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McCormick (MKC) EQ Review- 11/19 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 lowering our earnings quality rating on MKC to 3- (Minor Concern) from 3+ (Minor Concern)

MKC reported in-line earnings for the fourth fiscal quarter ended 11/29. However, revenues came up short of the consensus target and guidance for fiscal 2020 was well below the market's expectations. We are lowering our earnings quality rating largely due to the upcoming expiration of an earnings tailwind from lower pension costs.

- Lower pension costs have been adding about 3 cps to EPS growth for the last several quarters. This has been driven by declines in service cost from a series of pension freezes, a related decline in amortization of actuarial losses, as well as an increase to amortization of service credits related to changes in postretirement benefit plans. The decline in service cost will moderate in 2020 and the benefit from lower amortization of actuarial losses should decline or possibly reverse with lower a lower discount rate. Non-GAAP pretax income rose by 4% in the 11/19 quarter but that would have fallen to 2.2% without the lower pension expense.

- Accounts payable continued to skyrocket with days payable jumping to 90 days from 75 in the year-ago fourth quarter. We estimate this accounted for over half the reported increase in operating cash flow.

- The liability for estimated allowances for rebates, discounts, and returns at the end of the year fell on a slight increase in sales. We estimate that the decline relative to sales could have added about 3 cps to earnings during the year. Since the company only discloses the account on an annual basis it is impossible to tell when the impact fell. If the benefit came at the end of the year, it could have been a material boost to fourth-quarter results.

Pension Expense Decline Should Moderate Going Forward

MKC has made several changes to its pension and postretirement benefit structure over the last few years. On November 30, 2018, the company stopped accruing pension benefits for US employees as it had already done with its UK plan on December 31, 2016. The US Plan freeze can be seen in the decline in service cost starting in the 2/19 quarter in table 1 below:

Table 1

	11/30/2019	8/31/2019	5/31/2019	2/28/2019
Service Cost	$1.8	$1.9	$1.9	$1.9
Interest Cost	$11.7	$11.6	$11.6	$11.7
Expected Return on Plan Assets	-$14.8	-$14.6	-$14.8	-$14.7
Amortization of Prior Service Costs/(Credits)	-$1.9	-$2.1	-$2.0	-$2.0
Amortization of Net Losses/(Gains)	$0.4	$0.8	$0.7	$0.7
Settlement Losses	$0.0	$0.0	$0.0	$0.0
Total Pension/Postemployment Benefit Expense	-$2.8	-$2.4	-$2.6	-$2.4

	11/30/2018	8/31/2018	5/31/2018	2/28/2018
Service Cost	$5.2	$6.0	$6.0	$6.1
Interest Cost	$10.7	$10.8	$10.8	$10.9
Expected Return on Plan Assets	-$15.2	-$14.8	-$15.0	-$15.0
Amortization of Prior Service Costs/(Credits)	-$2.5	-$2.2	-$2.1	-$1.7
Amortization of Net Losses/(Gains)	$3.1	$3.1	$3.2	$3.2
Settlement Losses	$0.5	$0.0	$0.0	$0.0
Total Pension/Postemployment Benefit Expense	$1.8	$2.9	$2.9	$3.5

The US and UK plan freezes resulted in a reduction in the plan obligation of $77.7 million which produced an actuarial gain booked in other comprehensive income recognized in fiscal 2017. Effective November 30, 2019, the company will stop accruing benefits for participants in its Canadian pension plan. Since the freeze was approved in 2018, the company reduced its pension obligation by $17.5 million in that year as well as recognizing an actuarial gain in other comprehensive income.

Finally, the company made changes to its postretirement benefits plan to consolidate benefit providers, simplified/reduced its subsidy for postretirement benefits, as well as eliminated the life insurance benefits election for employees who were planning to retire prior to December 31, 2018. As a result of these changes, the company recorded a $27.1 million reduction in postretirement benefit obligation and a gain in comprehensive income which is being amortized into pension expense/income. Referring to Table 1, almost all the approximate $2 million quarterly income on the "Amortization of Prior Service Costs (Credits)" line is being generated by the amortization of the postretirement income credit. Roughly $20 million of the $27.1 million credit has been recognized as income. At a $2 million quarterly run rate, this should last through fiscal 2020 but will run out shortly after that.

In addition to the US plan freezes/changes, the pension obligation was likewise reduced during fiscal 2018 by an increase in the assumed discount rate used to determine the PBO seen below in Table 2.

Table 2

Benefit Obligations Assumptions

	11/30/2019	11/30/2018	11/30/2017
United States Plan			
Discount Rate- Funded Plan	3.4%	4.7%	4.0%
Discount Rate- Unfunded Plan	3.3%	4.6%	4.6%
International Plans			
Discount Rate- Funded Plan	2.2%	3.3%	3.0%
Rate of Compensation Increase	2.9%	3.0-3.5%	3.0-3.5%

The actuarial gain from the plan freeze and the increase in discount rate in fiscal 2018 drove the decline in the amortization of actuarial loss seen in Table 1 which has been another key source of the decline in pension expense.

However, this situation has now reversed as higher rates have led to an increase in the pension obligation shown in Table 3 below:

Table 3

Funded Status

	11/30/2019	11/30/2018	11/30/2017
United States Plan			
Benefit Obligation	$885	$753	$814
Fair Value of Plan Assets	$672	$640	$654
United States Plan Funded/(Unfunded) Status	-$213	-$112	-$160
International Plans			
Benefit Obligation	$346	$293	$342
Fair Value of Plan Assets	$341	$307	$331
International Plans Funded/(Unfunded) Status	-$5	$14	-$10
Total			
Total Benefit Obligation	$1,230	$1,046	$1,155
Total Fair Value of Plan Assets	$1,013	$947	$986
Funded Status	-$218	-$99	-$170

The Canadian freeze effective November 2019 should drive pension service cost to essentially zero in fiscal 2020 which could produce an approximate $1.5 million quarterly earnings headwind. However, the benefit from lower amortization of actuarial loss will wane and likely reverse as the benefit from a higher assumed discount rate and absence of gains from plan freezes will have passed. As noted earlier, the $2 million amortized gain from service credits to the postretirement benefit changes should continue to benefit earnings this year but will expire soon thereafter.

Lower pension expense has been adding about 3 cps to earnings growth each quarter in fiscal 2019. MKC's adjusted tax rate has been very volatile given the impact of stock option exercises, so we will use non-GAAP pretax income adjusted for special charges and transaction costs as a proxy for core growth. Table 4 below shows growth in non-GAAP pretax income before and after the decline in pension expense:

Table 4

	11/30/2019	8/31/2019	5/31/2019	2/28/2019
Non-GAAP Pretax Income	$272.0	$226.8	$179.1	$162.1
growth	3.9%	14.0%	8.4%	5.1%
Impact of Lower Pension Expense	$4.6	$5.3	$5.5	$5.9
Adjusted Non-GAAP Pretax Income	$267.4	$221.5	$173.6	$156.2
growth	2.2%	11.4%	5.1%	1.2%

Clearly, the lower pension expense has been a material contributor to recent non-GAAP growth rates, and it may be waning going forward.

Accounts Payable Are Still Skyrocketing

As we have noted in past reviews, like many companies in the food segment MKC is boosting cash flow by stretching its payment terms with suppliers.

Table 5

	11/30/2019	8/31/2019	5/31/2019	2/28/2019
Trade Accounts Payable	$847	$783	$707	$674
Trade Accounts Payable Days	90.2	91.3	81.9	79.3

	11/30/2018	8/31/2018	5/31/2018	2/28/2018
Trade Accounts Payable	$710	$646	$624	$584
Trade Accounts Payable Days	74.9	74.7	72.1	69.7

The company freely admits in its filings that it is receiving a boost to cash flow from "extending our payment terms to suppliers" and this has been going on for several quarters. The company does not itemize the cash flow impact of payables on its cash flow statement but our "back of the envelope" estimate from the change in balance sheet payables indicates the rise in payable days added about $70 million in incremental cash flow in fiscal 2019 or about half the reported growth in operating cash flow in the period.

Sales Allowances Down Along with Other Accrued Liabilities

At the time of the sale, MKC accrues for potential payments to customers in the form of trade discounts, rebates or returns. The company only discloses the balance of the accrued sales return liability on an annual basis, but it is worth noting that the allowance fell to $137.2 million at the end of 2019 from $142.1 million a year ago despite a slight increase to sales. This would have added about 3 cps to earnings over the course of the year. While not material when viewed over the whole year, the possibility exists that the entire impact could have fallen in a recent quarter and materially impacted the reported growth.

Likewise, the company disclosed in its 10-K that the “other” component of accrued liabilities declined to $287 million from $330 million, but we are uncertain as to the source of the decline. Nevertheless, a decline in accrued liabilities introduces the possibility that the company could have under-accrued for expenses to the benefit of earnings.

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 recently 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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