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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

Hershey (HSY) EQ Update- 12/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3-	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 maintaining our EQ rating of 3- (Minor Concern).

- Total pension expense was 8 cps lower in the 12/19 quarter driven by the absence of a $13 million settlement loss in the year-ago quarter. Management addressed this in the conference call, stating "'In the fourth quarter other expense was $34 million, a decrease of $5.1 million versus the year ago period, driven by non-service related pension expense." This statement could leave observers with the impression that the benefit was less than $5 million when, in fact, it was over twice that large and other expense would have increased without it. HSY does adjust out pension settlement charges related to employees leaving under a voluntary separation plan in its non-GAAP results, but those amounted to only $100,000 and $1.4 million in 12/19 and 12/18, respectively. Clearly, the company's 4 cps earnings beat becomes a similar-sized miss when taking the unusual swing in pension expense into account.

- HSY recorded a $113 million intangible asset impairment in the 12/19 quarter related to its 2015 Krave acquisition. Impairment charges have become a way

of life at HSY with charges totaling $113 million, $58 million, $209 million, $4 million and $280 million in each of the last five years, respectively.

- HSY's organic, FX-adjusted revenue growth was 1.9% in the 12/19 quarter. However, this was the result of 3.6% from higher prices offsetting a 1.7% volume decline. The company's two geographic segments, are a tale of two different markets. North America/Canada (88% of revenue) saw higher prices contributing 4% to growth with volume declines draining 2.7%. It took a 5.1% increase in advertising to generate this organic growth. International (12% of revenue) saw a 5.7% increase in volume with a mode modest 0.6% increase in prices. HSY expects this to continue in 2020 with gross margin benefitting from the higher prices yet being pressured by rising raw materials costs. Advertising is expected to continue to grow slightly more than sales.

- Pre-Covid forecasts called for free cash flow to experience will experience a large headwind as accelerating ERP investments are expected to drive capex to $475 million to $525 million in 2020, but from $318 million in 2019.

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 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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