Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

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JM Smucker Company (SJM) EQ Review Update-10/18 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 EQ Review rating on SJM to 3- (Minor Concern) from 3+ (Minor Concern).

SJM reported adjusted EPS of $2.17 which was $0.16 below the consensus estimate. Earnings were penalized by approximately 4 cps from unexpected legal costs and about 12 cps from higher than forecast tax rate due to the gain on the sale of the baking business. However, management did guide full-year fiscal EPS down due to these factors plus lower sales and higher costs.

We cite deterioration in the company's earnings quality in the quarter, namely an increase in accounts receivable.

- Accounts receivables DSOs jumped by 2.5 days over the year-ago quarter. While management blamed this partly on the Ainsworth acquisition, our adjustments indicate that this likely did not account for all the observed increase. Management noted in the conference call for the 7/18 quarter that sales fell later in the quarter than usual. For that to happen again in the 10/18 quarter could be evidence that sales growth has benefitted from increasingly aggressive extension of better payment terms.

- Accounts payable days year-over-year growth flattened in the last two quarters. We suspect this is a result of the Ainsworth deal. We noted in our last review that the company was increasing payables by extending payment times on suppliers. Cash flow growth could benefit in future quarters if the company is able to extend payment times at the new Ainsworth operations as well.

- Pet Food goodwill remains susceptible to more impairments.

Accounts Receivable DSOs up 2.5 Days

SJM's accounts receivable days sales outstanding (DSO) jumped by 2.5 days in the 10/18 quarter as shown in the following table:

	10/31/2018	7/31/2018	4/30/2018	1/31/2018
Sales	$2,022	$1,903	$1,781	$1,903
Accounts Receivable	$562	$504	$386	$423
Sales YOY growth	5.1%	8.8%	-0.1%	1.3%
Accounts Receivable YOY growth	16.7%	16.3%	-12.1%	0.3%
Sales Seq growth	6.3%	6.8%	-6.4%	-1.1%
Accounts Receivable Seq growth	11.4%	30.8%	-8.8%	-12.2%
Accounts Receivable DSOs	25.4	24.2	19.8	20.3

	10/31/2017	7/31/2017	4/30/2017	1/31/2017
Sales	$1,924	$1,749	$1,784	$1,879
Accounts Receivable	$482	$434	$439	$421
Sales YOY growth	0.5%	-3.7%	-1.3%	-4.8%
Accounts Receivable YOY growth	-7.0%	-17.1%	-2.5%	-16.4%
Sales Seq growth	10.0%	-2.0%	-5.1%	-1.8%
Accounts Receivable Seq growth	11.0%	-1.1%	4.1%	-18.6%
Accounts Receivable DSOs	22.8	22.6	22.4	20.5

Management was asked about the increase in receivables during the conference call:

> Analyst:
> "And just had one quick follow-up for you, Mark, in relation to the receivables balance, which was a quite strongly again last quarter. **I think last quarter you talked about some late in the quarter sales coming in through**. Can you give a good idea of what happened this quarter and how that affects the receivables balance and potentially sales, going forward?"

Mark Smucker
"So there is two things, one is just the absolute increase that came from the Ainsworth acquisition. So that's component of it. The second thing and I'm guessing -- I'm not sure exactly with your point comparison, but if you compare fact to the end of the fiscal year, you have to look at the last month of each quarter. So the last month of the second quarter are -- October is a big sales month if you look at the end of obviously the fourth quarter of last year, it was a smaller so it's just the incremental increase in sales dollar. Most of those receivables are still outstanding at the end of the month."

Also consider the company's comments regarding receivables in the conference call for the 7/18 quarter:

"Let me address the AR and then I'll let Joe address the Coffee. It actually was – that was part of it, but it was broader than that. ***If you just look at the way sales fell in the quarter versus a year ago, there was just more sales dollars in the third month, July, if you will of this year versus a year ago****. So, our days sales are trending quite well, just more the mechanics of when the sales actually occurred within the 90 days of the quarter."*

Let's examine the impact of the Ainsworth deal on receivables. The company acquired Ainsworth, a maker of premium pet food on May 14, 2018. This would have had some impact on our calculation of quarterly DSO although this would have been minimized given that the acquisition took place just a couple of weeks into the quarter and almost a full quarter of Ainsworth revenue would have been included in the total company sales figure. SJM does disclose that the value of receivables acquired on 5/14 was $66.3 million and total Ainsworth revenue included in the quarter was $162.8 million. If we take out the $66.3 million in inventory and $196 million in estimated Ainsworth revenue in the quarter ($162.8 million grossed up by 16.7% to account for the two weeks of the quarter prior to the acquisition) we get a very rough estimate of SJM's ex-Ainsworth DSO for the 7/18 quarter of 23.4. This is about 0.8 days lower than the reported total company DSO which includes the Ainsworth impact. This tells us that while Ainsworth's operations carried a higher proportion of receivables to sales than SJM's sore operations, the inclusion of Ainsworth in the mix only boosted total company DSO by less than a day.

We would also note that the company divested its US baking business on 8/31/2018 which would have actually depressed the DSO figure in the 10/18 period as baking receivables would have been removed from the quarter-end balance sheet while the quarterly sales figure would have included 1 month of baking sales. SJM does not disclose either receivables or sales for the baking unit. With that in mind, consider that DSO in the 10/18 quarter jumped by 2.5 days over the 10/17 period. We would assume that the impact of the inclusion of Ainsworth's operations would have actually been smaller in the 10/18 quarter than the 7/18 quarter considering SJM could have had time to improve collections. It is also worth noting that receivables consumed $111.2 million in cash in the 6 months ended 10/18 compared to $41.5 million in the year-ago period. This is more evidence that sales in the 10/18 quarter could have benefitted from the company offering better payment terms in the period which pulled revenue from the current 1/19 quarter forward. This raises the risk of disappointing revenue performance in the 1/19 period.

Payables DSP Growth Levelled Out- May Indicate an Opportunity

We noted in previous reviews that SJM's cash flow was benefitting from extending payment terms, but that its days payable was near the low-end of its peers and that the trend likely had some room to run. As the following table shows, year-over-year growth in accounts payable days (DSPs) was essentially flat the last two quarters:

	10/31/2018	7/31/2018	4/30/2018	1/31/2018
COGS	$1,250	$1,224	$1,091	$1,175
Accounts payable	$552	$532	$512	$471
COGS YOY growth	7.0%	12.7%	-4.1%	1.6%
Accounts payable YOY growth	8.9%	11.4%	7.3%	10.0%
COGS Seq growth	2.1%	12.2%	-7.2%	0.5%
Accounts payable Seq growth	3.8%	3.9%	8.7%	-7.1%
Accounts payable DSPs	40.3	39.7	42.8	36.6

	10/31/2017	7/31/2017	4/30/2017	1/31/2017
COGS	$1,169	$1,087	$1,137	$1,156
Accounts payable	$507	$478	$477	$429
COGS YOY growth	-0.2%	-0.6%	1.6%	-4.5%
Accounts payable YOY growth	16.4%	5.7%	3.9%	15.5%
COGS Seq growth	7.5%	-4.4%	-1.6%	-1.3%
Accounts payable Seq growth	6.2%	0.1%	11.4%	-1.7%
Accounts payable DSPs	39.6	40.1	38.3	33.8

This is likely a result of the Ainsworth acquisition and indicates that the acquired operations carried a lower DSP than SJM's core operations. This could actually play in the company's favor if it is able to use its size to push Ainsworth's suppliers for more favorable payments terms and boost cash flow growth at the combined operations.

Goodwill and Intangibles Still Susceptible to Write-Down

We noted in our previous review that the company has taken several write-downs to the value of goodwill in recent periods and the risk of future write-downs remains. The company specifically addressed this in the 10-Q filing for the quarter:

> *"The goodwill and indefinite-lived trademarks within the U.S. Retail Pet Foods segment remain susceptible to future impairment charges, as the carrying values approximate estimated fair values due to impairment charges recognized in 2018, as well as the recent acquisition of Ainsworth. Any significant adverse change in our near or long-term projections or macroeconomic conditions would result in future impairment charges."*

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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