Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

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www.btnresearch.com

McCormick (MKC) EQ Update-12/18 Quarter

Current EQ Rating*	Previous EQ Rating
3-	4-

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

We lower our earnings quality rating to 3- (Minor Concern).

MKC reported adjusted EPS of $1.67, 3 cps below the consensus. Management blamed the miss partly on inventory destocking by customers, in particular, one large customer that experienced problems with its ordering systems. The impact on the bottom line was magnified by the fact that the destocking involved a disproportionate share of more profitable products. We note several one-time benefits to the quarter, without which the miss would have been even larger. These benefits prompt our reduction in the earnings quality rating.

Putting aside earnings quality issues, we note that the company's valuation remains high at 24 times forward earnings even after the post quarter stock price decline. The debt level is also a concern. The validity of the company's inventory destocking explanation for the shortfall is a fundamental question beyond the scope of an earnings quality review.

- Management indicated that the tax rate for the quarter was lower than anticipated due to "due to the favorable impact of discrete items, principally a higher level of stock option exercises." The adjusted tax rate for the full year was 19.6%, lower than the company's full-year estimate given in the third quarter of 21%. This implies tax expense was over $10 million lower in the fourth quarter than the previous forecast which amounts to about 8 cps. There was a $6.7 million benefit to tax expense in the quarter related to adjustment from the Tax Act which the company removed in its calculation of adjusted EPS. Still, there was obviously a material benefit to tax expense from stock option exercises.

- Other income received a boost of $6 million from the gain on the sale of an office building. This would have added about 4 cps but would have been partially offset by $4 million in office consolidation expense which management said was recognized over the back half of the year.

- Days payable continued to rise, jumping about 9 days over the year-ago quarter as the company extends payment terms with suppliers.

- Adjusted debt/EBITDA remains elevated at 4x in the wake of the Frank's and French's acquisition. The company has a goal of reducing debt to 3x by 2020 and has suspended its buyback and share repurchase program. The dividend is well covered, consuming about 40% of FCF.

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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