0%	7.0%
Organic Volume	-1.0%	3.0%	3.0%	2.0%	1.0%	0.0%	5.0%	7.0%
Price	8.0%	5.0%	3.0%	1.0%	1.0%	2.0%	1.0%	1.0%
Mix	0.0%	2.0%	0.0%	1.0%	1.0%	2.0%	2.0%	1.0%
Organic Growth	7.0%	10.0%	6.0%	4.0%	3.0%	4.0%	8.0%	9.0%
Other	0.0%	0.0%	0.0%	0.0%	1.0%	0.0%	0.0%	1.0%
FX	-4.0%	-3.0%	0.0%	1.0%	3.0%	1.0%	0.0%	-1.0%
Total Sales Growth	3.0%	7.0%	6.0%	5.0%	7.0%	5.0%	8.0%	9.0%

Beauty	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Volume	-1.0%	0.0%	1.0%	0.0%	2.0%	2.0%	2.0%	7.0%
Organic Volume	-2.0%	-1.0%	1.0%	0.0%	2.0%	2.0%	2.0%	7.0%
Price	6.0%	4.0%	2.0%	2.0%	2.0%	2.0%	2.0%	1.0%
Mix	-4.0%	0.0%	-1.0%	0.0%	3.0%	3.0%	1.0%	0.0%
Organic Growth	0.0%	3.0%	2.0%	2.0%	7.0%	7.0%	5.0%	8.0%
Other	1.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
FX	-3.0%	-2.0%	1.0%	3.0%	2.0%	2.0%	1.0%	-1.0%
Total Sales Growth	-1.0%	2.0%	3.0%	5.0%	9.0%	9.0%	6.0%	7.0%

Grooming	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Volume	-3.0%	1.0%	1.0%	1.0%	4.0%	0.0%	4.0%	5.0%
Organic Volume	-2.0%	1.0%	1.0%	1.0%	4.0%	0.0%	4.0%	5.0%
Price	6.0%	6.0%	4.0%	2.0%	2.0%	2.0%	1.0%	2.0%
Mix	-1.0%	1.0%	1.0%	2.0%	0.0%	2.0%	1.0%	0.0%
Organic Growth	3.0%	8.0%	6.0%	5.0%	6.0%	4.0%	6.0%	7.0%
Other	1.0%	0.0%	-1.0%	-1.0%	0.0%	0.0%	0.0%	0.0%
FX	-6.0%	-5.0%	-1.0%	1.0%	4.0%	0.0%	-1.0%	-2.0%
Total Sales Growth	-3.0%	3.0%	4.0%	5.0%	10.0%	4.0%	5.0%	5.0%

Health Care	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Volume	0.0%	8.0%	4.0%	3.0%	13.0%	0.0%	4.0%	9.0%
Organic Volume	0.0%	8.0%	4.0%	3.0%	13.0%	0.0%	4.0%	9.0%
Price	5.0%	3.0%	1.0%	1.0%	1.0%	0.0%	1.0%	1.0%
Mix	4.0%	5.0%	3.0%	3.0%	0.0%	3.0%	4.0%	2.0%
Organic Growth	9.0%	16.0%	8.0%	7.0%	14.0%	3.0%	9.0%	12.0%
Other	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
FX	-4.0%	-3.0%	0.0%	1.0%	4.0%	1.0%	0.0%	-1.0%
Total Sales Growth	5.0%	13.0%	8.0%	8.0%	18.0%	4.0%	9.0%	11.0%

Fabric & Home Care	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Volume	-1.0%	4.0%	7.0%	2.0%	1.0%	3.0%	7.0%	10.0%
Organic Volume	-1.0%	5.0%	7.0%	2.0%	1.0%	3.0%	7.0%	10.0%
Price	10.0%	5.0%	2.0%	2.0%	0.0%	2.0%	1.0%	0.0%
Mix	0.0%	1.0%	-1.0%	1.0%	1.0%	2.0%	4.0%	4.0%
Organic Growth	9.0%	11.0%	8.0%	5.0%	2.0%	7.0%	12.0%	14.0%
Other	0.0%	0.0%	0.0%	-1.0%	0.0%	0.0%	0.0%	0.0%
FX	-5.0%	-3.0%	-1.0%	1.0%	3.0%	1.0%	0.0%	0.0%
Total Sales Growth	4.0%	7.0%	7.0%	5.0%	5.0%	8.0%	12.0%	14.0%

Baby, Feminine, & Family Care	6/30/2022	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Volume	0.0%	2.0%	1.0%	1.0%	-3.0%	-4.0%	4.0%	3.0%
Organic Volume	0.0%	2.0%	1.0%	1.0%	-3.0%	-4.0%	4.0%	3.0%
Price	6.0%	5.0%	3.0%	-1.0%	1.0%	2.0%	2.0%	1.0%
Mix	1.0%	2.0%	1.0%	2.0%	1.0%	1.0%	0.0%	0.0%
Organic Growth	7.0%	9.0%	5.0%	2.0%	-1.0%	-1.0%	6.0%	4.0%
Other	-1.0%	1.0%	0.0%	0.0%	-1.0%	0.0%	0.0%	0.0%
FX	-3.0%	-3.0%	0.0%	1.0%	3.0%	1.0%	0.0%	-1.0%
Total Sales Growth	3.0%	7.0%	5.0%	3.0%	1.0%	0.0%	6.0%	3.0%

- PG has posted the most consistent volume growth in the group over the last few quarters. However, rapid price increases appear to have induced more price elasticity as volume growth turned slightly negative in the 6/22 quarter.

- Health Care has seen rapid growth due to easy comps versus a year ago when mask mandates resulted in a non-existent cold and flu season. Comps will get much more difficult in this segment moving forward.

- The largest segment, Fabric and Home Care, has enjoyed easy comps in the last couple of quarters versus year-ago periods that saw moderating sales after the pandemic buying frenzy of 2020 and early 2021. Comps will get more difficult after the 9/22 quarter.

- Like other in the group, the company was seeing better than historical elasticities in the first half of the year but expects them to return to normal in the back half which will result in slight volume declines in the face of higher prices.

PG's Inventory Status

The following tables show PG's inventory components, component growth rates, and DSIs by component:

Inventory Component Data	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Materials and Supplies	$2,168.00	$2,146.00	$2,061.00	$1,839.00
Work in Process	$856.00	$837.00	$766.00	$769.00
Finished Goods	$3,900.00	$4,118.00	$3,846.00	$3,699.00
Total Inventory	$6,924.00	$7,101.00	$6,673.00	$6,307.00

Inventory Component Growth	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Materials and Supplies	31.8%	38.6%	32.5%	29.1%
Work in Process	19.1%	17.9%	9.6%	13.4%
Finished Goods	7.8%	10.0%	3.9%	2.6%
Total Inventory	15.7%	18.3%	12.0%	10.5%

DSI by Inventory Component	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Materials and Supplies DSI	18.3	18.7	17.8	16.3
Work in Process DSI	7.2	7.3	6.6	6.8
Finished Goods DSI	32.9	35.9	33.2	32.8
Total DSI	58.3	61.9	57.6	56.0
	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Materials and Supplies DSI	15.3	15.6	15.5	14.3
Work in Process DSI	6.7	7.2	6.9	6.8
Finished Goods DSI	33.6	37.8	36.8	36.3
Total DSI	55.6	60.5	59.2	57.4
	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Materials and Supplies DSI	14.4	13.8	15.1	14.7
Work in Process DSI	6.9	6.6	6.6	6.9
Finished Goods DSI	34.7	35.2	35.6	36.0
Total DSI	56.0	55.6	57.3	57.6

- All of PG's product-related inventories are accounted for under the FIFO method. FIFO expenses older, lower cost inventories first which benefits margins when prices are rising.

- We also note that PG turns its inventories in the mid-50-day range, one of the lowest in the group. This means that regardless of inventory method used, it will be impacted by inflation faster than others with higher turns.

- PG's DSIs have increased YOY for the last two quarters and are now slightly above pre-Covid levels. We do not see any hidden risks with PG's inventory at this point.

PG's Gross Margin Outlook

	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Adjusted Gross Profit Margin	44.6%	46.7%	49.1%	49.0%
	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Adjusted Gross Profit Margin	48.3%	50.7%	53.1%	52.7%
	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Adjusted Gross Profit Margin	50.9%	50.4%	51.6%	51.3%

PG's gross margin declined by 370 bps in the 6/22 quarter due to a 450 bp increase in commodity costs, 80 bps of higher freight, 40 bps of other cost increase, 20 bps of packaging, and 130 bps of mix partially offset by 390 bps of pricing.

PG raised prices a year ago in its Feminine Care and Baby Care categories and has raised prices since the beginning of 2022 in its other product categories in the US. It also began another round of price increases in Feminine and Baby Care products that took effect in mid-July and has announced additional price increases for US Home Care and Oral Care products that took effect after June.

PG's Advertising Spend

PG does not quantify its advertising or promotional spending quarterly. We know that for FY 2022, advertising fell by more than 3.5% despite a 5.3% increase in revenue.

Management offers little color on advertising and promotion. It stated on the call that it is not planning on increasing promotional spending significantly and contended it is becoming more productive on its advertising spending. However, with the company increasing prices and looking to push consumers to higher performing products with higher price tags, we would expect upward pressure on both advertising which will show up as higher SG&A expenses, and promotional spending which will show up as a reduction of net pricing.

PG's Non-GAAP Spread

Below is a reconciliation of PG's GAAP to non-GAAP EPS for the last eight quarters:

	6/30/2022	3/31/2022	12/31/2021	9/30/2021	06/30/2021	3/31/2021	12/31/2020	9/30/2020
GAAP Diluted EPS	$1.21	$1.33	$1.66	$1.61	$1.13	$1.26	$1.47	$1.63
Incremental Restructuring	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00
Anti Dilutive Impact	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00
Early Extinguishment of Debt	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.16	$0.00
Rounding	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.01	$0.00
Adjusted Diluted EPS	$1.21	$1.33	$1.66	$1.61	$1.13	$1.26	$1.64	$1.63

We can see that over the last eight quarters, PG's non-GAPP adjustments have been negligible with most quarters containing no adjustment whatsoever. We find this very refreshing. However, we note that this has not always been the case in the following table which gives per share restructuring amounts relative to non-GAAP EPS for the last ten fiscal years ended June:

FY	GAAP EPS	Restructuring	Non-GAAP EPS
2021	$5.50	$0.00	$5.66
2020	$4.96	$0.16	$5.12
2019	$1.43	$0.13	$4.52
2018	$3.67	$0.23	$4.22
2017	$3.69	$0.18	$3.67
2016	$3.49	$0.18	$3.67
2015	$2.84	$0.17	$3.76
2014	$3.93	$0.12	$4.22
2013	$3.83	$0.18	$4.02
2012	$3.66	$0.20	$3.85
2011	$3.93	$0.00	$3.87

Given the company's history, we will view any new restructuring programs with some skepticism.

We also note that the company contends that it always has an ongoing restructuring program with annual spending in the $250-$500 million range. The charges added back in the past were considered "incremental". The company used to disclose the amount of the charges quarterly until the 9/21 quarter. The following table shows the breakout between the ongoing and the incremental classification of total charges.

	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Quarterly Total Charges	NA	NA	NA	NA
Incremental Charges	$0.00	$0.00	$0.00	$0.00
"Ongoing" Charges	$0.00	$0.00	$0.00	$0.00

	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Quarterly Total Charges	$109.00	$134.00	$65.00	$22.00
Incremental Charges	$0.00	$0.00	$0.00	$0.00
"Ongoing" Charges	$109.00	$134.00	$65.00	$22.00

	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Quarterly Total Charges	$362.00	$222.00	$105.00	$93.00
Incremental Charges	$226.00	$141.00	$17.00	$31.00
"Ongoing" Charges	$136.00	$81.00	$88.00	$62.00

In the 10-K for the fiscal year ended 6/22, PG simply disclosed that total restructuring chargers for 2022 were $253 million versus $330 million in 2021. This represents a 2.4 cps tailwind to annual EPS in 2022. That's not a big deal for the year, but it's a big deal if it all came in one of the last fourth quarters where the company beat or missed by one or two pennies:

	6/22	3/22	12/21	9/21
EPS Beat (Miss)	($0.02)	$0.04	$0.01	$0.02

We encourage the company to return to disclosing the ongoing restructuring spending quarterly to improve visibility in this area.

PG's Other Items

Supply Chain Financing Program

PG maintains a supply chain financing arrangement under which its suppliers can sell PG receivables to third-party financing companies. As of the fiscal year ended 6/22, about 40% of the company's payables were to suppliers participating in the program, up from 36% the year before. The following table shows days payable for the last twelve quarters:

Days payable	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Trade Accounts Payable	$14,882	$14,175	$14,154	$14,223
Trade Accounts Payable Days	125.4	123.5	122.1	126.2
	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Trade Accounts Payable	$13,720	$12,134	$12,027	$11,935
Trade Accounts Payable Days	127.5	122.4	119.6	120.1
	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Trade Accounts Payable	$12,071	$10,464	$10,781	$10,951
Trade Accounts Payable Days	122.8	109.3	111.8	115.5

PG was seeing its days payable rise which it attributed to extending payment terms to customers. However, days payable actually declined YOY in the 6/22 quarter for the first time in years which is consistent with the warning the company gave in its 6/22 10-K:

> *"Although difficult to project due to market and other dynamics, we anticipate incremental cash flow benefits from the extended payment terms with suppliers could increase at a slower rate in fiscal 2023. Future changes in our suppliers' financing policies or economic developments, such as changes in interest rates, general market liquidity or the Company's creditworthiness relative to participating suppliers, could impact suppliers' participation in the SCF and/or our ability to negotiate extended payment terms with our suppliers. However, any such impacts are difficult to predict."*

We note that PG has the highest level of accounts payable of any in the group indicating it has been using its size to pressure its suppliers.

However, it appears the company is running out of room to pressure suppliers and rising rates should make it more difficult and expensive to get suppliers to finance the company's invoices. The increase in payables added roughly $1.5 billion to cash flow growth in FY 2022 but this source of growth may be set to reverse.

Potential for Goodwill and Intangibles Write Down

PG has a sizeable goodwill and intangibles balance as a result of large acquisitions made years ago. Together, the accounts amount to about 54% of total assets. The company has incurred significant write-downs in the past including an $8 billion charge to write down the value of the Gillette brand in 2019. While the company has not taken such a large charge since then, it is worth tracking the company's disclosures on the fair value of its goodwill and intangible assets to check for signs of erosion in the value of those brands.

According to the FY 2022 10-K, annual impairment testing indicated the fair value of the Shave Care unit exceeded the carrying value by more than 30% while the Gillette indefinite-lived intangible exceeded its carrying value by only 5%. The latter is a very thin cushion. With regards to the outlook for the unit, the company stated in the 10-K that:

> *"The continued evolution of the pandemic and the Russia-Ukraine War could impact the assumptions utilized in the determination of the estimated fair values of Shave Care reporting unit and the Gillette indefinite-lived intangible asset that are significant enough to trigger an impairment. Net sales and earnings growth rates could be negatively impacted by more prolonged reductions or changes in demand for our shave care products, which may be caused by, among other things: the temporary inability of consumers to purchase our products due to illness, quarantine or other travel restrictions, financial hardship, changes in the use and frequency of grooming products or by shifts in demand away from one or more of our higher priced products to lower priced products or by disruption in the supply chain or operations due to the evolving Russia-Ukraine War. In addition, relative global and country/regional macroeconomic factors including the Russia-Ukraine War could result in additional and prolonged devaluation of other*

*countries' currencies relative to the U.S. dollar**. Finally, the discount rate utilized in our valuation model could be impacted by changes in the underlying interest rates and risk premiums included in the determination of the cost of capital. As of June 30, 2022, the carrying values of the Shave Care goodwill and the Gillette indefinite-lived intangible asset were $12.3 billion and $14.1 billion, respectively."***

The company also discloses in the 10-K that a 25 bps increase in the discount rate used in valuing the Gillette name would result in a 6% decline in the value of the asset. This is more than the 5% cushion the company claimed which would seemingly result in an impairment. With the Gillette asset still carried at $14.1 billion, there seems to be a material risk of another charge in the event of more interest rate increases or a prolonged recession.

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.

Disclosure

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