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October 18, 2018 | www.btnresearch.com

# McCormick & Company (MKC) EQ Review

| Current EQ Rating* | Previous EQ Rating |
|---|---|
| 4- | NA |

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

**We initiate coverage of McCormick (MKC) with a rating of (4-) Acceptable**

We see very little to be concerned about with MKC's reported results. Our observations include:

- The company's 8/17 acquisition of RB Foods has impacted the year-over-year comparability of accounts receivable days sales outstanding (DSOs) and inventory days (DSIs) for the last four quarters. However, there appears to be a downward trend in DSOs which are already at a low level which bodes well for receivables management. Likewise, inventory DSIs are also indicating a decline. MKC utilizes the average cost method, which rules out any potential concern stemming from a "LIFO liquidation."

- MKC's accounts payable days (DSPs) have been increasing the last two years and the company has cited the extension of payment terms with suppliers as being a factor in the past. While we have seen no mention of the company's use of factored payable arrangements, we believe that the benefit from extending payment terms will likely reverse at some point in the future which will be a headwind on cash flow growth.

- Management noted in the 11/17 10-K that its *Kamis* brand name (on the books at $36 million) could be susceptible to a write-down in value should assumptions about future results change. The relatively small size of the carrying value makes this only a minor concern.

## Working Capital Appears In-Line

MKC acquired the food business of RB Foods (Reckitt Benckiser's Food Division) on 8/17/2017. The company disclosed the following fair values for working capital accounts at the time of the acquisition:

| | |
|---|---|
| Trade Accounts Receivable | $36.9 |
| Inventories | $67.1 |
| Trade Accounts Payable | $65.8 |

The RB Foods business only contributed to the income statement for the last two weeks of the quarter, yet the above working capital accounts would have all been reflected in the balance sheet immediately. This would have significantly skewed the working capital ratios for the 8/17 quarter. However, we can make a reasonable adjustment for this by simply removing the above balances from MKC's balance sheet as of the end of the quarter.

The following table shows the calculation of accounts receivable days of sales (DSO) for the last eight quarters, as well as an adjusted DSO for the 8/31/17 quarter which removes the RB Foods balance as of the 8/17/2017 acquisition date:

| | 8/31/2018 | 5/31/2018 | 2/28/2018 | 11/30/2017 |
|---|---|---|---|---|
| Sales | $1,345 | $1,327 | $1,237 | $1,491 |
| Accounts Receivable | $512 | $474 | $502 | $555 |
| Accounts Receivable DSOs | 34.7 | 32.6 | 37.0 | 34.0 |

| | 8/31/2017 | 5/31/2017 | 2/28/2017 | 11/30/2016 |
|---|---|---|---|---|
| Sales | $1,185 | $1,114 | $1,044 | $1,227 |
| Accounts Receivable | $556 | $430 | $404 | $465 |
| Accounts Receivable DSOs | 42.8 | 35.2 | 35.4 | 34.6 |
| Adjusted DSO | 40.0 | | | |

Note that the last four quarters include the consolidated RB Foods receivables as well as a full quarter of revenues. Therefore, the only impact to the year-over-year comparisons would simply be the extent to which the RB Foods business' DSOs differ from the DSO level of the base MKC business. With the exception of the 2/18 quarter, there has been a clear downward trend in DSOs. That coupled with the low level of DSOs indicates strong receivables collection. We note that moving forward, we will have better comparisons as the RB Foods deal will be completely lapped.

We see a similar trend with the company's inventory days (DSIs) driven by the same factors:

| | 8/31/2018 | 5/31/2018 | 2/28/2018 | 11/30/2017 |
|---|---|---|---|---|
| COGS | $750 | $752 | $717 | $823 |
| Inventory | $806 | $798 | $828 | $793 |
| Inventory DSIs | 98.0 | 96.8 | 105.3 | 88.0 |

| | 8/31/2017 | 5/31/2017 | 2/28/2017 | 11/30/2016 |
|---|---|---|---|---|
| COGS | $701 | $670 | $631 | $687 |
| Inventory | $836 | $780 | $767 | $756 |
| Inventory DSIs | 108.8 | 106.3 | 111.0 | 100.5 |
| Adjusted DSI | 100.1 | | | |

We note that the company utilizes the average cost method for inventory valuation which approximates the FIFO (first-in, first-out) method. Therefore, we are not concerned that declining inventories are resulting in a "LIFO Liquidation" where the company is eating into lower-priced inventories to boost reported profits. Also, note that the company does not typically utilize derivates to hedge its exposure to raw materials price fluctuations.

Again, the same exercise the accounts payable days (DSPs):

| | 8/31/2018 | 5/31/2018 | 2/28/2018 | 11/30/2017 |
|---|---|---|---|---|
| COGS | $750 | $752 | $717 | $823 |
| Accounts payable | $646 | $624 | $584 | $640 |
| Accounts payable DSPs | 78.6 | 75.7 | 74.4 | 71.0 |

| | 8/31/2017 | 5/31/2017 | 2/28/2017 | 11/30/2016 |
|---|---|---|---|---|
| COGS | $701 | $670 | $631 | $687 |
| Accounts payable | $517 | $453 | $448 | $451 |
| Accounts payable DSPs | 67.3 | 61.7 | 64.9 | 59.9 |

| | 8/31/2016 | 5/31/2016 | 2/29/2016 | 11/30/2015 |
|---|---|---|---|---|
| COGS | $637 | $631 | $625 | $680 |
| Accounts payable | $361 | $366 | $337 | $412 |
| Accounts payable DSPs | 51.7 | 53.0 | 49.1 | 55.3 |

Note that when we look at three years of payables data, we see that DSPs have been trending higher for the last two years. Here is the explanation of the increase in payables from the Liquidity section of the company's 11/17 10-K filing:

> *"The decrease in CCC [cash conversion cycle] in 2017 from 2016 is due to an* ***increase in our days payable outstanding as a result of extending our payment terms to***

*__suppliers__ and, to a lesser extent, a decrease in our days in inventory. The decrease in CCC in 2016 from 2015 is mainly due to an increase in our days payable outstanding as a result of extending our payment terms to suppliers."*

There is no mention in the company's recent SEC filings of it utilizing structured payable arrangements to allow suppliers to sell their receivables balances from the company to accelerate their receipt of cash. Still, it is clear the company has actively stretched its payable terms to maximize cash flow growth in recent periods, a common practice we have seen with virtually all the food companies which will likely reverse in the future.

## Potential for Minor Impairment of *Kamis* Brand

MKC disclosed in its 10-K filed for the year ended 11/17 that the fair value of its *Kamis* brand name was approximately 14% above carrying value. However, it has cautioned that a "change in assumptions with respect to future performance of the *Kamis* business could result in impairment losses in the future." The *Kamis* brand name is on MKC's books for about $36 million, so we do not consider this to be a significant concern.

# 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

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