BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Conagra (CAG)-EQ Review

Our review of CAG's recent results revealed a few items of concern. While overall earnings quality is reasonable, we worry that the company's ongoing reshuffling of brands is not creating much in the way of value for shareholders.

- Cash flow growth is essentially flat and will likely remain so for the foreseeable future.
- The shortfall of cash flow after the dividend and the buyback has exceeded $500 million in each of the last two years.
- CAG has significantly increased its usage of third-party financing for suppliers which has allowed it to boost cash flow growth by stretching the time it takes to pay suppliers. Payables days rose by 7 days and ten days in the 5/18 and 2/18 quarters, respectively.

- Pension income should fall about $50 million in FY 2019. While the company has discussed this openly, it nonetheless represents a headwind for results in the next twelve months.

- Advertising and promotion expense fell significantly in FY 2018. The risk remains that market share loss could lead to higher than expected spending in this area.

- CAG's history of its failed Ralston deal and long string of goodwill and intangible impairment charges make us skeptical that its ongoing acquisition and divestiture of brands will create any meaningful return for shareholders. While we have not done a full analysis of the Pinnacle Foods deal, on the surface it seems to us there is a high likelihood of ultimate disappointment.

Cash Flow Negative After Buyback

CAG's operating cash flow for the year ended 5/18 was essentially flat after adjustment for $150 million in incremental pension contributions during the year. Tax reform also provided a $46 million tailwind. While the company pays out only 51% of free cash flow in dividends, its stock buyback resulted in a significant free cash shortfall after dividend and buyback, as seen in the following table:

	5/27/2018	5/28/2017	5/29/2016
T12 Operating Cash Flow	$920	$1,141	$626
T12 Capex	$252	$242	$278
T12 Free Cash Flow	$668	$899	$348
T12 Dividends*	$342	$415	$433
Dividend % of FCF	51%	46%	124%
T12 Stock Repurchases	$967	$1,000	$0
Cash After Buyback	-$642	-$516	-$85

*Note that the decline in cash dividend spend is related to the 11/16 Lamb Weston spin-off and to a lesser extent, the stock buyback

Cash from operations will receive a significant boost next year as the $312.6 million pension contribution will fall to $19 million. However, some of this increase will be swallowed up by an expected $98 million in increase in capital spending ($350 million expected versus $252 million in 2018). Therefore, free cash flow growth should have a tailwind of about $200 million in 2019. However, a comparable buyback spend will still more than eat up post-

dividend free cash flow. The upcoming Pinnacle foods acquisition will obviously change the optics on this, but clearly core cash flow growth cannot support the dividend and buyback indefinitely at the current rate.

Account Payables DSPs Up

CAG is among the many food companies that has been stretching its payables to boost cash flow. The below table shows accounts payable days (DSP) for the last eight quarters:

	5/27/2018	2/25/2018	11/26/2017	8/27/2017
Accounts Payable DSPs	60.0	56.9	53.4	60.0

	5/28/2017	2/26/2017	11/27/2016	8/28/2016
Accounts Payable DSPs	52.9	46.3	49.7	67.1

CAG discusses in its 10-K how it utilizes agreements with third-party finance companies to allows its suppliers to finance amounts due from the company:

> *"We offer certain suppliers access to a third-party service that allows them to view our scheduled payments online.* ***The third-party service also allows suppliers to finance advances on our scheduled payments at the sole discretion of the supplier and the third-party.*** *We have no economic interest in these financing arrangements and no direct relationship with the suppliers, the third-party, or any financial institutions concerning this service. All of our accounts payable remain as obligations to our suppliers as stated in our supplier agreements. As of May 27, 2018, $103.1 million of our total accounts payable is payable to suppliers who utilize this third-party service."*

CAG discloses the amount its account payables that are utilizing third-party arrangements by quarter, which is shown in the following table:

	5/27/2018	2/25/2018	11/26/2017	8/27/2017	5/28/2017	2/26/2017
Accounts payable	$915	$870	$887	$846	$773	$690
Utilizing third-party financing	$103	$81	$69	$59	$25	$12
% of total payables	11.3%	9.3%	7.7%	7.0%	3.2%	1.7%

Just seven quarters ago, none of the company's payables were utilizing third-party financing, but that has already risen to over 11% in the most recent quarter. Concurrently, CAG's DSPs began to increase on a year-over-year basis in the 11/17 quarter. CAG's DSP rose by over ten days in the 2/18 quarter and 7 days in the 5/18 quarter. These increases were similar in size to shat we have seen from the other packaged good companies in the same time period. It has also been a huge boost to growth in cash flow from operations, adding well over $100 million to cash flow growth for the year. Money is pouring into companies that finance the purchase of these invoices from suppliers. However, rising rates will make these arrangements less and less attractive for some of these smaller suppliers. While this trend of stretching payables may have some legs left, we doubt that it can continue to benefit cash flows at its current pace for very long, at which point a key growth driver for cash flow will be gone.

Pension Benefit Will Subside

CAG recognized a pension benefit of $56.1 million in fiscal 2018 and a $21.4 million benefit in 2017. The increase in pension benefit was a result of a lower settlement loss, lower service cost and higher expected return on plan assets. However, the company also amended its plan during fiscal 2018 to stop accruing benefits for salaried and non-qualified employees as of 1/1/18. In conjunction with this, the company shifted plan assets from equities to fixed income to effectively move to more of a liability matching strategy. Expected return on plan assets will drop, as will its pension income. At this point, the company is expecting pension income to decline by $46 million in 2019. The company has spelled this out well and it should not come as a surprise to investors.

Advertising and Promotion Declining

Like many packaged food and consumer goods companies, CAG has cut its advertising spend in an attempt to boost profit margins. Advertising and promotion expense data for the last three fiscal years is shown in the below table:

Year ended:	5/18	5/17	5/16
Sales	$7,938	$7,827	$8,664
Advertising and promotion	$279	$328	$347
% of sales	3.5%	4.2%	4.0%

FY 2018 saw a significant benefit from lower advertising spend. However, we see this as a potential area of disappointment is market share losses lead to the company having to boost advertising above plan over the next year.

The Never-Ending Asset Reshuffling

A hallmark of the packaged food group that has always fascinated us is the degree to which these company's trade assets back and forth, often making huge deals which are later written down and sold off with significant destruction of shareholder capital in the process. We know from our experience with CAG years ago that it has been one of the worst in the group at this cycle. While we will not go into a detailed history here, one of the best examples of a deal gone bad was the company's 2013 creation of its private label food business with the $5 billion purchase of Ralcorp Holdings. At the time, we openly questioned the price paid and the logic behind adding such a large private label business to its stable of mostly branded products. It took only two years for the company to announce its was selling most of the business to Treehouse Foods for $2.7 billion, taking a $1.9 billion write-off in the interim.

Fast forward to today, and the divesting and acquiring continues. CAG spun off its Lamb Weston specialty potato business in the 11/16 quarter to focus more on its core consumer foods brands. Since then, the company has undertaken several other deals to rearrange its product portfolio including:

- Subsequent to the end of the 5/18 quarter, CAG closed a deal to buy Pinnacle Foods to $10.9 billion in cash and stock.

- 2/18, acquisition of Sandwich Brothers of Wisconsin for $87 million ($74.6 booked as goodwill and intangibles)

- 10/17 acquisition of Angie's Artisan Treats for $249.8 million ($239.3 million booked as goodwill and intangibles)

- 4/17 acquisition of Thanasi Foods for $217.6 million ($214.5 million booked as goodwill and intangibles)

- 9/16 acquisition of Frontera Foods and Red Fork LLC for $108 .1 million ($106.2 million)

Divestitures include:

- Subsequent to the end of the 5/18 quarter, CAG sold its Del Monte business in Canada for $43 million
- In 3/15, proposed deal to sell its Wesson oil business to Smuckers was shot down by the FTC. The unit remains on the block and the company expects to sell it in the next twelve months.
- 8/16 sale of its Spicetek and JM Swank business for $489 million.

CAG's goodwill and intangibles is about 55% of total assets. The packaged food group averages in the mid-60% range, so CAG is not excessive in this metric. However, when we look at the high allocation to goodwill and intangibles on deals done in the last two years, we can't help but wonder how long it will be before some of these amounts start showing up as impairment charges. Case in point, in fiscal 2018, the company already took a $4 million write down to the value partially related to its Red Fork brand acquired in 9/16.

Quick Look at the Pinnacle Foods Deal

As we noted earlier, the company is spending $10.9 billion in a cash and stock deal to buy Pinnacle Foods. The justification for the deal is that it gives CAG a presence in the faster-growing snack and frozen foods market. We will not do a full analysis of the deal here and plan to do more work on this subject in the future, but when we see brands such as *Bird's Eye, Mrs. Paul's* fish sticks and *Duncan Hines*, we are skeptical that this deal will lead to a lasting return to core growth for CAG. The deal is valued at a hefty 16 times EBITDA. Interestingly, the two companies were reportedly in talks in June of 2017 about a combination but were unable to come to a deal and walked away. However, after an activist hedge fund took a position in the company in May, things appeared to quickly change.

The bulk of packaged food brands are simply not growing, and history has shown that all the trading of assets back and forth among the different players has not resulted in

meaningful growth. We are therefore very skeptical that the Pinnacle deal has much chance of generating real return for shareholders.

AT&T – Time Warner Update 2Q18

As expected, AT&T added more color to the Time Warner deal in the 2Q18 earnings release and presentation. Our concerns on how rapidly debt would be repaid were increased after the discussion:

- The goal was to reduce Debt to EBITDA from 2.9x to 2.5x within one year. After the call, that goal has been pushed out 6-months to the end of 2019.

- We believed a rapid pay-down in debt would require some asset sales in the range of $15-$20 billion to hit their debt reduction target. So far, AT&T has only identified about $2 billion – the sale of some data centers to Brookfield and the sale of Broadcast 600 spectrum.

  It concerns us that they had nearly two-years to find more and couldn't come up with specifics. John Stephens on the call said, *"Well, we have normally planned for asset sales and constantly look at underutilized assets for monetization, for example, the data centers, the broadcast spectrum 600, which is a couple of billion dollars right there, we have under contract and waiting for approvals today. We'll continue to do that. If you want to give a scope to it, as of today, we have about $500 billion in total assets. And so finding a few more opportunities to monetize assets seems to be very reasonable on top of the things that we've kind of commonly done with regard to real estate and other underutilized business in spectrum. So that batch [ph], I'm not giving you any specific number on asset sales, but as we've proven this year, we're going to continue to do that."*

  We have not seen much more on a potential IPO of the Latin American assets of DirecTV and AT&T withdrew an IPO for Vrio Corp in April. Working against the debt paydown, it also bought AppNexus for an estimated $1.6 billion and another company Alien Vault.

- The free cash flow of Time Warner for the next 6 months is expected to go towards covering the integration, one-time payments, and various fees. It does not sound like Time Warner cash flow will start paying down debt until 2019 according to John Stephens, "Our free cash flow guidance at the beginning of the year was standalone. We expect most of the benefit of the Time Warner free cash flow for the last half of the year, about $2 billion, will be absorbed by integration and deal costs, including severance costs, retention incentives, legal fees, bankers' costs and interest expense prior to close."

- AT&T focused more on the debt ratio decreasing due to higher EBITDA and less on debt paydown. We believe some of their plans in that area may be successful, but that takes more time. As we noted, the combined company has about $8 billion in free cash flow AFTER paying the dividend. The company raised its free cash flow guidance on the 2Q18 call and it also mentioned that some of this $8 billion per year would be directed to debt reduction. The targets on Debt to EBITDA falling under 2x a few years out always looked realistic in our view given the cash flow figures that were present before accounting for any cost savings or revenue gains. We still do not see hitting the 2.5x EBITDA target in 18 months without a sizeable asset sale.

Our view of the Time Warner deal remains basically the same other than the goal of rapid debt paydown. The deal was expensive, but Time Warner's cash flow is growing and is large enough to pay the interest ($3 billion) and incremental dividends ($3.6 billion) on the newly issued shares. However, Time Warner's cash flow (EBITDA about $9 billion and Free Cash Flow of about $5 billion) is not large enough to make meaningful debt payments to drive rapid paydown after paying interest and dividends. AT&T's cash flow will provide the bulk of that. Raising the forecast slightly for free cash flow by AT&T remains a good sign. We would also point out again that without tax reform and the pension funding needs declining – this merger would not look as strong.

When we wrote on July 12, 2018 about improvements at AT&T in the last two years that are being masked by the Time Warner merger, we quantified the positives of the improvements in pensions and tax reform. We could not completely quantify the positives of accelerating copper retirement and faster rollout of broadband that is now being pushed by the FCC, but that is happening. Also, the FirstNet rollout, which is being reimbursed by the government is also getting the 5G-network equipment built-out for essentially the cost of parts and getting that network started. (Think in terms of replacing a water pump on a car – by itself, parts, time, and labor that may be $500. But, if you have it done at the same time the timing chain is replaced it may only cost $50 in incremental parts as the labor and

time are already being covered.) So, this is helping lower the costs of installing the next wave of technology. We do not believe that any of that is built into the stock price at this point.

Two other big trends are also not being priced into AT&T's stock in our view. The rollout of DirecTV Now is one, and greater advertising potential across its 170 million customer spectrum of wireless, broadband, and entertainment is another. The company spent a great amount of time on the earnings call discussing how their data analytics work is rapidly improving advertising effectiveness and yields by 3x-5x. They can tailor advertising more individually and having the TV assets moving to broadband they can do even more. The goal is to add revenue synergies as they run this data over the assets at Time Warner. AdWorks revenue was growing at an accelerating double-digit rate before Time Warner. The company believes this can be a game changer when it is run over sports programming and Turner Network properties. We are not going to quantify this in terms of additional cash flow and earnings, but if it works at all – this should be a positive result that grows over time too.

DirecTV Now is expected to give customers more options for TV watching with packages that more closely match what they want to see and lower initial price points. It offsets cord cutting at DirecTV and allows AT&T to pick up new customers, who cut other cable services. A cloud-based DVR service is now available as well as Video on Demand and Sports Packages. The result is DirecTV is adding more customers and the price they are paying is increasing with some of these add-on packages.

Investors have been sour on AT&T because of cord cutting at DirecTV and U-Verse and the idea of replacing them with DirecTV Now at a lower price point was not an apples-to-apples trade-off. Essentially if someone was paying $80/month for DirecTV with a satellite, having him move to DirecTV Now at $15/month was a net loss. There were some positives such as there was no need to send out a service guy to install the equipment or buy the equipment for the satellite service. DirecTV Now works with software and broadband so it's quick and cheap to add a customer. As broadband continues to build-out, DirecTV Now should be an area that keeps growing. More importantly, the growth rate remains strong here, and the lost earnings appears to be slowing:

#s in 000's	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18
Satellite adds	342	323	235	0	-156	-251	-147	-188	-286
U-Verse adds	-391	-326	-262	-233	-195	-134	-60	1	24
DirecTV Now adds	0	0	267	72	152	296	368	312	342

The bigger issue is Satellite vs. DirecTV Now – there are 19.9 million Satellite customers and 1.8 million DirecTV Now customers – the latter having rolled out only 7 quarters ago. The company is rolling out more specials for signing up additional DirecTV Now and as noted they now have a DVR option.

The market is pricing the churn away from DirecTV to DirecTV Now as a margin squeeze and money loser. The company is forecasting that the rest of 2018 may be lumpy but after that, it should grow again. Already, the Entertainment Group, which also includes people with high-speed Internet and those with landline phones is seeing income and margins recover:

$ in mm	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18*	2Q18*
Oper. Income	$1,625	$1,461	$1,335	$1,576	$1,642	$1,290	$1,041	$1,125	$1,233
Income Margin	12.8%	11.5%	10.1%	12.5%	13.0%	10.2%	8.2%	9.5%	10.4%
EBITDA	$3,115	$2,966	$2,717	$2,996	$3,100	$2,670	$2,408	$2,437	$2,579
EBITDA Margin	24.6%	23.4%	20.6%	23.8%	24.5%	21.1%	18.9%	20.7%	21.8%

The asterisk for the 2018 quarters reflect using the historical accounting methods so the figures will be comparable. In 2018, AT&T changed the way it allocated regulatory fees and commission expenses. The net impact of the changes is that revenues and expenses are both lower, with income and margins higher:

$ in mm	1Q18	2Q18
Oper. Income	$1,326	$1,452
Income Margin	11.50%	12.50%
EBITDA	$2,638	$2,798
EBITDA Margin	22.80%	24.00%

The company is not back where it was in terms of income and margins yet, but it appears to be moving in right direction. This could become another area of tailwind for growth or at least remove another negative focus for investor sentiment.

Lockheed Martin (LMT)-Pension Update 6/18 Quarter

We discussed LMT's pension funding issues in our April 19, 2018 issue and recommend readers review that for a full understanding of what is happening here and why it should get better after 2018. We explained how three sets of rules have been impacting LMT's pension funding, cash flow, and earnings for years: FAS, CAS, and ERISA. For FAS – think GAAP accounting for pension expense. For CAS – think government reimbursement of pension costs. Since 2014, this has been a sizeable part of LMT's earnings because CAS has exceeded FAS:

$ in mm	2018e	2017	2016	2015	2014	2013	2012
FAS	$1,400	$1,372	$1,019	$1,127	$1,144	$1,948	$1,941
CAS	$2,400	$2,248	$1,921	$1,527	$1,520	$1,466	$1,111
FAS/CAS Spread	$1,050	$876	$902	$400	$376	-482.00	-830.00

The FAS/CAS spread represents income when CAS exceeds FAS and a drag on earnings when FAS is larger. More importantly, CAS represents cash income as it is invoiced and paid by the government. So, earnings have been improving and LMT is paying $5 billion into its pension plan this year. A higher asset total in the pension plans should reduce FAS in future years too. The pension assets are multiplied by the expected rate of return and that produces an offsetting source of income against the expense calculations in computing FAS. In 2019, assuming LMT does not lose money on its pension investments, the $5 billion should reduce FAS by about $375 million. That sets up LMT for a larger FAS/CAS spread in 2019 and more earnings growth. Also, LMT has not increased the discount rate yet – but it may have bottomed out at 3.625% for 2017 and 2018. The company's estimate is a 0.25% change in the discount rate changes pension expense by $115 million. At this point, we would wager that the discount rate is more likely to move up, which would reduce the pension expense further. So, there are two ways to see earnings rise in 2019 and beyond at LMT via the pension plan. That is important because we believe the CAS figure will likely peak in 2019 and remain flat as the transition stage to larger payments shown in the table above is now complete, thus removing a tailwind LMT has enjoyed for several years.

The company's cash flow performance in the first half of 2018 is ahead of forecast and LMT raised guidance for cash from operations by $300 million. This positive is also coming from improved operations – not from growth in FAS/CAS adjustment. We think this is important

because 2018 is expected to see a serious cash flow drain due to funding $5 billion into the pension. Net of CAS funding, it was expected to be -$2.6 billion.

$ in mm	2018e	2017	2016	2015	2014	2013	2012
Pension Funding	$5,000	$46	$23	$5	$2,000	$2,250	$3,837
CAS	$2,400	$2,248	$1,921	$1,527	$1,520	$1,466	$1,111
Cash Flow	-$2,600	$2,202	$1,898	$1,522	-$480	-$784	-$2,726

The shortfall in 2018 will be met with cash on hand and borrowing. The dividend coverage will look tighter this year. However, we anticipate the balance sheet will be improving overall and free cash flow will see strong improvement in 2019 and 2020:

$ in mm	2020e	2019e	2018e	2017	2016	2015
Cash from Ops	$7,000	$6,800	$3,300	$6,476	$5,189	$5,101
Capital Spend	$1,200	$1,200	$1,200	$1,177	$1,063	$939
Free Cash Flow	$5,800	$5,600	$2,100	$5,299	$4,126	$4,162
Dividend	$2,773	$2,547	$2,345	$2,163	$2,048	$1,932
Dividend % FCF	48%	45%	112%	41%	50%	46%

This assumes no share repurchases, for the next 2.5 years, which is something the company does frequently. It is assuming an annual increase in the dividend of 20-cents per quarter from the current $2.00 to $2.20 and then $2.40 or basically 10%. Even with that, LMT should be generating about $3 billion in remaining free cash flow after the dividend. From 2015-2017, the company bought back $3 billion, $2 billion, and $2 billion in stock. It is on pace to buy at least $1.0 billion this year. So, it would not be surprising if LMT did retire more stock in 2019 and 2020, which would lower the forecasted dividend payment and improve the payout ratio.

What we think will also make investors more pleased is the debt on the balance sheet should improve with these pension actions. We are going to assume the LMT borrows about $2 billion in short term debt in the second half of 2018 to make the rest of the pension payments. Funded debt is essentially flat since the end of 2017 at $14.3 billion. The pension liability should fall at least $5 billion with the payments this year. Also, the pension liability should also decline if the discount rate increases. LMT estimates that a 25bp move in the discount rate translates to $1.5 billion in change for pension liabilities.

At the end of 2017, LMT had $14.3 billion in debt and $15.7 billion in underfunded pension obligations for $30.0 billion in debt against $7.1 billion in EBITDA or 4.2x. By the end of 2018, debt could be about $16.3 billion and the underfunded pension under $11 billion or $27 billion. If we assume that in 2019 and 2020, the $2.0 billion of borrowing is repaid and LMT sees a 50bp increase in discount rate that cuts the PBO by $3.0 billion more – LMT's balance sheet would likely have under $21 billion in debt or 2.6-2.8x EBITDA and additional pension cash funding needs would likely remain much lighter than in several prior years.

We believe LMT should remain very capable of completing this pension transition and still being very shareholder friendly with a growing dividend that has ample cash flow coverage in the next couple of years. Essentially, the full harmonization of CAS and FAS should allow LMT to avoid repeating the 2010-14 period when pension funding required annual cash funding of $1.0-$2.0 billion as the CAS figure will be higher. And, this should be a company that benefits further from some interest rate increases.

Kimberly-Clark (KMB)-EQ Update 6/18 Quarter

Kimberly-Clark (KMB) reported adjusted EPS of $1.59, two cents above the Zack's estimate. Revenue came in slightly below. However, the company lowered its outlook for 2018 EPS to $6.60-$6.80 from the previous range of $6.90-$7.20, citing higher commodity costs and eroding currency situation as the culprits.

We currently see no significant concerns with KMB's earnings quality and note the following developments in the quarter:

- We mentioned in the previous quarter that inventory days of sales declined significantly versus the year-ago period with most of the decline coming from its LIFO inventories. This raised some concern about the possibility of a "LIFO liquidation" impact. While inventories declined again in the 6/18 quarter, the decline was more muted and balanced between LIFO and FIFO components.

- Other current assets and other assets have been trending upward in recent quarters. These accounts have many components making the trend difficult to pinpoint.

However, any such increase always warrants watching as it could be a sign of increased capitalization of expenses.

- Management indicated that advertising expense declined slightly in the quarter as the company seeks to become more efficient in its marketing spend. We remain concerned this could be an area of disappointment if the company begins to lose market share and is forced to increase its rate of spending.

- KMB disclosed that the rapid devaluation of the Argentinian peso will trigger the use highly inflationary accounting for its Argentinian operations going forward. Given that the company's Argentina operations are less than 2% of sales, we are not concerned of a material negative surprise coming from this area.

Inventory Days of Sales Down Again

We noted in the last quarter that KMB's inventory days of sales (DSI) fell significant, with most of the decline centered in its LIFO inventories. About 25% of inventories are accounted for under LIFO with the remainder accounted for under FIFO or average cost. In the 6/18 quarter, the decline in inventory continued with DSIs falling to 50.7 from 54.2 in the year-ago quarter. However, this was a moderation from the 7.4-day decline seen in the 3/18 quarter. We can also see from the following table that the decline was spread more evenly between FIFO and LIFO inventories which reduces our concern that the quarter benefitted from a LIFO liquidation.

	6/30/2018	03/31/2018	12/31/2017	09/30/2017	06/30/2017	03/31/2017
LIFO Inventory						
Raw Materials	$86.00	$86.00	$87.00	$88.00	$89.00	$91.00
Work in Process	$108.00	$102.00	$110.00	$106.00	$110.00	$113.00
Finished Goods	$453.00	$412.00	$421.00	$396.00	$440.00	$444.00
Supplies	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00
Excess FIFO cost over LIFO cost	-$177.00	-$178.00	-$176.00	-$173.00	-$165.00	-$163.00
Total LIFO Inventory	$470.00	$422.00	$442.00	$417.00	$474.00	$485.00
LIFO Inventory Days of Sales	13.6	11.3	13.6	12.8	14.8	15.6
FIFO/Average Cost Inventory						
Raw Materials	$247.00	$266.00	$258.00	$249.00	$251.00	$245.00
Work in Process	$99.00	$101.00	$103.00	$97.00	$87.00	$88.00
Finished Goods	$654.00	$685.00	$684.00	$687.00	$632.00	$620.00
Supplies	$280.00	$304.00	$303.00	$298.00	$294.00	$290.00
Total FIFO/Average Cost Inventory	$1,280.00	$1,356.00	$1,348.00	$1,331.00	$1,264.00	$1,243.00
FIFO/Average Cost Inventory Days of Sales	$37.09	$36.32	$41.40	$40.74	$39.45	$39.88
Total Inventory Days of Sales	50.7	47.6	55.0	53.5	54.2	55.4

The lower inventory spend has benefitted cash flow in recent quarters, but with inventories now at multi-year lows, there is not much improvement left to be gleaned.

Other Assets Steadily Increasing

A trend worth noting is the increase in other current assets and other assets, as seen in the following table:

	6/30/2018	03/31/2018	12/31/2017	09/30/2017	06/30/2017	03/31/2017
Other current assets	$508	$498	$490	$463	$380	$325
Other current assets days of sales	10.1	9.6	9.8	9.1	7.6	6.6
Other Assets	$729	$767	$695	$653	$624	$583
Other Assets days of sales	14.4	14.8	13.9	12.8	12.4	11.8

It is difficult to pinpoint what is causing this increase as both of these accounts are "catch-alls" with many different components including derivates balances and company sponsored life insurance policies. However, a pronounced, gradual increase always catches our eye as it could be an indication that the company is capitalizing amounts that should be expensed in current periods. The sequential increase in other assets actually turned in the most recent quarter but the account is still relatively high when viewed over the last several quarters. If these accounts do contain a level of capitalized expenses that have been delayed from

hitting the income statement, it could be a headwind to margins in upcoming quarters as these amounts are recognized. Nevertheless, given the lack of clarity, we give this a low concern level and will continue to monitor the trend.

Marketing Continues to Decline

We noted in previous reviews that KMB's advertising expense fell by 20 bps as a percentage of sales in 2017. The company does not disclose advertising expense by quarter, but management did indicate that results benefited some in the second quarter from lower spending as it looks to be more efficient in how it doles out advertising dollars. The company is calling for essentially flat marketing spend for 2018, but we remain concerned that this could be a source of disappointment if spending must be accelerated to maintain market share.

Inflationary Accounting in Argentina

KMB noted in its 10-Q that due to the rapid devaluation of the Argentinian peso in the quarter, which indicated that the three-year cumulative inflation rate exceeded 100% as of the end of the quarter. GAAP accounting will therefore require the company to adopt highly inflationary accounting which means KMB will begin using US dollar as the functional currency of its Argentinian operations with the effect of exchange rates on financial assets being immediately reflected in other income. KMB's Argentinian operations accounted for less than 2% of sales in the six months ended 6/18. This development is not surprising and we do not expect a material negative surprise given the small size of the operation.

Danaher (DHR)-EQ Update 6/18 Quarter

Danaher (DHR) reported adjusted EPS of $1.15 in the 6/18 quarter, $0.06 ahead of the Zack's consensus estimate. Revenue also came in ahead of expectations. We saw little in the way of concern in the company's earnings quality in the quarter:

- Accounts receivable days of sales continued its trend of year-over-year declines, falling by over 4 days in the quarter.

- We note that with the company's adoption of ACS 606 for revenue recognition, it began disclosing unbilled receivables and deposits in excess of revenue recognized. However, this information is only itemized for the last two quarters. These will important amounts to monitor going forward.

- Inventory days of sales were up about 2 days over the year-ago period. This is not overly alarming but should be monitored going into the next quarter.

- Accounts payable days were up over two days over last year's second quarter, but given the increase in inventories and the inflationary environment, we do not consider this to be an indication of an unsustainable squeezing of suppliers.

Accounts Receivable Down and New Disclosures to Watch

DHR's revenue recognition looked healthy in the quarter as accounts receivables days of sales (DSOs) continued a trend of year-over-year declines:

	6/29/2018	3/30/2018	12/31/2017	9/29/2017
Accounts Receivable DSOs	60.4	63.6	63.2	65.6

	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Accounts Receivable DSOs	65.0	65.8	63.4	68.1

We also note that the company adopted ASC 606 under the modified retrospective method in 2018. As such, it has begun breaking out unbilled receivables and deposits in excess of billings in its footnotes the last two quarters but does not disclose those amounts for quarters prior to adoption. A significant portion of the company's revenue is recognized

under long-term contracts, so these disclosures will provide a great deal of insight into the company's business trends and revenue recognition, but without year-ago data to compare to, they are of limited benefit at the moment. We will be watching these balances closely going forward.

Inventory DSIs Up Approximately Two Days

We note that inventory days (DSIs) were up over the year ago quarter by three days:

	6/29/2018	3/30/2018	12/31/2017	9/29/2017
Inventory DSIs	83.5	86.7	74.8	86.7

	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Inventory DSIs	80.6	86.1	74.8	84.6

DHR acquired Integrated DNA on 4/13. However, this did not have a material impact on the above calculation of DSI as even if we remove all of the acquired inventory (and none of the associated COGS) it only takes about a half a day off of the 6/18 DSI number. Given the strong sales growth and inflationary environment, we are not too alarmed by the increased in inventory, but this is an trend to watch going into the next quarter.

Accounts Payable

Accounts payable days (DSPs) crept up by two days in the 6/18 quarter, continuing a trend seen in the previous quarter.

	6/29/20	3/30/20	12/31/2(	9/29/20
Accounts Payable DSPs	66.9	70.2	61.3	68.8

	6/30/20	3/31/20	12/31/2(	9/30/20
Accounts Payable DSPs	64.2	68.4	65.0	67.0

The impact of the Integrated DNA acquisition was negligible. Given the increase in inventory, we do not consider a two day increase to be indicative of an unsustainable trend of squeezing suppliers.

Altria – quick update 2Q18

As we were compiling this issue, Altria and British American Tobacco released earnings. We will review this more completely for a more thorough note, but on the surface, this is playing out as we forecasted.

The headline figure is a 10.8% drop in US cigarette volumes, which is overstating the situation. Last year, California had a sizeable increase in taxes and the trade channel bought heavily ahead of that. This happens frequently ahead of tax increases and Altria estimates an adjusted figure is closer to a 5% decrease. Even that is evidence that the decay in cigarette volumes is continuing to accelerate:

y/y change	1H18	2017	2016	2015
US Cig. Volume	-4.50%	-4.40%	-2.40%	0.10%

Altria's market share is dropping faster than the industry because it is unable to take share from other brands. We have been warning about this because we have seen how much market share lesser brands have already lost in recent years. Altria now has to fight with other heavyweights, who are investing in their brands to take share. In the 2Q and first half of 2018, Marlboro lost 40bp and 30bp of share; Other premium brands at Altria lost 10bp and 10bp of share; Discount brands at Altria lost 30bp and 30bp. This compares to British American Tobacco that reported in the US it gained 20bp of share with premium brands and overall lost 10bp of share in the first half of 2018. Among their brands, Newport added 10bp, Natural American Spirit added 10bp, Camel lost 10bp.

Altria's plan is to offset volume decay with price increases to grow earnings. However, competition makes it tougher to boost prices as aggressively without giving up more market share. It can reach the point where volume losses are not offset by pricing. That happened to Altria Smoking results in 2Q18:

$ in mm	2Q18	2Q17
Net Revenue	$4,158	$4,366
Adj. Op Income	$2,186	$2,248

The company saw an increase in litigation costs in 2Q and that is adjusted out in those figures. Smoking is still 88% of the operating income at Altria so if this area is not growing,

it is a problem when the company wants to have a rising dividend that is about 80% of EPS. Already the dividend is about 70% of EPS, which was reset down due to the reduced tax rates. We estimate the dividend will consume about 85% of free cash flow this year, which will make it difficult for Altria to buy back shares as aggressively as in the past as well.

Disclosure

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