

Kimberly-Clark (KMB)-EQ Update 6/18 Quarter

Kimberly-Clark (KMB) reported adjusted EPS of \$1.59, two cents above the Zack's estimate. Revenue came in slightly below. However, the company lowered its outlook for 2018 EPS to \$6.60-\$6.80 from the previous range of \$6.90-\$7.20, citing higher commodity costs and eroding currency situation as the culprits.

We currently see no significant concerns with KMB's earnings quality and note the following developments in the quarter:

- We mentioned in the previous quarter that inventory days of sales declined significantly versus the year-ago period with most of the decline coming from its LIFO inventories. This raised some concern about the possibility of a "LIFO liquidation" impact. While inventories declined again in the 6/18 quarter, the decline was more muted and balanced between LIFO and FIFO components.
- Other current assets and other assets have been trending upward in recent quarters. These accounts have many components making the trend difficult to pinpoint. However, any such increase always warrants watching as it could be a sign of increased capitalization of expenses.
- Management indicated that advertising expense declined slightly in the quarter as the company seeks to become more efficient in its marketing spend. We remain concerned this could be an area of disappointment if the company begins to lose market share and is forced to increase its rate of spending.
- KMB disclosed that the rapid devaluation of the Argentinian peso will trigger the use of highly inflationary accounting for its Argentinian operations going forward. Given that the company's Argentina operations are less than 2% of sales, we are not concerned of a material negative surprise coming from this area.

Inventory Days of Sales Down Again

We noted in the last quarter that KMB's inventory days of sales (DSI) fell significant, with most of the decline centered in its LIFO inventories. About 25% of inventories are accounted for under LIFO with the remainder accounted for under FIFO or average cost. In the 6/18 quarter, the decline in inventory continued with DSIs falling to 50.7 from 54.2 in the year-ago quarter. However, this was a moderation from the 7.4-day decline seen in the 3/18 quarter. We can also see from the following table that the decline was spread more evenly between FIFO and LIFO inventories which reduces our concern that the quarter benefitted from a LIFO liquidation.

	6/30/2018	03/31/2018	12/31/2017	09/30/2017	06/30/2017	03/31/2017
LIFO Inventory						
Raw Materials	\$86.00	\$86.00	\$87.00	\$88.00	\$89.00	\$91.00
Work in Process	\$108.00	\$102.00	\$110.00	\$106.00	\$110.00	\$113.00
Finished Goods	\$453.00	\$412.00	\$421.00	\$396.00	\$440.00	\$444.00
Supplies	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
Excess FIFO cost over LIFO cost	-\$177.00	-\$178.00	-\$176.00	-\$173.00	-\$165.00	-\$163.00
Total LIFO Inventory	\$470.00	\$422.00	\$442.00	\$417.00	\$474.00	\$485.00
LIFO Inventory Days of Sales	13.6	11.3	13.6	12.8	14.8	15.6
FIFO/Average Cost Inventory						
Raw Materials	\$247.00	\$266.00	\$258.00	\$249.00	\$251.00	\$245.00
Work in Process	\$99.00	\$101.00	\$103.00	\$97.00	\$87.00	\$88.00
Finished Goods	\$654.00	\$685.00	\$684.00	\$687.00	\$632.00	\$620.00
Supplies	\$280.00	\$304.00	\$303.00	\$298.00	\$294.00	\$290.00
Total FIFO/Average Cost Inventory	\$1,280.00	\$1,356.00	\$1,348.00	\$1,331.00	\$1,264.00	\$1,243.00
FIFO/Average Cost Inventory Days of Sales	\$37.09	\$36.32	\$41.40	\$40.74	\$39.45	\$39.88
Total Inventory Days of Sales	50.7	47.6	55.0	53.5	54.2	55.4

The lower inventory spend has benefitted cash flow in recent quarters, but with inventories now at multi-year lows, there is not much improvement left to be gleaned.

Other Assets Steadily Increasing

A trend worth noting is the increase in other current assets and other assets, as seen in the following table:

	6/30/2018	03/31/2018	12/31/2017	09/30/2017	06/30/2017	03/31/2017
Other current assets	\$508	\$498	\$490	\$463	\$380	\$325

Other current assets days of sales	10.1	9.6	9.8	9.1	7.6	6.6
Other Assets	\$729	\$767	\$695	\$653	\$624	\$583
Other Assets days of sales	14.4	14.8	13.9	12.8	12.4	11.8

It is difficult to pinpoint what is causing this increase as both of these accounts are “catch-alls” with many different components including derivatives balances and company sponsored life insurance policies. However, a pronounced, gradual increase always catches our eye as it could be an indication that the company is capitalizing amounts that should be expensed in current periods. The sequential increase in other assets actually turned in the most recent quarter but the account is still relatively high when viewed over the last several quarters. If these accounts do contain a level of capitalized expenses that have been delayed from hitting the income statement, it could be a headwind to margins in upcoming quarters as these amounts are recognized. Nevertheless, given the lack of clarity, we give this a low concern level and will continue to monitor the trend.

Marketing Continues to Decline

We noted in previous reviews that KMB’s advertising expense fell by 20 bps as a percentage of sales in 2017. The company does not disclose advertising expense by quarter, but management did indicate that results benefited some in the second quarter from lower spending as it looks to be more efficient in how it doles out advertising dollars. The company is calling for essentially flat marketing spend for 2018, but we remain concerned that this could be a source of disappointment if spending must be accelerated to maintain market share.

Inflationary Accounting in Argentina

KMB noted in its 10-Q that due to the rapid deceleration of the Argentinian peso in the quarter, which indicated that the three-year cumulative inflation rate exceeded 100% as of the end of the quarter. GAAP accounting will therefore require the company to adopt highly inflationary accounting which means KMB will begin using US dollar as the functional currency of its Argentinian operations with the effect of exchange rates on financial assets being immediately reflected in other income. KMB’s Argentinian operations accounted for less than 2% of sales in the six months ended 6/18. This development is not surprising and we do not expect a material negative surprise given the small size of the operation.

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