BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Fortune Brands (FBHS) EQ Update-12/18 Quarter

Current EQ Rating*	Previous EQ Rating
3-	3-

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

We maintain our earnings quality rating on FBHS of 3- (Weak)

FBHS's adjusted 12/18 quarter EPS of $0.94 fell 8 cps short of expectations.

- We warned in our review of the 9/18 quarter that EPS received a non-operational 2.5 cps boost from a decline in warranty provision. However, this tailwind reversed in the 12/18 quarter as warranty provision expense for the period rose by over $5 million, representing an almost 3 cps headwind to EPS growth. This was possibly a factor in the earnings disappointment.

- We also noted in our review of the previous quarter that the company took $27 million in intangible tradename write-downs and had warned two tradenames with an estimated carrying value of $190 million were at risk of further impairment. The 12/18 quarter saw an additional $35.5 million in charges to write-down these tradenames.

- We remind clients that FBHS's share count continues to benefit from its massive buybacks in the 3/18 and 6/18 quarters (share count was 7% lower in the 12/18 period versus the year-ago quarter.) The company did not buy back shares in the 9/18 quarter due to its acquisition. While it did start the buyback up again in the 12/18 quarter, its current net debt level of 2.4 times EBITDA will likely keep it from returning to such a dramatic rate of share count reduction in the near future. The negative impact will be felt on EPS growth in the back half of the year.

- FBHS announced in the fourth quarter that it was changing its inventory accounting from LIFO to FIFO method for products in which metal is a significant component. This resulted in a $7.3 million one-time benefit to cost of sales as the company adjusted certain inventories in Plumbing and Doors and Security segments to FIFO. The company disclosed that impacted inventories amounted to $259.3 million at 12/17, or about 45% of total inventory. The 2016 and 2017 results were not restated as the impact was not deemed to be material. The impact was removed from adjusted EPS, so there was not a non-operational boost to EPS in the quarter. Regardless, we view this as a negative development for earnings quality as the FIFO method matches older inventories against current sales on the income statement which results in an understatement of current costs in a rising cost environment.

- Inventory days (DSI) jumped by 8 days year-over-year to 67.4. There was a 5.5-day year-over-year increase in the 9/18 quarter which was driven by the late third-quarter Fiberon acquisition. If we adjust out the above-mentioned FIFO adjustment, the 12/18 quarter increase is still about 6.6 days. Given that the 12/18 quarter had a full contribution of Fiberon cost of sales in the calculation, the large increase in days of sales is concerning, especially since the quarter featured slower than expected sales and management citing inventory builds at customers.

- One final note on inventory, the company disclosed in the 10-K that inventory provision for obsolete or slow-moving inventory was $45.3 million at the end of the 12/18 quarter versus $45 million a year ago. The increase in total inventory caused the allowance as a percentage of gross inventory to fall to about 6.3% from 7.2% last year. This could be due to the addition of the Fiberon inventories acquired in September which could imply the company may be boosting the reserves there to match its existing reserve levels. We estimate it would take about 4 cps in charges to do so.

Explanation of EQ Rating Scale

Rating	Description
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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