BEHIND THE NUMBERS

EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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ConAgra Brands (CAG)
Maintain SELL

Welcome to 1985 – just raise prices and ignore private label. CAG's first strike was the admission that Pinnacle Foods sales are eroding and results are coming in below forecast. After strike two with CAG's Legacy business posting disappointing fiscal 4Q19 results, we are maintaining our SELL recommendation. The company posted weaker sales at all units except international which had a product roll-out in Canada. Volume was shed and it appears that pulling Food Stamp delivery forward with the government shutdown that helped 3Q results reversed and created a tough 4Q for CAG. Weakness in margins also remains an issue as the company needs both sales and margin gains to reach EPS and debt reduction targets:

- **Kroger and Wal-Mart confirmed that CAG's 3Q was helped by accelerated food stamp payments and numerous winter storms.** Out of the blue, CAG reported volume gains in the prior quarter with little explanation. KR and WMT said their sales jumped as more people received an additional food stamp payment due to the government shut down and storms caused people to stock up on supplies. KR and WMT forecast a reversal and just confirmed it. **CAG reported a typical quarter of negative volume and found it tough to hold pricing.**

- **CAG continues to focus on boosting pricing for growth. We noticed it cut marketing and brand building that was supposed to support the higher prices and product roll-out and that alone likely added 2-cents to EPS last quarter. Legacy CAG is now joining Pinnacle Foods and posting negative growth**

- **Looking at a couple of small parts of the portfolio show growth is slowing and not offsetting areas of negative growth for CAG. We noticed that Pinnacle's sales continued to decline at an accelerating rate again too.** After much hype around *Wish-Bone* and *Duncan Hines* in the spring – they received no attention in 4Q results or presentation beyond a comment, "they are moving toward stabilization."

- **Taking pricing when the rest of the market does not – swiftly cuts volumes. CAG saw this hit three product lines in the last quarter – *Hunt's Tomatoes, Chef Boyardee*, and *Marie Calendar's*.** CAG noted that it will stick to its guns and hold higher pricing.

- **The lower volumes quickly hurt margins too. Grocery & Snacks saw margins fall 220bp in 4Q and Refrigerated fell 100bp. CAG may have a tough time winning back customers too if it is not only higher priced than private-label brands but other name-brand competitors too.** They posted negative growth all 3 brands and it looks like *Chef Boyardee* volume fell at double digits. *Marie Calendar's* looked very hard hit by competitors' pricing actions.

- **CAG believes discount pricing is temporary and its way of operating will win out in the long run. It touted that these brands continue to be big cash cows and iconic brands.**

- **However, it also took an impairment charge against *Chef Boyardee*, which indicates to us that the future cash flows are not facing temporary pressure.**

- **We still think the debt and margin goals are unrealistic. Looking at free cash flow and the dividend, it appears debt could fall about $1.2 billion in the next two years. To reach the 3.5x EBITDA target, the EBITDA would require a 20% operating margin.** The company is only forecasting mid-16% in the next year and a long-term target of 18%-19%. Plus, marketing and R&D likely needs to rise after underinvestment and the need to remake product lines and roll out new products.

- **Margin goals rely heavily on realizing synergies which we still consider optimistic – especially the increased synergy target after Pinnacle Food disappointed. The company just saw margins decline in fiscal 2019 even with some realized synergies and lower marketing costs as negative volume offset pricing.** It will require more than just the just synergies, which means taking more pricing and we're watching that plan not work so well right now. Moreover, looking at the 4-years of remaking legacy CAG – margins were only up about 40bp from 2015-18, and they fell in fiscal 2019.

Kroger and Wal-Mart confirmed that Food Stamps Were a Headwind Last Quarter

Whenever something that normally doesn't grow suddenly has a nice quarter – we look for explanations. CAG's fiscal 3Q19 had a surge in volume, which was out of line with past trends. The company attributed the increase to its brand-building plans and changing the labels of various products. We were skeptical as noted in our 3Q update and pointed out that winter storms that impacted nearly the full country for periods of time caused more people to eat at home and stock up in case of power outages or closed roads during those times and thus shopped more at grocery stores. Also, with the federal government shut down, Food Stamp payments were accelerated with many people getting four payments in the last quarter vs three.

According to Kroger, the food stamp issue added 44bp to its sales comp and Walmart gained 40bp. Due to the timing of their quarter ends, they effectively had 2 months of this period in their fiscal 3Qs and 1 month in fiscal 4Q. The results are in and Kroger saw the Food Stamp issue as a 15bp headwind and Walmart said it was about 40bp for it in the most prior quarter:

Comp Sales	1Q19	4Q18	3Q18	2Q18	1Q18	4Q17
Kroger	1.5%	1.9%	1.6%	1.6%	1.9%	1.5%
Wal-Mart	3.4%	4.2%	3.4%	4.5%	2.1%	2.6%

ConAgra's legacy business returned to the normal trend of weak volume and trying to hold some pricing and ended up with negative sales growth after enjoying the full impact of Food Stamps and winter storms in its last quarter:

CAG Grocery	4Q19	3Q19	2Q19	1Q19	4Q18	3Q18
Volume	-1.1%	2.1%	-2.2%	0.1%	-0.3%	-4.1%
Price	-1.4%	0.8%	0.3%	0.0%	1.4%	-2.2%
Total growth	-2.5%	2.9%	-1.9%	0.1%	1.1%	-6.3%

CAG Refrigerated	4Q19	3Q19	2Q19	1Q19	4Q18	3Q18
Volume	-1.5%	3.5%	0.5%	0.5%	2.9%	1.8%
Price	0.9%	-1.1%	0.0%	0.9%	2.3%	0.8%
Total growth	-0.6%	2.4%	0.5%	1.4%	5.2%	2.6%

CAG had the best of that in its third quarter and the worst of it last quarter. We continue to believe that the last two quarters aside, CAG is simply not a growth company.

Just Keep Boosting Prices – But Don't Marketing Investments Need to Continue?

CAG repeatedly says it does not want to focus on market share and is more concerned value over volume. Higher profits on smaller volume. As a result, its plan is to follow what P&G and Coke did for years – unsuccessfully btw. Keep raising prices and sacrifice volume. Private label goods have a place too and they can have the lower margin sales. In the prior section, it is already clear that taking pricing at the grocery and refrigerated divisions is becoming more problematic to maintain. For the total legacy part of CAG, it simply isn't growing the topline.

Org. CAG Growth	4Q19	3Q19	2Q19	1Q19	4Q18	3Q18
Legacy Vol	-1.2%	1.2%	-2.2%	0.0%	-0.1%	-2.8%
Legacy Price	0.7%	2.1%	1.1%	2.1%	2.1%	0.6%
Brand Building	-0.2%	-1.4%	-0.5%	-0.9%	0.0%	0.0%
Growth	-0.7%	1.9%	-1.6%	1.2%	2.0%	-2.2%

We want to point out three things here. First, with the exception of the 3Q19 when storms and Food Stamps helped demand, Legacy CAG is generally posting negative volume continually. Moreover, the pricing gains are not that strong either and appear to be slowing. The recent trends in volume follow several years of negative volume as CAG has been working to take pricing for four years now. So even with easy comps, CAG's base business is not growing.

Second, taking price against cheaper competition requires marketing and brand support. Recently, some of this spending has been reallocated as a reduction to sales rather than an expense. That is the line on brand building in the table above. After a heavy investment in 3Q19 to roll out some new products – this area of spending was cut significantly in 4Q19. That is a key point too. CAG missed on revenue forecasts even though the contra-account charge to sales almost disappeared completely last quarter. In effect, that cut in marketing boosted net sales – and CAG still missed.

Brand building investments and marketing were supposed to be very necessary to roll out all the new innovations like changing the name of *Wish-Bone* ranch dressing to *Wish-Bone RANCH DRESSING*. Yet, it continues to slash spending:

Marketing	4Q19	3Q19	2Q19	1Q19
Advertising	$73.9	$67.4	$69.4	$42.7
Brand Building	$3.7	$28.0	$10.5	$16.2
Total	$77.6	$95.4	$79.9	$58.9

We estimated the brand-building in dollar terms by using the basis points allocated as a drag on sales in the various quarterly presentations. Pinnacle Foods was acquired in the 2Q of last year. Historically, Pinnacle spent about $30 million per year on marketing along with some unquantified slotting fees. For the fiscal year of 2019, CAG spent $312 million. Assuming a full year of Pinnacle, it would likely have been about $320 million.

The problem is stand-alone CAG used to spend $330-$350 million per year. With Pinnacle at roughly $30 million and the company highlighting how much support spending it will be making – we're surprised to see the combined company coming in below $360 million. **Simply having brand building come $10 million light added 2-cents to EPS in the 4Q19 results.**

The third thing we want to point to is CAG's calling out of some new innovations for growth in a handful of products is not always sustainable nor is it driving positive sales for all of legacy CAG. We've talked about this in prior reports but the playbook often looks like this: discontinue a current product/packaging by investing in mark-downs of previously shipped product and clearing shelf space in the stores, then against those ugly comps, roll-out the new version and packaging with some marketing and enjoy the initial stocking of the shelves again. As sales equal customer consumption and not shelf stocking, the growth rate declines. For individual areas in the product line-up, growth can pop – but because people do not necessarily eat more food – they may not buy another product in the company's portfolio creating negative growth elsewhere as they try the new version of something else. Thus, the total growth of the company does not increase:

Sales Growth	4Q19	3Q19	2Q19	1Q19	4Q18	3Q18
Frozen Single Meals	5.7%	8.3%	11.3%	10.0%	13.0%	13.2%
Snack Foods	6.5%	7.5%	6.4%	3.2%	5.8%	5.7%
Total Legacy CAG	-0.7%	1.9%	-1.6%	1.2%	2.0%	-2.2%

The company doesn't break down frozen single-serve meals and snacks into volume and price, but it is clear that the growth phase for frozen single meals is slipping. The company blames some of that on competitors offering lower prices than Marie Calendar items. Someone wants the market share more.

What is interesting in this dynamic is some of the Pinnacle divisions - that are not in the numbers above - received enormous attention in 3Q19 and Investor Day. Sales at *Duncan Hines* and *Wish-Bone* have been declining at double-digit rates for some time. Investors were told, the new product is starting to roll-out, the innovation teams at CAG are fixing this. There were multiple slides for each in various presentations. **Did anyone else notice that neither were mentioned in the 4Q presentation at all? In fact, the only mention of them on the call was "they are moving toward stabilization."** That sounds like sales trends are still negative even with the new label designs. Pinnacle sales at retail are still showing accelerating declines:

PF Retail	4Q19	3Q19	2Q19	1Q19	4Q18	3Q18
Sales Change	-5.6%	-4.6%	-3.0%	-1.4%	1.1%	2.1%

The company has already warned that a turnaround for Pinnacle Foods will probably not start for 6-10 months. What's the plan? They are going to repackage products and raise prices in an attempt to boost total sales and margins. We'll talk about this more below, but we're skeptical that if customers aren't buying cake mix and salad dressing now – what will make them buy more at higher prices? Maybe higher marketing and brand investments – which again looks like a headwind for future results.

Chef Boyardee, Hunt's Tomatoes, Marie Calendar's Show the Fine Line of Price Hikes and Material Volume Declines

During the quarter, CAG noted that the price of steel cans had risen and therefore they raised prices for *Hunt's Tomatoes* and *Chef Boyardee* canned pasta. In *Hunt's* they raised prices by 5.1%, more than any other branded companies while many private-label tomatoes took much less pricing and many held flat. They did not quantify how much volume CAG lost, but CEO Sean Connolly noted, "*what we did not anticipate is that private label would stay flat and, in some instances, actually decrease price.* ***By the end of the quarter, price gaps were simply too wide for consumers to ignore and we lost volume."***

Anecdotally, we noticed this week that *Hunt's Tomatoes* were selling for a 100% premium to the store brand. Across the aisle, Kraft macaroni and cheese was selling for $1/box versus $0.89/box for the store brand. Both companies are getting a premium price, but has CAG already pushed the pricing gap too far?

Chef Boyardee saw sales fall by 8.9%. Now remember, they raised prices. So, if sales fell 8.9%, the volume decline was likely greater than 10%-12%. Going back to our red flag above, that the company also cut back on marketing, this probably hurt sales even more. Here's what Sean Connolly said on that:

> "*Similarly, on Chef Boyardee,* ***we took price increases*** *throughout the year. In Q4, the* ***elasticity impacts of these increases were exacerbated by a decrease in merchandising support that was beyond our expectations.*** *Each of these brands, Marie Calendar's, Hunt's and Chef Boyardee has a leadership role in its respective category.* ***When on-shelf price gaps grow too wide or merchandising becomes uncompetitive, volume can***

> ***be impacted quickly and significantly*** *in the short-term windows and that was the case in Q4."*

Leaving aside the odd comment that CAG's marketing spending was lower than they expected as though the company had no control on that matter, we think this captures the problem that branded companies have been dealing with for 40 years. They don't operate in a vacuum anymore. There are other big players in food and supermarkets have huge private label offerings on the same shelves. Raising prices is not a pain-free way to grow – It cost their iconic brand over 10% volume decay in one quarter. Marketing has to be ramped up to try to limit volume decay and that is a sales/margin headwind too.

Marie Calendar's saw sales fall 3.3% despite all the new product remakes. CAG is blaming promotional pricing by competitors taking market share:

> *"Slide 14 highlights one example, where our* ***competitor's product was discounted to drive significant incremental or promoted growth.*** *As we moved through the fourth quarter, our competition became more aggressive on price and displaced some of the very valuable merchandising support that we had anticipated for Marie Calendar's. We don't believe that the short-term renting of our market share is a sustainable way to compete."*

CAG is still pushing its plan as better – raise prices and take more profit. Its view is other players cannot survive with big volume gains at lower prices (incremental sales growth of competitor's products vs. *Marie Calendar's* was +75% vs -20%. We would note two things. The first is **shoppers stock up on products that are on sale. It is called pantry inventory** (or in this case freezer inventory). If meals are normally $5 and suddenly only cost $3, people buy thirty of them instead of four. **It takes longer to work off supply at home. Also, they become conditioned to wait for a sale before they buy again** – there's no hurry to buy more given the supply at home. This was seen when shoppers were conditioned in the early 2000s to see that pricing changes and thus, they were conditioned to stock up on shampoo or laundry detergent anytime they were on sale. When the recession hit and people stopped spending, Procter & Gamble and Clorox found that even lowering prices didn't get people to start buying again because they still had 7 bottles of soap at home. Also, it's rare that the cheaper brand doesn't stay cheaper at all times. The gap may narrow, but it still offers a lower price than CAG. Thus, once market share is lost, it's tougher to get it back.

The second problem in our view is when CAG loses volume or has only modest gains – its margins tend to fall. This is key to the whole plan, give up low profit volume, boost price and enjoy higher margins:

CAG Grocery	4Q19	3Q19	2Q19	1Q19	4Q18	3Q18
Vol. Change	-1.1%	2.1%	-2.2%	0.1%	-0.3%	-4.1%
Price Change	-1.4%	0.8%	0.3%	0.0%	1.4%	-2.2%
Margin Change	-220bp	+142bp	-2bp	-129bp	+121bp	-257bp

CAG Refrigerated	4Q19	3Q19	2Q19	1Q19	4Q18	3Q18
Vol. Change	-1.5%	3.5%	0.5%	0.5%	2.9%	1.8%
Price Change	0.9%	-1.1%	0.0%	0.9%	2.3%	0.8%
Margin Change	-100bp	+17bp	+100bp	-162bp	+109bp	-58bp

In talking about *Hunt's* and *Chef Boyardee*, CAG's CEO was clear to point out how strong those brands are and how much cash flow they generate. They have seen temporary pricing issues from competitors before, they expect those products to remain very strong:

> *"We have a variety of canned food businesses that have quite frankly been very reliable contributors over the last several years, Hunt's is a good example of one of those businesses as has Chef. It is quite possible that from time to time for all the reasons we've discussed quite a bit today that we can see kind of this non-economic behavior by competition. That will happen from time to time.*
>
> ***But, it doesn't tend to happen often and it does tend to be transitory. So, to label a reliable contributor as no longer reliably contributing is if that the perpetual notion is a bit of an overreaction.*** *But I'm not going to say that we don't evaluate these kinds of things all the time. I don't think you'll find a company in our space that's been as active as we have over the last five years in reshaping the portfolio. And that includes divesting things that are kind of chronic drag on what we're trying to accomplish. So, we're always looking at that.* ***We did more of that this quarter. I just wouldn't want you to paint -- to label canned foods as not reliably contributing as a perpetual notion when that's just not been what we experienced. In fact, what we've experienced is, historically it's been a high cash flow business and it's thrown off a lot of cash****, a lot of fuels for growth elsewhere in the portfolio like frozen."*

The question has to become – why did they take an $89.6 million impairment charge against *Chef Boyardee* last quarter? If all this is temporary, the long-term cash flow should not be

impaired. We also question how such a strong brand can get hit for a double-digit volume decline so quickly.

Are Debt and Margin Goals Realistic?

CAG expects to pay down its debt to 3.5x EBITDA by FY2021. That's two full years. Currently, the company is giving guidance for $1 billion in free cash flow for 2020 and the dividend consumes just over $400 million. The company also expects to spend over $300 million to merge the companies and develop synergies. Let's keep it simple and assume the $300 million in cost is in free cash flow guidance and forecast the company can retire $600 million in debt each of the next two years. That would drop debt from the current $10.4 billion to $9.2 billion. **If the ratio is going to be 3.5x, EBITDA needs to be above $2.6 billion.**

What is the starting point? Legacy CAG just did $1.17 billion in adjusted operating profit for 2019, which was down $18.8 million from fiscal 2018 with $31 million of synergies achieved. Pinnacle Foods did $3.15 billion in sales and $690 million in EBITDA for fiscal 2018 We only have a partial year to look at for 2019, but we know the sales are down about 4%, and the operating margin was 15.3%. Also, depreciation is running about $100 million for the total group per quarter. We are going to break that down as $70 million to Legacy CAG and $30 million to Pinnacle. **We estimate the starting point is basically $2.0 billion in EBITDA**

Starting EBITDA	
CAG Legacy EBIT 2019	$1,172
PF est. EBIT	$463
Annual Dep/Amt	$400
Est. EBITDA	$2,035

CAG believes it will find $285 million in synergies by the end of fiscal 2022. The 2019 results already include $31 million. If we give them credit for finding another $200 million by the end of fiscal 2021, that would be 80% the target and get EBITDA to $2.2-$2.25 billion. **We've already addressed many times that we do not think that forecast is realistic. Pinnacle had been restructured extensively by the prior owners and CAG was forecasting $215 million in synergy which was 700bp of margin from Pinnacle when it first acquired it.** After Pinnacle disappointed and CAG announced it would need to rebuild the product line and support mechanisms, it magically boosted the synergy forecast to $285 million. **With**

Pinnacle results continuing to fall, we remain skeptical about the full level of synergy will be realized.

Sales growth is expected to be about 1%, so getting EBITDA above $2.6 billion is not going to come from the top line. That would only contribute about $30 million to the $350-$400 million shortfall. The only way this can happen is if CAG picks up about 300bp of margin on top of all the cost synergies! If revenues rise by 1% and 1%, they would top $11 billion in FY21. That would require a 20% operating margin to reach $2.2 billion in EBITDA and $2.6 billion in EBITDA. CAG isn't forecasting a margin that high.

We know their marketing and brand support needs to increase – that's a headwind for margins. In fact, marketing was lower in 2019 than in recent years for just CAG without Pinnacle. A $50 million increase in this area would be a 45bp headwind on margins. We also know they are remaking many products which means R&D should be rising, which is also a headwind for margins. Combining computer systems, buying in bulk, shipping on the same truck – all those types of margin increases are part of the synergies the company expects to find and we already added that into the total. CAG has to achieve those synergies – then likely double it with other margin boosting means. Let's also not forget, even CAG expects Pinnacle to be digging its hole deeper in early fiscal 2020 until they can fully apply their plan.

As we pointed out after the Investor Day presentation, CAG is touting how it grew margins by 400bp from fiscal 2015-18. However, the bulk of that involved selling a lower margin potato business and spinning off a money-losing RalCorp. Looking at what CAG was operating now and in 2015 – basically the legacy grocery business – margins only grew by 40bp as a result of 4-years of remaking the business. And as we've pointed out, they gave back margin last year at the two biggest units:

Legacy Margins	f-2019	f-2018
Grocery 50% EBIT	22.5%	22.9%
Refrig 33% of EBIT	17.2%	17.4%

Even the company's forecasts do not seem to call for much more than simply the $285 million in synergies to materialize by FY22. Sales are under $11 billion and should rise slightly over that by FY22. That makes $285 million in synergies worth 260bp by then. Operating margins in 2019 were 15.4%, the forecast is for those to rise to 16.2%-16.8% this year that's basically $90-$150 million increase in EBIT so there's synergy kicking in. Then the goal is

18-19% margins after the integration is complete in FY22. That's 260bp-360bp of margin gain. They would still be shy of reaching $2.6 billion in EBITDA too. $11.1 billion * 18% is $2 billion of EBIT and add in $400 million of depreciation = $2.4 billion for EBITDA. That would be another year out too.

Healthcare Services Group – 10-Q Update
Maintain SELL

After seeing the latest 10-Q we maintain our SELL recommendation on HCSG. We won't belabor the issues we discussed a few weeks ago after earnings. We will point out that **the SEC investigation into reported earnings continues.** We still believe the selling point for customers to hire HCSG is to slow pay the bills and essentially use HCSG's capital. Despite claims of accelerating collections, the A/R and DSO trends continue to show growth even against falling revenues.

- We believe the SEC issues center on years of the company rounding up factions of a cent and noted that the sum of the quarterly EPS reported by HCSG was often higher than the annual EPS reported by the company. We discussed this in prior reports.

- The cash flow statement shows receivables continue to consume cash despite falling revenues and the company's repeated statements that is speeding collections in a material way.

- Even with massive reserves for bad debt, writing off reserves, and reclassifying some receivables to long-term notes receivables – the gross DSOs are 89.5 days now! The highest we have seen. Net DSOs are being lowered by 13.1 days due to rising bad debt reserves and 7.5 days by classifying receivables out of current status.

- Troubled receivables have risen from 7% of total A/R to 29% in the last year. If we subtract the troubled figure from gross receivables – the concentrated pool of clean receivables should be isolated. It should show the impact of the company's statement that it has moved 55% of customers to a faster collection cycle often of only 7-14 days. Instead, DSOs of just that pool remains above 60 and is not declining.

Now that we can see the cash flow statement and the actual bad debt reserves, the receivables continue to grow. This runs completely counter to what investors should expect from a company that is not only losing business, but also claiming it is accelerating collections. Last quarter, HCSG noted that it has increased collection speed with 55% of customers in the last year. How can receivables be a drain on cash flow if that is true?

	1Q19	4Q18	3Q18	2Q18	1Q18	4Q17
Sales	$476.1	$496.4	$506.9	$503.7	$500.6	$499.4
Seq/Sales Chg	-$20.3	-$10.5	$3.2	$3.1	$1.2	$8.1
Seq A/R growth	$26.0	-$5.5	$23.7	$9.4	$16.8	$17.9

The company should be seeing receivables growth match sales growth if collection speed is flat – they aren't even close to doing that. 1Q19 showed a $26 million rise in receivables as sales fell sequentially by over $20 million!

HCSG wants investors to focus on simply net Accounts Receivable.

	1Q19	4Q18	3Q18	2Q18	1Q18	4Q17
Revenues	$476.1	$496.4	$506.8	$503.7	$501.8	$499.4
Net Receivables	$392.4	$384.8	$399.4	$381.1	$373.8	$394.2
Net DSOs	75.0	70.5	71.7	68.9	67.8	71.8

Even under this measure, the receivables are increasing. The talk is that many customers are now paying in 7-14 days. DSOs net of reserves are 75! What makes this picture still worse is HCSG is writing off receivables, taking huge reserves for bad debt, and reclassifying receivables into long-term assets. In fact, we have never seen the gross receivable balance this high.

	1Q19
Net A/R	$353.1
Net N/R	$39.3
Reserves	$68.6
written off in 1Q	$7.0
Total Gross A/R	$468.0

By this measure – DSOs are 89.5 days. They are classifying 13.1 days of DSOs in bad debt reserves and 7.5 days in long-term notes receivable. Trying to take the most optimistic view, HCSG discloses the size of their problem receivables that the reserves are held against. This figure continues to rise rapidly. Subtracting the troubled receivables from the total gross receivables should be the receivables that customers are current on and it should be obvious that HCSG has accelerated collections. It does not show that at all:

	1Q19	4Q18	3Q18	2Q18	1Q18
Gross A/R	$461.0	$442.0	$448.0	$430.0	$422.7
Troubled A/R	$133.8	$115.7	$102.6	$98.2	$30.0
Current A/R	$327.2	$326.3	$345.4	$331.8	$392.7
DSOs of Current	62.5	59.8	62.0	59.9	71.4

Troubled receivables have risen from 7% of the total to 29% in the last year giving the pool of clean receivables to really shine. DSOs have still held at 60 days or higher of just the current receivables. All the talk of having 55% of customers now paying more quickly with many on 7-14 day terms should be evident by isolating the "quality" receivables. These are not going down at all. This is confirmed again by the receivables balance continually rising quarter after quarter. Forget 7-14 days, if current receivables were being paid in 30 days – those DSOs should be about $150-$160 million. They are holding flat at more than twice that level.

Boston Scientific (BSX) EQ Update

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 are maintaining our earnings quality rating of 4- (Acceptable).

BSX reported adjusted EPS of $0.35, a penny shy of the consensus estimates. The company had several relatively minor unexpected items not included in its original outlook for the quarter, however, they essentially offset themselves. A gain related to litigation payments received of about 2 cps was offset by an approximately equal impairment related to the withdrawal of its mesh products. Likewise, a slightly lower than anticipated tax rate was largely offset by make-whole call payments related to the February bond offering. With all the small back and forth items, we are not viewing the miss with too much concern although it certainly was not a decisive beat.

- Accounts receivable days adjusted for receivables derecognized under the securitization program declined by three days and the rate of factoring slowed. We remain unconcerned about the company's receivables balances.

- We note that deferred revenue ended the quarter at $369 million (13.5 days of sales), down from $373 million (13.3 days) in the 12/18 quarter and $393 million (15.1 days) in the year-ago first quarter. This is a mild concern as the decline on the days sales basis could be an indication of accelerated revenue recognition in the current quarter. However, given the contraction in receivables days, we are not as concerned about aggressive revenue recognition in the quarter.

- BSX announced on January 20th that it closed the acquisition of the remaining 80% of privately-held Millipede for $325 million with an additional $125 million in payments contingent upon meeting certain commercial milestones. Millipede was formed in the first quarter of 2018 to develop a Transcatheter Annuloplasty Ring System for the treatment of severe mitral regurgitation. BSX's original investment included an acquisition option agreement. BSX made an upfront cash payment of $90 million at the time. By the fourth quarter of 2018, Millipede had successfully completed in-human clinical trials and BSX exercised its option to acquire.

Arrangements like this are commonplace in the pharma and medical device industry, but we remain critical of them as we see them as essentially a way to keep R&D expense off the income statement. The original investment was capitalized, as was the payment for the remainder of the company. Of the $510 million total purchase price, $271 million was booked as goodwill and $295 million was booked as indefinite-lived intangibles, neither of which will ever be amortized.

- BSX recorded a reversal of $28 million to its reserve for contingent consideration related to past acquisitions. To the company's credit, the boost to profit was adjusted out of its non-GAAP results.

- The company received a one-time cash payment related to its litigation with Edwards Life Sciences which resulted in a $25 million net gain. This was also adjusted out of the non-GAAP earnings figure.

- Subsequent to the quarter, the FDA ordered all makers of transvaginal surgical mesh products to stop selling products in the US due to reclassification as high risk devices. The company recognized $25 million in pre-tax charges related to inventory, intangibles write-offs and return reserves.

Medtronic (MDT) EQ Update

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 are lowering our earnings quality rating on MDT to 3- (Minor Concern) from 4- (Acceptable). We are not overly concerned by the company's earnings quality but given the meaningful jump in receivables and ongoing restructuring charges, we were compelled to lower the rating.

- MDT's restructuring spending increased in fiscal 2019. In the 1/18 quarter, the company announced its Enterprise Excellence plan with the goal of improving global manufacturing and operating models and optimizing certain commercial processes and systems. It estimates total pretax costs will run $1.6-$1.8 billion through 2022. Total charges in fiscal 2019 were $424 million compared to $96 million in 2018. We note that $193 million of these charges were labelled as "associated costs" and included the salaries of employees working on the program. The concern with large restructuring charges is that ongoing operating costs could be included in these charges thus benefitting current charge-adjusted earnings. Note that the Enterprise Excellence program was started in the same quarter the Cost Synergy program ended. While the company is no longer taking charges to earnings related to the Cost Synergy program, it is still making cash payments against the restructuring reserve which amounted to $57 million in fiscal 2019.

- Accounts receivable days were up by 2.6 over the year-ago fourth quarter. Management did not address the receivables increase in its conference call or financial commentary in its filings, but the CFO did make the following comment in the call:

  "We expect our first quarter growth rate to be lower than normal on the heels of a better than expected fourth quarter…"

  This statement seems to imply that sales from the fiscal first quarter (1/19) were pulled into the fourth quarter (4/19) and the increase in receivables could be a symptom of that.

- Days payable jumped to 72, almost 10 days over the year-ago fourth quarter. The company attributed this to a “decrease in cash paid to suppliers… due to our continued progress in extending supplier payment terms.” Management specifically noted its higher than forecast cash flow conversion rate for the year. Days payable actually declined on a year-over-year basis in the previous two quarters so this quarter represented somewhat of a “catch up” period likely due to timing.

- The company reduced its contingent consideration liability by $66 million as results at acquired operations missed the top end of expectations. However, this was adjusted out of non-GAAP results.

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Charles River Labs (CRL) EQ Update

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 are maintaining our earnings quality rating of 4+ (acceptable).

Most of the company's revenue is recognized over time under long-term contracts which makes that area the first place to look for potential distortions of results. However, we continue to not see any disturbing trends in trade receivables, unbilled receivables, deferred revenues or contract liabilities.

Fortune Brands (FBHS) EQ Update

Current EQ Rating*	Previous EQ Rating
3-	3-

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

We are maintaining our earnings quality rating of 3- (Minor Concern).

FBHS reported adjusted EPS of $0.60 in the 3/19 quarter, 2 cps ahead of Street expectations. While the benefit from lower warranty expense has abated, our concern with rising inventories increased.

- Inventory days of sales continued to climb in the quarter, rising 8 days over the year-ago quarter. The company noted in the 10-Q that the increase in inventory was a result of buildout for new products launches as well as pre-buys ahead of tariffs. We also remind clients that the company switched to the FIFO method of inventory accounting in the fourth quarter for inventories with a large metal component. This likely contributed to the observed increase in inventory as older, lower-cost inventories were matched against sales in the current period, leaving the newer, higher cost inventory on the balance sheet to be expensed later. This alone erodes the quality of reported earnings.

  In addition, management blamed weaker than expected sales growth on a work down of channel inventories by customers which increases the likelihood that the continuing rise in DSI represents an unexpected buildup in inventory that could result in a negative surprise to gross margin in upcoming quarters as inventories are discounted and/or production is scaled back. Should

- According to the 10-Q, 2.8 million shares were excluded from the share count due to being antidilutive versus only 500 K last year. We estimate that this added about 1 cps to EPS in the period.

- The benefit of lower warranty expense which we cited in our review of the 9/18 quarter has disappeared as provision expense was flat in the 3/19 quarter.

Thermo Fisher Scientific (TMO) EQ Update

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 earnings quality rating of 4+ (Acceptable) as we continue to see little in the way of concern in the quality of the company's earnings.

- The "other items" component of other expense net swung to a $12 million gain compared to a $1 million expense in the year ago quarter even after adjustment for unusual gains removed from the non-GAAP earnings number. On the call, management stated that this was "primarily due to changes in nonoperating foreign exchange." We estimate this would have added about 2.5 cps to EPS in the quarter, considerably less than the 7 cps earnings beat recorded in the period.

Church & Dwight (CHD) EQ Update

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 lower our earnings quality rating to 3- (Minor Concern) from 3+ (Minor Concern).

CHD's 3/19 quarter adjusted EPS of $0.70 was 4 cps ahead of expectations. The rating reduction primarily reflects the continuing increase in inventory along with the cuts to marketing spending.

- Inventory DSI continues to climb, rising 4.7 days which is the fifth straight quarter of 3+ day jumps. As in previous quarters, the buildup was centered in finished goods. We remind clients that prior to the 6/18 quarter, the company accounted for a little less than 20% of its inventory under the LIFO method. However, beginning in the 6/18 quarter, it moved to 100% FIFO. This could be contributing some to the year-over-year increase in DSI. However, CHD recorded only $4 million in *cumulative* benefit related to the accounting change in the 6/18 quarter and we estimate that the entire amount would only account for about a 1-day increase in DSI.

- We note that marketing spending fell 50 bps as a percentage of sales with 30 attributed to sales leverage and 20 from lower expenses. The slowdown in spending can also be seen in the drop in accrued marking and promotion costs which fell to $110.1 million at the end of the 3/19 quarter versus $114.8 million a year ago. We view this as a low-quality source of margin expansion for a consumer products company.

- Days payable increased by 3 days over the year-ago period. Payables still stand under 70 days, so we are not as concerned that cash flow is being stretched as we are at some other consumer goods companies with payable days in excess of 90.

- CHD closed on its acquisition of the Flawless and Finishing Touch hair removal business on May 1. While this was subsequent to the end of the 3/19 quarter, the accounting for this deal is unusual. CHD paid $475 million at closing and will make up to $425 million in additional earn-out payments through December 31, 2021.

Management expects a 4-month transition period during which Flawless management will continue to operate the business and the new cash received from acquired operations will be recorded as "other revenue." Following the transition period, the company will purchase inventory and a one-time working capital build which will total another $30 million.

Danaher (DHR) EQ Update

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 earnings quality rating of 4- (Acceptable)

- We continue to see little in the way of warning signs surrounding DHR's earnings quality. It is worth noting that the company has disclosed that IRS has proposed adjustments to the company's taxable income from 2012 to 2015 relating to its self-insurance program which would increase taxable income by $2.7 billion. In addition, the company could have to revalue its deferred tax liabilities related to these amounts from 21% to 35% assuming it loses its case with the IRS.

  In addition, the company has received assessments from Denmark totaling $253 million which the company has appealed. Resolution of both the matters is uncertain in both timing and ultimate amount to potentially be paid, but they are material contingencies of which investors should be aware.

General Mills (GIS) EQ Update

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).

GIS reported adjusted EPS of $0.83, 7 cps ahead of the estimate. The rating reduction reflects the increase in prepaid expenses and the decline in trade and promotional accrual. While we don't see egregious signs of earnings quality problems, we note that for five straight quarters, GIS has handily beat earnings estimates while missing the top-line target which increases our skepticism.

- The company breaks out the composition of "prepaid expenses and other current assets" in its 10-K filings. The "prepaid expense" components increased from $174.4 million at the end of FY 18 to $250.2 million in FY 2019 which represents an increase of 1.4 days on a days of sales basis. Essentially, cash has been spent but not yet recognized on the income statement. While the exact composition of the account is unknown, the increase indicates that the company could have essentially capitalized operating expenses to delay recognition.

- The company accrues for trade and consumer promotional activity at the time of sale. As with the prepaid expense details, it only discloses accrued trade and consumer promotions on an annual basis in the footnotes of its 10-K. In 2019, the accrual fell from $499.6 million at the end of FY 2018 to $484.4 million at the end of FY 2019. This was about 1.1 days on a days of sales basis. Interestingly, the company cited higher promotional spend as having a negative impact on price/mix in the 5/19 quarter. The accrual account represents the company's estimate of how much of its current sales it will have to eventually pay to retailers in the form of in-store, sales-based promotions. A decline in the account indicates that the company could be under reserving to the benefit of current results.

- During the second quarter (11/18) of fiscal 2019, GIS wrote off $193 million in intangible assets related to its *Progresso, Food Should Taste Good*, and *Mountain High* brands. In addition, the company disclosed that the fair values of its Latin

American reporting unit and its *Yoki* brand intangible assets exceeded carrying value by only 7% and 10%, respectively. Finally, while the coverage of its *Pillsbury* and US Yogurt intangibles was "significant" GIS warned that they were at risk of decreasing coverage.

- We remind clients that Sodiaal has the right to put its half of the Danone joint ventures to GIS which currently stands at $552 million.

Explanation of EQ Rating Scale

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

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

Key Points to Understand About the EQ Score

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

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

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