BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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McCormick & Co. (MKC) EQ Update- 3/19 Qtr.

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 increase our earnings quality rating to a 3+ (Minor Concern) from a 3- (Minor Concern).

MKC's $1.12 in adjusted EPS in the 2/19 quarter topped the consensus by 8 cps. While the company's high leverage and hefty valuation stand out, the quality of the reported earnings in the quarter appeared to improve.

- Days payable rose by 6 days over the year-ago quarter as the company continues to extend payment times on its suppliers. The movement in accounts payable used approximately $36 million in the three months ended 2/19 versus $52 million in the year-ago quarter. With days payable at 80, the company seems to be running out of room to continue to squeeze cash from this source.

- MKC froze its US pension plan at the end of the November quarter, resulting in lower service cost in the 2/19 quarter. We estimate that lower pension expense added about 3.5 cps to EPS growth in the period.

Pension Expense Declined

Since 2016, MKC has frozen the pension plans in both its UK and Canadian operations. As of November 2018, the US pension plan was also frozen and the company no longer accrues benefits for its US employees. This resulted in service costs for the US plan falling from $4.4 million to $0.5 million in the 3/19 quarter. In addition, amortization of net actuarial losses in the US plan fell to $0.6 million from $2.5 million last year. These two factors resulted in $1.3 million in pension *income* in the 3/19 quarter compared to $4.0 million in pension *expense* in the year-ago period.

Pension Expense (Income)	2/28/2019	11/30/2018	8/31/2018	5/31/2018
US Plans	-$0.8	$3.2	$4.0	$3.9
International Plans	-$0.5	$0.0	-$0.1	-$0.1
Total Pension Expense	-$1.3	$3.2	$3.9	$3.8

Pension Expense (Income)	2/28/2018	11/30/2017	8/31/2017	5/31/2017
US Plans	$4.0	$3.0	$2.2	$2.1
International Plans	$0.5	-$3.9	$1.2	$1.2
Total Pension Expense	$4.5	-$0.9	$3.4	$3.3

We estimate that this benefit added almost 3.5 cps to the EPS growth rate in the quarter. The year-over-year benefit to growth will last for another three quarters.

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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