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BTN Earnings Quality Review

January 18, 2018

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Kimberly Clark (KMB)

Kimberly Clark (KMB) is another favorite among dividend investors given its multi-decade history of increasing its dividend and its perceived safety as a consumer staples company. (This time of year, we are reminded that people will always have to blow their noses.) However, market penetration, increased competition from generics and pressure from a consolidated retail base have all conspired to keep growth down at KMB. This can be easily seen in its 9/17 quarterly results which saw sales volume growth of 1%, being almost offset by price declines. KMB has been fighting the lackluster top-line, pricing pressure and rising input costs with its FORCE cost reduction program, which has allowed it to essentially tread water at the operating profit line over the last couple of years.

The company has also cut capex and milked working capital to keep its free cash flow coverage of the dividend in an acceptable range:

	9/30/2017	9/30/2016	9/30/2015
T12 Operating Cash Flow	$2,937	$3,026	$2,231
T12 Capex	$784	$840	$1,107
T12 Free Cash Flow	$2,153	$2,186	$1,124
T12 Dividends	$1,347	$1,301	$1,266
Div % of FCF	62.6%	59.5%	112.6%

KMB manages to add another 1-2% to EPS growth via its share buyback program. In recent periods, the company has been able to cover the buyback with cash flow after the dividend. However, our analysis of the 9/17 quarter turned up a couple of red flags investors should watch going forward.

Accounts receivable DSOs jumped in the 9/17 quarter

KMB has actually missed analysts' revenue targets in the last several quarters, but has managed to essentially meet or exceed earnings estimates through more aggressive cost cutting. This makes the two-day jump in accounts receivable seen in the 9/17 quarter more disturbing:

	Quarter Ended: 9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016	6/30/2016	3/31/2016
Sales	$4,640	$4,554	$4,483	$4,544	$4,594	$4,588	$4,476
Accounts Receivable	$2,360	$2,221	$2,224	$2,176	$2,222	$2,249	$2,255
Sales YOY growth	1.0%	-0.7%	0.2%	0.1%	-2.6%	-1.2%	-4.6%
Accounts Receivable YOY growth	6.2%	-1.2%	-1.4%	-4.6%	-2.7%	-1.6%	0.5%
Sales Seq growth	1.9%	1.6%	-1.3%	-1.1%	0.1%	2.5%	-1.4%
Accounts Receivable Seq growth	6.3%	-0.1%	2.2%	-2.1%	-1.2%	-0.3%	-1.1%
Accounts Receivable DSOs	**46.4**	**44.5**	**45.3**	**43.7**	**44.1**	**44.7**	**46.0**

Receivables have been trending down for the previous five quarters, but suddenly rose by more than 6% in the third quarter on a 1% increase in revenue. While not a gargantuan jump in DSOs, given the flat trend and weak sales growth, the uptick definitely stands out. There is no specific mention of the increase in the company's 10-Q or quarterly conference call. If receivables had grown in line with revenues, it would have taken about $115 million off of revenue, resulting in a more than 1% decline. It is possible that these revenues were pulled forward into the third quarter and will put an even greater burden on fourth quarter sales growth.

Accounts payables are increasing

KMB management is pulling out all the stops to save money, and that has included putting pressure on its suppliers. The following table shows the calculation of days payable (DSPs) for the last 7 quarters:

	Quarter Ended: 9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016	6/30/2016	3/31/2016
Sales	$4,640	$4,554	$4,483	$4,544	$4,594	$4,588	$4,476
Accounts payable	$2,729	$2,629	$2,571	$2,609	$2,454	$2,448	$2,442
Sales YOY growth	1.0%	-0.7%	0.2%	0.1%	-2.6%	-1.2%	-4.6%
Accounts payable YOY growth	11.2%	7.4%	5.3%	-0.1%	-2.5%	-5.8%	-2.4%
Sales Seq growth	1.9%	1.6%	-1.3%	-1.1%	0.1%	2.5%	-1.4%
Accounts payable Seq growth	3.8%	2.3%	-1.5%	6.3%	0.2%	0.2%	-6.5%
Accounts payable DSPs	**53.7**	**52.7**	**52.3**	**52.4**	**48.7**	**48.7**	**49.8**

DSPs have shown significant year-over-year increases in the last three quarters. Keep in mind that DSPs are at a five-year high, so this does not represent a bounce off an unusually low level. Such an increase in payables clearly shows that management is pushing its suppliers to extend payment terms, keeping the company's cash in its possession for longer. While this is certainly good financial stewardship, it calls into question how much longer the company can squeeze incremental cash flow growth from that source. Also, keep in mind that the cash flow benefit of increasing payables has been partially offset by the cash use of rising receivables.

Capital spending cuts

Referring to the first table, we see that the company has cut capital spending significantly in the last three years. For the full year 2017, the company is now expecting capital spending to come in below its initial projected range of $850-$950 million. The low end of that range represents a meaningful increase from 2016's $771 million. In fact, quarterly spending on capex has increased in each of the last two quarters, marking an end to the benefit of capex cuts to free cash flow.

KMB reports on 1/23.

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