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Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

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Kimberly-Clark (KMB) EQ Review Update-9/18 Quarter

Current EQ Rating*	Previous EQ Rating
4-	4+

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

We are lowering our rating on Kimberly Clark (KMB) to 4- (Acceptable).

KMB reported adjusted EPS of $1.71 in the 9/18 quarter which was 8 cps above the consensus targets. However, the adjusted effective tax rate dipped 3.4 percentage points sequentially. We don't know what the average consensus estimated tax rate was going into the quarter, but we estimate the decline in effective rate would have added at least 7 cps to the average analyst's models, likely more. This takes the shine off the headline earnings beat and is the main factor behind the slight lowering of our rating. In addition, negative FX translation shaved 3 percentage points off sales growth in the period. We saw no other new earnings quality issues and note the following development of previously cited issues:

- The decline in inventory DSIs continues, but our concerns of a "LIFO liquidation" are further diminished by the increase in inventories accounted for under LIFO. We note that there was a year-over-year jump in LIFO finished goods inventories. However, much of that appears to be a rebound from lower 2017 balances and we are not overly concerned at the present.

- While other assets increased, this appears to be largely due to rising time deposit balances.

Lower Tax Rate Benefits Results

Like many companies with slow core growth, much of KMB's recent EPS growth has come from the lower corporate tax rate. However, KMB saw its adjusted effective tax rate fall even further in the 9/18 quarter. The following table shows the adjusted effective tax rate for the last three quarters as well as the forecast tax rate for full-year 2018 as of the end of each quarter:

	9/30/2018	6/30/2018	3/31/2018
Adjusted Effective Tax Rate	19.6%	23.0%	22.0%
Forecasted Full-Year Rate	21-22%	23-26%	23-26%

There was a clear drop off in the sequential adjusted effective tax rate which the company attributed to "planning initiatives". While certainly a positive, the decline was likely not anticipated in analysts' models. If we assume that analysts were anticipating an effective rate of 23% going into the quarter, the lower-than-expected decline would have been a more than 7 cps boost to adjusted EPS. Realistically, models were likely expecting the effective rate to be higher than 23%, implying an even larger boost. With this in mind, the $0.08 per share earnings beat looks much less impressive.

Inventory DSIs Declining with LIFO Portion Increasing

We noted two quarters ago that KMB's inventory days of sales (DSIs) were trending down which warranted observation since about 30% of inventories (most US inventories) are accounted for under the LIFO (last-in, first-out) method. A decline in LIFO inventories can artificially inflate profits as older, lower-cost inventory layers are matched up with current sales on the income statement. However, the decline in LIFO inventories fell more in-line with the decline in FIFO inventories in the 6/18 quarter, which alleviated some of our concern. As the following table shows, the decline in total inventory DSIs continued into the 9/18 quarter, but LIFO inventory DSIs actually climbed to 13.5 days from 12.7.

	9/30/2018	6/30/2018	3/31/2018	12/31/2017	9/30/2017	6/30/2017
LIFO Inventory						
Raw Materials	$83	$86	$86	$87	$88	$89
Work in Process	$120	$108	$102	$110	$106	$110
Finished Goods	$450	$453	$412	$421	$396	$440
	$653	$647	$600	$618	$590	$639
Excess FIFO cost over LIFO cost	-$184	-$177	-$178	-$176	-$173	-$165
Total LIFO Inventory	$469	$470	$422	$442	$417	$474
LIFO Inventory Days of Sales	13.5	13.6	11.3	13.7	12.7	14.8
FIFO/Average Cost Inventory						
Raw Materials	$252	$247	$266	$258	$249	$251
Work in Process	$106	$99	$101	$103	$97	$87
Finished Goods	$664	$654	$685	$684	$687	$632
Supplies	$279	$280	$304	$303	$298	$294
Total FIFO/Average Cost Inventory	$1,301	$1,280	$1,356	$1,348	$1,331	$1,264
FIFO/Average Cost Inventory Days of Sales	37.5	37.1	36.3	41.8	40.5	39.4
Total Inventory Days of Sales	51.0	50.7	47.6	55.6	53.2	54.2

While the increase in LIFO inventories may alleviate the concern of a LIFO liquidation, the rapid increase also brings with it some concern, particularly the near-14% increase in LIFO finished goods. To get a better feel for the trend in US inventories, we need to track them relative to US results. The company breaks out sales for North America which primarily reflects the US. While we ordinarily calculate DSIs with cost of sales to eliminate the impact of sales prices changes, revenue is close enough to give us an idea of the rough DSI trend. However, we note that North American revenue in the 9/18 quarter fell by 5% while volumes actually declined by 8%. This means that overall inventories moved in the quarter less than the sales figures indicate implying that the most recent sales-based DSI figures in the table below are likely understated.

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
North American Sales	$2,407.00	$2,347.00	$2,385.00	$2,295.00
LIFO Finished Goods	$450.00	$453.00	$412.00	$421.00
LIFO FG DSI (on sales)	17.1	17.6	15.8	16.7
	9/30/2017	6/30/2017	3/31/2017	12/31/2016
North American Sales	$2,428.00	$2,379.00	$2,324.00	$2,352.00
LIFO Finished Goods	$396.00	$440.00	$444.00	$430.00
LIFO FG DSI (on sales)	14.9	16.9	17.4	16.7
	9/30/2016	6/30/2016	3/31/2016	12/31/2015
North American Sales	$2,410.00	$2,410.00	$2,373.00	$2,350.00
LIFO Finished Goods	$442.00	$472.00	$499.00	$525.00
LIFO FG DSI (on sales)	16.7	17.9	19.2	20.4

We would point out that there was a downward trend in US finished goods in 2017, so much of the recent year-over-year increase in US finished goods inventories is due to a rebound. Also keep in mind that the LIFO finished goods number above is before the LIFO adjustment, so it still contains the most recent, higher-cost inventory. This means at least some of the increase is due to the rising costs the company is experiencing. With all of these factors in mind, we are not overly concerned by the rise in LIFO finished goods, but the trend should be watched closely in future quarters.

Other Assets Increase- Not a Concern

While other current assets and other assets rose in the quarter, this now appears to be related to the company's time deposits balance. We currently see no concern of increased capitalization of expenses.

Explanation of EQ Rating Scale

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

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

Key Points to Understand About the EQ Score

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

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

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