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Fortune Brands (FBHS) EQ Update 9/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3-	3-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

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

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

FBHS's adjusted EPS of $0.95 missed the consensus estimate by 2 cps. While the company has experienced rising costs from tariffs and a slowdown in activity in its end markets, it has promised that price increases and improving housing starts will reignite growth in upcoming quarters.

- Inventory days rose by 3.7 compared to the 9/19 quarter with the bulk of the growth coming from finished goods. While this is a moderation versus the DSI growth of the last three quarters, DSI of over 74 days is still elevated compared to the mid-60s level in the third quarter of 2017 and 2016. Note that the year-ago quarter DSI of 70 was inflated by the Fiberon deal. Management indicated in the conference call that inventory will continue to drain cash flow in upcoming quarters, noting that they "expect 2019 free cash flow of approximately $480 million to $500 million, which includes the accelerated investments in capacity and inventory to support new composite decking customers." The company has also cited lower retail and wholesale inventories as negatively impacting sales in the last few quarters and indicated filling that void will be a tailwind for upcoming results. If FBHS can move its inventory into those channels without significant discounting, the higher inventory may not be an issue for margins. However, the risk of discounting remains and the red flag will intensify if we don't see a decline in DSI after next quarter. Interestingly, raw materials DSI actually fell by 0.8 days verus the year-ago quarter which does not indicate management is gearing up to meet demand far beyond the next quarter.

- FBHS took a $29.5 million impairment charge to the carrying value of an indefinite-lived tradename in the Cabinet segment in the 9/19 quarter due to reduced revenue forecasts for the remainder of 2019 and 2020. Management stated that this was "primarily the result of a continuing shift in demand from semi-custom cabinetry products to value-priced cabinetry products, which led to consecutive downward adjustments of internal revenue forecasts associated with the tradename." This follows a $35.5 million charge in the 12/18 quarter for the same trade name. The remaining carrying value of this trade name as of 9/19 was $85 million. Also, in the 9/18 quarter, the company took a $27.1 million charge related to a second tradename in the Cabinet segment. The company further stated in the 10-Q that "a reduction in the estimated fair value of these two tradenames could trigger an additional impairment in future periods. In addition, future impairments could be triggered on a third tradename in the event of lower-than-expected sales in our custom cabinetry product line. As of September 30, 2019, the total carrying value of the three tradenames was approximately $174 million."

- Pension expense rose by 2.2 cps, but the company added the bulk of the increase back in its non-GAAP EPS presentation.

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 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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