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Fortune Brands (FBHS) EQ Update- 3/20 Qtr

Current EQ Rating*	Previous EQ Rating
4+	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 an explanation of the EQ Review Rating scale, please refer to the end of this report

We are raising our earnings quality rating on FBHS largely due to the improvement in inventories during the quarter.

- FBHS's inventory DSIs fell by 6 days compared to the 3/19 quarter. This represents a reversal of a trend in rising inventories that have been a point of concern in previous reviews. While management had previously indicated that inventories would begin to normalize after the first of the year, we note that the company attributed the decline in inventories to supply chain disruptions related to COVID-19 and higher than expected sales. Regardless, the company seems to be in a better position with inventories which alleviates one of our larger points of concern.

- FBHS's tax rate adjusted for one-time items fell by 350 bps due to the tax benefit of stock options. This added over 4 cps to earnings in the period which was likely unexpected by analysts. However, the company beat earnings estimates by 9 cps in the quarter, so the outperformance was not wholly attributable to the tax benefit.

- In January, FBHS entered into an agreement to buy the remaining interest of its minority investment in Flo Technologies in stages over the next year. At the end of the 3/20 quarter, the company owned 75% of Flo Technologies, but due to substantive participation rights held by the minority owners, FBHS determined that it did not have controlling interest which resulted in the investment being accounted for under the equity method rather than being consolidated. When the substantive participation rights expire in early 2021, Flo's results will be consolidated. The newly enacted ASC 2020-01 required the company to remeasure the value of its investment in Flo Technologies prior to adopting the equity method of accounting. This resulted in a $6.6 million gain which was recognized in other income but removed from non-GAAP earnings.

- We have cited the long string of goodwill and intangible charges at FBHS over the last several quarters. The trend continued into the first quarter as COVID-19 required a remeasurement of assets resulting in a $9.5 million write-down to trade names in the cabinet segment. The value of this tradename was $29 million at the end of the quarter. Impairment testing on two more tradenames with a combined carrying value of $120 million revealed that fair value exceeded carrying value by less than 10%. This indicates we still may have not seen the last of the impairment charges.

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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