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BTN Earnings Quality Review

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Kimberly-Clark (KMB)

Last week, we previewed KMB's 12/17 quarter earnings, noting some items of concern. This week, the company once again missed top-line revenue targets, but managed to report adjusted EPS of $1.57 which was 2.5 cents above consensus. The company also announced the largest restructuring program since it began its global initiative in 2003. We discuss the status of our concerns and the new program below.

Accounts receivable still elevated

Last week, we noted that after several quarters of trending down, KMB's receivables began to increase in the 9/17 quarter. This trend in the year-over-year DSO increase continued into the 12/17 quarter:

Quarter ended:	12/31/2017	9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Sales	$4,582	$4,640	$4,554	$4,483	$4,544	$4,594
Accounts Receivable	$2,315	$2,360	$2,221	$2,224	$2,176	$2,222
Sales YOY growth	0.8%	1.0%	-0.7%	0.2%	0.1%	-2.6%
Accounts Rec. YOY growth	6.4%	6.2%	-1.2%	-1.4%	-4.6%	-2.7%
Sales Seq growth	-1.3%	1.9%	1.6%	-1.3%	-1.1%	0.1%
Accounts Rec. Seq growth	-1.9%	6.3%	-0.1%	2.2%	-2.1%	-1.2%
Accounts Receivable DSOs	**46.1**	**46.4**	**44.5**	**45.3**	**43.7**	**44.1**

As we pointed out last week, the 9/17 jump in receivables could have pulled over $100 million into the third quarter at the expense of the fourth quarter. This very well could have contributed to the approximate $25 million revenue miss in the quarter. To be fair, KMB has missed 7 of its last 8 quarterly revenue targets, so that is nothing new. As far as the current status of the receivables, there was another 2.4 day year-over-year increase in DSOs in the 12/17 quarter. However, the sequential decline in the accounts receivable balance was more in-line with what we would expect in a fourth quarter, indicating there was less of a noticeable buildup in receivables than in the previous quarter. We are therefore less concerned about the receivables balance going into the 3/17 quarter, but will remain watchful of the trend going forward.

Accounts payable still rising

We noted last week that KMB's cash flow was benefitting from the company putting pressure on its suppliers. This trend continued into the 12/17 quarter, as seen in the below table which shows the calculation of accounts payable days of sales:

Quarter ended:	12/31/2017	9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Sales	$4,582	$4,640	$4,554	$4,483	$4,544	$4,594
Accounts payable	$2,834	$2,729	$2,629	$2,571	$2,609	$2,454
Sales YOY growth	0.8%	1.0%	-0.7%	0.2%	0.1%	-2.6%
Accounts payable YOY growth	8.6%	11.2%	7.4%	5.3%	-0.1%	-2.5%
Sales Seq growth	-1.3%	1.9%	1.6%	-1.3%	-1.1%	0.1%
Accounts payable Seq growth	3.8%	3.8%	2.3%	-1.5%	6.3%	0.2%
Accounts payable DSPs	**56.4**	**53.7**	**52.7**	**52.3**	**52.4**	**48.7**

While sales rose by just under 1% in the quarter, accounts payable jumped by 8.6% over last year's fourth quarter. Keep in mind that accounts payable days of sales has risen consistently over the last six years from about 46 days to the current 56. As we noted last week, we are certainly not faulting management for efficient working capital management. Nevertheless, squeezing suppliers has been a meaningful boost to cash flow growth in recent years and the questions arises as to how much longer it can continue to be. This is an important question for a company struggling to grow its cash flow at all.

Next round of charges announced- and they are huge

KMB management announced in the quarterly conference call that it is starting its next round of restructuring activities. While KMB is not as bad as some companies about taking a material restructuring charge every quarter, regular restructurings are definitely a part of its history as seen in the below table:

	2016	2015	2014	2013	2012	2011
2014 restructuring	$35	$63	$133			
Pulp & tissue charges					$135	$415
European restructuring			$33	$81	$299	
Other	$23					$32
Total charges	$58	$63	$166	$81	$434	$447
Adjusted pretax income	$3,033	$2,932	$2,918	$2,758	$1,980	$1,844

The latest round of restructuring is the largest so far. The "2018 Global Restructuring Program" is expected to result in total restructuring charges of $1.7-$1.9 billion through 2020. Management predicts actual cash outlays of $900 million to $1 billion plus another $600-$700 million in incremental capital spending associated with the plan. The bulk of the charges are expected to be recognized in 2018 with $1.20-$1.35 billion expected in 2018. This will of course be added back to adjusted earnings. All of this spending is expected to result in annual cost savings of $500-$550 million by the end of 2021 and is in addition to its ongoing FORCE cost reduction program.

KMB management made an interesting comment on the conference call in regards to the 2018 Plan:

> "I will tell you I think I had an investor once tell me that he thought every CPG company restructured every five years. And I think your point would be, gosh, it would be great if we could avoid adding the cost in the first place so we didn't have to restructure it. But we've probably historically proven that we're not capable of that."

We tend to agree with the unnamed investor. While we understand global organizations are complex and it is impossible to expect one grand plan to align operations forever, at what point does one look at the regularity and magnitude of these charges over time and conclude that these are a regular cost of doing business that should be subtracted out of profits? Just a quick glance at the table above shows that from 2011-2016, these "one-time" charges amounted to over 8% of adjusted pretax income. That's pretty meaningful. One might argue that these programs resulted in ongoing annual cost savings, but do those cost savings cover the newest round of "incremental" spending on the next plan?

There is no doubt that the company's charge-adjusted operating margins have improved as a result of costs being removed from the model. The company's ongoing FORCE program has been attributed with $300-$450 million a year in cost savings over the last several years, and the company does not take one-time charges directly associated with that program. Since the 2014 restructuring program, the company has identified roughly $160 million in savings from the 2014 program and another $1.5 billion in FORCE program reductions. However, given that the latest program will spend almost all of that, it calls into question how much was actually saved over the whole time frame. One has to believe that this charge is the last charge, but as management confessed in the call, history doesn't seem to show they are capable of that. Meanwhile, the cash costs and incremental capex will weigh on what is available for future dividend growth.

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