BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Hershey (HSY) EQ Update-6/19 Qtr.

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 at 3- (Minor Concern) noting a one-time boost to margins from an inventory buildup.

- Inventory days (DSI) jumped by more than 10 days over the year-ago quarter. The company made the following comment about increased inventory levels during the call:

  "Second, we increased internal inventory levels to support more demand from our retailers in the coming weeks as we transitioned to the new prices, which resulted in favorable fixed cost absorption."

  The company raised prices in the summer of 2018 and recently announced a new wave of price increases. Customers have accelerated their purchases ahead of these increases taking effect which resulted in increased production. The increased production increases efficiency and lowers per-unit cost. With the company utilizing the LIFO (Last-in, first-out) method of inventory accounting for the majority of its US inventories (about 60% of total inventories), these lower-cost units are expensed first, which provided a temporary boost to gross margin in the quarter.

- After adjusting for mark-to-market gains on derivative contracts not designated as hedges, gross margin rose by 200 bps. About 90 bps was due to the above-mentioned inventory buildup as well as sales mix. The remainder was due to better commodity costs and price increases. However, management noted that it expects this to reverse in the second half, saying in the conference call "about 90 basis points of our gross margin expansion in the second quarter can be attributed to these two factors**, and is expected to be offset in the second half, primarily Q3 as the internal and external inventory levels normalize."** It remains to be seen if the company's sell-through is impacted by rising prices at a time when the company's main commodity costs are roughly flat with last year.

- Advertising expense is rising and will pressure margins in the second half as last year's media efficiencies are lapped and the company's boosts support of its brands in conjunction with price increases. However, this was partially offset by higher interest income related to an international local tax settlement.

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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