BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Fortune Brands (FBHS) EQ Update

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

FBHS reported adjusted EPS of $0.60 in the 3/19 quarter, 2 cps ahead of Street expectations. While the benefit from lower warranty expense has abated, our concern with rising inventories increased.

- Inventory days of sales continued to climb in the quarter, rising 8 days over the year-ago quarter. The company noted in the 10-Q that the increase in inventory was a result of buildout for new products launches as well as pre-buys ahead of tariffs. We also remind clients that the company switched to the FIFO method of inventory accounting in the fourth quarter for inventories with a large metal component. This likely contributed to the observed increase in inventory as older, lower-cost inventories were matched against sales in the current period, leaving the newer, higher-cost inventory on the balance sheet to be expensed later. This alone erodes the quality of reported earnings.

  In addition, management blamed weaker than expected sales growth on a work down of channel inventories by customers which increases the likelihood that the continuing rise in DSI represents an unexpected buildup in inventory that could result in a negative surprise to gross margin in upcoming quarters as inventories are discounted and/or production is scaled back.

- According to the 10-Q, 2.8 million shares were excluded from the share count due to being antidilutive versus only 500 K last year. We estimate that this added about 1 cps to EPS in the period.

- The benefit of lower warranty expense which we cited in our review of the 9/18 quarter has disappeared as provision expense was flat in the 3/19 quarter.

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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