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BTN Research

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

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The Hershey Company (HSY) EQ Review Update-9/18 Quarter

Current EQ Rating*	Previous EQ Rating
4-	4+

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

We are lowering our rating on The Hershey Company (HSY) to 4- (Acceptable)

- Accounts receivable DSOs jumped 2.5 days over the year-ago quarter. The third quarter typically sees the highest level of receivables for the year and the current level is not especially alarming when compared to 2016 and 2015 levels. Regardless, this warrants closer attention in the next quarter.

- Inventory DSIs continue to plummet as the company contends it can meet customer demand with lower inventory balances. As we noted in our previous review, the company utilizes LIFO for 60% of its inventories, but given the continued decline in spot prices for its major raw materials prices and lack of recent pricing pressure, we are yet to be concerned about a "LIFO liquidation."

- HSY has cited significant cuts to overall advertising levels despite increased spending for its core brands. In our experience, this seldom ends well for packaged goods companies.

Receivables Continue to Increase

In our review of HSY's second quarter, we highlighted a 3.2-day increase in accounts receivable days of sales (DSO) in the 6/18 quarter. However, we concluded that the size of the increase was largely due to an unusually low level of receivables in the year-ago quarter from the timing of seasonal sales. However, DSOs in the 9/18 quarter registered another 2.5-day year-over-year increase.

	9/30/2018	7/01/2018	4/01/2018	12/31/2017
Sales	$2,080	$1,752	$1,972	$1,940
Accounts Receivable	$815	$502	$614	$588
Sales YOY growth	2.3%	5.3%	4.9%	-1.6%
Accounts Receivable YOY growth	9.7%	20.2%	3.1%	1.2%
Accounts Receivable DSOs	35.8	26.1	28.4	27.7

	10/01/2017	7/02/2017	4/02/2017	12/31/2016
Sales	$2,033	$1,663	$1,880	$1,970
Accounts Receivable	$743	$417	$596	$581
Sales YOY growth	1.5%	1.5%	2.8%	3.2%
Accounts Receivable YOY growth	-2.2%	-13.7%	9.5%	-3.0%
Accounts Receivable DSOs	33.3	22.9	28.9	26.9

Management mentioned in the second quarter commentary that the receivables increase was due to the Amplify acquisition. However, we expressed skepticism that Amplify could have had a significant impact on our DSO calculation given its timing. Management offered no explanation for the receivables increase in the 9/18 quarter in either the conference call or the 10-Q. We observe that the third quarter typically has the highest DSO level of the year due to the timing of sales ahead of the key holiday season. While the 9/18 level of 35.8 is ahead of last year's 33.3, it is not materially ahead of the 34.6 and 35.4 registered in the 9/16 and 9/15 quarters, respectively. Therefore, we are still not concerned with the company's level of receivables.

Inventory Continues to Decline

HSY's inventory continues to decline, as shown in the following table:

	9/30/2018	7/01/2018	4/01/2018	12/31/2017
COGS	$1,216	$958	$998	$1,111
Inventory	$881	$916	$782	$753
COGS YOY growth	11.5%	6.8%	2.8%	-9.6%
Inventory YOY growth	-6.1%	-2.1%	-1.6%	1.0%
Inventory DSIs	***66.1***	***87.3***	***71.5***	***61.9***

	10/01/2017	7/02/2017	4/02/2017	12/31/2016
COGS	$1,090	$897	$970	$1,228
Inventory	$938	$936	$795	$746
COGS YOY growth	-5.4%	0.8%	-4.1%	16.4%
Inventory YOY growth	11.2%	7.5%	3.2%	-0.7%
Inventory DSIs	***78.5***	***95.2***	***74.8***	***55.4***

As with the previous quarter, the decline is more centered in raw materials which implies a slowdown in production of new inventory:

	9/30/2018	7/01/2018	4/01/2018	12/31/2017
Raw Materials % of inventory	23.0%	24.6%	27.0%	24.1%
Goods in Process % of inventory	10.3%	12.7%	13.2%	10.0%
Finished Goods % of inventory	66.7%	62.8%	59.8%	65.9%
Adjustments to LIFO as % of Total FIFO	16.2%	15.6%	17.8%	19.4%

	10/01/2017	7/02/2017	4/02/2017	12/31/2016
Raw Materials % of inventory	26.2%	27.1%	30.6%	33.8%
Goods in Process % of inventory	9.1%	11.0%	11.8%	9.5%
Finished Goods % of inventory	64.7%	61.8%	57.6%	56.7%
Adjustments to LIFO as % of Total FIFO	16.2%	16.3%	18.6%	20.0%

Management noted in the 10-Q filing for the 9/18 quarter that it is purposefully drawing down inventory:

> *"This $43 million fluctuation [in working capital] was mainly due to lower investments in inventory resulting from* ***lower year-over-year build up on inventories to maintain sufficient levels to accommodate customer requirements."***

As we discussed in the last review on HSY, the company utilizes the LIFO (last-in, first-out) method of accounting for about 60% of its inventories and that investors should be alert when a company utilizing LIFO draws down inventory. The concern is that older, lower cost inventory is being matched against current sales on the income statement. Given that the company is not seeing rampant inflation in its raw materials costs and has not been

increasing prices on its products, we were less concerned in our review of the second quarter that a LIFO liquidation was occurring. A company must be experiencing rising raw materials costs and increasing its prices in order to benefit which has not been the case for HSY. In the few weeks since our second quarter review, spot prices for HSY's key raw materials have continued to decline. The company also stated in the conference call that its price realization on its products has been roughly flat after adjusting out increasing promotional spend. It is also planning on starting to raise prices on products which will begin to take effect in January. At this point, the only risk we see to HSY is a sudden spike in its raw materials costs that left it vulnerable to having to replenish inventories at significantly higher prices.

The aforementioned decline in raw materials prices led to increases in mark-to-market losses in the quarter as seen in the following table.

	9/30/2018	7/01/2018	4/01/2018	12/31/2017
Net (Gains)/Losses on mark-to-market- (In COGS)	$71.088	-$0.183	-$66.590	$15.234
Net Losses Reclassified from unallocated to segment income	$23.471	$20.648	$29.660	$23.040
Unallocated (Gains)/Losses to Adjust Segment to Reported Income	$47.617	-$20.831	-$96.250	-$7.806
Cumulative (Gains)/Losses Recognized in COGS but unallocated	$58.482	$10.865	$31.696	$127.946
(Gains)/Losses Expected to Be Reclassified to Segment over 12 Months	$25.418	$41.445	$77.411	$94.449

	10/01/2017	7/02/2017	4/02/2017	12/31/2016
Net (Gains)/Losses on mark-to-market- (In COGS)	$2.445	$32.519	$5.536	$134.577
Net Losses Reclassified from unallocated to segment income	$24.399	$20.963	$22.624	$2.190
Unallocated (Gains)/Losses to Adjust Segment to Reported Income	-$21.954	$11.556	-$17.088	$132.387
Cumulative (Gains)/Losses Recognized in COGS but unallocated	$135.538	$157.492	$145.937	$0.000
(Gains)/Losses Expected to Be Reclassified to Segment over 12 Months	$93.814	$91.119	$88.675	$0.000

We showed this table in the previous review of HSY and explained that HSY records mark-to-market gains and losses in cost of sales when they occur, but only includes the impact of gains and losses related to products sold in the period in its adjusted profit figures. This amount is shown on the "Net Losses Reclassified from Unallocated to Segment Income" line. We also see that while the cumulative losses expected to be recognized in segment results over the next 12 months continues to decline which could result in a benefit to adjusted profits in upcoming periods.

Reduction in Advertising

We note that the company is reducing its overall advertising spend. Total advertising and consumer-related spending declined by 10% in the quarter with the decline in North America particularly sharp:

> *"North America advertising-related consumer marketing spend declined 18.5% in the quarter. I want to spend a couple of minutes providing some important details and context here. Media spend for our strategic scale brands was in line with prior year for the quarter. We are leveraging analytic tools to improve effectiveness of this spend to get more reach and impressions for the same amount of dollars. So far this year, we have achieved double-digit ROI increases in four of our top five brands. We are also focused on expanding our reach through earned media by having authentic and appropriate content in the right channels.*
>
> *Our Heartwarming campaign is a great example of this. As we work through new models, we are also taking advantage of cost savings in agency and production fees, as we leverage the appropriate production for different channels. An example of this is the creation of our own in-house production studio that went live earlier this year. This is enabling us not only to take advantage of our great employee creativity, but also to be faster and more cost effective. We have also continued to right-size our investments in our smaller, emerging brands in line with our previously-stated strategy. We remain committed to supporting our portfolio and will continue to invest at levels significantly above industry average."*

Our history with consumer packaged goods companies is that advertising cuts, no matter how focused and efficient, eventually result in a rebound to salvage volume growth.

Explanation of EQ Rating Scale

Rating	Explanation
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

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