BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

March 1, 2019 | www.btnresearch.com

Goodwill in the Wake of Kraft Heinz

Kraft Heinz (KHC) shocked the market last week by reporting not only disappointing adjusted earnings, but also a write-down of $15.4 billion to its massive goodwill and intangibles balances. To top it off, it disclosed an SEC subpoena from October examining its procurement accounting practices. The stock has lost over 30% of its value since the announcement as investors come to terms with the fact that the massive goodwill write-down is clear evidence that the bull story based on creating shareholder value by acquiring brands and slashing costs has simply not materialized.

Growth through acquisition has been the "go to" strategy of most packaged food and consumer products companies due to the simple fact that these markets have been flat at best for years. KHC is certainly not the only player in these markets with massive goodwill on its balance sheet. We thought it would be helpful to take a closer look at makeup of goodwill and intangibles of large "big brand" companies with the largest percentage of goodwill to total assets and assess the likelihood of material write-downs in the foreseeable future.

Index

What Happened at Kraft Heinz? p.16
Ramifications of the Kraft Write-Down p.17
Things to Consider When Evaluating Goodwill p.18
Review of JM Smucker (SJM) p.20
Review of McCormick (MKC) p.26
Review of ConAgra Brands (CAG) p.30
Review of Church & Dwight (CHD) p.34

The List

The following list shows a selection of the largest big brand companies where goodwill and intangibles comprise more than 50% of total assets. We note that there are many companies with goodwill and intangibles balances less than 50% of assets that are still at risk of a material write-down. However, the largest ones are the most logical place to begin a review.

Company	Goodwill & Intang % of Total Assets
Kraft Heinz (KHC)	86.1%
JM Smucker (SJM)	78.0%
McCormick (MKC)	72.2%
ConAgra Brands (CAG)	70.8%
Church & Dwight (CHD)	70.3%
General Mills (GIS)	69.8%
Mondelez International (MDLZ)	61.7%
Campbell Soup (CPB)	59.5%
Procter & Gamble (PG)	58.9%
Kellogg (K)	52.9%

Note that we have earnings quality ratings on all of these companies as well as a NEUTRAL rating on CAG (upgraded on 1/10/19 from our original SELL issued on 8/9/2018). We have also issued a NEUTRAL rating on MDLZ which documents many problems we see with the company.

This report will focus on the top four companies after KHC, all of which have goodwill and intangibles balances greater than 70% of total assets. (SJM, MKC, CAG, CHD).

So, What Happened at Kraft Heinz?

Behind the Numbers has a long history of being critical of KHC's never-ending cycle of acquiring companies, taking huge restructurings and write-offs, and later spinning off the acquired assets. Meanwhile, margins actually showed declines along the way. This history is explored in the Mondelez (MDLZ) piece elsewhere in this issue.

Prior to the most recent implosion, we had an EQ rating of 2+ (Weak) on KHC. Note that we are awaiting the release of the 10-K before updating our EQ rating on the company. Problems we had identified in previous EQ Reviews included:

- Working capital manipulations including receivables securitizations and stretching accounts payable to boost cash flow.

- The 11/17 restatement of past earnings for improper accounting of operating cash flows and the identification of a material weakness in internal controls over financial reporting

- Decline in allowance for bad debts

- Massive, recurring restructuring charges and goodwill write-offs coupled with warnings from the company of deteriorating fair value of goodwill and intangibles.

- High debt levels and elevated ratio of dividend to free cash flow.

KHC's 2/21/19 earnings release not only contained a 10 cps adjusted earnings miss, but also a $15.4 billion write-down to the value of goodwill and intangibles which represented 15% of those account balances and an eye-opening 13% of total assets. In addition, the company announced an October SEC subpoena into its accounting practices focusing on the area of procurement and contracts with its vendors along with a $25 million charge related to its own internal investigation into the matter. While an SEC subpoena is nothing to slough off, especially for a company that had to restate results and identify a material weakness in internal controls just a year ago, we believe the key issue to focus on for now is the ramifications of the goodwill write-down.

Ramifications of the Write-Down

To understand the ramifications of the write-down, one needs to ponder what intangible assets represent. When a company acquires another company or its assets, the purchase price must be allocated among the various asset and liability accounts. In theory, when management determined the price it was willing to pay for a company, it considered the present value of the cash flows it expected to be able to generate with the acquired assets. This would include estimates of the synergies it hopes to achieve through actions such as consolidating the acquired company's operations with its own, introducing acquired products into new distribution channels, co-marketing efforts, etc. In almost all cases, this estimated intangible value comprises a material part of the overall purchase price. For

accounting purposes, this "excess purchase price" is allocated among the goodwill and intangibles balances and allocated even further in the footnotes among items such as customer lists and trademarks.

All goodwill is not evil. However, for a company in a market that is showing little or even negative growth, a large and rising goodwill balance deserves special attention, and this is very true of the big consumer brand companies. Big brands have faced a growing mountain of problems for years including consolidation of their customer base which shifts power to the customers and away from suppliers, competition from generics as more consumers see them as a viable option, and international markets that are closer to saturation and less brand loyal. These companies have historically boasted premium valuations relative to their growth rate based on the premise that "people will always buy toothpaste." With many now struggling to report positive organic growth, most have had to resort to serial restructurings and growth through acquisition strategies. It has almost been amusing to watch these companies trade assets back and forth with brands changing hands multiple times in just a few years. It has been common to see one company breathing a sigh of relief for unloading a failing brand from a disappointing acquisition while the acquiring company is cheering how well its newly acquired gem is growing.

All of these deals assume aggressive benefits from synergies and cost-cutting. As noted above, all of these assumptions wind up as components of goodwill and intangibles. **A write-off like KHC's represents management finally coming to terms with the fact that the assumptions made in determining the purchase price years ago were wildly optimistic. In short- management overpaid for the acquired assets and they now must be written down to reflect reality.**

In the case of KHC, the negative impact was further magnified by its hefty debt balance which required a growing cash flow stream to pay down. With the future of those cash flows now called into question,

Things to Consider When Evaluating Goodwill and Intangibles

We found it interesting that KHC's management stated in the 4Q press release that:

> *"During the fourth quarter, as part of the Company's normal quarterly reporting procedures and planning processes, the Company concluded that,* ***based on several***

> ***factors that developed during the fourth quarter, the fair values of certain goodwill and intangible assets were below their carrying amounts. As a result, the Company recorded non-cash impairment charges of $15.4 billion to lower the carrying amount of goodwill in certain reporting units,*** *primarily U.S. Refrigerated and Canada Retail, and certain intangible assets, primarily the Kraft and Oscar Mayer trademarks."*

We have to respectfully disagree that 13% of the company's total assets are now worthless because of something that just popped up in the fourth quarter. This was a problem which has been festering for years and finally reached a point that no reasonable forecast of discounted future cash flows could justify the carrying value. It is difficult to tell exactly when a company will reach that point, but there are several red flags we can watch for:

- Goodwill and intangibles balances are large and growing
- Disappointing growth emanating from the acquired operations
- Big expectations for value added by cost-cutting at acquired operations. This is especially true when the assets have already been previously acquired and restructured by another company or owned by private equity firms that have stripped them bare. How much more efficiency is left to wring out via cost-cutting?
- Never-ending restructuring charges that result in no or minimal improvements to margins

We will keep all of these items in mind as we take a closer look at four big brand companies with the largest goodwill and intangibles balances relative to assets.

J.M. Smucker (SJM)

SJM's goodwill and intangibles as a percentage of total assets is 78% as of 1/19. This is the second-highest total of the big-brand companies behind pre-blowup KHC's 86%.

Risks

- Pet Food represents the largest component of goodwill and intangibles and is comprised of assets from the 2015 Big Heart deal and the 2018 Ainsworth deal. Big Heart has already experienced write-downs as many of the acquired brands have struggled. The original deal assumed generous margin improvement despite these assets being owned by private equity prior to purchase. More write-downs seem possible.

- Two-thirds of Ainsworth's sales are from *Rachel Ray's Nutrish* premium pet food. This area is currently growing and we are not as concerned about a near-term write-down from this area. However, competition is increasing in the segment and the bulk of the assets are centered around one brand which could increase the risk of longer-term disappointment.

- We are less concerned about a large write-down from the Coffee and Consumer Foods portion of goodwill.

What's in Goodwill and Intangibles?

The following table shows the trend in goodwill and intangibles balances versus total assets for the last five trailing 12-month periods:

	1/31/2019	01/31/2018	01/31/2017	01/31/2016	01/31/2015
Goodwill	$6,438.90	$5,949.40	$6,084.70	$5,944.90	$3,134.90
Intangibles	$6,759.00	$5,970.80	$6,262.00	$6,715.00	$2,973.90
Total Assets	$16,927.60	$15,329.20	$15,811.70	$16,281.50	$9,095.60
Goodwill/Intang % of Total Assets	78.0%	77.8%	78.1%	77.8%	67.2%

The company offers the following breakdown of goodwill by segment as of 1/19:

Goodwill by Segment	
US Retail Pet Food	$2,469.20
US Retail Coffee	$2,090.90
US Consumer Foods	$1,456.50
International and Away from Home	$422.30
TOTAL	$6,438.90

We will look at each segment of goodwill below:

Pet Food

US Retail Pet Food is the largest component of goodwill. While the company does not break out intangibles by segment, we can see that the large jumps in intangibles in 2016 and 2019 coincide with SJM's pet food acquisitions indicating the large majority of intangibles emanates from this area.

Big Heart Deal

The spike in total goodwill and intangibles 2015 to 2016 was a result of the acquisition of Big Heart in early 2015. Big Heart was the pet food division of Del Monte Foods and includes the *Milk-Bone, Kibbles 'n Bits* and *Meow Mix* brands. A private equity firm had previously acquired Del Monte and sold off its flagship canned food division prior to selling Big Heart to SJM for $5.8 billion. At the time of the deal, Big Heart was generating an estimated $2.3 billion in sales and $450 million in EBITDA. Management also forecasted $200 million in annual synergies to be realized within 3 years and for sales growth to be 4-5% for several years after the deal.

Looking back, the forecast for $200 million in synergies seems very aggressive considering 1) Big Heart has been owned by a private equity firm whose job was to eliminate any excess expense and 2) EBITDA margins were already almost 20%. Consider that in 2017, Blue Buffalo, a premium pet food maker, was producing EBITDA margins of around 24. To almost double that with $200 million in cuts seems very optimistic.

The Ainsworth Deal

The second jump in goodwill and intangibles from 2018 to 2019 was a result of the company's mid-2018 acquisition of Ainsworth. Two-thirds of Ainsworth's sales are generated by the *Rachel Ray's Nutrish* brand of premium pet food while the balance contains such premium brands as *Nature's Recipe*. Ainsworth was a privately-held company that was expected to generate $800 million in sales after its first year of operation and pre-synergy EBITDA of $85 million. Annual cost synergies are expected to be $25 million the first year and $55 million after that. While the forecasted synergies are large relative to current EBITDA, they seem more reasonable than those for Big Heart given the fact that the company was smaller and privately-held prior to the deal and could conceivably have more fat to cut.

SJM has already taken write-downs to the value of its goodwill and intangibles in the last three years. We cited the company's warning of the potential impairment for its Pet Food goodwill in our 12/6/18 EQ Review of SJM. That was followed by a $107.2 million charge in the 1/19 quarter for impairment to related trademarks, as explained by the company below:

> *"We review goodwill and other indefinite-lived intangible assets at least annually on February 1 for impairment, and more often if indicators of impairment exist.*
>
> *During the third quarter of 2019, we began our annual planning cycle, inclusive of a strategy review within our strategic business areas. Our planning process was not complete as of January 31, 2019; however, we have made some decisions related to certain brands resulting in a reduction in our long-term forecasted net sales of certain indefinite-lived trademarks within the U.S. Retail Pet Foods segment, excluding the acquired Ainsworth business. As a result of the reduction in long-term forecasted net sales for these indefinite-lived trademarks and narrow differences between fair value and carrying value as of April 30, 2018, we performed an interim impairment analysis on these trademarks as of January 31, 2019, which resulted in an impairment charge of $107.2. This charge was included as a noncash charge in our Condensed Statement of Consolidated Income.*
>
> *As of January 31, 2019, we do not believe that our Pet Foods reporting unit or any of the remaining indefinite-lived trademarks within the U.S. Retail Pet Foods segment are more likely than not impaired.* ***The trademarks subject to the interim impairment analysis performed during the quarter do not represent a significant percentage of the Pet Foods reporting unit's forecasted segment profit. In addition, we anticipate growth from other brands, inclusive of the recently acquired Ainsworth business, will***

mostly offset the declines noted on the impaired trademarks evaluated during the quarter. The U.S. Retail Pet Foods segment goodwill and indefinite-lived intangible assets of $2,469.2 and $1,496.1 , respectively, remain susceptible to future impairment charges given the narrow differences between fair value and carrying value. As we continue our planning process during the fourth quarter, any significant adverse changes to the current year or forecasted net sales or profitability, as well as any significant adverse changes in strategy, would result in additional impairment charges which could be material."

The brands picked up in the Big Heart acquisition have been a disappointment from the start due to slower than expected growth in the traditional pet food segment. However, Ainsworth competes in the premium brand segment which is currently experiencing good growth. Consider management's comments below regarding 9-month results which illustrate the bifurcated trends in the Pet Food segment:

"The U.S. Retail Pet Foods segment net sales increased $525.5 in the first nine months of 2019, reflecting the $546.2 contribution from Ainsworth. Excluding Ainsworth, net sales declined $20.7, driven by unfavorable volume/mix, which reduced net sales by 1 percentage point, as declines for the Natural Balance and Gravy Train brands were partially offset by gains for the Meow Mix and Nature's Recipe brands. Segment profit increased $34.4, driven by the addition of Ainsworth. Excluding Ainsworth, segment profit decreased $24.0, as the impact of higher input costs was only partially offset by reduced marketing expense, primarily related to the Natural Balance and Nature's Recipe brands. In response to a sustained increase in input costs, we implemented a list price increase on select pet food products sold in the U.S. effective February 2019."

We still see a significant risk of write-downs from the Pet Food segment in the future. The legacy Big Heart business is hardly firing on all cylinders and remains susceptible to the market continuing to shift to premium brands. Meanwhile, competition in the premium market is increasing with the prime example being General Mills' purchase of the premium *Blue Buffalo* brand which is reportedly doing very well with consumers. Also keep in mind that the bulk of Ainsworth was represented by a single brand: *Rachel Ray's Nutrish*. Any drop in popularity there could lead to disappointment and as the company warned, the recent timeframe on the acquisition means there is little cushion between carrying value and fair value, increasing the chance of an impairment.

US Retail Coffee

US Retail Coffee is primarily made up of the company's *Folgers and Dunkin Donuts* brands acquired in 2008 and the *Café B*ustelo brand acquired in 2011. While *Folgers* has experienced a challenge from competition from premium blends, overall the division is still showing growth.

> "*The U.S. Retail Coffee segment net sales increased $16.1 in the first nine months of 2019. Favorable volume/mix contributed 3 percentage points, driven by the Dunkin' Donuts , 1850 , and Café Bustelo brands, partially offset by declines in Folgers roast and ground coffee. The favorable volume/mix was partially offset by lower net price realization, which reduced net sales by 2 percentage points, primarily driven by the Folgers brand. Segment profit increased $48.9, primarily due to lower input costs and favorable volume/mix, partially offset by an increase in marketing expense, the majority of which related to the 1850 launch, and lower net price realization."*

We are not as concerned by a material unexpected impairment related to this segment.

US Consumer Foods

Consumer Foods is represented by iconic brands such as *Jif, Carnation* and *Eagle Brand*. Sales growth remains positive in this segment, but profit growth is hit or miss as higher input costs and pricing pressure negatively impacts growth. However, given the age and relatively solid positioning of these brands, we are not as concerned about a meaningful write-down from this segment.

Debt and Cash Flow

SJM's financial picture is definitely better than KHC's as the following table shows:

	1/31/2019	01/31/2018	01/31/2017
Total Debt	$6,275.10	$4,942.50	$5,087.00
EBITDA	$1,448.40	$1,341.80	$1,511.20
Debt/EBITDA	4.3	3.7	3.4
Dividend % of Free Cash Flow	42.2%	38.7%	34.8%

Cash for Repurchases	$5.30	$425.50	$452.30
Dividend + Repo % of Free Cash Flow	42.8%	85.8%	82.2%
Cash for Acquisitions	$1,903.00	$0.00	$0.00

Forward debt/EBITDA is below 4x with a full year of the Ainsworth deal included. The dividend consumes well under 50% of free cash and the company has scaled back the buyback to focus on reducing leverage.

Summary

Given the size, uncertain future and narrow margin between fair value and carrying value, we believe there is a material risk of further write-downs from the company's pet food segment. Further deterioration in the Folgers or foods segments seem less likely but still possible, particularly if there is continued deterioration in the instant coffee market.

McCormick (MKC)

McCormick (MKC) has the second-highest goodwill and intangibles balances relative to assets of the companies we are reviewing. We also note that we currently have an EQ rating of 3- (Minor Concern).

- Approximately 70% of the company's goodwill and intangibles balances are a result of the 8/17 acquisition of RB Foods from Reckitt Benckiser.

- The difference between fair value and carrying value for the RB Foods assets is narrow owing to the fact that the deal is less than 2 years old. While this gives less room for error, we note that the *Frank's* and *French's* brands picked up in the deal appear to be performing well and we are not especially concerned with a near-term write-down at this point.

- Fair value of the remaining brand names and trademark intangibles exceeds 25% of carrying value reducing concern of a material write-down from non-RB Food assets.

What's in Goodwill and Intangibles?

The following table shows MKC's trend in goodwill and intangibles as a percentage of total assets:

	11/30/2018	11/30/2017	11/30/2016	11/30/2015	11/30/2014
Goodwill	$4,527.90	$4,490.10	$1,771.40	$1,759.30	$1,722.20
Intangibles	$2,873.30	$3,071.10	$424.90	$372.10	$330.80
Total Assets	$10,256.40	$10,385.80	$4,635.90	$4,472.60	$4,414.30
Goodwill/Intang % of Total Assets	72.2%	72.8%	47.4%	47.7%	46.5%

While the company does not give a complete itemized list of goodwill by segment, it does provide goodwill associated with some of its key brands which include:

Goodwill by Segment	
RB Foods	$2,320.00
Zatarain's	$106.40
Lawry's	$48.00
Kamis	$33.20
Stubb's	$27.1

Clearly, the 8/17 acquisition of RB Foods from Reckitt Benckiser generated the bulk of the company's goodwill and intangibles balances. The RB Foods brands include *French's*, *Frank's RedHot,* and *Cattlemen's*. Sales adjusted for currency grew by 2% in the quarter, but the company blamed inventory destocking by customers for the weak results and pointed to a 5% increase in end consumption of its products in the period with the *French's* and *Frank's* brands accelerating throughout the year. This reduces the concern that the RB Foods assets are in danger of a write-down near-term.

The company stated in its 10-K with regards to its goodwill balances:

> *"An impairment charge would be recognized to the extent the carrying amount of goodwill exceeds the implied fair value. As of November 30, 2018, we had $4,527.9 million of goodwill recorded in our balance sheet ($3,398.9 million in the consumer segment and $1,129.0 million in the flavor solutions segment).* ***Our fiscal year 2018 testing indicated that the estimated fair values of our reporting units were significantly in excess of their carrying values. Accordingly, we believe that only significant changes in the cash flow assumptions would result in an impairment of goodwill."***

The company's intangibles balances consist mostly of trademarks and brand names;

> *"As of November 30, 2018, we had $2,646.9 million of brand name assets and trademarks recorded in our balance sheet, and none of the balances exceeded their estimated fair values at that date.* ***Excluding the brand names associated with the 2017 RB Foods acquisition, and those brand names discussed below, the percentage excess of estimated fair value over book values for our major brand names and trademarks was 25% or more as of November 30, 2018."***

The brand names picked up in the RB Foods deals have a much more narrow gap between fair value and carrying value due to the recent timing of the deal. As noted above, these

brands appear to be performing well which minimizes our concern of the likelihood of a write-down in the near future.

MKC has taken a string of restructuring charges in the past, as seen in the following table:

	11/30/2018	11/30/2017	11/30/2016	11/30/2015
Sales	$5,408.90	$4,834.10	$4,411.50	$4,296.30
Adjusted Gross Margin	43.8%	42.0%	0.0%	0.0%
Adjusted Operating Margin	17.4%	16.3%	14.9%	14.3%
Restructuring Charges	$38.80	$99.30	$16.00	$65.50
Restructuring Charges % of Op Profit	4.1%	12.6%	2.4%	10.7%

In 2018, $16.3 million related to completion of cost-reduction initiatives with $22.5 million related to integration costs for the RB Foods deal. Likewise, $77.1 million of the $99.3 million in charges were integration-related. According to the 10-K, these integration costs

> *"primarily consisted of outside advisory, service and consulting costs; employee-related costs; and other costs related to the acquisition. In 2017, these expenses consisted of amortization of the acquisition-date fair value adjustment of inventories of $20.9 million that was included in cost of goods sold; outside advisory, service and consulting costs; employee-related costs; and other costs related to the acquisition, including the costs related to the bridge financing commitment of $15.4 million that was included in other debt costs."*

Given the size of the deal, the makeup and size of these costs seem reasonable. Also, the higher margins of the acquired business have driven charge-adjusted margins upwards. We do not currently see hidden signs of problems with the profitability of the RB Foods brands that threaten a write-down in the near-term.

Debt and Cash Flow

MKC's debt to EBITDA at the end of 2018 was over 4x due to the RB Foods deal. Management has a goal of reducing it to under 3x by 2020.

	11/30/2018	11/30/2017	11/30/2016	11/30/2015
Total Debt	$4,696.40	$5,027.10	$1,447.20	$1,394.40
Adjusted EBITDA	$1,158.70	$967.00	$826.10	$769.90
Debt/EBITDA	4.1	5.2	1.8	1.8
Dividend % of Free Cash Flow	41.9%	37.5%	43.2%	44.4%
Cash for Repurchases	$62.30	$137.80	$242.70	$145.80
Dividend + Repo % of Free Cash Flow	51.5%	59.3%	91.3%	76.0%
Cash for Acquisitions	$4.20	$4,327.40	$120.60	$210.90

The dividend consumes just over 40% of free cash and the buyback has been suspended, so the debt reduction goals seem plausible. Regardless, the high debt level does increase the risk profile. If the slowdown in growth was due to temporary inventory destocking issues, then we should see growth return in the next couple of quarters. However, continue disappointing top-line growth or expansion of restructuring activity should be viewed with concern especially given the high debt.

ConAgra Brands (CAG)

CAG's goodwill and intangibles balances amounted to 71% of total assets at the end of the most recent quarter. We currently have a NEUTRAL rating on CAG with a key point of the story being the unrealistic expectations surrounding the company's acquisition of Pinnacle Foods which accounts for the bulk of the company's goodwill and intangibles. Note that we initiated coverage of CAG with a SELL on 8/9/2018 and upgraded it to NEUTRAL after the sharp drop after the most recent quarter.

CAG is no stranger to the impairment charge. The company took $1.92 billion, $1.56 billion and $596.2 million in impairment charges in 2016, 2015 and 2014, respectively. Much of this was related to the company's ill-fated Ralcorp deal which took all of two years to completely implode.

Risks

- The bulk of goodwill and intangibles is the result of the recent Pinnacle Foods deal. We refer clients to our 8/18 report for more detail where we examined the deal in detail

- The Pinnacle deal was based on CAG boosting margins by 700 bps through aggressive cost-cutting and synergies. However, Pinnacle was itself a roll-up that did extensive restructurings of its acquired companies and boosted margins as much as 1000 bps in some cases. How much room is left for CAG to improve? We believe there is a very real risk of an eventual material write-down emanating from this area.

- CAG paid more for Pinnacle than Pinnacle paid for the companies it acquired.

- CAG regularly takes charges to the remaining portions of its goodwill. Growth remains anemic in most segments which leaves open the possibility of a material negative surprise emerging.

- Debt is over 5x EBITDA. The company has plans to reduce that to 3.5x by 2021, which requires $2.7 billion with assumed Pinnacle synergies but $3.5 billion without.

-

What's in Goodwill and Intangibles?

	11/25/2018	11/25/2017	11/25/2016	11/25/2015	11/25/2014
Goodwill	$11,167.20	$4,457.00	$4,248.70	$4,685.50	$7,616.80
Intangibles	$5,132.20	$1,298.20	$1,260.90	$1,383.90	$3,114.90
Total Assets	$23,006.80	$10,400.10	$11,425.00	$15,994.60	$19,501.70
Goodwill/Intang % of Total Assets	70.8%	55.3%	48.2%	37.9%	55.0%

The company offers the following breakdown of its goodwill balance:

Goodwill by Segment	
Pinnacle Foods	$6,667.70
Grocery & Snack	$2,594.30
Refrigerated & Frozen	$1,095.20
Foodservice	$571.00
International	$238.90
Total	$11,167.10

We can see that over half of goodwill originated with the Pinnacle deal. While the company does not break out intangibles by segment, the large jump in 2018 indicates that about 75% of intangibles also originated with Pinnacle.

Pinnacle

The Pinnacle goodwill and intangibles balances have all the red flags we would look for pointing to a likely eventual write-down of goodwill. CAG has forecast enormous margin improvements related to cost-cutting and synergies through integrating Pinnacle. However, Pinnacle itself is roll-up play consisting of several companies it acquired in its own acquisition string. Along the way, it had already boosted the operating margins materially at is acquired operations. Margins at some of its acquired companies were in the low teens at the time of acquisition before Pinnacle quickly boosted them to the 20% range. Major restructurings were undertaken including relocating R&D facilities, consolidation of manufacturing and the closing of redundant plants. We believe much of the inefficiency has

already been squeezed out of these companies by Pinnacle, making further improvement by CAG difficult.

Also, CAG paid 15.8 times EBITDA for Pinnacle which is higher than what Pinnacle paid for many of the companies it acquired, offering further evidence that CAG overpaid for the deal. Meanwhile, volume growth at some of Pinnacle's key brands such as frozen foods was non-existent prior to the acquisition by CAG. We encourage clients to review our previous work on CAG for more detail on these items.

As a result of the above issues, we believe there is a significant risk that CAG will ultimately have to incur material impairment charges on the goodwill and/or intangible balances associated with the Pinnacle acquisition.

Grocery & Snack

CAG's grocery and snack brands include *Marie Callender's, Reddi-Whip, Hunt's, Healthy Choice, Slim Jim* and *Orville Redenbacher's*. These brands have been in the company's stable for many years along with other smaller brands picked up in various acquisitions. The company seems to regularly take small to medium sized charges to its portfolio of brand assets. In fiscal 2017 (ended May), the company took $343 million in charges spread among its international and grocery segments. 2016 saw $50 million in impairment charges related to its *Chef Boyardee* brands. In 2015, the company took another $20.9 million in charges against the remaining portion of its Private Label brands held in snack foods along with $4.8 million for its *Poppycock* brand. We don't see growth reigniting at in any of these old brands which means we have likely not seen the last of the charges from this division. There is also the risk that like KHC, the company will have to finally make assumptions that could lead to one-large impairment write-down, but it is difficult to assess the level of risk with the information we have.

Debt and Cash Flow

CAG is currently levered at 5.1 times EBITDA based on forecasted numbers. Management plans to reduce leverage to 3.5 times by fiscal 2021. However, as we pointed out in our original warning, this will require the company to pay down $2.7 billion in debt and it will only be generating $500-$700 million in free cash flow after the dividend. In that time, the

company will also have to spend about $350 million to produce its hoped-for synergies. Finally, the $2.7 billion debt paydown assumes the company realizes the margin expansion assumptions which we believe are very aggressive. For perspective, the paydown jumps to $3.5 billion without the synergies. Therefore, any significant disappointment surrounding future cash flows at acquired companies, particularly Pinnacle, would have a significant negative impact on the company's future leverage position.

Church & Dwight (CHD)

CHD's goodwill and intangibles balances represent over 70% of its total assets at year-end. We remind clients that we currently have an EQ rating of 2+ (Weak) on CHD which reflects our concern about the lack of visibility into the company's receivables factoring program, recent increases in inventory and its recent switch to FIFO inventory accounting for the 20% of inventories previously accounted for under LIFO.

Risks

- We estimate that approximately $420 million in goodwill and $800 million in intangibles are the result of last year's acquisitions of the *Waterpik* assets. This area is currently growing, unlike many of the stagnant food brands discussed elsewhere.

- We estimate that approximately $350 million in goodwill and a similar amount of intangibles resulted from the 2012 acquisition of Avid Health, a maker of gummy vitamins. This area has struggled to grow as competition has increased in recent years. The company specifically warned in 2017 that fair value for these assets was falling near carrying value, but this has reversed in 2018. For perspective, cutting the value of these assets in half would represent about 5% of total assets. Management seems to have taken action to revive growth which has been successful so far, but this area seems the most likely to produce a material write-down in the foreseeable future and should be watched closely going forward.

- Unlike many big brand companies, CHD does not have a recent history of taking regular write-downs to its goodwill and intangibles.

What's in Goodwill and Intangibles?

The following table shows the balances and their percentage of total assets for the last five years:

	12/31/2018	12/31/2017	12/31/2016	12/31/2015	12/31/2014
Goodwill	$1,992.90	$1,958.90	$1,444.10	$1,354.90	$1,325.00
Intangibles	$2,274.00	$2,320.50	$1,431.80	$1,269.50	$1,272.40
Total Assets	$6,069.20	$6,014.80	$4,354.10	$4,256.90	$4,359.20
Goodwill/Intang % of Total Assets	70.3%	71.1%	66.1%	61.7%	59.6%

In addition, the company provides the following breakout of goodwill by segment:

Goodwill by Segment	
Consumer Domestic	$1,633.20
Consumer International	$223.70
Specialty Products	$136.00
	$1,992.90

Unlike recent acquisitions at some other big brand companies, CHD's recent deals have included picking up more specialized products in potentially higher growth areas than its core baking soda business. From looking at previous 10-Ks, we were able to piece together that of the $1.8 billion in goodwill in the consumer segments, over $420 million was from last year's acquisition of *Waterpik* with about $800 million in intangibles picked up in the deal. The 2012 acquisition of Avid Health, a maker of children's gummy vitamins added about $345 million in goodwill and a similar amount in intangibles. As we will see below, these assets are more than capable of disappointing. However, they are at least not a #3 brand in a commodity food market segment competing for evaporating supermarket shelf space.

CHD also does not have a history of taking large goodwill write-offs and excessive restructuring charges. The company discloses the following in its 10-K regarding the carrying value of its goodwill and intangibles:

> *"We determined that the fair value of all other intangible assets for each of the years in the three-year period ended December 31, 2018 exceeded their respective carrying values based upon the forecasted cash flows and profitability.* ***In 2017 there was a personal care trade name that, based on recent performance, had experienced sales and profit declines that had eroded a significant portion of the excess between fair and carrying value, which could potentially result in an impairment of the asset. In 2017, this excess had been reduced due in large part to an increased competitive***

> ***market environment therefore resulting in reduced cash flow projections. The performance of the tradename improved in 2018, thereby increasing the excess between fair value and carrying value. This indefinite-lived intangible asset could still be susceptible to impairment risk.*** *While management can and has implemented strategies to address the risk, significant changes in operating plans or adverse changes in the future could reduce the underlying cash flows used to estimate fair values and could result in a decline in fair value that could trigger future impairment charges of this asset."*

The personal care asset the company is referring to is likely it gummy vitamin brands. Consider the following comment the company made in its 10-K regarding the space:

> *"In addition, the gummy vitamin category has grown from eight competitors to 30 in the last five years. We continue to evaluate and vigorously combat these pressures through, among other things, new product introductions and increased marketing and trade spending. However, there is no assurance the categories will not decline in the future and that we will be able to offset any such decline."*

Clearly gummy vitamins is a particular area of challenge for CHD and it is taking steps to remain competitive in the space. As noted above, much of the company's gummy vitamin presence was a result of the 2012 Avid Health deal which we estimate added about $700 million in combined goodwill and intangibles. This portion of the company's acquired assets seem to be the most vulnerable to a near-term write-down should the company be unable to mount a sustained comeback in this segment. To put this in perspective, cutting the value of the associated goodwill and intangibles in half would result in an approximate $350 million charge which represents a little over 5% of total assets. Given that the company seems to have staged a recovery in the assets for now, we view this as a relatively low risk at the moment, but warrants scrutiny in the future.

Debt and Cash Flow

Of the four companies we reviewed, CHD has the least concern with regards to debt. The company had very low leverage prior to the *Waterpik* acquisition in 2017 which only raised its debt to EBITDA to 2.8x. As if the end of 2018, debt to EBITDA is already down to 2.3x and the company has adequate free cash to cover the dividend and still make significant debt repayments.

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.

Disclosure

BTN Research is a research publication structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. Information included in this report is derived from many sources believed to be reliable (including SEC filings and other public records), but no representation is made that it is accurate or complete, or that errors, if discovered, will be corrected.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.