Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

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Fortune Brands (FBHS) EQ Review

Current EQ Rating*	Previous EQ Rating
3-	NA

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

We initiate coverage of FBHS with a rating of 3- (Minor Concerns)

FBHS reported adjusted EPS of $0.93 in the 9/18 quarter, a full 12 cps short of the expected $1.05. Management blamed 7 cps of the shortfall on Hurricane Florence with the balance presumably related to a weaker than expected housing market and "temporary inefficiencies" in its security segment. While we are always skeptical of weather-related excuses, we note that the hurricane did not just impact demand, but also directly affected both shipping and production activity in its North Carolina facilities. Management noted in the call:

> *"Hurricane Florence hit our Plumbing operations hard at the end of the quarter and led to eight-lost shipping days as our main Moen assembly plant for the U.S. is in New Bern, North Carolina, and our component warehouse is in Kinston, North Carolina. The effect is to push some sales from Q3 to Q4.*
> *Across the company, we have a number of operations in North Carolina. Although our manufacturing facilities missed some third quarter production time, they are all up and running, having suffered only minimal damage during the storm. "*

Management noted that it expects to recoup all but $0.01 per share in lost sales and profits from the hurricane in the fourth quarter. Regardless, it still lowered guidance for the full year to $3.41-$3.49 from the previous $3.62-$3.72. Management's comments in the call indicated that of the 22 cps reduction in the guidance midpoint, about 13.5 cps was from lowered market forecast, 3.5 cps from increase in forecast for inefficiencies, 3 cps from dilution from the 9/18 acquisition of Fiberon and 1 cps each from unrecovered business from the hurricane and tariffs.

Despite the big earnings miss, we note that the company's recently reported results have benefitted from several temporary sources which cannot continue indefinitely.

- Provision for warranty expense in the 9/18 quarter fell by almost $5 million (2.5 cps) versus last year's unusually high third quarter. The overall reserve level is consistent with recent history, so we are not especially concerned the company is under-reserved at this point.

- Other income increased by over $7 million versus the year-ago quarter due to hedge gains from debt issuance and beneficial moves in the ineffective portion of FX hedges. We consider the approximate 4 cps increase to be a non-operational benefit.

- The company aggressively bought back shares in the 3/18 and 6/18 quarters, reducing the share base by more than 5% and giving a huge boost to reported EPS growth. However, acquisitions have driven up debt to over 2.6 times EBITDA, prompting the company to suspend the buyback after the 6/18 quarter. While the dividend consumes only about 30% of free cash flow, the high debt, coupled with management's indication that more acquisitions are on the way will likely siphon cash away from both future dividend growth and share buybacks.

- The almost 2-day increase in accounts receivable DSOs in the 9/18 quarter was entirely due to the 9/18 Fiberon acquisition. However, the approximate 2.5-day increases in the 3/18 and 6/18 quarters are out of line with the smooth historical trend which prompts us to pay careful attention to the future movement in receivables.

- FBHS took a $27 million write-down to intangible tradenames in the 9/18 quarter and disclosed that two tradenames with total carrying value of $190 million could face write-downs if there is further erosion in estimated carrying value.

Provision for Warranty Decline Added about 2.5 CPS to EPS Growth

FBHS reserves for future warranty costs at the time of sale based on estimates from past experience. The following table shows the development of the warranty reserve for the last eight quarters:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Beginning Reserve Balance	$17.0	$17.2	$17.2	$22.0
Provision for Warranties Issued	$5.5	$6.4	$6.2	$1.8
Settlements	-$4.5	-$6.6	-$6.2	-$7.3
FX Translation	-$1.9	$0.0	$0.0	$1.2
Acquisitions	$9.1	$0.0	$0.0	-$0.5
Ending Balance	$25.2	$17.0	$17.2	$17.2

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Beginning Reserve Balance	$16.0	$15.9	$16.2	$17.4
Provision for Warranties Issued	$10.2	$4.9	$8.2	$2.0
Settlements	-$3.7	-$4.8	-$8.5	-$2.7
FX Translation	-$1.2	$0.0	$0.0	$0.3
Acquisitions	$0.7	$0.0	$0.0	-$0.8
Ending Balance	$22.0	$16.0	$15.9	$16.2

The company experienced unusually higher warranty expense in the 9/17 quarter which led to a very easy comp in the 9/18 quarter. We estimate that the $4.7 million decline in warranty expense boosted EPS growth by more than 2.5 cps when compared to the year-ago quarter.

The following table shows the adjusted warranty reserve balance as a percentage of sales for the last eight quarters:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Revenue	$1,380.8	$1,429.0	$1,254.6	$1,382.5
Warranty Reserve	$16.1*	$17.0	$17.2	$17.2
Warranty Reserve % of Sales	1.2%	1.2%	1.4%	1.2%

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Revenue	$1,348.6	$1,365.4	$1,186.8	$1,301.6
Warranty Reserve	$22.0	$16.0	$15.9	$16.2
Warranty Reserve % of Sales	1.6%	1.2%	1.3%	1.2%

**Note that for the purpose of calculating the reserve percentage, we adjusted the 9/18 reserve balance down by the $9.1 million picked up in the Fiberon acquisition as the 9/18 quarter had very little contribution for Fiberon sales.*

We see that while the reserve percentage is below the year-ago-level, the 9/17 figure was unusually high compared to other quarters. Thus, we do not believe the company is materially under-reserved at this point and view the decline in warranty expense as simply an artificial benefit the year-over-year EPS growth rate from an easy comp.

Other Income Increase

FBHS reported other income of $9.6 million in the 9/18 quarter compared to just $2.2 million in the 9/17 quarter. The 2018 figure included $500,000 in restructuring charges along with $300,000 in defined benefit actuarial loss. Both were removed from the company's adjusted EPS amount. Likewise, the 2017 figure included a $1.3 million actuarial gain which was added back to adjusted EPS. Still, the $7.4 million difference was mostly due to hedge gains associated with the 9/18 debt issuance along with favorable movement of the ineffective portion of foreign currency hedging instruments. We believe the approximate 4 cps increase in other income should be considered a non-operational boost to adjusted EPS.

Acquisitions Have Driven Up Debt and Ended the Buyback

Recent EPS growth has benefitted significantly from FBHS aggressively buying back shares in the 3/18 and 6/18 quarters. We can see in the following table that the average diluted share count declined over 5% year-over-year in each of the last two quarters:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Quarterly Cash Buyback	$0	$278	$325	$41
Average Diluted Shares	144.2	146.6	152.1	154.4
Year-Over-Year Decline	-7.5%	-6.4%	-2.6%	-1.5%

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Quarterly Cash Buyback	$141	$5	$27	$62
Average Diluted Shares	155.9	156.6	156.2	156.8
Year-Over-Year Decline	1.1%	2.1%	0.3%	-3.8%

We can see in the following table just how much of recently-reported EPS growth has been coming from the reduction in the share count by comparing the growth in adjusted net income to the growth in adjusted EPS:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Adjusted Net Income	$134.4	$146.7	$85.1	$123.3
YOY Growth	4.1%	2.4%	1.9%	11.4%
Adjusted EPS	$0.93	$1.00	$0.56	$0.80
YOY Growth	12.0%	8.7%	5.7%	12.7%

Therefore, the fact that the company had to discontinue the buyback after the 6/18 quarter due to debt incurred in the Fiberon deal is concerning. The following table shows trailing-twelve cash flow figures for the last three years ended 9/30:

	9/30/2018	9/30/2017	9/30/2016
T12 Operating Cash Flow	$591	$623	$532
T12 Capex	$176	$139	$148
T12 Free Cash Flow	$415	$484	$384
T12 Dividends	$115	$107	$96
Dividend % of FCF	29%	25%	25%
T12 Net Stock Repurchases	$644	$236	$399
Cash After Buyback	-$344	$141	-$111

The dividend consumes less than 30% of free cash flow and the discontinuation of the buyback will leave the company with about $300 million of cash flow after the dividend to reduce debt. However, FBHS currently has net debt of approximately $2.1 billion compared to trailing-12 EBITDA of $820 million, or about 2.6 times. This is not daunting, but it will still likely require the company to channel much of the excess cash flow towards debt reduction in the foreseeable future.

In addition, management has stated that it is actively eyeing acquisitions, so further jumps in the debt load are quite possible. While there is certainly no obvious reason to expect a dividend cut, we could see the dividend growth rate begin to slow, especially in the event of more debt being taken on to fund a large deal.

Regardless, more massive share buybacks do not appear to be in the cards in the near future which will result in the loss of a significant tailwind to EPS growth after the next two quarters.

Receivable DSOs

The following table shows accounts receivable days (DSO) for the last eight quarters:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Sales	$1,380.8	$1,429.0	$1,254.6	$1,382.5
Accounts Receivable	$635.4	$657.5	$631.5	$555.3
Sales YOY growth	2.4%	4.7%	5.7%	6.2%
Accounts Receivable YOY growth	6.8%	10.4%	11.8%	0.8%
Accounts Receivable DSOs	42.0	42.0	45.9	36.7

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Sales	$1,348.6	$1,365.4	$1,186.8	$1,301.6
Accounts Receivable	$594.7	$595.7	$564.9	$550.7
Sales YOY growth	5.4%	5.2%	7.3%	6.3%
Accounts Receivable YOY growth	4.6%	4.6%	7.5%	9.6%
Accounts Receivable DSOs	40.2	39.8	43.4	38.6

We are not alarmed by the 1.8-day year-over-year increase in DSOs in the 9/18 quarter. The company disclosed that the 9/18 receivables balance included $56 million of receivables from the Fiberon acquisition while the quarter had virtually no revenue from Fiberon. This accounted for all of the observed increase in DSO in the quarter.

However, we do think it is worth noting that both the 3/18 and 6/18 quarters saw DSO increases of 2.5 and 2.3 days, respectively. Such jumps are unusual for FBHS and we will continue to monitor the trend in receivables in future quarters.

Intangible Impairments

FBHS took a $27 million impairment charge in the 9/18 quarter to write down the value of an indefinite-lived tradename in the Cabinet segment. In addition, the company disclosed that further reduction in estimated tradenames could trigger future impairments with carrying values of $189.9 million. It is worth noting that goodwill and intangibles amount to $3.4 billion of the company's assets versus an equity balance of $2.2 billion. FBHS has already written down roughly $400 million in goodwill in the last few years.

Explanation of EQ Rating Scale

6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor “red flag”, but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company’s recent reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company’s recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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