BEHIND THE NUMBERS

EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Macy's (M) 1Q Update
Maintain BUY

We are maintaining our BUY recommendation on Macy's (M). The results beat forecasts by $0.10 and the company confirmed guidance. More importantly, many of the growth initiatives are showing positive results. We still believe the best bargain at Macy's is its stock price with a 6.4% yield trading for 7x EPS. Discussions on the call about Chinese tariffs hurt the stock after earnings, which we consider overstated and not a permanent risk.

Market Watch pointed out yesterday that the tariffs being talked about are almost immaterial. There is no discussion of putting tariffs on all Chinese goods at this point, and Market Watch points out that even if 100% of goods had a 25% tariff – it would amount to $135 billion against the US economy of $20.5 trillion. It would amount to a 0.65% increase in prices to consumers. On top of that, Macy's guidance already assumes the first three rounds of tariffs will be in place and the primary area where Macy's has exposure is furniture sales. Clothing would only be impacted if a fourth round comes to fruition – Per CEO Jeff Gennette:

> *"The three tranches of tariffs that were enacted in 2018 have no meaningful impact on our business and were factored into our 2019 guidance. The increase of the Third Tranche from 10% to 25% on May 10 does have some impact, particularly on our furniture business. However, the team anticipates that this can be mitigated. If the potential Fourth Tranche is placed on displays on all Chinese imports, that will have an impact on both our private and our national brands (for apparel).*
>
> *We would work with our manufacturing and brand partners to size and minimize the impact to our customers. This potential fourth tranche of tariffs was not contemplated when we provided annual guidance. We are hopeful that trade talks between U.S. and China will continue productively and the trade actions between the two countries will deescalate."*

Later on the call, Mr. Gennette noted that Macy's has been working to move production out of China for years already and that helps its private brands business (about 20% of sales) avoid tariffs. On national brands, Macy's believes it can work with partners to find solutions if the next round of tariffs kicks in.

After seeing the positive trends, we do not believe tariff risk can offset those. Plus, if tariffs are not enacted, it represents another positive catalyst for sentiment on the stock:

- **Another positive sales comp with very strong transaction volume.** This is now six straight quarters of positive sales comps. Transactions were up 5.7%. It appears BackStage is driving volume at a lower price point and people are shopping more frequently but buying fewer products per sale.

- **Gross margin was better than it looks at first glance.** Gross margin was down 80bp y/y. The company guided toward lower margin for 1Q and 2Q of 2019 as it worked off some inventory. Margin was actually flat before higher costs of free shipping.

- **Macy's is working to pull costs out of inventory and shipping.** It is combining shipments to stores to reduce delivery charges on the BOSS (Buy Online Ship to Store) program. It is tinkering with price points and number of units to set thresholds to earn free shipping. In the current 2Q, Macy's is rolling out systems to control inventory markdowns on a per store basis. Vendor Direct is expanding rapidly which gives customers more choices without Macy's owning the inventory.

- **Guidance seems conservative with gross margin down in 1Q and 2Q and calling for sales comps of flat to 1%. This should be the last year of heavy investment in remaking the store base with BackStage and Growth 150 rollouts.** Thus, free cash flow should improve noticeably as new rollouts annualize with higher sales, lower SG&A with the transition declines, and capital spending declines. Macy's has already focused on deleveraging too so stockholders should get more of the attention of rising free cash flow.

Comps Remain Positive with High Transaction Volume

Sales Comps	1Q19	4Q18	3Q18	2Q18	1Q18
Comp Sales	0.7%	2.0%	3.3%	0.5%	4.2%
Transactions	5.7%	6.2%	3.8%	0.5%	1.0%
Units/Trans	-2.2%	-4.9%	-3.1%	-2.6%	-2.0%
Rev/Trans	-2.7%	-0.3%	2.6%	4.6%	5.0%

There are several moving parts here. The roll-out of BackStage stores has continued during this time. The company has seen BackStage add to comps in a meaningful way:

Jeff Gennette:

> "*any time you add BackStage into one of our buildings, it lifts the comp of that store by about five full points. What's really exciting about BackStage is that when you look at it in the second and the third year that the momentum continues. It's not just a one-year episodic issue or opportunity.*
>
> *We look at -- the other headline we brought up in the fourth quarter was the cross-sell that goes on for our customer. About 15% of the customers that are in the stores that have BackStage across buying in both areas of the store and their purchases are up about 40% when they do that. So that gave us the confidence to add more BackStage. We've added nine so far of the 50 from 2019, but we're very excited about seeing what's happening with the comps and how the comps of BackStage are driving the comp of the entire store."*

BackStage is bringing in traffic and creating sales. However, BackStage is also a lower price point. The company guided to the first half of 2019 being a period when it would work down some inventories, which depressed prices and faced tough comps on pricing the prior year. Thus, the lower revenue per transaction was expected. The fact that BackStage started as only a few dozen stores, was boosted to about 170 by the end of 2018, and is adding 50 more this year creates some apples-to-oranges issues in the comps.

As this roll-out normalizes, we would expect to see the revenue per transaction level out and begin to rise again.

Adding BackStage and the Growth 150 stores are pulling in traffic and people shop more frequently. Also, the loyalty program brings in people more often and they are buying more.

Paula Price:

> *"Our Star Rewards loyalty program continues to perform very well. Our <u>Platinum customers are shopping with us more frequently. They're spending more with us.</u> They really love the simplicity and value of the new programs, and we had great responses to the exclusive Platinum customer experiences that we can offer them. <u>And so, platinum customers make up about 30% of our sales and their spending behavior is up 10%."</u>*

If the results are showing multiple years of higher traffic and sales from BackStage, but the downside is people make more frequent purchases that encompass fewer units – Macy's will likely take that tradeoff. The only area where more transactions of smaller sales hurts is when there is free shipping involved. We'll discuss below ways Macy's is addressing that.

Gross Margin Was Flat Before Delivery Charges

	1Q19	4Q18	3Q18	2Q18
Gross Margin	38.2%	37.5%	40.3%	39.7%

	1Q18	4Q17	3Q17	2Q17
Gross Margin	39.0%	38.6%	40.3%	39.0%

We noted that 4Q18, the company saw margin pressure from both mark-downs on inventory and shipping costs not leveraging as reasons for 110bp of lower gross margin. In 1Q19, there was a tough margin comp because 1Q18 had few mark-downs and the company guided that it would be working down inventory in 1Q19. Also, more BackStage stores in operation would lower price points.

Despite those pressures, Macy's noted that gross margin would have come in flat for 1Q19 except for shipping costs. We take that as a good sign as the company is working to improve its spending on shipping and inventory overall.

- BOSS (Buy Online Ship to Store) – this program offers free shipping and gets the customer to the store where he/she often buys more goods. Macy's is combining all the BOSS orders to various stores into fewer packages to reduce shipping costs.

- Changing free shipping policies based on customer status and buying habits. Rather than give free shipping to homes at $40, maybe it becomes $75. Other times, maybe it becomes free if another item is added. That should also help leverage the free shipping costs more.

- Inventory levels pressured 1Q19 and are expected to impact 2Q19 as well. Not only because inventory is higher than Macy's wants, but those two quarters have tough comps from 2018 when mark-downs less. That should allow gross margin to recover during the year.

- Hold and Flow Inventory system is rolling out in 2Q. This policy showed a 15% improvement in margin vs. non-test stores. Essentially, it gives each store an allocation of seasonal inventory and holds back more at the distribution center. Stores seeing stronger sales can rapidly be replenished, while the stores with lower sales of particular items have less to mark down.

- Localized inventory mark-downs are rolling out too. This will mark down inventory store by store rather than category across a full region. Essentially, why mark down an item by 50% that is selling in one store simply because it isn't selling in another nearby city.

- Vendor Direct is expanding. This is where vendors ship direct to the store or consumer with online sales. This gives Macy's access to a huge amount of inventory that it does not have buy or risk markdowns on. Plans are to add another 1 million

SKUs and boost the number of vendors in the program to 1000 up from 700. Shipping is still a cost here – but there is no incremental SG&A. Jeff Gennette was very excited about this program on the call:

> *"Vendor Direct has only upside. So, it adds sales. It adds profit. It increases customer consideration of Macy's. It increases traffic to our site. It addresses failed searches. And the profit rate on Vendor Direct is basically -- it's accretive to our overall, when you look at it. Because you really don't have any of the SG&A expenses, the minimal incremental capital, the no inventory investment, it makes for a very high ROIC case. And in Q1, it was about 10% of our online sales, came from Vendor Direct. But we see that penetration increasing as we add more and more content to it."*

There is more work being done on the supply chain as well. We see this as still being in transition, but all of the announced changes point to higher gross margin and more control on costs.

2019 May Be the Final Year of Heavy Transition

We like Macy's because the company has very clear plans on what it is doing and can specify them. Clients know how much we rip companies who continually throw out restructuring plans without showing much in the way of sales or margin gains. The plan is hailed but very little is ever spelled out, "We're going to spend $400 million over three years and will find ways to become more efficient." We always ask, "wasn't that the last plan also, which only cost $80 million?"

In the case of Macy's, they have been remaking the company through a series of large steps including asset sales, remodeling stores, boosting technology, better training of staff, retaining best staff… Through it all, investors have been collecting a dividend of over 6% waiting for the process to be complete and seeing a company set up with considerable upside leverage as better sales and margins meet.

The company has always had well laid out plans for its changes as well. For example, it has done entire presentations on just BackStage and the testing they did with it initially, how it rolled out into weaker stores first so they could tweak it further and still showed significant improvement for the store. How these will enter the comps going forward after

13 months. The cost per unit, the time to implement, the plan for rolling it out to more stores… They can quantify the change; BackStage is adding 5% to store comps and it continues to add after the first year.

In 2018, Macy's rolled out 120 BackStage stores and 50 of the Growth 50 stores. In 2019, another 50 BackStage and 100 Growth stores will be completed. While these heavy remodelings and reconfiguring of stores takes place – a store is likely losing some sales, running up extra SG&A investments, and seeing higher than normal capital spending.
Capital spending in 2018 was $932 million and 2019 should come in at $1 billion. After that, the issue starts to become there simply will not be stores left that have not received upgrading attention. The supply chain and logistics will have been addressed too. The major programs like Vendor Direct and mobile ordering will have been rolled out. We simply believe Macy's will have a tough time spending $1 billion annually in capital investments plus more in SG&A.

Right now, cash from operations is running about $1.8 billion per year with $1 billion in capital spending and the dividend is $460 million. As the transitions start to annualize, it should boost sales and income driving up cash from operations. We have noted before that closing stores costs Macy's about $1 billion in sales, which it has programs in place to recover. SG&A should largely be flat – so adding back that $1 billion in sales should add $280-$320 million in income to the cash flow statement. It is also $1.00 in EPS. Lower SG&A and lower capital spending will further drive up free cash flow. And, Macy's has already deleveraged that balance sheet too. We think free cash flow could double after 2019 and set up the company for share repurchases or higher dividends.

Guidance remains tame for 2019 too. We think Macy's is likely to beat forecasts calling for 0%-1% comp sales growth, a lower gross margin in Q1 and Q2 that moderates in the second half and EPS without gains on asset sales of $2.80-$3.05. It has some momentum in many areas and will add more of the growth initiatives in 2019 and they are comparing to an EPS in 2018 of $3.26 before gains on asset sales.

Hanesbrands 1Q Update
Maintain SELL

We are maintaining our SELL recommendation on HBI after 1Q results, which beat forecasts by 2-cents. Despite several areas of stronger sales, HBI did not boost guidance and in fact, reduced it slightly for 2019 in our view. Many of our concerns were evident such as margin pressure despite heavy restructuring. Past cuts in advertising are proving unsustainable. Sales growth also appears to be coming largely from initial stocking at new stores and forecasts of 2% sales growth are not calling for that to continue.

- **Guidance may be at the lower end for forecasts now.** The company kept the same EPS range of $1.72-$1.80 for 2019 but noted that operating profit would be hit by an extra $10 million in FX headwinds. That is worth 2.3-cents in EPS.

- **HBI is seeing areas of margin gain reverse as it has to support brands more.** We noted in our original report that the company's 70bp of margin gains since 2013 were driven by 161bp by cutting advertising, R&D and 401-k payments. Also, shipping and royalty costs are rising.

- **After a strong 1Q, HBI did not raise sales forecasts. Much of the growth seems to come from initial stocking. How many more stores are there to roll-out Champion?**

Guidance Is Unchanged Despite Ramping up Forecasts of FX Headwinds

EPS guidance for 2019 calls for HBI to earn $1.72-$1.80. That is the forecast based on 2% sales growth, 50bp gain in gross margin and 10bp gain in operating margin. After 4Q18, the company built in a headwind of $60 million on sales and $7 million headwind on operating profit from FX that was expected to heavily impact 1Q19. After 1Q19, the only part of guidance that changed was the FX headwind which is now expected to be $115 million for sales and $17 million for operating profit.

The $10 million in lost operating profit would be 2.3 cents in EPS using the expected 14% tax rate. With an 8-cent range on EPS guidance, a 2 cent change could happen and HBI remain in the same 8-cent range. However, it should move the forecast toward the lower end.

The company's view of this is outperformance in the 1Q offsets the bulk of the incremental $10 million in FX headwind. Barry Hytinen the CFO said, "In effect, this incremental FX headwind has been fully offset by the $9 million of outperformance in our first quarter operating profit."

We are not so certain this is the case. First, sales came in above guidance, but the operating profit margin fell from 11.3% to 10.7% (10.9% if you exclude the $4 million bad debt charge). The higher sales at the lower margin produced $4.1 million in higher operating profit. The company came in at $169.4 million in adjusted operating income which beat forecasts of $157-$167 million. So, the outperformance looks like 2.4 million, not $9 million.

Second, the company also talks about $4 million of bad debt expense in the quarter and adjusts for that, but that was an actual expense and given the credit quality of many retailers – we don't view that as a one-time event. It doesn't sound like HBI does either with this comment from the 10-Q, *"Net sales in our intimate apparel business decreased primarily driven by declines in our bras product category, which continues to be impacted by door closings and the challenging retail landscape within the mid-tier and department store channel."* We don't think investors should forget that bad debt expense was $29 million in 2018 and is normally over $20 million. Part of the margin improvement being forecasted by HBI involves that figure declining by 50%.

Third, HBI expected $7 million of FX headwind for 2019 with the bulk impacting 1Q19 – which came in at $5.9 million. It then raised this headwind to $17 million so they are not ahead of the game here already.

Fourth, 2019 guidance is calling for gross margin gains of 50bp. The first quarter came in +10bp. It is calling for 10bp of operating margin improvement for the year. After the first quarter and even adjusting for the $4 million bad debt charge, operating margin fell 40bp. So, they are in the hole on margins after 1Q.

Margins were actually helped by taking price increases against higher raw material costs. However, HBI uses FIFO accounting and routinely has 160-200 days of inventories. Cotton prices have been falling for much of 2018 and only rose for a month during 1Q19. They have since fallen rapidly in 2Q. We doubt they will have much success retaining pricing against falling cotton prices as they also battle with the strong dollar. Since inventory turns more slowly here – the brief rise in cotton prices could work their way through cost of goods sold against lower selling prices. We are actually concerned about the 50bp gross margin improvement prediction if 1Q only rose by 10bp.

Oil would be another key raw material for nylon. Prices for oil have been rising in 2019 and would justify some price hikes for HBI. The problem here is the slow inventory turns would have meant price hikes helping revenue and low-cost merchandise going through the income statement first and holding down cost of goods sold. As the year progresses, cost of goods sold for oil-derived raw materials should rise as revenues are flat. That could mean margin pressure going forward.

The fifth reason we aren't so certain guidance should be looked at as 1Q offset the higher FX headwind is the company didn't raise sales guidance. That was the whole reason 1Q looked better than forecast as it certainly didn't shine on margins. After the quarter, HBI held forecasts for sales flat at $6.885-$6.985 billion. Given that FX is expected to jump from a $60 million to a $115 million headwind now for sales, one could argue, they did boost sales guidance by $55 million. Let's grant that. $38 million was already realized in 1Q, so only half of that amount is now expected in the next three quarters. That still doesn't sound like much of an earnings driver to offset the increased headwinds.

HBI Is Seeing Higher Spending on Advertising and Brand Support

In our initial report on HBI, we noted that despite years of restructuring and digesting acquisitions, the company only improved margins by 100bp. That was overstated because 30bp came from moving pension expense out of the mix to a line item below operating income. So 70bp of margin was the gain after years of work.

Looking further, we saw that the company's biggest source of margin gains came from cutting Advertising, R&D, and 401-k contributions. These three items from 2013 to 2018 produced 161bp of higher margins with advertising being 125bp.

Our concern was that HBI would need to invest more in these areas and that would create headwinds on margin. That is already happening according the company:

From the 10-Q, *Activewear operating margin was 10.8%, representing a decrease from 11.1% in the prior year as a result of higher selling, general and administrative expenses,* *reflecting an increase in investments to support our brands and investments in distribution to maintain service levels and fulfill accelerating demand for Champion products.*

Guidance calls for $25 million in brand support for 2019 also – that's 36bp of margin headwind. We would not be surprised to see the company spend more than this. The company will argue the $25 million is built into their forecasts. But with the company assuming only 10bp of margin gain on a 2% increase in sales – those two items are only looking at a $35 million increase in operating profit. If the advertising needs to rise more, or R&D rises – it doesn't take much to chip away at the $35 million in expected growth.

Also, we noted in the first report, HBI is paying more in royalties to designers on products and more shipping for online sales. Those two areas have been rising as a percentage of sales and may be another 30bp ($21 million) of headwind this year:

$ spent	2018	2017	2016	2015	2014	2013
Royalties	$109.9	$100.9	$95.7	$84.7	$57.1	$42.1
Shipping	$409.1	$376.4	$324.8	$332.7	$295.3	$241.0

basis points	2018	2017	2016	2015	2014	2013
Royalties	162	156	159	148	107	91
Shipping	601	582	539	580	555	521

We Still Believe Much of Sales Growth is From Initial Stocking in the Channel

Initial stockings are real sales. But, the next year sales to the consumer need to grow or the shipments to retailers will be flat or down and HBI would report negative growth. It's more of an issue with how sustainable growth trends are. In the case of HBI, we're not seeing much evidence that 1Q sales growth was much more than one-time in nature:

Sales Growth	2Q19e	1Q19	4Q18	3Q18	2Q18
Innerwear	-2.0%	-3.1%	-0.1%	-6.9%	-3.4%
Activewear	11.0%	17.1%	13.5%	6.8%	6.9%
International	1.0%	13.4%	11.7%	11.3%	14.9%

The Innerwear division has been seeing retailers vanish and has been posting negative sales for some time. Activewear benefited from stocking products in new sporting goods stores and more directly to consumer channels. The Champion brand is expected to show strong results again in 2Q19 to offset mid-single digit declines in the rest of the portfolio. The

International unit has talked about selling into new stores in Asia and Australia with Europe being negative. Guidance is now for a 1% quarter coming – much lower than recent periods.

This goes back to the basic issue we have with HBI, there just isn't much growth and much of it has come from inorganic ways such as acquisitions. We noted in the original report that since 2013, HBI has bought companies with $2.7 billion in sales. Yet, total sales are only up $2.2 billion since 2013.

Moreover, while Innerwear has been showing negative growth for years, Activewear was not seeing stellar growth until 2018 as more retail stores took their products. Forecasts already show the growth there is going down again. International was growing at over 30% in 2016 and 2017. The 13% growth of 1Q is going to be followed up with 1% in 2Q? How much have things really changed in a few months other than there may not be as many stores to stock?

The fact that the company didn't raise sales guidance after beating in 1Q was curious to us. When the company expects International to drop off in growth rate and is forecasting a decline in non-Champion activewear is another bad sign.

Ball Corp (BLL) EQ Update-3/19 Qtr.

Current EQ Rating*	Previous EQ Rating
2-	2-

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

We maintain our earnings quality rating of 2- (Weak).

BLL's adjusted EPS of $0.49 missed consensus estimates by 2 cps. We continue to see multiple items of concern in the company's results.

- BLL's first quarter effective GAAP tax rate of 7.1% was lower than anticipated courtesy of excess benefits for share-based compensation. At the end of 2018, the company forecasted a 24% effective rate for all of 2019. Adjusted pre-tax earnings were $187 million and adjusted taxes were approximately $30 million, implying a 16% adjusted effective tax rate. If the adjusted tax rate had been 24%, we estimate it would have taken over 4 cps off earnings per share.

- The company is forecasting net debt to be about $6 billion at the end of 2019. Free cash flow is expected to be in excess of $1 billion, but management plans to spend $850 million on buybacks through the remainder of 2019 ($1 billion for the full year) and $185 million on dividends. Debt levels have reached their target level of before the Rexam acquisition. We find it interesting when a company openly commits to doing the full buyback for the year in May as it is essentially an admission that share price is not a consideration in the decision. Note that the 4.2% reduction in share count is adding a material tailwind to EPS growth.

- Accounts receivable securitizations continued to skyrocket with receivables sold but outstanding finishing the quarter at $1 billion, up from $589 million at the end of the 3/18 quarter. This likely gave an enormous boost to cash flow growth. Sold but outstanding receivables balances have flattened out in the last three quarters and we remain concerned that cash flow growth from receivables sales will fall off in 2019.

- In addition, the receivables sales appear to be masking an acceleration in the buildup of receivables. If we add back sold but outstanding receivable to trade receivables on the balance sheet plus an estimate of the China beverage packaging accounts receivable moved to held for sale during the quarter, it appears that receivable DSOs at the end of the 3/19 quarter jumped about 6 days over the year-ago quarter. We also note that the unbilled receivables portion of receivables on the balance sheet increased disproportionately as well. The jump in receivables could be an indication of the extension of more generous payment terms to drive revenue growth in the period.

- The company has warned that deteriorating conditions in China have eroded the value of goodwill associated with the Asia Pacific and AMEA segments and further deterioration could result in the need for a write-down. Carrying value is currently $78 million and $101 million, respectively. With the sales of the Chinese assets on the schedule for the second half of the year, we do not expect this to be a relevant issue.

- Pension expense fell $6 million versus the year-ago quarter from a lower recognition of actuarial loss. We view this as a non-operational benefit that added a little over a penny per share to EPS.

Sysco (SYY) EQ Update-3/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3+	3+

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

We maintain our earnings quality rating at 3+ (Minor Concern).

SYY's adjusted EPS in the 3/19 quarter of $0.79 topped the consensus by 9 cps. While we see fundamental warnings signs such as management warning of traffic declines in restaurants, declines in European operations and rising wage pressures, the company's overall earnings quality appears to be improving over the last two quarters.

- Cash from operations for the 9 months ended 3/19 rose to $1.4 billion from $1.1 billion in the comparable year-ago period. However, this was aided by last year's $400 million pension contribution as well as $35 million in lower MEPP liability payments and an increase of $72 million in accruals of severance payment related to European restructuring. Without these benefits, cash from operations would have declined in the period due to unfavorable working capital developments.

- Provision expense once again rose by $4 million in the 3/19 quarter compared to the year-ago quarter as the benefit received in the 6/18 and 9/18 quarters has reversed. We are no longer concerned about this issue.

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

Current EQ Rating*	Previous EQ Rating
3-	4-

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

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

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

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

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

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

DSOs Up 3 Days

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

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

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

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

Jump in Accrued Advertising and Promotion

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

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

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

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

Fall in Other Accrued Liabilities

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

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

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

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

Explanation of EQ Rating Scale

6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

Disclosure

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