BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

October 8, 2019 | www.btnresearch.com

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

Contents

American Water Works (AWK)- 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 are initiating earnings quality coverage of AWK with an EQ Rating of 4+ (Acceptable).

Because the company operates largely as a Regulated Utility company, it has ways to recover costs that run above forecasts such as with pensions or rising interest rates. At the moment, the pension may be a minor headwind on cash flow, but not significant. Interest rates are unlikely to be a headwind. Non-cash AFUDC (Allowance for Funds Used During Construction) is about 5% of earnings and that may tick up further.

AWK's earnings and cash flow are hindered by the new tax law causing regulators to rebate the savings back to customers – this drag should vanish in two more years and that is why we gave the company a plus mark on the rating. The company is also not generating enough cash flow to cover its growth capital spending, which is boosting the debt levels. This needs to be watched but does not appear excessive at this time. Finally, the results from non-regulated business acquisitions are mixed which is adding lumpiness to results along with potential for write-downs that have already been experienced.

- **The current cash flow of about $1.4 billion does not support $1.5 billion in capital spending, $200 million in acquisitions, and $360 million in dividends.**

- **We estimate maintenance capital spending at about $0.5 billion, and by that figure, the cash flow works, there just wouldn't be much growth. The growth investing is being added to the rate base and boosting revenues going forward and will require minimal additional spending. The growth spending and acquisition policy is expected to continue for many years to come.**

- **AWK is covering the spending shortfall by borrowing.** Its debt/capital ratio is ticking up and caused Moody's to downgrade its rating one notch. The ratio is likely to continue rising because **the company is also retaining less of net income due to the rising dividend. Thus, the equity component of the capital base is growing more slowly than debt.**

- **The new 21% corporate tax rate has caused utility commissions to rebate much of the tax savings to AWK back to water customers.** The largest adjustments made to EPS have been related to deferred tax accounts. Also, this has reduced recent growth rates for revenue from 3%-5% to under 1% in 2018.

- **AWK expects the tax rebating situation to cost it $100-$200 million in cash from operations in 2019-2021. That further pressures the company to borrow more to cover growth-related capital spending.**

- **AFUDC is a common practice for utilities whereby they preserve their equity base by posting a non-cash income credit** to offset interest paid on projects being built and not yet earning a return by being in the rate base. **This is still only 5% of AWK's earnings but increasing and the construction of a desalination plant could boost it further.**

- **AWK also wants to grow at a faster rate via non-regulated businesses, while keeping them a smaller part of the overall business. Currently, they are about 15% of the total.**

- **Looking at the last few years, we aren't seeing much growth at all in this area even with some new contracts and acquisitions. It has already exiting one of the units that operated water systems for municipalities and large corporations. It has already written off a large percentage of a 2015 purchase that supplies water to fracking operations.**

- **The latest deals are adding to debt, causing more share issuance, and have high levels of goodwill. It is not clear that the returns are there to support the asset levels.** The Pivotal deal that sells home warranties will need to quadruple earnings in four years to hit guidance by our estimate.

Basic Back Story – American Water's Current Cash Flow Doesn't Support the Model

	1H19	2018	2017	2016	2015	2014
Cash Flow Ops	$480	$1,386	$1,449	$1,289	$1,179	$1,097
Cap-Ex	$712	$1,586	$1,434	$1,311	$1,160	$956
Removals	$41	$87	$76	$84	$107	$78
Acquisitions	$80	$398	$177	$204	$197	$9
Free Cash Flow	-$353	-$685	-$238	-$310	-$285	$54
Dividend	$173	$319	$289	$261	$239	$216

The company's growth story is built heavily on two items: 1) it has a huge amount of very old infrastructure – these can be replaced/modernized to improve safety and reliability and regulators will let them earn a set return on the investment and 2) water and waste-water systems are heavily fragmented and it can continually make tuck-in acquisitions to its network.

On capital spending – American Water sees 5-7% of its growth coming from earning a regulated return on its spending as it modernizes the system. Like a pipeline or other infrastructure company, it often has to build the new system before it starts to get paid. This is called regulation lag. Once it is built, it will earn the higher return for year after year with minimal additional capital spending. So, currently capital spending is considered inflated. However, the company expects to spend $7.3 billion in this area from 2019-23. That's basically $1.5 billion per year. From that level of spending alone, free cash flow will be negative for some time.

Also, as part of the modernization efforts, older systems and abandoned assets have to be removed and cleaned up. This is the removal line above and it is running just under $100 million per year. We also expect this cash outflow to continue.

At the same time, more acquisitions are expected to happen. Many of these are small and represent acquiring more regulated water and waste-water systems in existing AWK states. This allows the company to generate more growth via the purchase, gain a regulated set rate of return, and perhaps reduced overhead costs by folding the new company into its already established network. We'll talk more about acquisitions below, but for now, investors should expect more of this and the company's forecast is to spend $0.6-$1.2 billion in this area for 2019-23 to add 1%-2% to its growth.

While the company's cash flow does not support the current growth model – the focus is to treat growth capital spending as a long-term investment that will drive cash flow for decades. Thus, the argument is that maintenance capital spending is considerably lower. The first way to look at this depreciation vs. capital spending. The last three years' depreciation has been $497 million, $460 million, and $435 million. That compares to total capital spending of about $1.5 billion. We can also look at the company's list of PP&E and average life. This also points to needing just over $500 million per year to maintain the system.

PP&E	2018	Wgt Avg Life	Depreciation
Sources of Supply	$821	47	$17
Treatment Facilities	$3,607	40	$90
Transmission Facilities	$10,164	70	$145
Services/Meters	$4,018	31	$130
Gen. Structures/Equipment	$1,625	15	$108
Waste Collection	$943	60	$16
Waste Treatment	$570	41	$14
Total			$520

In many cases, maintenance spending of these assets has suffered from under-investment for a considerable time. But, pulling out the growth capital spending and acquisitions, the model is $1.5 billion in cash from operations to pay $600 million in capital spending and removals and $360 million in dividends at the current $2/share annualized rate.

How Does American Water Cover this Ongoing Growth Investment – With Borrowing

The company has a cushion to pay for growth out to free cash flow beyond maintenance. However, it is growing even faster because it is borrowing the money:

	1H19	2018	2017	2016	2015
Debt	$9,070	$8,604	$7,725	$7,182	$6,556

The key ratio to monitor here is the debt/capital ratio. The company's maximum level cannot exceed 0.70x. It has risen from 0.55x to 0.60x now. The high capital spending exceeding cash flow caused Moody's to cut the company's debt rating last April. This ratio bears watching:

	1H19	2018	2017	2016	2015
Debt/Capital	0.60	0.59	0.59	0.58	0.56

What is helping to a large degree is earnings exceed the dividend, so the equity balance is rising as part of capital and offsetting some of the increase in debt in the ratio. By issuing more shares in 2018 and raising the dividend – the growth in equity is being reduced. More importantly, they issued 2.3 million shares for $183 million to by Pivotal. Pivotal is not expected to add to earnings early on, and only add $0.12 in 2022, which would be about $20 million in net income. The incremental shares will be adding $4.6 million to the dividend and rising on the way to 2022. The result is equity will likely rise slower than debt and continue to push up the debt/capital ratio:

	1H19	2018	2017	2016	2015
Net Income	$283	$567	$426	$468	$476
Dividend	$180*	327	$297	$267	$244
Retained	$103	$240	$129	$201	$232
% Retained	36.4%	42.3%	30.3%	42.9%	48.7%

- The dividend is paid in the following quarter, in the first half of 2019, only one quarterly dividend payment of $90 million was posted – the annualized rate is $360 million.

In 2018, the company raised $183 million in equity as it financed the Pivotal deal with a 50-50 debt/equity split and announced this would lower the debt/capital ratio. It did – they just kept borrowing more after this deal. American Water is saying it will not need to raise additional equity to fund its plans. Clearly, it will need external capital to pay for acquisitions and growth – so investors should keep an eye on the debt to capital ratio as it appears debt will continue to rise faster than equity.

The Tax Cuts Are Pressuring Growth, Income, and Cash Flow

Because American Water is largely a regulated public utility – much of its revenue is set by various state agencies to ensure a set rate of return on assets that covers all the costs and yields a profit for the company. When the tax cuts were passed in 2017 and the corporate rate was reduced from 35% to 21% – that was a big positive to many companies for earnings and cash flow. We have noted how that really bought some extra time for Altria and also improved AT&T's situation before it made the Time Warner deal.

American Water had the opposite situation happen. Its rates had been set based on recovering a cost structure involving a 35% tax rate. When the tax rate fell, the company's fee structure was lowered to give utility customers the benefit of lower taxes too. The company also had to remeasure all its deferred tax items, which become the largest adjustments to EPS:

	2018	2017	2016
GAAP EPS	$3.15	$2.38	$2.62
Gain on Sale	-$0.06		
Impairment	$0.22		
Insurance Settlement	-$0.08	-$0.07	$0.22
Parent Debt Exting.		$0.02	
TCJA Adjustment	$0.07	$0.70	
Total non GAAP adj.	$0.15	$0.65	$0.22
Non GAAP EPS	$3.30	$3.03	$2.84

In addition, the tax cuts are specifically offsetting growth in other areas:

	2018	2017	2016	2015
Rate hikes on New CapX	$149	$81	$92	$45
Acquisitions	$22	$43	$23	$6
Misc/Volume/Adjustments	n/a	-$39	$13	$8
Tax Law Change	-$148	n/a	n/a	n/a
Total Revenue Growth	$26	$87	$128	$69
% Growth	0.9%	3.0%	4.7%	2.6%

Cutting rates to give customers the benefits of the tax rate reduction cut revenue growth to a crawl and that in turn produced lower income and cash flow than would have been expected. Plus, this situation is expected to be a drag on results into 2022.

American Water sees the drag on cash flow from operations as $100 million in 2019, $200 million in 2020, and $100 million in 2021.

The rest of the story is working, the company is getting higher revenues from new investments in the PP&E. It just has a few more years of heavy drag on cash flow at the same time it is making these investments. Right now, this is the most pressure on the growth story and the need for external capital. Over time, this should improve.

AFUDC – Allowance for Funds Used During Construction Is Increasing

This is an accounting treatment used by public utilities to preserve equity in the capital structure. It allows companies to add back the interest costs incurred during construction of new assets that will eventually enter the rate base. The interest expense is still paid in cash. But AFUDC is a non-cash credit that adds it back and inflates income.

Much of the work done by American Water happens fairly quickly and joins the rate base plus interest rates have been lower of late. Both of those situations hold down the size of the AFUDC credit. Despite this, it has been rising and the company is building a desalination plant in California that is expected to be completed in 2021 and is a part of the AFUDC credit.

	2018	2017	2016
AFUDC Borrowed Funds	$13	$8	$6
AFUDC other Funds	$24	$19	$15
Total AFUDC	$37	$27	$21
Adj. EPS	$3.30	$3.03	$2.84
Adj. EPS Growth	8.9%	6.7%	
AFUDC/Share	$0.16	$0.12	$0.08
EPS Growth w/o AFUDC	7.9%	5.4%	

Without AFUDC, the EPS growth rate would be a full point lower.

Non-Regulated Acquisitions Are Getting Larger

American Water has ventured into some new areas in its acquisition strategy. It wants to have some unregulated businesses where it can achieve higher rates of growth. It calls these the Market Based Businesses. The goal is to keep them under 15% of total earnings and remain primarily a roll-out and modernizer of public utility water and waste-water systems.

So far these have come in four areas:
1) Military base water and waste-water systems with the US Government
2) Homeowner warranties for water, sewer, gas lines and appliances
3) Providing water for fracking oil and gas
4) Contract operations to operate and maintain water systems for municipalities and large food/beverage companies

The first problem is the cost is going up and the benefits are not. In 2015, the company spent $133 million to buy Keystone, which provides water for fracking. $91 million of the price was allocated to goodwill. The comment in the 2016 10-K is "*The pro forma impact of our acquisitions was not material to our consolidated results of operations for the years ended December 31, 2016 and 2015.*"

In 2018, American Water bought Pivotal for $365 million to add to its warranty business. Goodwill is $247 million of the purchase price. The company noted it did not have a material impact on results in 2018 and at the time of the deal, it forecast a neutral impact on EPS in 2018 that could become $0.12 in EPS by 2022. That would be about $21 million in additional earnings by 2022. At the time of the deal, the purchase price was said to be 7.5x EBITDA, so EBITDA was close to $50 million. Given a zero impact on EPS and the extra shares issued, we can back into $3.00 in EPS requiring this deal to be producing about $7 million in earnings.

The next problem is how much growth is really here? They only owned Keystone for under three years before encountering problems and decided to narrow the scope of service and exit some of Keystone's prior business. American Water took a $57 million write-down in goodwill or 63% of the total. They also sold the Contract Operations in 2018 as well. This was only for $27 million. The Pivotal unit is expected to quadruple income from $7 million to $28 million in four years.

Market Based Biz	2018	2017	2016	2015
Revenue	$476	$422	$451	$434
Adj Pretax Income	$85	$66	$65	$68

- Adj pretax adds back impairments, subtracts gains

Buying Pivotal added to revenue and income and 2018 has some revenue and income from the Contract Operations prior to being sold. Where is the growth?

While we are often skeptical about warranty/insurance style businesses – we will give American Water some slack in this area. For one thing, the coverage only runs for one-year, which matches the duration of the premium. They are not agreeing to cover damage from water/gas/electricity lines breaking for 5-years after a one-time payment. If they start to see a surge of problems in an area, they can raise premiums or stop renewing warranties in that area.

Also, because the duration of the premium and liability match – this should limit a situation where income is very high in the early years due to a lack of claims followed by falling income as claims increase over time. They also bought an existing book of customers, which should remove some of that front-loading of earnings.

American Water also had a similar business already and had not seen problems with it. There may not be as many growing pains often associated when a company buys something out of its normal experience. We still would question just how much growth potential is here. Many people already carry homeowner's insurance to cover much of the same risk that Pivotal is pitching.

Consumer Staples Industry Overview
Part 1- Cash Flow Review
(PG, CLX, KMB, CL, CHD)

We understand that many clients are required in practice to own companies in many industries and are trying to find the healthiest constituents to include in their portfolios. To that end, we plan to regularly provide analysis of both cash flows and earnings quality of several major players in specific industries in a "compare and contrast format."

This report examines factors impacting recent cash flow growth at these firms and their overall ability to sustain their dividend growth rates. Companies reviewed include Procter & Gamble (PG), Clorox (CLX), Colgate (CL), Kimberly-Clark (KMB) and Church & Dwight (CHD).

	Dividend Yield	Dividend Growth	Adjusted CF Growth	Capex % Revenue	Dividend Cover	FCF Covers Repo	Acquisition Dependent	Debt/ EBITDA
PG	2.5%	4.0%	-3.8%	4.9%- declining	63.0%	No	No	1.1
CLX	2.8%	9.4%	7.0%	3.3%- flat	62.0%	No	Yes	2.0
CL	2.4%	3.7%	-3.6%	2.4%- declining	60.7%	No	No	1.7
KMB	3.0%	3.0%	2.5%	6.0%- rising	95.0%	No	No	1.7
CHD	1.2%	9.2%	5.9%	1.5%- flat	30.1%	Yes	Yes	2.0

We adjust cash from operations growth for each one for one-time factors including pension payments and cash restructuring payments. Working capital movements are examined for sustainability, as is the level of capital spending, stock buybacks, dependence on acquisitions, and current leverage.

Part 2 will compare and contrast the earnings quality of these companies in a head-to-head comparison with the goal being to give clients unique insights to help in the selection and weighting process of names in the industry.

Procter & Gamble (PG)
Cash Flow Review

Key Points

- Cash flow for the most recent trailing 12-month period adjusted for pension contributions and regular cash restructuring payments fell more than 1%.

- Working capital was a significant boost to reported growth as the company continues to stretch payment terms on its suppliers. With days payable at 115 (up from 104) we are skeptical this growth source will continue and runs the risk of reversing. Adjusting out the working capital benefit results in cash flow falling almost 4%.

- Free cash flow benefitted from a $370 million cut to capital spending. PG's capex as a percentage of its sales is still one of the highest in the group and its estimated average age of equipment is one of the lowest. So, while the cut to capex is not a sustainable boost to free cash flow growth, we do not see underspending as a huge problem.

- PG's dividend consumes 63% of free cash flow which is typical for the group. However, its share buyback more than consumes the remainder. While large infusions of cash from the exercise of stock options can offset this in some years, that is a low-quality source of cash flow and the 3-4% reduction in the share count every year is a key part of the company's EPS growth.

- While the company did acquire Merck's consumer healthcare business last year, that was the only major acquisition in the last three years. Debt is more than manageable at 1.1 times EBITDA.

Supporting Data

Adjusted Cash Flow Growth

	6/30/2019	6/30/2018	6/30/2017
T12 Cash Flow from Operations	$15,242	$14,867	$12,753
growth	2.5%	16.6%	-17.4%
Non-Operating Cash Flow Adjustments			
+Cash Restructuring Payments	$547	$468	$395
+Cash Pension Contributions/Settlements	$209	$439	$352
+Other Material Non-Operating Cash Payments	$0	$0	$0
-Stock-Based Compensation	-$515	-$395	-$351
Total Adjustments	$241	$512	$396
T12 Adjusted. Cash Flow	$15,483	$15,379	$13,149
growth	0.7%	17.0%	-18.1%
Changes in Operating Working Capital	$681	$3,451	-$281
T12 Adjusted Pre-Working Capital Cash Flow	$14,802	$11,928	$13,430
growth rate	-3.8%	-9.3%	-16.4%
Working Capital Ratios			
DSO	26.4	25.9	26.1
DSI	51.2	47.7	50.2
DSP	115.0	104.1	104.6
Cash Conversion Cycle	-37.3	-30.5	-28.3

PG's reported cash from operations rose by 2.5% for the 12 months ended 6/19. However, when we adjust the reported periods for the sizeable cash restructuring payments regularly incurred by PG, the company's contributions to its pension and postretirement benefit plans and treat the stock-based compensation as if it were a cash expense, the adjusted growth rate falls to under 1%.

In addition, cash flow growth in the period received a large boost from working capital as accounts payable continues to rise from the company stretching payment terms on suppliers. Adding $1.9 billion to cash flow in the period. PG's days payable ratio of 115 is by far the highest in the group. While the company is the largest and should arguably be able to exert more pressure, we remain skeptical that this can continue to be a tailwind for cash flow growth. The payable boost was offset by a slight rise in receivables from a lower number of collection days, higher inventory to support growth and payment of a portion of the repatriation tax payable. Adjustment for all these factors leaves us with an adjusted cash from operations growth rate of negative 3.8%

Capital Spending

	6/30/2019	6/30/2018	6/30/2017
Reported T12 Operating Cash Flow	$15,242	$14,867	$12,753
T12 Capital Spending	$3,347	$3,717	$3,384
T12 Free Cash Flow	$11,895	$11,150	$9,369
Capex % of Revenue	4.9%	5.6%	5.2%
Gross PPE	$43,393	$41,847	$40,148
Accumulated Depreciation	$22,122	$21,247	$20,255
Net PPE	$21,271	$20,600	$19,893
Depreciation & Amortization	$2,824	$2,834	$2,820
Amortization of Intangibles	$349	$302	$325
T12 Depreciation Expense	$2,475	$2,532	$2,495
Avg Age	8.9	8.4	8.1
Depreciation % of Gross PPE	5.7%	6.1%	6.2%
Depreciation Method	Straight Line		
Buildings & Improvements	40 yrs.		
Equipment	3-20 yrs.		
Furniture & Fixtures	15 yrs.		
Computer Equipment	3-5 yrs.		

Lower capex helped propel reported free cash flow growth above that of operating cash flow. However, we are not overly concern about the company's rate of capex at this point. As a percentage of sales, it is one of the highest of the group and is still well above where it was in just 2017. We note that the above depreciation expense figure is estimated from taking depreciation and amortization and subtracting the reported amortization of intangibles and should be taken with a grain of salt, along with the derivative average age figure. Still, the estimated average age of under 9 years is the youngest in the group.

Dividend Cover

	6/30/2019	6/30/2018	6/30/2017
Dividend Per Share Growth	4.0%	3.3%	1.5%
Free Cash Flow	$11,895	$11,150	$9,369
Cash Spent on Dividends	$7,498	$7,310	$7,236
Dividend % FCF	63.0%	65.6%	77.2%
Share Repurchases	$5,003	$7,004	$5,204
Cash After Dividends & Repurchases	-$606	-$3,164	-$3,071
Cash from Stock Option Exercises	$3,324	$1,177	$2,473
Cash from Asset Sales	$394	$269	$571
Share Count	2646	2621	2696
growth	1.0%	-2.8%	-4.1%

PG's dividend cover as a percentage of free cash flow is at the low end of the group. However, also like all of the other companies in the group, PG's free cash flow is not sufficient to cover its dividend and aggressive buyback. While the share count actually rose in the 6/19 period, this was due to the write-down of the Shave Care intangible asset causing the preferred share to become anti-dilutive and include in the weighted average diluted share count. Adjusting for this would leave the share count down another 3% in the 6/19 period. As shown in the table, the company received a huge cash inflow of $3.3 billion the exercise of stock options which more than covered the shortfall. However, as we have noted in past reviews of PG, this is a low-quality source of cash flow and should not be counted on to sustain the buyback without driving up debt.

Acquisition Spending

	06/30/2019	06/30/2018	06/30/2017
T12 Cash Spending on Acquisitions	$3,945	$109	$16
T12 FCF after Dividend, Repo and Acquisitions	-$4,551	-$3,273	-$3,087

PG spent $3.7 billion on its late 2018 acquisition of the consumer healthcare division of Merck. However, this is the only material acquisition made in the last three years so we would not label PG as dependent on acquisitions to meet expectations.

Leverage

	6/30/2019	6/30/2018	0/30/2017
Cash & Equivalents	$4,239	$2,569	$5,569
Short Term Investments	$6,048	$9,281	$9,568
Short-Term Debt	$9,697	$10,423	$13,554
Long Term Debt	$20,395	$20,863	$18,038
Net Debt/EBITDA	1.1		
Debt Due in 3 Years	$8,237		
maturities			
2020	$3,388		
2021	$2,009		
2022	$2,840		
2023	$2,465		
2024	$2,461		
Unfunded Pension and Retirement Obligations	-$5,523		

Despite the cash shortfall after the buyback and the acquisition, the cash from stock option exercises has allowed the company to keep its leverage at a very comfortable 1.1 times adjusted EBITDA.

PG's dividend appears more than safe given the healthy free cash flow coverage and the low debt level. However, absent the cash from stock option exercise, the company's aggressive buyback which is a significant portion of the company's EPS growth, cannot go on indefinitely without beginning to drive up the debt. This could be a limiting factor on dividend growth going forward.

Clorox (CLX)
Cash Flow Review

Key Points:

- Reported operating cash flow growth was 1.6% in the 12 months ended 6/19. However, this was hindered by higher pension contributions. After adjustment for this, cash flow grew by 7% in the period.

- Working capital had a minimal net impact on cash flow growth. Inventory days rose by 3.5 over the year-ago quarter which we noted in our latest earnings quality review of the company. However, management has noted that it will be working down inventory in upcoming quarters which could be a tailwind to cash flow growth.

- Days payable did rise by almost 3 days which offset most of the inventory build. However, CLX's days payable are the lowest in the industry with the company paying its suppliers in less than 60 days. As PG seems to be pushing the edge of the envelope in stretching payment terms on suppliers, CLX actually seems to have room for improvement in this area.

- Capital spending was up slightly but still down from 2017. Its capital spending stands at 3.3% of sales which is around the mid-point for the group. However, the estimated average age of plant and equipment of 13 is the highest in the group, which could indicate the company will have to increase its spending on capex in the future.

- CLX's dividend consumes less than 63% of free cash flow. The bought back a large number of shares in the last 12 months which consumed more than the surplus free cash flow after dividend. However, this is not typical practice for CLX and management has said nothing to create expectations for "growth through buyback" on the Street.

- While we do not label CLX as a serial acquirer, it has made two acquisitions (Nutranext and Renewlife) in the last three years which has led to a steady rise in debt. Debt is one of the highest of the group at 2 times EBITDA. While this is below the company's long-term target of 2.5, the company is somewhat limited in its ability to continue to pursue growth through acquisition and maintain its recent near-10% dividend growth.

Supporting Data:

Adjusted Cash Flow Growth

	6/30/2019	6/30/2018	6/30/2017
T12 Cash Flow from Operations	$992	$976	$865
growth	1.6%	12.8%	11.2%
Non-Operating Cash Flow Adjustments			
+Cash Restructuring Payments	$0	$0	$0
+Cash Pension Contributions/Settlements	$66	$26	$34
+Other Material Non-Operating Cash Payments	$0	$0	$0
-Stock-Based Compensation	-$43	-$53	-$51
Total Adjustments	$23	-$27	-$17
T12 Adjusted. Cash Flow	$1,015	$949	$848
growth	7.0%	11.9%	15.7%
Changes in Operating Working Capital	-$2	-$87	-$47
T12 Adjusted Pre-Working Capital Cash Flow	$1,017	$1,036	$895
growth rate	7.2%	22.2%	22.1%
Working Capital Ratios			
DSO	35.4	32.4	31.3
DSI	52.3	48.8	46.8
DSP	51.8	48.9	51.1
Cash Conversion Cycle	35.9	32.3	27.0

CLX reported growth in cash flow from operations of 1.6% in the trailing 12-month period ended 6/19. However, pension contributions increased in the 6/19 period while stock-based compensation declined, resulting in an adjusted cash flow growth of 7%.

Total working capital had a minimal impact on cash flow growth as drains from increasing receivables and inventories were partially offset by rising accounts payable and taxes payable. We have noted in past EQ reviews of CLX that the company's inventory has been rising. Management has indicated that it will be working inventory down in upcoming quarters. If this materializes, this could be a boost to cash flow growth. While we are ordinarily skeptical of cash flow growth from rising payables, there is a huge difference between payable days rising from 49 to 52 versus 110-115. CLX's payable days ratio is by far the lowest in the group and with the company paying its bills in less than 60 days, we are not worried about potential pushback.

Capital Spending

	6/30/2019	6/30/2018	6/30/2017
Reported T12 Operating Cash Flow	$992	$976	$865
T12 Capital Spending	$206	$194	$231
T12 Free Cash Flow	$786	$782	$634
Capex % of Revenue	3.3%	3.2%	3.9%
Gross PPE	$3,184	$3,057	$2,932
Accumulated Depreciation	$2,150	$2,061	$2,001
Net PPE	$1,034	$996	$931
T12 Depreciation Expense	$165	$156	$931
Avg Age	13.0	13.2	13.1
Depreciation % of Gross PPE	5.2%	5.1%	5.2%
Depreciation Method	Straight-Line		
Land Improvements	10-30 yrs.		
Buildings & Improvements	7-40 yrs.		
Equipment	3-15 yrs.		
Computer Equipment	3-5 yrs.		
Capitalized Software	3-7 yrs.		

Capex was up slightly in the 2019 period, but was still down from the 2017 level. As a percentage of sales at 3.3%, capex is in the middle of the group. However, what does stand out is that the average age of equipment is by far the highest at 13 years versus single-digit figures for its peers. This could be somewhat skewed by acquisitions, but coupled with the low percentage of sales, it could be an indication that rising capex could crimp free cash flow growth in the future.

Dividend Cover

	6/30/2019	6/30/2018	6/30/2017
Dividend Per Share Growth	9.4%	12.5%	3.9%
Free Cash Flow	$786	$782	$634
Cash Spent on Dividends	$490	$450	$412
Dividend % FCF	62.3%	57.5%	65.0%
Share Repurchases	$661	$271	$183
Cash After Dividends & Repurchases	-$365	$61	$39
Cash from Stock Option Exercises	$147	$45	$75
Cash from Asset Sales	$0	$0	$0
Share Count	128	132	132
growth	-2.6%	0.0%	0.0%

CLX boasts the highest dividend growth of the group and the free cash flow consumes one of the lowest percentages of free cash flow. However, the company recently boosted its buyback activity beyond the ability of post-dividend free cash flow to cover it. Management has been less than clear on the outlook for the repurchase program. In the fourth quarter call, management stated:

> *"If I just think broadly about fiscal year 2019, we're quite pleased. We returned about $1.2 billion to shareholders in 2019. That's a combination of both dividend and share repurchases. That's up about 60% versus fiscal year 2018 as you've seen us lean into the dividend over the last couple of increases. That also includes on our share repurchase program, we have now executed about $425 million against my $2 billion authorization so about 20% of the authorization, which also included about $250 million in Q4.*
>
> *As I look forward, as we've talked before this is not an ASR so I do not have a defined number of shares I'm going to buy. We've got an internal program we manage. What I'd tell you is I would have you believe that within the outlook we provide there may be some level of share repurchases. I'm not going to provide a forecast on it. But to extent, it materially changes one way or the another -- I'd certainly update you. But for now you should assume it's embedded within our EPS outlook range."*

We are not as concerned about CLX's buyback as we are the situation at PG or CL where the 2-3% boost to EPS from a buyback not covered by post-dividend free cash flow has been in place for years and is likely baked into the Street's expectations.

Acquisition Spending

	06/30/2019	06/30/2018	06/30/2017
T12 Cash Spending on Acquisitions	$0	$681	$0
T12 FC after Dividend, Repo and Acquisitions	-$365	-$620	$39

What is a little more concerning with regards to CLX is its recent acquisitions. The company acquired Nutranext in the 6/18 quarter for $681 million and Renewlife for $290 million in the 6/16 quarter. This far from qualifies CLX as a reckless serial acquirer but coupled with the buyback, it has led to a steady rise in debt in the last few years:

Leverage

	6/30/2019	6/30/2018	6/30/2017
Cash & Equivalents	$111	$2,284	$1,391
Short Term Investments	$0	$0	$0
Short-Term Debt	$396	$199	$804
Long Term Debt	$2,287	$2,284	$1,391
Net Debt/EBITDA	2.0		
Debt Due in 3 Years	$300		
maturities			
2020	$0		
2021	$0		
2022	$300		
2023	$600		
2024	$0		
Unfunded Pension and Retirement Obligations	-$153		

Debt now stand at 2 times EBITDA. This is below the company's long-term target of 2.5, but it does limit the company's ability to push growth through acquisition without putting a lid on dividend growth.

Kimberly-Clark (KMB)
Cash Flow Review

Key Points:

- Reported cash flow from operations fell by more than 14% in the trailing 12-month period ended 6/19. However, much of this was due to higher cash restructuring payments. Higher working capital and tax payments were also a significant drain. After adjustment for these items, cash flow fell by only 2%.

- Inventory days jumped by almost 4 which management has attributed to temporary investment in supply chain initiatives. Cash flow could receive a boost in upcoming quarters if this situation improves.

- The inventory build was more than offset by an almost 7 day jump in payables. KMB is one of the more aggressive in the group at pressuring its suppliers. It is currently taking about 88 days to pay , up from about 82 a year ago. This is not nearly as aggressive as PG, but we are skeptical that continuing the increase payable aggressively is a reliable source of future cash flow growth.

- Capital spending jumped to 6% of sales, but this is skewed by increased investment related to its restructuring program. The average age of equipment is declining and capital spending should be expected to decline after the restructuring spending falls off.

- KMB's dividend consumed 95% of the headline free cash flow, but when restructuring spending declines and working capital normalizes, the ratio should fall back to its historical level of the mid-60% range which is typical for the group.

- When cash flow returns to normal, KMB will be able to largely support the buyback at the current pace. The company has made no major acquisitions in the last three years and debt is manageable at 1.7 times EBITDA.

Adjusted Cash Flow Growth

	6/30/2019	6/30/2018	6/30/2017
T12 Cash Flow from Operations	$2,567	$2,997	$3,080
growth	-14.3%	-2.7%	5.2%
Non-Operating Cash Flow Adjustments			
+Cash Restructuring Payments	$309	$158	$20
+Cash Pension Contributions/Settlements	$0	$0	$0
+Other Material Non-Operating Cash Payments	$0	$0	$0
-Stock-Based Compensation	-$63	-$52	-$127
Total Adjustments	$246	$106	-$107
T12 Adjusted. Cash Flow	$2,813	$3,103	$2,973
growth	-9.3%	5.8%	-2.6%
Changes in Operating Working Capital	-$229	$136	$143
T12 Adjusted Pre-Working Capital Cash Flow	$3,042	$2,967	$2,830
growth rate	-2.0%	1.2%	-7.3%
Working Capital Ratios			
DSO	47.6	45.3	44.3
DSI	54.5	50.7	54.2
DSP	87.9	81.2	82.0
Cash Conversion Cycle	14.2	14.8	16.5

Cash from operations for the 12 months ended 6/19 fell by more than 14%. Cash flow growth for the year ended 12/19 was slightly positive and the deterioration in growth occurred in the first six months of the year. Management stated in the liquidity section of the 10-Q that the decline in the six months ended 6/19 was due to “increased working capital and higher tax payments.” Cash restructuring spending rose significantly in the 2019 period and after adjustment, the decline in cash flow fell to 9.3%. The 2018 Restructuring Plan began in the 3/18 quarter. Cash costs are expected to total $900 million through the end of 2020 and to date, roughly half that has been spent. While costs will remain high over the next year, cash flow should receive a noticeable boost as those costs begin to fall off. KMB has a habit of taking large restructuring charges, so investors can expect more, but may get a few quarters to enjoy the lower spending before the next plan is launched.

KMB does not disclose pension contributions on a quarterly basis. We do know that pension contributions were $166 million in the fiscal year ended 12/18 versus $53 million a year ago.

We can tell from detail in the itemized section of the cash flow statement that postretirement benefits drained cash flow by $32 million in the trailing 12-month period ended 6/19 versus $4 million in the year-ago period so this was not a material impact on cash flow growth.

The company noted that rising working capital and higher tax payments drove the decline in cash flow growth in the 6-month period ended 6/19. KMB does not itemize the working capital components in its cash flow details and we assume that the tax payment impact is included in its "Operating Working Capital" line. After adjusting for the movement in that line, the decline in cash from operations fell to just 2%. Looking at the key working capital accounts on the balance sheet, inventory days jumped noticeably, and the company has blamed this in past quarters on supply chain restructuring. It is likely that will improve going forward. The DSI increase was more than offset by a rise in payables. KMB has noticeably stretched its suppliers and while not as extreme as PG, it is pushing 3 months in terms of average payment time. We are skeptical that this is a reliable source of future cash flow growth.

While the company's cash flow growth was much stronger than it appeared on the surface, KMB nonetheless has and will likely continue to struggle to eke out low single-digit cash flow growth which will limit its ability to increase the dividend.

Capital Spending

	6/30/2019	6/30/2018	6/30/2017
Reported T12 Operating Cash Flow	$2,567	$2,997	$3,080
T12 Capital Spending	$1,099	$746	$760
T12 Free Cash Flow	$1,468	$2,251	$2,320
Capex % of Revenue	6.0%	4.0%	4.2%
Gross PPE	$17,972	$17,463	$0
Accumulated Depreciation	$10,765	$10,417	$0
Net PPE	$7,207	$7,046	$0
data as of:	12/18	12/17	
T12 Depreciation Expense	$882	$724	
Avg Age	12.0	14.5	
Depreciation % of Gross PPE	5.0%	4.0%	
Depreciation Method	Straight-Line		
Land			
Buildings	40 yrs.		
Equipment	16-20 yrs		
Furniture & Fixtures			
Computer Equipment			
Capitalized Software	5 yrs.		

KMB's free cash flow took a hit in the 12-month period ended 6/19 which is related to incremental restructuring spending. Note that these amounts are separate from the amounts recorded in operating cash flow. This impact inflates the headline capex as a percentage of revenue figure to unrealistic levels. However, the decline in average age seems to indicate that the company is at a healthy level of investment spending on plant and equipment. Capital spending returning to a more normal level would be a material tailwind on free cash flow growth.

Dividend Cover

	6/30/2019	6/30/2018	6/30/2017
Dividend Per Share Growth	3.0%	4.2%	5.0%
Free Cash Flow	$1,468	$2,251	$2,320
Cash Spent on Dividends	$1,395	$1,376	$1,335
Dividend % FCF	95.0%	61.1%	57.5%
Share Repurchases	$710	$734	$1,043
Cash After Dividends & Repurchases	-$637	$141	-$58
Cash from Stock Option Exercises	$200	$36	$156
Cash from Asset Sales	$0	$0	$0
Share Count	346	350	354
growth	-1.0%	-1.2%	-1.6%

As noted above, KMB's free cash flow for the trailing 12-month period from both higher restructuring spending and a spike in working capital, both of which will likely reverse shortly. Therefore, the figure showing that the dividend consumes 95% of free cash flow is very misleading and it should gravitate back toward the mid-60% range which is in-line with the group. This will result in the buyback at the current level being mostly if not completely covered by free cash flow after the dividend.

Note that KMB has not made any major acquisitions in the last three years so this has had no impact on cash flow.

Leverage

	6/30/2019	6/30/2018	6/30/2017
Cash & Equivalents	$534	$484	$1,051
Short Term Investments	$0	$0	$0
Short-Term Debt	$1,291	$1,741	$1,246
Long Term Debt	$6,701	$5,746	$6,777
Net Debt/EBITDA	1.7		
Debt Due in 3 Years	$1,730		
Debt Due in 3 Years			
maturities			
2019	$716		
2020	$758		
2021	$256		
2022	$304		
2023	$464		
Unfunded Pension and Retirement Obligation	-$962		

KMB's debt is not a problem at 1.7x EBITDA. As noted above, cash flow should rebound over the next few quarters to covering the dividend and the buyback at the current pace and the company does not have Wall Street trained to expect growth via acquisition.

Colgate-Palmolive (CL)
Cash Flow Review

Key Points

- Reported cash from operations fell by 1.2% for the 12 months ended 6/19. While lower cash restructuring payments were a boost to cash flow growth, higher pension contributions more than offset the benefit. After adjustment for both factors, cash flow would have been roughly flat versus a year ago.

- The net impact of working capital was minimal. A change in lease accounting on January 1 artificially boosted working capital which the company cited as a factor in the 6 months ended 6/19.

- As we noted in our recent earnings quality review on CL, inventory days rose by more than 5. This was more than offset by a more than 6-day increase in payables. Days payable are under 71, so the company had not been as aggressive as some of its peers in stretching payment terms and seems less susceptible to a pushback from suppliers.

- Capital spending fell to 2.4% of sales for the 12-months ended 6/19, down from the mid-3% range in the previous two years, adding $174 million to free cash flow growth in the period. The current forecast for capex spending of 2.3-2.6% of sales in 2019 is already down from the 2.5-2.6% range at the beginning of the year, implying the company has become more aggressive in cutting cash spending in this area. Our estimated average age of equipment is below 10 years and one of the youngest in the industry, so we do not see this as a crisis yet. However, this should be viewed as a short-lived boost to cash flow growth.

- The dividend consumes only 60% of free cash flow, the lowest in the group. However, the company's buyback more than consumes the surplus. The regular reduction in the share count adds 1-2% to EPS growth every year, so it is not quite as dependent as PG on the buyback.

- CL does make the occasional acquisition with the latest being Physicians Care Alliance in the 3/18 quarter. However, debt remains manageable at 1.7 times EBITDA.

Adjusted Cash Flow Growth

	6/30/2019	6/30/2018	6/30/2017
T12 Cash Flow from Operations	$3,008	$3,046	$3,126
growth	-1.2%	-2.6%	2.6%
Non-Operating Cash Flow Adjustments			
+Cash Restructuring Payments	$112	$240	$241
+Cash Pension Contributions/Settlements	$169	$24	$60
+Other Material Non-Operating Cash Payments	$0	$0	$0
-Stock-Based Compensation	-$96	-$121	-$128
Total Adjustments	$185	$143	$173
T12 Adjusted. Cash Flow	$3,193	$3,189	$3,299
growth	0.1%	-3.3%	0.5%
Changes in Operating Working Capital	-$37	-$362	$62
T12 Adjusted Pre-Working Capital Cash Flow	$3,230	$3,551	$3,237
growth rate	1.3%	7.6%	-1.4%
Working Capital Ratios			
DSO	37.5	36.3	36.4
DSI	77.4	72.2	71.7
DSP	70.8	64.5	67.6
Cash Conversion Cycle	44.1	43.9	40.5

Cash from operations declined by 1.2% for the trailing 12-month period ended 6/19. Management noted in the 6/19 10-Q that higher voluntary pension contributions were a drain on cash flow growth in the six months ended 6/19. The company itemizes the voluntary portion of its pension contributions in the cash flow statement detail. However, these amounts do not match the total pension contributions reported in its pension asset section of the 10-K on an annual basis and CL does not report the pension detail on a quarterly basis. From the annual pension disclosure, we know that total employer contributions to all pension and postretirement plans was $147 million in the year ended 12/18 versus $172 million a year earlier. Still, we believe it is fair to adjust the trailing 12-month cash flow growth at 6/19 just based on the voluntary portion of the contribution which shown in the table above.

The drag from the higher pension contribution was mostly offset by lower cash spending on the company's restructuring plans. After both adjustments, cash from operations was essentially flat with last year.

Working capital was a minor drain on cash flow growth in the 12-month period. Management did note in its discussion in the 10-Q for 6-months that an increase in working capital for that time period was largely due to a change in lease accounting. After adjustment for working capital, cash flow would have risen about 1.3%.

Looking at the key working capital accounts, CL's inventory did increase by over 5 days. We noted our concern regarding the noticeable jump in inventory in the quarter (focused in finished goods) in our recent earnings quality review of CL (8/1/19). The cash flow impact of the inventory build was more than offset by a rise in payables as days payable rose by 6.3 over the year-ago June quarter. CL has not been nearly as aggressive at pressuring suppliers as some of its larger peers so the risk to cash flow growth from a pushback from suppliers seems minimal.

Capital Spending

	6/30/2019	6/30/2018	6/30/2017
Reported T12 Operating Cash Flow	$3,008	$3,046	$3,126
T12 Capital Spending	$366	$540	$574
T12 Free Cash Flow	$2,642	$2,506	$2,552
Capex % of Revenue	2.4%	3.4%	3.8%
Gross PPE	$8,476	$8,408	$8,261
Accumulated Depreciation	$4,683	$4,500	$4,331
Net PPE	$3,793	$3,908	$3,930
Data as of	12/18	12/17	
Depreciation & Amortization	$511	$475	
Amortization of Intangibles	$59	$35	
T12 Depreciation Expense	$452	$440	
Avg Age	9.9	10.0	
Depreciation % of Gross PPE	5.4%	5.2%	
Depreciation Method	Straight-Line		
Buildings	40 yrs		
Machinery & Equipment	3-15 yrs		

Free cash flow growth has seen a significant reduction in capital spending. Interestingly, the company stated in its 10-K for fiscal 2018 that it expected capex to be 2.5-3.0% of sales in 2019. In the 6/19 10-Q, it reduced that outlook to 2.3-2.6% and stated that it "continues to focus its capital spending on projects that are expected to yield high after-tax returns."

CL does not disclose depreciation expense, but we arrive at an estimate by taking reported depreciation and amortization and subtracting amortization of intangibles. From this, we can calculate an estimated average age which seems to indicate that CL's equipment is on par with the industry norm and holding steady. Still, capex as a percentage of sales is the second-lowest in the group and it is unlikely the company can maintain it at the depressed level for long before age before rising age becomes a problem. This source of free cash flow growth therefore looks to be short-lived.

Dividend Cover

	6/30/2019	6/30/2018	6/30/2017
Dividend Per Share Growth	3.7%	3.8%	2.6%
Free Cash Flow	$2,642	$2,506	$2,552
Cash Spent on Dividends	$1,605	$1,569	$1,520
Dividend % FCF	60.7%	62.6%	59.6%
Share Repurchases	$1,206	$1,435	$1,513
Cash After Dividends & Repurchases	-$169	-$498	-$481
Cash from Stock Option Exercises	$436	$330	$509
Cash from Asset Sales	$0	$0	$0
Share Count	859	872	891
growth	-1.4%	-2.1%	-1.1%

CL's dividend consumes just 60% of free cash flow which is the best of the four higher-yielding names in the group. However, the company is similar to PG in that its buyback regularly consumes more than surplus after the dividend. Also, like P&G, cash from the exercise of stock options often covers this shortfall. However, we again point out this is not a reliable, high-quality source of cash flow. CL's share count reduction from the buyback adds 1-2% of EPS growth which is also less than the boost from PG's plan.

Acquisition Spending

	6/30/2019	6/30/2018	6/30/2017
T12 Cash Spending on Acquisitions	$1	$727	$5
T12 FCF after Dividend, Repo and Acquisitions	-$170	-$1,225	-$486

CL acquired Physicians Care Alliance in the 3/18 quarter for $730 million which was its only material acquisition in the last three years. CL is clearly not addicted to spending cash and taking on debt to drive the top line.

Leverage

	6/30/2019	6/30/2018	6/30/2017
Cash & Equivalents	$863	$833	$1,241
Short Term Investments	$0	$0	$0
Short-Term Debt	$5	$346	$13
Long Term Debt	$6,640	$6,519	$6,506
Net Debt/EBITDA	1.7		
Debt Due in 3 Years	$544		
maturities			
2019	$0		
2020	$246		
2021	$298		
2022	$886		
2023	$893		
Unfunded Pension and Retirement Obligations	-$1,678		

CL's leverage of 1.7 times EBITDA is very manageable. It has already begun reducing debt from the Physicians Care deal.

Church & Dwight (CHD)
Cash Flow Review

Key Points:

- Operating cash flow rose by 5.6% after adjustment for minor net working capital impacts. The company has no major restructuring payments and no longer supports a defined benefit pension plan.

- Extending its time to pay suppliers did boost cash flow as days payable jumped 5 days to 72. This is not an overly aggressive level, but such large improvement is unlikely to last.

- CHD factors receivables but offers minimal information on its impact on an annual basis and none on a quarterly basis. Accounts receivable days rose a modest 1.5 days which the company attributed to timing of sales.

- CHD is less capital intensive than its peers which leads to a significantly lower ratio of spending to sales. However, its average age of equipment is one of the lowest in the group and we do not foresee a significant jump in capex in the near-term.

- The company is growing through acquisition and therefore maintains a lower dividend yield as it spends its cash on buying companies. CHD has also throttled back its share repurchase program to save cash.

- Debt has risen to 2 times EBITDA. This is not daunting by any means. However, continued acquisitions could increase the debt to the point the rapid dividend growth is threatened.

- Several of the company's recent deals came with a significant portion of the consideration tied up in contingency payments related to future performance. The most recent Flawless/Finishing Touch acquisition had an upfront price tag of $475 million but the company could potentially have to pay an additional $425 million based on how well the acquired operations perform over the next couple of years.

Likewise, the 2017 acquisition of Agro Biosciences still has a potential $25 million in contingency payments through 2019.

Adjusted Cash Flow Growth

	6/30/2019	6/30/2018	6/30/2017
T12 Cash Flow from Operations	$792	$755	$608
growth	4.9%	24.1%	-7.0%
Non-Operating Cash Flow Adjustments			
+Cash Restructuring Payments	$0	$0	$0
+Cash Pension Contributions/Settlements	$0	$0	$25
+Other Material Non-Operating Cash Payments	$0	$0	$0
-Stock-Based Compensation	-$22	-$22	-$16
Total Adjustments	-$22	-$22	$9
T12 Adjusted. Cash Flow	$770	$733	$617
growth	5.0%	18.8%	-2.6%
Changes in Operating Working Capital	-$6	$23	$10
T12 Adjusted Pre-Working Capital Cash Flow	$776	$710	$607
growth rate	5.9%	15.1%	-4.2%
Working Capital Ratios			
DSO	32.4	30.9	30.9
DSI	61.3	58.8	54.7
DSP	71.7	66.9	70.2
Cash Conversion Cycle	22.1	22.9	15.4

Cash flow from operations rose by 4.9% in the 12 months ended 6/19. Unlike most of the others in the group, CHD does not maintain a formal restructuring program so there are no unusual, material cash payments to adjust out. In addition, it terminated its Canadian pension plan in 2017 so it does not have ongoing cash contributions to retirement plans.

Working capital had a minimal net impact on cash flow growth and after adjustment, cash flow rose by 5.9%.

Like most of its peers, CHD's cash flow did get a boost from extending payment terms to suppliers as days payable jumped almost 5 days to 72, which is not as aggressive as some in the group.

A unique aspect of CHD's working capital is that it regularly sells accounts receivables off its balance sheet. As we have pointed out in our earnings quality review of CHD, it disappointingly provides very little information on its receivables factoring on an annual basis and none on a quarterly basis. We do know that in fiscal 2018 (ended December) the company factored a total of $112.9 million in receivables which was up $7.5 million over 2017. No mention of receivables factoring was made in the 6/19 10-Q which leaves us nothing to go on with respect to the potential boost to cash flow from factoring. Days sales outstanding did increase over last year's June quarter and receivables consumed $35.9 million in cash flow in the twelve months ended 6/19 versus only $7.7 million in the comparable year-ago period. The company attributed the rise in receivables to the timing of sales.

Capital Spending

	6/30/2019	6/30/2018	6/30/2017
Reported T12 Operating Cash Flow	$792	$755	$608
T12 Capital Spending	$64	$54	$42
T12 Free Cash Flow	$728	$701	$566
Capex % of Revenue	1.5%	1.3%	1.2%
Gross PPE	$1,240	$1,240	$1,181
Accumulated Depreciation	$681	$647	$608
Net PPE	$559	$593	$573
T12 Depreciation Expense	$65	$63	$59
Avg Age	10.5	10.3	10.3
Depreciation % of Gross PPE	5.2%	5.0%	5.0%
Depreciation Method	Straight-Line		
Buildings & Improvements	9-40 yrs		
Machinery & Equipment	3-20 yrs		
Office Equipment	3-10 yrs		

CHD has by far the lowest capital spending as a percentage of sales in the group give it is considerably less capital intensive. The average age of its equipment is near the low end of the group and we do not anticipate a large jump in capex in the near future.

Dividend Cover

	6/30/2019	6/30/2018	6/30/2017
Dividend Per Share Growth	9.2%	10.9%	6.5%
Free Cash Flow	$728	$701	$566
Cash Spent on Dividends	$219	$201	$187
Dividend % FCF	30.1%	28.7%	33.1%
Share Repurchases	$100	$300	$500
Cash After Dividends & Repurchases	$409	$200	-$121
Cash from Stock Option Exercises	$85	$23	$102
Cash from Asset Sales	$0	$0	$0
Share Count	253	249	256
growth	1.4%	-2.5%	-2.4%

CHD is by far the lowest yielding member of the group as it is seen as more of a growth play which it is currently pursuing via acquisitions. As such, the company spends only 30% of its free cash flow on its dividend and its has throttled back on its share repurchases to cover its recent deals.

	6/30/2019	6/30/2018	6/30/2017
T12 Cash Spending on Acquisitions	$475	$1,075	$365
T12 FCF after Dividend, Repo and Acquisitions	-$66	-$875	-$486

We can see that while cash after dividend and buyback has been solidly positive the last two years, the surplus has been more than consumed by spending on acquisitions…

Leverage

	6/30/2019	6/30/2018	6/30/2017
Cash & Equivalents	$98	$89	$238
Short Term Investments	$0	$0	$0
Short-Term Debt	$411	$410	$629
Long Term Debt	$1,809	$1,803	$894
Net Debt/EBITDA	2.0		
Debt Due in 3 Years	$599		
maturities			
2019	$599		
2020	$0		
2021	$0		
2022	$1,000		
2023	$0		

…which has led to a steady increase in debt. Another important aspect of its recent deals is the high degree of contingent consideration involved. For example, the company paid $475 million for Flawless/Finishing touch in the most recent quarter. However, the deal includes potential contingency payments of $425 million based on the performance of the acquired operations over the next couple of years. Likewise, the upfront payment for the June 2017 acquisition of Agro BioSciences was $75 million, but there is still another $25 million that could potentially be owed base on performance through 2019.

Debt is in no way out of control at 2 times EBITDA, but growth through acquisition is key to the company's strategy and if debt continues to build, it could become to work at odds with continued rapid dividend growth.

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

BTN Research is a research publication structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. Information included in this report is derived from many sources believed to be reliable (including SEC filings and other public records), but no representation is made that it is accurate or complete, or that errors, if discovered, will be corrected.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.