BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Ares Capital Corporation (ARCC) – Buy

We wrote about ARCC and other BDCs (Business Development Companies) in the March 29, 2018 issue. Essentially, these investments pay high dividend yields by earning a spread between lending to small to mid-sized U.S. companies and what they pay in terms of their own cost of funds. Hard caps on how much debt can be employed and requirements to return at least 90% of income to avoid federal taxes along with an incentive to distribute 98% of income and capital gains to also avoid a 4% federal excise tax historically make it tough for a BDC to grow. Because it is distributing much of its income and cash flow, growth often means issuing new equity, which in turn means more dividend payments. We encourage readers to review that piece for a full primer on how a BDC operates and other details involved.

ARCC is compelling now due to three factors. First, as we noted in March, BDCs now have the ability to boost Debt to Equity ratios from 1:1 to 2:1. Second, ARCC has largely digested and transitioned many of the assets acquired in the American Capital deal into higher yielding investments. As a result, ARCC has one of the lowest Debt to Equity ratios at 0.57x and it has laid out a plan to boost this ratio to 0.9-1.25x over the next 12-36 months. This will come via boosting leverage and deploying cash, so there will not be a need to issue equity. This should boost the core earnings, book value and the dividend. One of the downsides of a BDC is dividend growth is often non-existent or very low, thus they trade like a bond substitute. ARCC boosted its dividend for the 3Q18 already and seems likely to see this growth continue. Third, much of the debt is fixed and assets have variable rates tied to LIBOR. Thus, rising interest rates will drive cash flow higher. **The dividend yield is currently 9% and increasing. In our view, this is a compelling story as it should no longer be seen as a bond substitute and it does not need to raise equity capital to grow further.**

- **ARCC and its investment manager have decades of experience in this field and know the customer base well.** They have seen recessions, they have board seats for almost half the portfolio investments, and review investments quarterly. The new BDC rules are helping it work more with companies they already know well. 75% of recent deals came from existing customers

- **The portfolio stats are improving.** The overall size of EBITDA for the average ARCC company is 19% higher than just 6 quarters ago. EBITDA growth of the companies is accelerating. The number of non-accruals fell last quarter and the quality review is moving more companies up the highest score on the ARCC scale.

- **Competition has been more intense, but it may be returning to more normalized levels.** ARCC used this time to sell more investments it was not thrilled about and improve the number of secured loans on the books. We are concerned that the spread for high-yield loans vs. the Treasury has come down to about 350bp. However, ARCC has locked 78% floating rate investments and fixed much of its funding costs so rising rates should help EPS. The yield on income-producing investments is up 140bps in six-quarters.

- **ARCC has already enjoyed steady growth.** Core Quarterly EPS has risen from 32 cents in early 2017 to 39 cents now. Book value has grown despite the high payout ratio, which is now under 100% and the dividend is now growing. This is despite

reducing net debt/equity to 0.57x and the goal is to reach 0.9-1.25x within the next 3 years.

- **Investment Management contract with Ares was recently relaxed to allow base fees to drop from 150bp to 100bp on investments that are done at a debt-to-equity of over 1.0x.** This is designed to support more growth and utilize higher debt ratios as a result of the new BDC rules adopted this year.

- **Simple modeling shows that every $500 million of additional investment at the current roughly 6% spread produces 1-cent per quarterly EPS. ARCC could add well over $3 billion in investments without raising capital. In addition, LIBOR increases against the current floating rate portfolio financed with fixed rates adds another 4-cents per quarter for every 100bp rise in LIBOR. BDC rules require higher earnings to be paid out as dividends.**

- **We see three potential risk areas. The accounting here is very conservative overall.** We found a lawsuit that has $117 million in potential exposure that will move forward in 2019 – that's roughly 27-cents of the $17.05 book value. Ares Management is forgiving $10 million in fees per quarter until the end of 2019, which is 2.3 cents per quarter. And, ARCC has the ability to have a very large non-traditional investment component of up to 30% of the portfolio. Historical signs point to ARCC being conservative with this basket, but we are listing this as an area where it could be a bit more aggressive or buy non-income producing investments.

ARCC's Portfolio Is Strong and it Plans to Do More Business Here

One of the advantages of ARCC is it was formed 14-years ago. Ares Management is the Investment Advisor and has been in business for over 30-years. That compares to many of the BDCs having been formed in the last 5-7 years after the 2007-09 fireworks. There is a sizeable amount of experience dealing with companies in place as well as industry knowledge. It is also the largest BDC out there with over $11 billion in investments. Many of the competitors are essentially small-cap stocks too with portfolios under $300 million. So the breadth of companies ARCC and Ares have worked with is substantial.

The company finds that many of its existing clients are where it finds new investments as those businesses grow, merge, or develop new infrastructure and products.

Kipp deVeer CEO on the 2Q18 earnings call – "*We continue to differentiate ourselves from the competition with our large-scale commitment and hold capability, long-standing relationships, ability to take advantage of incumbency and the flexibility of our capital. We remain very selective our new deals as evidenced by the fact that we closed less than 4% of the transactions that we review from new companies. And as Mitch will discuss later in more detail, the vast majority of our investments today are backing our strongest existing borrowers where we believe we take the least risk of deploying capital.*"

Mitch Goldstein Co-President concurred on the 2Q18 call, *"The sheer size of our portfolio along with growing financing needs of our portfolio companies offers a significant differentiated deal flow from our existing borrowers, which represent nearly 75% of our second quarter investment activity."*

These portfolio companies are reporting accelerating growth and debt coverage remains strong

ARCC Portfolio	2Q18	1Q18	4Q17	3Q17	2Q17	1Q17
LTM EBITDA Growth	7%	7%	6%	4%	5%	5%
Debt/EBITDA	5.4	5.4	5.4	5.4	5.5	5.3
Interest Coverage	2.2	2.2	2.3	2.4	2.3	2.4
Avg. EBITDA	$82.4	$76.5	$62.2	$65.9	$70.1	$69.4

Some of the higher interest rates are cutting the interest coverage ratios, but EBITDA growth is picking up as is the size of EBITDA at the average ARCC company.

ARCC rates investments on quality and reevaluates them each quarter. There is a 1-4 scale with 1 being the worst and 4 being the best. New investments start at a 3 and are followed for positive or negative trends.

	2Q18	1Q18	4Q17	3Q17	2Q17	1Q17
Grade 4	16.5%	13.6%	11.2%	10.8%	10.9%	12.3%
Grade 3	78.6%	81.2%	85.3%	85.4%	86.0%	84.2%
Grade 2	3.6%	4.5%	2.9%	3.0%	2.1%	2.5%
Grade 1	1.3%	0.7%	0.6%	0.8%	1.0%	1.0%

In terms of non-accruals, two came off in the 2Q18 and none were added. They totaled 0.8% of the portfolio down from 1.0% in 1Q18 and 1.1% in 2017's 1Q.

The accounting procedure in this area is strong in our opinion. Assets are listed as being in non-accrual status after 30-days being past due or there is reasonable double about full collection. ARCC reverses accrued and unpaid interest if an investment is listed as non-accrual status. To be taken off non-accrual status, the past due amounts need to be paid and management believes the account will remain current.

Competition in the Market – Quality is Holding Up at ARCC

Like all companies in this type of business, there are periods of time when more money is chasing deals. This can lead to ARCC customers refinancing with another BDC, bank or private equity group. It can also lead to money chasing yield and pushing down the yield premium. All of this remains a risk for ARCC in our view. This can be followed by looking at the spread high-yield investments are getting over the Treasury Bond.

The St. Louis Fed follows this spread. It is currently at 3.5%. Over 20-years, the bottom is essentially 2.5% and the normal range is high 4%-5%. There are spikes with recessions that reach 10%-20% but those are short-lived. With the growth in the companies cash flows noted above, this may not be a warning sign yet but is definitely worth noting.

During this period, ARCC has been staying away from deals and opportunistically selling some assets into the market. It noted that it has seen competitive pressures in the market earlier in the summer that seem to be balancing out again now. It noted that it closed only about 4% of deals for new companies. We think this again plays into the experience ARCC has in the market versus newer players and it has pruned some investments it wasn't thrilled with:

Kipp deVeer – "So part of what you do late in the credit cycle, and we do think late in the credit cycle is, you try to get your portfolio to be as clean as possible. You use liquidity in the market to get your refinance out of situations that you're not thrilled about and there are a couple of examples as for sure in Q2, and frankly, over the last 18 to 24 months where we've been doing that."

The company has also dealt with risks by fixing more of its interest costs and maintaining floating rate investments as much as possible. The bulk of debt is now fixed at about 4.5%. The company calculates that every 100bp increase in LIBOR adds 17-cents to EPS. The yield on the portfolio has been rising:

	2Q18	1Q18	4Q17	3Q17	2Q17	1Q17
Yield on Income Securities	10.5%	10.1%	9.8%	9.7%	9.5%	9.1%
% Floating Rate	78.0%	79.0%	81.0%	82.0%	81.0%	79.0%

At the same time, ARCC has been ramping up first lien investments:

	2Q18	1Q18	4Q17	3Q17	2Q17	1Q17
1st lien Sr	40%	42%	44%	41%	25%	24%
2nd lien Sr	35%	30%	32%	35%	33%	34%
Subordinated	9%	10%	8%	8%	8%	8%

Some of this is the rotation out of the American Capital portfolio, which came with more equities and non-income producing investments. But, we believe ARCC is still seeing improving growth in its current portfolio and has a built-in hedge against rising rates at the same time it is moving up in higher credit quality.

ARCC Has Already Shown Steady Growth

	2Q18	1Q18	4Q17	3Q17	2Q17	1Q17
Core EPS	$0.39	$0.39	$0.38	$0.36	$0.34	$0.32
Book Value/Share	$17.05	$16.84	$16.65	$16.49	$16.54	$16.50
Net Debt/Equity	57%	69%	66%	64%	64%	64%

As the company has digested the American Capital deal and remade the portfolio there as well as enjoyed a rising yield, it has seen EPS increase along with book value per share – even after paying out $0.38 per quarter in dividend. The coverage for the dividend has definitely improved and it has done all this with a very low Net Debt/Equity ratio. This came even after selling/being repaid on more investments than it made last quarter. The portfolio

shrank by nearly $600 million looking at commitments less exits to $11.5 billion and cash balances grew.

The old debt to equity limit was 1.0x. BDCs generally didn't get much above 0.85%-0.90% so there would be a cushion if investments became impaired. Now the limit is 2.0x. So in our view, there is tremendous growth potential just getting back to a reasonable amount of leverage under the old rules.

Simply adding $500 million to the portfolio without taking on any debt could almost be done here. Assuming it came with $200 million of debt at 4.5% and was put to work at 8% would add 1.1 cents to EPS per quarter. Putting the money to work at 10% would add 1.6 cents per quarter. Even then the debt to equity would only by about 63%. We think there is room to grow earnings much more if the company is successful in reaching a 90%-125% debt to equity ratio.

ARCC can save itself a 4% excise tax if it distributes 98% of capital gains. We point this out because on the conference call, ARCC noted that in July it had $326 million in gains largely from exiting one position. It had some loss carryforwards to use and also took some losses to offset this gain. But, there could be some dividend coming in this area in the near future.

The Investment Agreement with Ares Management

ARCC pays Ares Management for overhead costs and administrative duties like accounting, office staff, storing records. It also pays Ares Management for running the portfolio under several methods. First, there is a base management fee of 1.5% of average total assets less cash. For investments that may occur at a debt to equity ratio above 1.0x, Ares Management reduced the base fee to 1.0% of net total assets.

There is also an income fee. Under simple terms, this is all interest income and dividend income (there can be some consulting fees and commitment fees as well) less interest expense, preferred dividends, the base management fee, and administrative fees. It does not include capital gains as income. So, of that income amount, ARCC keeps the first 1.75% per quarter. Ares Management gets 100% of the income amount between 1.75% and 2.1875% per quarter. Anything above 2.1875% per quarter is split 80% to ARCC and 20% to Ares Management. Rising LIBOR against fixed interest expense could result in Ares Management getting a higher income fee under this definition.

Ares Management also gets a 20% Capital Gains Incentive Fee. However, this is also viewed on a long-term basis in the context of total capital gains earned since the inception of ARCC. Thus, there is a cumulative high-water mark to always reach. Also, cash payments for both the income fee and capital gains fee are deferred if four quarters of (distribution to shareholders) and the (net change in total asset less debt) is less than 7% of net assets at the beginning of the period. This latter part may not play much of a role given that the distribution alone is about $665 million per year going forward and 7% of net assets at the end of 2017 is $531 million. The net asset total would need to fall to trigger this clause.

Some Simple Modeling Shows the Potential Here

We went for the incremental change here. We assumed that ARCC grows its portfolio by $500 million to $2.5 billion. Assuming it essentially borrows all of that money, and we will ignore cash on the balance sheet for this exercise – the debt to equity would only rise from 0.64x now to 0.72x-0.98x adding between $500 million and $2.5 billion.

Also, we did not add in any additional administrative fees but used a 150bp base management fee. We did not give ARCC credit for any investments coming in under the new 100bp base fee. The company is basically earning about a 6% spread now and we modeled for 4%-8% here.

Interest Spread/AUM	$500	$1,000	$1,500	$2,000	$2,500
8%	1.5	3.1	4.6	6.1	7.6
7%	1.3	2.6	3.9	5.2	6.5
6%	1.1	2.1	3.2	4.2	5.3
5%	0.8	1.6	2.5	3.3	4.1

Remember these are quarterly EPS changes. We did not forecast any capital gains either, nor did we add in any additional EPS from LIBOR rising on the current portfolio where 100bp generates just over 4-cents per quarter. It would not take much to envision another 4-5 cents per quarter coming in from the larger portfolio as well.

Right now the company is earning 39-cents per share in Core EPS per quarter. At 46-49-cents in EPS from LIBOR and a larger portfolio, there should be more dividend growth plus capital gains would boost that further. It should take the perception away of this being

bond-substitute and give some capital appreciation potential along with the current yield of about 9%.

Remaining Risks

In looking at the accounting here, we are comfortable that there are few risks. Each investment is a very small and is reviewed quarterly. So the portfolio is diverse. Of the portfolio in dollar terms, ARCC has board seats or board observation at 47% of the investments Also, as a BDC, ARCC is expected to provide management expertise to the companies it invests with and with its industry knowledge that is likely welcome.

We noted that ARCC is conservative in assessing credit quality trends and 30-days past due is the latest something goes to non-accrual status. It has locked in fixed rates for some time and has bumped up its weighting in more senior lending.

We only have three other issues here. The first is a lawsuit over the sale of assets in bankruptcy several years ago. The exposure is $117 million and none of that has been reserved for. The company's language is as follows:

> *"On May 20, 2013, the Company was named as one of several defendants in an action filed in the United States District Court for the Eastern District of Pennsylvania by the bankruptcy trustee of DSI Renal Holdings LLC ("DSI Renal") and two affiliate companies. On March 17, 2014, the motion by the Company and the other defendants to transfer the case to the United States District Court for the District of Delaware (the "Delaware Court") was granted. On May 6, 2014, the Delaware Court referred the matter to the United States Bankruptcy Court for the District of Delaware (the "Bankruptcy Court"). The complaint alleges, among other things, that each of the named defendants participated in a purported fraudulent transfer involving the restructuring of a subsidiary of DSI Renal. Among other things, the complaint seeks, jointly and severally from all defendants, (1) damages of approximately $425, of which the complaint states the Company's individual share is approximately $117, and (2) punitive damages. The defendants filed a motion to dismiss all claims on August 5, 2013. On July 20, 2017, the Bankruptcy Court issued an order granting the motion to dismiss certain claims and denying the motion to dismiss certain other claims, including the purported fraudulent transfer claims. The defendants answered the complaint on August 31, 2017. Under the operative scheduling order, discovery*

> *will continue until early 2019 with dispositive motions due on April 30, 2019. No trial date has been set. The Company is currently unable to assess with any certainty whether it may have any exposure in this matter. However, the Company believes the plaintiff's claims are without merit and intends to vigorously defend itself in this matter."*

We looked at the July 20th ruling – much of the dismissals asked for by ARCC were denied or deferred until the trial. The order to dismiss certain claims helped another group called Centre, not ARCC. The trustee also withdrew one of the points. So the bulk of this case is still pending in our view. This represents about 27-cents per share of potential payments.

In addition, ARCC has the ability to invest up to 30% of its assets in non-traditional BDC investments. That allows foreign investments, non-small companies, and equity positions. As the largest player in the BDC world, ARCC has the largest basket to invest in this area. This gives some flexibility to aim more for growth and focus less on fixed income. Traditionally, ARCC has sought to reduce low and non-income paying investments and that was a big part of remaking the American Capital assets it acquired. Often this has gone into Joint Venture investments and currently, ARCC works with an AIG group to buy senior loans. That is about 5% of the portfolio.

The last item is Ares has been foregoing $10 million in quarterly fees as part of the transformation of the American Capital deal. This deal will expire at the end of 2019. It has aspects that can reduce it before then. This is not part of core EPS but will become a drag on GAAP EPS for 2.3 cents per quarter in 2020.

Eaton (ETN) EQ Review Update- 6/18 Quarter

Current EQ Rating*	Previous EQ Rating
3+	NA

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

We initiate coverage of Eaton (ETN) with a 3+ (Minor Concern) rating.

- No development of new earnings quality issues in the 6/18 quarter.

- ETN's 6/18 quarter adjusted EPS of $1.39 beat consensus estimates by 6 cps. The beat remained intact even after adjusting for lower pension expense of about 2.8 cps and lower R&D which added about a penny.

- Inventory days of sales (DSI) at the end of the 6/18 quarter jumped by approximately five days over the year-ago period, comparable to the year-over-year increase we highlighted in our review of the 3/18 quarter. However, the company's explanation of pre-buying ahead of tariffs seems plausible and alleviates the concern of a buildup of obsolete product. However, a five-day rise in DSIs is always worthy of attention, and with the company recently switching to the use of FIFO for 100% of its inventories, there is the possibility that rising costs will be delayed in hitting the income statement. This could conceivably lead to a negative surprise from higher-than-expected costs in the next couple of quarters. Should inventory balances moderate in the 9/18 quarter, we will likely raise our rating on ETN.

Lower Pension Expense

US pension expense fell by $6 million (1.2 cps) in the quarter due to lower pension settlement costs. Non-US pension expense fell by $8 million (1.6 cps) primarily due to lower service, interest and amortization costs which are likely the result of higher assumed discount rates. While we view this benefit as non-operational, the company's pension plan assumptions at the end of 2017 were reasonable and we saw no problems with the accounting for the plan.

Lower R&D Expense

We note that R&D expense fell by $5 million (cps) in the quarter. The following table shows R&D expense as a percentage of sales:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Sales	$5,487	$5,251	$5,213	$5,211
R&D Expense	$145	$156	$144	$147
% of Sales	2.6%	3.0%	2.8%	2.8%

	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Sales	$5,132	$4,848	$4,867	$4,987
R&D Expense	$150	$143	$145	$146
% of Sales	2.9%	2.9%	3.0%	2.9%

While the company does not mention the overall level of R&D spending in the conference call, the higher level of spending in the 3/18 quarter makes us think that the decline in R&D expense in the 6/18 quarter was to some degree due to the timing of spending. Still, upcoming quarters may see a minor drag if spending return to its normal 2.8-3.0% range as a percentage of revenue.

Inventory Rising Ahead of Tariff Impact

We noted in our review of ETN's 3/18 quarter that inventory days of sales (DSIs) jumped by more than five days over the comparable year-ago quarter which the company attributed to an acceleration in sales growth, as seen in the following table.

	06/30/2018	03/31/2018	12/31/2017	09/30/2017
Inventory DSIs	68.4	70.1	67.7	64.6

	06/30/2017	03/31/2017	12/31/2016	09/30/2016
Inventory DSIs	63.3	64.7	64.3	63.0

While inventories remained elevated in the 6/18 quarter, the year-over-year increase in DSIs remained steady at approximately five days and declined sequentially from the 3/18

quarter. Management indicated that it engaged in pre-buying ahead of raw materials price increases related tariffs. This seems like a plausible explanation and would be prudent under the current circumstances. As we noted in the 3/18 review, ETN switched to using FIFO accounting for 100% of its inventories in 2018. While this will effectively delay the impact of rising costs on the income statement when compared to the LIFO method, ETN turns its inventories in less than a quarter, so we are not too concerned that investors will be caught off guard by higher than expected costs in the next quarter. We will continue to watch inventory balances in the upcoming quarters and will raise our rating should inventory growth moderate.

Thermo Fisher Scientific (TMO) EQ Review Update-6/18 Quarter

Current EQ Rating*	Previous EQ Rating
4+	NA

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

We initiate coverage of Thermo Fisher (TMO) with a 4+ (Acceptable) rating.

Despite a history of making multiple acquisitions, TMO does not display any of the warning signs of a serial acquirer failing to create value with its deals. In addition, we currently have no significant items of concern regarding the company's earnings quality.

- We note that the company's adoption of ASC 606 has resulted in inventories being materially lower than they would have been under the old method of accounting for revenue recognition. Since the company utilized the modified retrospective method of adopting ASC 606, historical periods have not been restated for the change. Rough adjustments for the accounting change indicate that DSIs in the first two quarters would have increased around 2-4 days over the comparable year-ago periods. This is not overly alarming given the unavoidable uncertainty in our adjustments and the strong reported organic growth.

Note on Adoption of ASC 606

TMO adopted ASC 606 starting in 2018 and, like most companies we have reviewed, elected to use the modified retrospective method of adoption. As such, it recorded a one-time adjustment to retained earnings and will apply the new accounting method on all new contracts and all uncompleted contacts as of the date of adoption. TMO is not required to restate historical periods for the change, but it does disclose what the 12/17 account balances were prior to restatement. Adoption of the new revenue recognition guideline did not have a meaningful impact on reported profits or cash flows, but we do want to point out that it did have a meaningful impact on the company's reported inventory balances which must be taken into consideration when analyzing inventory balances for the next two quarters.

Prior to adoption, TMO recorded costs related to pharmaceutical development and manufacturing services were in inventory. However, such costs are now recorded under contract assets which are included in the "other current assets" account. The shift resulted in inventory at 12/17 being $252 million, or about 7 days of cost of sales lower than under the old method. This must be taken into consideration when comparing current inventory levels to historical balances that have not been restated for the change.

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Inventory DSIs	81.4	83.9	83.4	106.2

	7/01/2017	4/01/2017	12/31/2016	10/01/2016
Inventory DSIs	85.7	86.8	79.3	93.7

Note that the 12/17 quarter is based on the original inventory balance reported under the old method, not the adjusted amount disclosed in the notes of the last two 10-Qs. Likewise, none of the previous quarters have been restated for ASC 606. As noted above, the 12/17 inventory balance adjusted for the accounting change would have taken about 7 days off the 12/17 DSI figure. While we don't know what inventory balances for 6/18 and 3/18 would have been under the old method, we think it is reasonable to add 5-7 days to each quarter's DSI when comparing to the year-ago periods. Using the high-end of adding 7 days to the first two quarters of 2018, we get that DSIs would have registered year-over-year increases of 2.5 days and 4.1 days in the 3/18 and 6/18 quarters respectively. We are not very concerned about these increases, especially given the unavoidable uncertainty in our adjustments coupled with the roughly 8% organic sales growth the company is reporting. Still, investors should be aware of the necessary adjustments when analyzing inventory balances over the next two quarters.

Procter & Gamble (PG) EQ Review Update- 6/18 Quarter

Current EQ Rating*	Previous EQ Rating
3+	NA

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

We initiate coverage of Procter and Gamble (PG) with a 3+ (Minor Concern)

Our previous reviews of PG included discussion of the challenges the company has faced from competition, pricing pressure and rising raw materials costs. All of these factors remain in play, but our EQ Review Rating incorporates only our view of the quality and sustainability of earnings and cash flows.

- We previously cited a three-day jump in accounts receivable days of sales (DSO) in the 3/18 quarter as being an item of concern. DSOs fell back in line in the 6/18 quarter coming in essentially flat with the year-ago quarter and down 3 days from the 3/18 quarter. We are therefore no longer concerned about receivables balances and note that PG has the lowest DSOs of any of the consumer or household goods companies.

- We also cited in the 3/18 quarter that the company has been stretching payment terms on its suppliers. This appears to have leveled off in the 6/18 quarter as payables days of cost of sales (DSPs) fell over 1 day from the year-ago quarter and almost 2 days sequentially. While we view it as a positive sign, management admits that this source of cash flow growth could dissipate in upcoming quarters.

- We expressed concern in previous reviews about the fact that PG's cash flow cannot cover its dividend and its aggressive buyback. While its net debt/EBITDA of under 1.6 gives it some room to run, longer-term this remains a problem as lower share count has been providing most of the reported growth in adjusted EPS.

Growth in Payables Has Levelled Off, Taking Away Key Tailwind

We have noted in previous reviews that accounts payable days of cost of sales (DSPs) have been rising as the company has been stretching its payment terms with suppliers. However, this trend appears to have reversed in the 6/18 quarter, as shown in the following table:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Accounts Payable DSPs	104.5	106.3	102.5	104.9

	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Accounts Payable DSPs	105.9	94.0	91.3	101.6

This was the first such decline in several quarters, and management addressed this issue in the 10-K:

> *"Accounts payable, accrued and other liabilities increased, generating $1.4 billion of cash.* ***This was primarily driven by extended payment terms with our suppliers*** *and an increase in fourth quarter marketing activity versus the prior year. These factors, along with offsetting impacts of foreign exchange, drove a 2-day increase in days payable outstanding.* ***Although difficult to project due to market and other dynamics, we anticipate incremental cash flow benefits from the extended payment terms with suppliers could decline slightly over the next fiscal year."***

We see no reason for a sharp reversal of payables terms in the upcoming year, it appears that a key source of cash flow growth is fading.

Dividend and Buyback Outlook

We have noted our overall concern with the fact that PG's cash flow is not sufficient to cover the buyback and the dividend. For the fiscal year ended 6/18, operating cash flow of $14.9 billion, cap-ex of $3.7 billion, cash dividends of $7.3 billion and $7 billion in share repurchases left a $3.2 billion cash shortfall.

T12 Operating Cash Flow	$14,867
T12 Capex	$3,717
T12 Free Cash Flow	$11,150
T12 Dividends	$7,310
Dividend % of FCF	66%
T12 Stock Repurchases	$7,004
Cash After Buyback	-$3,164

Management's mid-point EPS guidance of $4.45 per share implies net income of approximately $11.7 billion. In its outlook, the company also stated that is expects free cash flow productivity of at least 90% which implies free cash flow could be as low as $10.5 million, or over $600 million below FY 2018's level. The company also expects to pay "over $7 billion in dividend and repurchases and up to $5 billion in stock in fiscal 2019." This implies another shortfall of more than $1.5 billion. In addition, the pending $4 billion acquisition of Merck's OTC business will likely add to the company's debt load.

Retroactive EQ Review Ratings of Recent Updates

Below are some retroactive ratings on companies which we have already updated for the June quarter.

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

Current EQ Rating*	Previous EQ Rating
4+	NA

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

We initiate coverage of Kimberly-Clark (KMB) with a 4+ (Acceptable) rating.

We see very little concern with the quality of KMB's recent earnings quality. We have noted in the past that the company's inventory days of sales (DSIs) have declined, and with 25% of inventories accounted for under LIFO, it opened the possibility of a LIFO liquidation

benefit. However, while DSIs continued to decline in the 6/18 quarter, the decline was evenly spread between the LIFO and FIFO components. We also note an upward trend in other assets which we will be monitoring going forward but are not concerned about yet. Finally, the company has been spending less on advertising which may be difficult to maintain in the current environment.

Danaher (DHR) EQ Review Update- 6/18 Quarter

Current EQ Rating*	Previous EQ Rating
4+	NA

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

We initiate coverage of Danaher (DHR) with a 4+ (Acceptable) rating.

We see little that concerns us in DHR's recent results. We noted in our review of the 6/18 quarter that inventory DSIs were up about two days versus the year-ago quarter but given the uptick in sales and the inflationary cost environment, we are not alarmed at this point. We note that new ASC 606 disclosures will be very useful in tracking revenue recognition trends once we have year-ago data to compare to.

Campbell Soup (CPB) EQ Review Update- 6/18 Quarter

Current EQ Rating*	Previous EQ Rating
3+	NA

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

We initiate coverage of Campbell Soup (CPB) with a 3+ (Minor Concern) rating.

We noted in our review of the 6/18 quarter that like almost all of the packaged food companies, CPB is stretching its payables to boost cash flow. Even after adjustment for the

Snyder's acquisition, CPB's payable days of cost of sales (DSPs) rose by four days over the year-ago period. However, CPB's DSPs are well below the industry average and its four-day increase is less aggressive than some of its peers. We also noted that the company has written off the rest of the goodwill associated with its Campbell Fresh unit. In addition, CPB's limited partnership with Acre looks peculiar and reminds us of R&D subsidiaries created by drug companies to keep development expenses off the income statement. However, the amounts involved are immaterial to recent results which makes this more of a curiosity than a concern.

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 recent reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem as 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 score 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.

Disclosure

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