Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

August 30, 2018 | www.btnresearch.com

Lancaster Colony (LANC) EQ Review Update- 6/18 Quarter

Current EQ Rating*	Previous EQ Rating
3+	NA

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

We initiate coverage of Lancaster Colony (LANC) with a 3+ (Minor Concern) rating.

Overall, we are not very concerned with LANC's quality of earnings but would point out the following two items:

- Inventory days of sales (DSIs) rose by over 3 days in the 6/18 quarter. Management indicated this was due to rising costs, volume growth in dressings and pre-buying. These explanations seem plausible and we are not overly alarmed by the increase. We will be watching the trend closely in the upcoming quarter.

- Accounts payable days (DSPs) rose by over 5 days as the company admittedly is stretching payment to suppliers. Given LANC's noticeably low level of payables, we actually consider this to be advisable and we do not consider this a negative at this point.

Inventory DSIs Rose

Inventory days of sales (DSIs) rose by 3.6 days over the year-ago quarter as seen in the following table:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Inventory	$91	$88	$78	$85
COGS	$232	$228	$236	$223
Inventory DSIs	35.7	35.2	30.1	34.8

	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Inventory	$76	$80	$80	$90
COGS	$217	$222	$233	$211
Inventory DSIs	32.1	32.7	31.4	38.9

This is not an overly large jump and management addressed the inventory increase in the conference call:

> *"The increase in our inventory balances since June reflect higher commodity input cost, volume growth for our shelf stable licensed dressings and sauces, and an earlier pre-build of seasonal dip inventories for improved planned efficiencies."*

Given the manageable size of the increase and the inflationary environment, we are not overly alarmed by the jump in inventories. However, this is an area to be watching in the next quarter and should inventory remain elevated, it will become a more serious source of concern.

Accounts Payable Also Jumped

Accounts payable days also increased, continuing a trend of significant jumps seen in the last three quarters:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Accounts Payable	$58	$58	$53	$48
COGS	$232	$228	$236	$223
DSPs	22.8	23.3	20.4	19.5

	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Accounts Payable	$41	$42	$39	$42
COGS	$217	$222	$233	$211
DSPs	17.4	17.2	15.4	18.0

While we would expect some increase in payables to match the rise in inventories, the 5-6 days year-over-year increases indicate something else is at work. As with the inventory increase, management addressed the issue on the call:

> *"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 lean six sigma efforts."*

Actively stretching payment terms has been an almost universal theme in the packaged food group in the last several quarters. Some food companies have pushed payables days to extremely high levels, in some cases exceeding 80-90 days with the help of structured payable arrangements. Our concern with those companies is that they can only push so far and may face a backlash as suppliers push back and the game unwinds. In the case of LANC, the company's days payable is quite low, to the point it is almost advisable that they increase them for the sake of prudent working capital management. Therefore, while we will continue to monitor the trend, we do not consider this issue a concern at this point.

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.

Disclosure

BTN Research is a research publication structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. Information included in this report is derived from many sources believed to be reliable (including SEC filings and other public records), but no representation is made that it is accurate or complete, or that errors, if discovered, will be corrected.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.