BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

May 16, 2019 | www.btnresearch.com

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

The Hershey Company (HSY) EQ Update-3/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3-	4-

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

We lower our earnings quality rating to 3- (Minor Concern) from 4- (Acceptable)

HSY reported adjusted EPS of $1.59, beating the consensus EPS targets by 12 cps. Margins benefitted from lower raw materials costs, increased efficiencies and price increases. However, a few minor red flags appeared in the 3/19 quarter that prompt us to lower our rating.

- Accounts receivables days of sales (DSO) jumped by 3 days compared to the year-ago quarter. The company noted in the 10-Q that this was due to more sales falling in the last 15 days of the quarter compared to last year. This was driven by Easter falling in the second half of April in 2019 versus April 1 in 2018. Therefore, sales to retailers stocking up for the Easter holiday were pulled forward into March this year, and the company did not have time to collect the associated receivables before the end of the quarter. Higher DSOs in the first quarter of a year with a later Easter is not unusual for the company. We would expect to see weaker sales growth in the 6/19 quarter and a YOY decline in DSOs as the first quarter receivables should be collected early in the 6/19 quarter.

- HSY noted that SG&A expense benefited from a 0.8% reduction in advertising spend. However, accrued advertising, promotional and product allowance expense spiked by more than 2 days of sales in the 3/19 quarter after a string of absolute declines. Lower advertising spend has been a trend the company has noted in previous quarters. However, price realization in its international business declined by 0.8% which the company attributed to higher promotional spending, which is booked as a reduction to sales rather than an expense in SG&A. The promotional spending accrual may have been boosted some by the late Easter impact similar to what we saw with receivables as cash for coupons and rebates would not have been spent until April while the estimated expense would have been accrued in March. Nevertheless, we remain concerned that it will be difficult for HSY to maintain any net benefit from cutting advertising without negatively impacting volumes.

- The company discloses an "other" accrued current liability account in the footnotes of its financial statements. After several quarters of gradual increases, the account fell $54 million sequentially in the 3/19 quarter. We can only trace about $14 million of the decline to potential drivers such as derivative liabilities or cash restructuring payments. Such a marked decline in an accrued liability account is always a red flag as it can indicate the current results are artificially benefitting from the under-accrual of future cash expenses. Given the uncertain nature of the movement in the account, we are not assigning a high degree of concern to it, but trends should be monitored going forward.

DSOs Up 3 Days

Accounts receivable days of sales (DSO) jumped three days over the year-ago period as shown in the following table:

	3/31/2019	12/31/2018	9/30/2018	7/01/2018
Sales	$2,016	$1,988	$2,080	$1,752
Accounts Receivable	$694	$594	$815	$502
Accounts Receivable DSOs	31.4	27.3	35.8	26.1

	4/01/2018	12/31/2017	10/01/2017	7/02/2017
Sales	$1,972	$1,940	$2,033	$1,663
Accounts Receivable	$614	$588	$743	$417
Accounts Receivable DSOs	28.4	27.7	33.3	22.9

In the 10-Q, management attributed this to US sales being "measurably higher in the last 15 days for the first quarter of 2019 versus the first quarter of 2018." The reason for the concentration of sales late in the first quarter was due to Easter falling in the second half of April in 2019 versus April 1 in 2018. This is not an unusual trend for HSY to see a later Easter result in higher DSOs in the first quarter as receivables generated from the later sales have not been collected by the end of the period. This should be followed by both weaker sales growth and lower DSOs in the 6/19 quarter as the receivables generated late in the first quarter are collected.

Jump in Accrued Advertising and Promotion

The following table shows HSY's accrued advertising, promotional and product allowance expense for the last eight quarters:

	3/31/2019	12/31/2018	9/30/2018	7/01/2018
Accrued Advert., Promo, and Product Allowances	$345.642	$293.645	$294.638	$257.228
Sales	$2,016.488	$1,987.902	$2,079.593	$1,751.615
Days of Sales	15.6	13.5	12.9	13.4

	4/01/2018	12/31/2017	10/01/2017	7/02/2017
Accrued Advert., Promo, and Product Allowances	$285.970	$305.107	$320.788	$280.645
Sales	$1,971.959	$1,939.636	$2,033.121	$1,662.991
Days of Sales	13.2	14.4	14.4	15.4

HSY has been spending less on advertising for the last few quarters and noted in the 3/19 10-Q that "total advertising and related consumer marketing expense declined by 0.8% due mainly to spend optimization and shifts relating to our emerging brands.". However, while advertising is expensed as incurred in the SG&A line, promotional spending (coupons, rebates, etc.) is recorded as a reduction in sales. The company noted in its discussion of international results that price realization was a negative 0.8% which is blamed on increased levels of trade promotional spending. There was no reference to promotional spending in the discussion of North American results. We can see the impact of the increasing promotional activity in the spike in accrued advertising and product allowances account. The promotional spending accrual may have been boosted some by the late Easter impact similar to what we saw with receivables as cash for coupons and rebates would not have been spent until April while the estimated expense would have been accrued in March. Nevertheless, the increase in promotional spending in the international segment is a reminder that it is very difficult for a consumer products company to cut all forms of advertising and promotion without negatively impacting volumes.

Fall in Other Accrued Liabilities

HSY discloses an "other" accrued current liability account in its supplemental balance sheet disclosure in the footnotes of its 10-Qs. The following table tracks the account balance for the last six quarters which is far back as the company reports it.

	3/31/2019	12/31/2018	9/30/2018	7/01/2018	4/01/2018	12/31/2017
Other Current Accrued Liabilities	$150.125	$204.379	$204.350	$185.647	$182.264	$180.164

We note the account dropped off suddenly in the 3/19 quarter after a fairly consistent trend of increases.

There was an approximate $9 million sequential decline in derivative liabilities in the 3/19 quarter, but this would have accounted for only a portion of the observed decline. Likewise, the company made only $5.6 million in cash payments from the restructuring liability account associated with its Margin for Growth program during the 3/19 quarter. Assuming that both of these declines were centered in the other liabilities account, it still leaves about $40 million of the sequential decline unaccounted for. Such a sharp decline in an accrued liability account is a red flag as it could indicate the company has under-accrued for expenses that should have been charged in the current period. Given the uncertain nature of the movement in the account, we do not sign a high degree of concern, but trends in this account should be monitored going forward.

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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