BEHIND THE NUMBERS

EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Healthcare Services Group (HCSG) 3Q18 Update

For the fourth quarter in a row, HSCG missed on both EPS and revenues. Keep in mind, people own this company because it is supposed to be a growth story based on more people moving into senior living facilities. It trades for over 28x EPS. If we back the income tax cut out, there is no growth here at all:

	3Q18	2Q18
Y/Y Op. Inc Growth	-1.7%	1.4%
Y/Y pretax Inc. Growth	0.0%	0.7%
Y/Y Net Income Growth	11.1%	14.5%

They will anniversary the tax cut soon so there better be some improvement in growth coming. Otherwise, a 2% yield and 28 P/E ratio are both obvious reasons that the stock is overpriced. Our July 19, 2018, May 17, 2018, and February 22, 2018 issues have more discussion on HCSG.

- There is no customer growth and HCSG is working against the reasons that customers sign up in the first place.

- HCSG is trying to push labor costs back onto customers to boost its own margins even though margins have been rising.

- Receivables continue to grow faster than sales many months after HCSG claimed to be cutting payment terms in half.

- HCSG blames lack of staff for the reason there is no growth in 2018, but that doesn't explain the last five years of missing growth and now a tight labor market should make additional employees more expensive.

What Growth?

This is not a new thing. We have talked for some time about how HCSG is already dealing with 95% of the senior housing industry that outsources its housekeeping operations. It had a surge of dietary customers (largely from existing housekeeping customers) in 2017. Other than that, HCSG does not grow.

	2Q18	2017	2016	2015	2014
Housekeeping Customers	3,500	3,500	3,500	3,500	3,500
Dietary Customers	1,500	1,500	1,000	1,000	900

Let's remember what HCSG offers to customers and why they should sign up:

1. The customers face rising costs from wages, insurance, and other operating costs. HCSG can cap costs related to housekeeping, laundry, and cafeteria operations.

2. HCSG offers a 2-month interest-free source of cash by converting those operations into an outsourced aspect of the business and slow paying HCSG.

3. They offer experienced management for these duties.

Focusing on the conference call, management talks often about trying to pick up 20bp of margin by tweaking customer contracts and other methods. The company makes 35-cents in EPS per quarter. Much of the margin gains they are aiming for add up to 1-cent in EPS or about 3% growth. That doesn't solve the problem and maintain the 28 P/E multiple. We think the much bigger growth problems are more obvious – no one is signing up, the customer base has its own margin squeeze, and the labor market is tighter.

HCSG wants to push labor costs back on customers as a way to grow its earnings

HCSG is working against every one of these selling points. It is adjusting relationships to push labor costs back onto the customers. This will result in lower revenues and HCSG gave guidance for negative $10 million in revenue in this area. When asked on the 3Q18 call if this is a moving more of the labor costs back on the customers for margins or credit issues, Matthew McKee responded:

> *"I'd say it's a bit of the former in the sense in line with those company priorities [to boost margins] that Ted outlined in his company remarks, we are prioritizing, putting the company in the best position possible as we close out the year and look to '19. And part of that included taking a hard look at the housekeeping and laundry business."*
>
> *"But ultimately, in these scenarios (where a customer falls into the bottom 10% profitability], it typically took the form that you described in the sense that the first step is to give the payroll back to the customer."*

The funny part about this debate is HCSG's housekeeping margin is actually rising:

	2Q18	2Q17	1Q18	1Q17	2017
HK Labor % Rev	78.2%	80.5%	78.4%	80.1%	80.1%
HK Supplies % Rev.	7.9%	8.1%	7.9%	8.0%	8.0%

As is normal for HCSG, they do not report full numbers in the 2-page press release and we will need to wait for the 3Q 10-Q to see 3Q results. But, this has been an area of rising margin for them and they are asking for price hikes or they will punt customers. As HCSG claims they will try to muscle clients – they ate a $3 million tax settlement in the quarter for a dispute over an account. That has little to do with this full situation, but the fact that they have not seen growth in the Housekeeping area for years when they are handing out free credit is a good picture that HCSG does not have much power in these deals.

Receivables still exceed revenue growth and HCSG claims it is cutting payment terms – another reason to doubt it will see customer growth

We have pointed out the problems with extending credit to customers for several quarters and HCSG reserved $37.1 million or 9% of receivables in 1Q18. Remember in 1Q, they did not write these receivables off. They took a reserve and pushed many of them into Long-Term Notes receivable. After boosting these reserves, HCSG touted that their DSOs magically improved, and their receivables aren't excessive. Again, they do not report the size of the reserve in the 2-page press release, but does anyone think the gross receivables are going down here?

	3Q18	2Q18	1Q18	4Q17
Sales	$506.9	$503.7	$501.8	$499.4
Net A/R	$353.5	$343.7	$335.0	$378.7
Reserves	n/a	$49.7	$48.9	$12.0
LT Notes Rec.	$45.9	$37.4	$38.8	$15.5
Total Gross A/R	n/a	$430.8	$422.7	$406.2

The company noted that $10 million of the increase was due to the quarter ending on a weekend and it was paid the next week. However, net receivables rose $7.3 million in the second quarter on a sales bump of only $1.9 million. Plus, the bad debt reserves rose again in the second quarter. Now, in 3Q, net receivables rose $18.3 million on a sales gain of $3.2 million. The excuse that receivables rose due to the weekend doesn't hold much weight as the sales would have accrued on the weekend too. We also note that the long-term receivables increased by $8.5 million too and remember those are due over a period greater than 1-year. They convert standard receivables into long-term notes when customers run into cash problems and cannot pay their bills so those are lower quality credits to begin with and they are rising.

Let's match the receivables growth exceeding sales growth several quarters with the discussion on the conference call. That sounds exactly like 2Q18 when HCSG was cracking down on extended payment terms:

> *Ted Wahl from 3Q18:*
> *"**Strengthening customer payment terms and conditions, which includes increasing customer payment frequency from monthly to semi-monthly or semi-monthly to weekly payments,** with the goal of collecting what we bill and having operating cash*

flows approximate net income and replenishing the management pipeline with the goal of being prepared for the next wave of growth in 2019 and beyond."

Matthew McKee from 3Q18:
"Over the years, there was a migration to a monthly billing system and process rather than a weekly or biweekly. A couple years ago, we started the migration back for a couple reasons. One, and most importantly for us, it gives great visibility into the customer. Having four look-sees or two look-sees a month versus one at the end of the month provides us with a whole different level of visibility as well as a more constructive conversation if and when there's a shortfall.

From a customer perspective, it lines up better with either their own payroll cycle they had as well as their revenue stream, whether it be from the Medicare and Medicaid or insurance programs they may be part of. So, it's win-win. That's the way we think about it. That's the way we've approached it. It's been positively received. Here we are two years into this focus, this strategy, which is a migration.

*It's a process, not an event, but **more than a third of our customers are now paying us on something other than an end of month payment.** We'll continue to have those conversations with our customers and where it makes sense for both of us, we'll have that change take place. But again, very well received and something we look forward to continuing into the future."*

So, receivables are growing faster than sales for several quarters. At the same time, HCSG is cutting payment terms. The turn is 60-75 days depending on how you account for the huge bump in bad debt reserves. We should be seeing evidence of the 14-day terms if they cut the bulk of customers payment terms in half and that is not happening. **HCSG also noted that its customers continue to see declining occupancy rates. Running a senior living facility is a high fixed cost operation so lower occupancy hurts profitability.** HCSG continues to extend nearly a full quarter's sales in credit to these customers. If one-third of the customers are paying in under a month now, the rest must be stretching terms because the numbers clearly show receivables are growing faster than sales.

HCSG is blaming lack of staff to support growth

We would also argue that if you cut payment terms in half, customers will leave – or not sign up. Obviously, extending credit did not make more customers sign up. Either way, this should be a sizeable headwind. Yet, a company that has not increased customer totals in years, claims they have a huge backlog:

> *Ted Wahl:*
> ***"The pipeline of customers is as great as it's ever been****. That is, of all of the priorities -- and growth is one of them, but it's as an offshoot or an output of management development, but the actual opportunity as reflected within our pipeline and even outside of the pipeline, the targets that we would have that we've engaged in some sort of dialogue or even beyond that with is as robust and enough to keep us busy for the next five years without meeting another customer.*
>
> ***The pipeline and the demand for the services are very strong. It's just a matter of having the management depth*** *and then growing in a smart and strategic type of way, which has always been the focus of the company, but now as much as ever before -- selective expansion."*

We are not believing this at all. Not only has the company not grown its customer base in years, but it also has cut back on managers that seem to be the magic key to future growth:

	2017	2016	2015	2014
Managers	6,700	5,800	8,600	8,600

HCSG has been losing managers for years. We have pointed this out as an impediment to growth for some time now. They took a charge for $1.6 million in 3Q to retain more staff. Managers in the past have sued the company for unpaid overtime. Let's keep in mind, they have been cutting unionized workers too. HCSG has a history of hiring people who qualify for tax credits like paroled prisoners and chronically unemployed. Those tax credits are big in year one, decline in year two and then disappear. HCSG hires more of the same types of people to restart the tax credits. Essentially, employees leave and get better jobs. This is where HCSG is actually a counter-cyclical company. They hire people who have few options and potential employers can be choosy. They are a company that offers the customer a way to control wages. It was announced last week the country had 7 million more job openings than people to fill them. Wages are rising and nearly every issue of the *WSJ* notes that retailers cannot find people to work at Christmas, there are not enough truck drivers, e-commerce warehouses cannot get enough workers. HCSG should be seeing wage pressure and a lack of people to hire. We would also expect unionization to increase at the company.

	2017	2016	2015	2014
Hourly Employees	48,300	43,100	37,300	37,100
Unionized Employees	5,500	5,400	8,600	7,800

Sealed Air (SEE)-9/18 Quarter Update
Maintain HOLD

Sealed Air (SEE) confirmed nearly all of our areas for concern when it reported preliminary 3Q18 results and reduced its full-year outlook on October 17. The full results will not be released until November 1. Sales growth before FX has been cut from 7% to 6%. EPS is now expected to be $2.40-$2.35 down from $2.45-$2.55. EBITDA of $870-$880 million Is expected vs. $890-$910 million. Much of this is FX related, but we see more reasons for concern. Our August 23, 2018 report gives more background into these issues:

- **We were concerned that if the end markets for e-commerce, fresh food, and protein were growing so strongly, why wasn't SEE reporting better sales volume growth?** We estimated that volumes should be rising about 4% per year. Instead, sales volume was running less than 2%. In the preliminary 3Q results, SEE reported only "a slight increase in volume." It expected lower global volumes at a division that is 30% of sales in 4Q too. The biggest source of growth in 3Q is an acquisition that accounts for about half the constant currency growth.

- **Rising raw material prices were crimping margins and cash flow.** According to SEE, that is continuing and is resulting in it lowering its outlook. "Our third quarter profitability was adversely affected by currency headwinds and higher than expected raw material and freight costs." Continuing in the press release, the company expects higher input costs to continue in the 4Q. Rising working capital was already hurting cash flow and we questioned how much more the company could stretch payables. That remains an issue in our view.

- **FX is becoming a bigger headwind as we predicted too.** SEE lowered guidance from 2Q's outlook based on a forecast of currency hurting sales by $40 million up from $20 million and EBITDA by $10 million up from $5 million. SEE started the year with FX as a tailwind helping sales and EBITDA. This has changed in a big way for them.

- **We continue to question how much Sealed Air can boost prices to drive growth.** Already volumes are weak. More importantly, **a strong dollar effectively boosts prices for foreign buyers. This is actually a larger part of the FX problem that is tough to quantify.** SEE is having trouble with earnings based on foreign sales being translated back on a discounted rate. What investors are not seeing is how many foreign sales are not happening at all because SEE is priced above local competitors? In the first half of 2018, pricing was a big part of overall 6.6% sales growth: 2.7% from price, 2.1% from FX, and 1.8% from volume. They are guiding to negative FX and soft/negative volume. It sounds like pricing was the only organic source of sales growth in 3Q, "This [8% constant currency] growth was attributable to favorable pricing, a slight increase in volumes, and $44 million in acquisitions (4% of sales)." **It sounds to us that SEE is becoming more dependent on pricing at the same time it sees a lack of volume.** As the FX becomes a bigger headwind, pricing should become more difficult to take.

We're not convinced these headwinds are over with the cut in guidance on Wednesday.

McCormick & Company (MKC) EQ Review

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 McCormick (MKC) with a rating of (4-) Acceptable

We see very little to be concerned about with MKC's reported results. Our observations include:

- The company's 8/17 acquisition of RB Foods has impacted the year-over-year comparability of accounts receivable days sales outstanding (DSOs) and inventory days (DSIs) for the last four quarters. However, there appears to be a downward trend in DSOs which are already at a low level which bodes well for receivables management. Likewise, inventory DSIs are also indicating a decline. MKC utilizes the average cost method, which rules out any potential concern stemming from a "LIFO liquidation."

- MKC's accounts payable days (DSPs) have been increasing the last two years and the company has cited the extension of payment terms with suppliers as being a factor in the past. While we have seen no mention of the company's use of factored payable arrangements, we believe that the benefit from extending payment terms will likely reverse at some point in the future which will be a headwind on cash flow growth.

- Management noted in the 11/17 10-K that its *Kamis* brand name (on the books at $36 million) could be susceptible to a write-down in value should assumptions about future results change. The relatively small size of the carrying value makes this only a minor concern.

Working Capital Appears In-Line

MKC acquired the food business of RB Foods (Reckitt Benckiser's Food Division) on 8/17/2017. The company disclosed the following fair values for working capital accounts at the time of the acquisition:

Trade Accounts Receivable	$36.9
Inventories	$67.1
Trade Accounts Payable	$65.8

The RB Foods business only contributed to the income statement for the last two weeks of the quarter, yet the above working capital accounts would have all been reflected in the balance sheet immediately. This would have significantly skewed the working capital ratios for the 8/17 quarter. However, we can make a reasonable adjustment for this by simply removing the above balances from MKC's balance sheet as of the end of the quarter.

The following table shows the calculation of accounts receivable days of sales (DSO) for the last eight quarters, as well as an adjusted DSO for the 8/31/17 quarter which removes the RB Foods balance as of the 8/17/2017 acquisition date:

	8/31/2018	5/31/2018	2/28/2018	11/30/2017
Sales	$1,345	$1,327	$1,237	$1,491
Accounts Receivable	$512	$474	$502	$555
Accounts Receivable DSOs	34.7	32.6	37.0	34.0

	8/31/2017	5/31/2017	2/28/2017	11/30/2016
Sales	$1,185	$1,114	$1,044	$1,227
Accounts Receivable	$556	$430	$404	$465
Accounts Receivable DSOs	42.8	35.2	35.4	34.6
Adjusted DSO	40.0			

Note that the last four quarters include the consolidated RB Foods receivables as well as a full quarter of revenues. Therefore, the only impact to the year-over-year comparisons would simply be the extent to which the RB Foods business' DSOs differ from the DSO level of the base MKC business. With the exception of the 2/18 quarter, there has been a clear downward trend in DSOs. That coupled with the low level of DSOs indicates strong receivables collection. We note that moving forward, we will have better comparisons as the RB Foods deal will be completely lapped.

We see a similar trend with the company's inventory days (DSIs) driven by the same factors:

	8/31/2018	5/31/2018	2/28/2018	11/30/2017
COGS	$750	$752	$717	$823
Inventory	$806	$798	$828	$793
Inventory DSIs	98.0	96.8	105.3	88.0

	8/31/2017	5/31/2017	2/28/2017	11/30/2016
COGS	$701	$670	$631	$687
Inventory	$836	$780	$767	$756
Inventory DSIs	108.8	106.3	111.0	100.5
Adjusted DSI	100.1			

We note that the company utilizes the average cost method for inventory valuation which approximates the FIFO (first-in, first-out) method. Therefore, we are not concerned that declining inventories are resulting in a "LIFO Liquidation" where the company is eating into lower-priced inventories to boost reported profits. Also, note that the company does not typically utilize derivates to hedge its exposure to raw materials price fluctuations.

Again, the same exercise the accounts payable days (DSPs):

	8/31/2018	5/31/2018	2/28/2018	11/30/2017
COGS	$750	$752	$717	$823
Accounts payable	$646	$624	$584	$640
Accounts payable DSPs	78.6	75.7	74.4	71.0

	8/31/2017	5/31/2017	2/28/2017	11/30/2016
COGS	$701	$670	$631	$687
Accounts payable	$517	$453	$448	$451
Accounts payable DSPs	67.3	61.7	64.9	59.9

	8/31/2016	5/31/2016	2/29/2016	11/30/2015
COGS	$637	$631	$625	$680
Accounts payable	$361	$366	$337	$412
Accounts payable DSPs	51.7	53.0	49.1	55.3

Note that when we look at three years of payables data, we see that DSPs have been trending higher for the last two years. Here is the explanation of the increase in payables from the Liquidity section of the company's 11/17 10-K filing:

> *"The decrease in CCC [cash conversion cycle] in 2017 from 2016 is due to an* ***increase in our days payable outstanding as a result of extending our payment terms to***

> ***suppliers*** *and, to a lesser extent, a decrease in our days in inventory. The decrease in CCC in 2016 from 2015 is mainly due to an increase in our days payable outstanding as a result of extending our payment terms to suppliers."*

There is no mention in the company's recent SEC filings of it utilizing structured payable arrangements to allow suppliers to sell their receivables balances from the company to accelerate their receipt of cash. Still, it is clear the company has actively stretched its payable terms to maximize cash flow growth in recent periods, a common practice we have seen with virtually all the food companies which will likely reverse in the future.

Potential for Minor Impairment of *Kamis* Brand

MKC disclosed in its 10-K filed for the year ended 11/17 that the fair value of its *Kamis* brand name was approximately 14% above carrying value. However, it has cautioned that a "change in assumptions with respect to future performance of the *Kamis* business could result in impairment losses in the future." The *Kamis* brand name is on MKC's books for about $36 million, so we do not consider this to be a significant concern.

Danaher (DHR)EQ Review Update-9/18 Quarter

Current EQ Rating*	Previous EQ Rating
4-	4-

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

We maintain our rating on DHR at 4- (Acceptable)

DHR reported adjusted EPS for the 9/18 quarter of $1.10 which was 2 cps ahead of the consensus. We are maintaining our EQ Review rating of 4- (Acceptable) based on the following observations:

- We had previously noted that inventory days (DSI) increased by almost 3 days on a year-over-year basis in the 6/18 quarter but expressed minimal concern given the relatively small increase coupled with strong revenue growth. DSI trends improved further in the 9/18 quarter, registering 85.6 days in the 9/18 quarter compared to the year-ago number of 86.7.

- GAAP EPS benefitted 3 cps from "the release of valuation allowances associated with certain foreign operating losses and excess tax benefits from stock-based compensation, which in aggregate reduced the reported tax rate by 2.9%." However, the company removed this benefit from its adjusted non-GAAP numbers and it was not a factor in the reported earnings beat.

- With approximately 60% of sales coming from overseas and over 30% from undeveloped markets, DHR is very exposed to fluctuations in foreign currencies. FX was a 1.5% drag on reported sales growth in the period. Management further noted on the conference call that total company EBIT margins took an approximate 30 bps hit from both FX translation and mark-to-market impacts. FX risk was a key focus on the call and remains a risk going forward.

Procter & Gamble (PG) EQ Preview for 9/18 Quarter

Current EQ Rating*
3+

PG reports third-quarter earnings tomorrow. We noted in a previous review of PG based on 3/18 results that accounts receivable days were increasing. However, DSOs improved in the 6/18 quarter. In addition, the increase in days payable (DSPs) also reversed slightly in the 6/18 quarter which could be a headwind to cash flow growth in upcoming periods. We will be watching these trends along with free cash flow trends and commentary on share repurchases as the company's free cash flow does not currently cover the buyback.

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 recent 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.

Disclosure

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