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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Lancaster Colony (LANC) EQ Review Update-9/18 Quarter

Current EQ Rating*	Previous EQ Rating
3-	3+

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

We are slightly lowering our EQ Review rating on Lancaster Colony (LANC) to a 3- (Minor Concern) to reflect a worsening of the red flags we had previously identified.

- Inventory DSIs jumped by 5 days year-over-year in the 9/18 quarter. This is an acceleration from the 3-day increase in the 6/18 quarter. In addition, raw materials as a percentage of total inventory rose by 220 bps which seems to rule out rising costs as a major driver of the increase. Management's explanation of an increase in sales volume and an increase in planned forward coverage is possible, but such a pronounced jump centered in finished goods always deserves attention.

- Accounts payable days continued to rise rapidly, but given the relatively low level of payables, we believe this trend could run for some time.

Inventory Growth Accelerated

We highlighted in our last review that LANC's inventory days (DSIs) rose over three days in the 6/18 quarter. The growth in inventory relative to sales continued to accelerate in the 9/18 quarter, as seen in the following table.

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Inventory	$103	$91	$88	$78
COGS	$235	$232	$228	$236
Inventory DSIs	39.8	35.7	35.2	30.1

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Inventory	$85	$76	$80	$80
COGS	$223	$217	$222	$233
Inventory DSIs	34.8	32.1	32.7	31.4

DSIs increased by 5 days in the 9/18 quarter which the company attributed to the following factors during the conference call:

> *"The noticeable increase in inventory was anticipated and reflects the impact of several items, including increased sales volumes, continued higher input cost from commodities, balancing of production within our plants for seasonal inventory builds and adjustments to our days of forward coverage to maintain high levels of customer service."*

We admit that the company has seen an uptick in sales growth which was 5.9% and 6.3% in the 9/18 and 6/18 quarter, respectively. This was up from essentially flat in the 3/18 quarter and down 2.2% in the 12/17 quarter. It is also plausible that rising costs could contribute to an increase in inventories. However, we are struck by the significant shift in finished goods inventories witnessed during the quarter which is shown in the table below:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Raw Materials % of inventory	36.5%	36.0%	39.1%	44.7%
Finished Goods % of inventory	63.5%	64.0%	60.9%	55.3%
	100.0%	100.0%	100.0%	100.0%

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Raw Materials % of inventory	38.7%	37.2%	38.3%	40.1%
Finished Goods % of inventory	61.3%	62.8%	61.7%	59.9%
	100.0%	100.0%	100.0%	100.0%

While finished goods inventories did increase 120 bps as a percentage of total inventory in the 6/18 quarter over the year-ago period, they jumped by 220 bps in the 9/18 quarter as raw materials fell. If rising costs had been a major contributor to the rise in DSIs, we would have expected to see a more balanced increase between raw materials and finished goods. The rise in finished goods matches with the company's explanation of a seasonal buildup and an increase in forward coverage. Nevertheless, the distinct acceleration in the buildup deserves attention and raises the possibility that some of the buildup was not planned. This issue deserves continued attention in the next quarter.

Payables Continue to Rise

Another trend at LANC we have been observing is its rising payables level which continued into the 9/18 quarter. LANC discloses the amount of contribution in progress which is included in accounts payable. That number has risen in the last few quarters, so we will adjust it out to get a more accurate reading of the trend in trade payables. This is shown in the following table:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
COGS	$235.455	$231.988	$228.261	$235.724
Accounts Payable	$67.483	$57.978	$58.187	$52.579
Construction in Progress in Accounts Payable	$3.219	$2.070	$1.279	$0.446
Adjusted Accounts Payable	64.3	55.9	56.9	52.1
Adjusted Days Payable	24.9	22.0	22.7	20.2

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
COGS	$223.441	$217.388	$221.929	$233.034
Accounts Payable	$47.796	$41.353	$41.840	$39.420
Construction in Progress in Accounts Payable	$0.590	$0.622	$1.887	$1.298
Adjusted Accounts Payable	47.2	40.7	40.0	38.1
Adjusted Days Payable	19.3	17.1	16.4	14.9

Management offered the following explanation of the rising payable in the conference call:

> *"As we conveyed last quarter, the increase in our accounts payable since June largely reflects an emphasis by our procurement team to extend payment terms with our vendors in conjunction with our ongoing lean six sigma efforts."*

We would also add that the increase in inventories, regardless of source, would also have an elevating force on payables.

As we noted in our previous review, LANC's payables are relatively low and it seems that the company has some room to run in boosting cash flow by optimizing payables. We are therefore not overly concerned with this trend.

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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