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BTN Thursday Thoughts

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Contents

Spring Break

Spring Break leaves today's *Thursday Thoughts* a little shorter than typical, but below we present two Earnings Quality Reviews on Prestige Brands (PBH) and Air Products (APD).

Quick Look at Prestige Brands (PBH)

Prestige Brands (PBH) has taken a significant beating in the last year. Last March, the company was selling for $55 per share, but lost ground all year, falling to around $45 prior to the announcement of results for its fiscal third quarter ended 12/17. While PBH essentially met quarterly estimates for EPS and sales, guidance for the full year was below consensus. Management made several references in the call regarding problems with retailers paring back on their inventories to the detriment of PBH's sales growth:

> "This destocking headwind is coming in at the higher end of our original expectations and we're therefore narrowing our fiscal 2018 guidance metrics to the low point of the range, specifically the revenues. We now expect revenue growth of 18% or $1.4 billion in revenue."

In addition, there were unexpectedly high freight costs as well as costs related to labor issues at its warehouses. Investors did not react well to the call, pushing the stock down below $32 in the days following the quarter before rebounding to its current level of $36.

Short sellers have been circling the company since the summer with short interest as a percentage of the float now hovering around 15%.

Our initial thought on PBH is that it is much more of a consumer goods company than a true over-the-counter healthcare company. Its brands include *Compound W.* and *Summer's Eve*, items which more closely match up with Proctor & Gamble's stable than with Johnson and Johnson's. As we noted in last week's *Thursday Thoughts*, we expect consumer goods companies will continue to come under pressure from ever more powerful retailers, competition from private label, and the inability to push through price increases. A smaller company with seemingly second-tier brands would seem at least as susceptible to these forces if not more so than P&G or Kimberly Clark. Nevertheless, since the price decline, does PBH represent a value or a possible takeover target at 11 times EBITDA? The short answer is, we need to do more work to know. (The debt/EBITDA of almost 6x and the lack of significant organic growth don't work in its favor.) However, we took a look at the quarter and noted some issues with the numbers investors should consider:

- Advertising and promotion costs as a percentage of sales fell a full percentage point in the quarter, helping to offset a disappointingly low gross margin.

- Accrued marketing costs fell in the quarter, which could be an indication of aggressive expense recognition.

- Accounts receivable DSOs were up by 7 days over the year-ago quarter, which the company attributed to timing. However, receivables appeared elevated in the previous quarter as well.

- Inventory DSI's fell sharply, which may be an indication of management's muted outlook for sales growth.

- The company also utilizes the FIFO (first-in, first-out) inventory method of accounting which can overstate profits in time of rising costs. This may cause the impact of recent higher than expected costs to linger for longer than some are expecting.

The Quick Bull Story

PBH is a consumer OTC health company that has collected several brands in niche product areas through a series of acquisitions. The company's brands include:

-digestive care products such as *Tagamet* and *Beano*
-Eye, ear, nose and throat products such as *Murine* and *Chloraseptic*
-Oral care products like *Efferdent*
-Pain relief products like *Goodys* and *Anacin*
-Pediatric care products *Pedia Lax* and *Boudreaux's Butt Paste*
-Skin care products *Outgro* and *Compound W*
-Sleep aids *Nytol* and *Sominex*
-Women's health products like *Monistat* and *Summer's Eve*

While people have heard of these brands, most are in smaller categories and seem relatively replaceable by brands from other consumer care companies. The story PBH tells is that it acquires these unloved brands from companies that have underspent on advertising, rolls them into its portfolio and puts the advertising dollars behind them to realize their true potential. Think Valeant Pharmaceuticals in reverse. PBH does, in fact, have a relatively large advertising budget, spending about 14.5% of sales on advertising and promotion compared to about 11% for P&G (PG), and 13.8% for Edgewell Personal Care (EPC).

Lower Advertising Makes Up for Higher Costs in Other Areas

Apart from talk of retailers' destocking effects, another disappointing area in the quarter was lower than expected gross margins brought on by higher than expected costs. Gross margin for the quarter was 54.6% compared to 57.5% in the year-ago period. This was partially due to the 1/26/17 acquisition of Fleet, which carries lower margins than the company's core business. However, management also cited higher than expected trucking costs and higher turnover at its warehouses that required hiring an outside labor force at more cost. Higher trucking costs stemming from not only higher fuel costs but also underinvestment by the trucking industry in recent years and a shortage of qualified drivers is something that we think could plague many companies more than anticipated in upcoming quarters. While its labor issues at its warehouses will likely prove temporary, they are something that could nick the next quarter or two as well.

Despite these higher costs, profits came in essentially in-line, helped by considerably lower advertising and promotional expenses:

	12/31/2017	9/30/2017	6/30/2017	3/31/2017
Sales	$270.62	$258.03	$256.57	$240.67
Gross Profit	$147.67	$144.10	$143.48	$130.18
Gross Margin	54.6%	55.8%	55.9%	54.1%
Advertising and Promotional	$35.84	$39.19	$36.94	$41.45
% of sales	13.2%	15.2%	14.4%	17.2%
	12/31/2016	**9/30/2016**	**6/30/2016**	**3/31/2016**
Sales	$216.76	$215.05	$209.58	$207.86
Gross Profit	$124.55	$123.97	$121.59	$118.25
Gross Margin	57.5%	57.6%	58.0%	56.9%
Advertising and Promotional	$30.68	$28.59	$27.64	$26.55
% of sales	14.2%	13.3%	13.2%	12.8%
	12/31/2015	**9/30/2015**	**6/30/2015**	**3/31/2015**
Sales	$200.20	$206.07	$192.13	$190.05
Gross Profit	$116.78	$119.94	$112.24	$110.07
Gross Margin	58.3%	58.2%	58.4%	57.9%
Advertising and Promotional	$29.94	$27.89	$26.42	$25.37
% of sales	15.0%	13.5%	13.8%	13.3%

Advertising and promotional costs fell to 13.2% in the 12/17 quarter from 14.2% a year ago following three straight quarters of year-over-year increases. Management seemed to indicate in the call that this was due to typical variability:

> *"In terms of A&P, we came in at 13.2% of revenue in Q3 and 14.3% year-to-date. A&P expense grew in dollars versus the prior year attributable to a shifting mix of business towards our invest for growth brand. As we've highlighted previously, there can be some variability in A&P from quarter-to-quarter and we continue to invest behind the long-term brand building efforts Ron discussed earlier."*

However, a year-over-year decline of that size is quite unusual and not related to the Fleet acquisition given the year-over-year increases seen leading into the 12/17 quarter. The whole PBH bull story is centered around aggressive marketing and the company can ill afford to let advertising and promotion costs lag for long. The timing of the decline with the unexpected gross margin hit is also interesting, and we would expect a sharp rebound in ad spending in the next quarter or two.

Also related to advertising, the company's accrued marketing costs (reported as a sub-account to "other accrued liabilities") showed a notable decline in the quarter:

	12/31/2017	9/30/2017	6/30/2017	3/31/2017
Sales	$270.62	$258.03	$256.57	$240.67
Accrued Marketing Costs	$29.50	$30.02	$35.28	$29.38
Accrued Marketing Days of Sales	9.9	10.6	12.5	11.1

	12/31/2016	9/30/2016	6/30/2016	3/31/2016
Sales	$216.76	$215.05	$209.58	$207.86
Accrued Marketing Costs	$33.79	$29.94	$29.41	$26.37
Accrued Marketing Days of Sales	14.2	12.7	12.8	11.6

	12/31/2015	9/30/2015	6/30/2015	3/31/2015
Sales	$200.20	$206.07	$192.13	$190.05
Accrued Marketing Costs	$24.76	$20.91	$20.82	$16.90
Accrued Marketing Days of Sales	11.3	9.3	9.9	8.1

PBH expenses advertising costs as incurred. With promotional costs such as coupons and price reductions in conjunction with the retailer, PBH estimates its eventual cost and records it as a reduction to revenue. We are unsure if the accrued marketing costs include both advertising and promotional costs. Regardless, the fact that the account declined sequentially in the 12/17 quarter when its seasonal pattern is to increase, coupled with four-day year-over-year decline on a days-of-sales basis is a concern. Advertising and promotion expense, while down as a percent of sales, still increased over last year. The fact that the accrual balance was lower than the year-ago period could be a result of timing of payments but could also be an indication of a change in expense recognition.

Receivables Climbing

Accounts receivable have been increasing on a day's sales basis the last several quarters:

	12/31/2017	9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Sales	$271	$258	$257	$241	$217	$215
Accounts Receivable	$150	$145	$135	$137	$104	$93
Sales YOY growth	24.8%	20.0%	22.4%	15.8%	8.3%	4.4%
Accounts Rec.	44.5%	56.6%	36.8%	43.5%	22.3%	1.7%
Sales Seq growth	4.9%	0.6%	6.6%	11.0%	0.8%	2.6%
Accounts Rec. Seq growth	3.4%	7.9%	-1.4%	31.3%	12.1%	-5.7%
Accounts Receivable DSOs	***50.7***	***51.4***	***47.9***	***51.8***	***43.8***	***39.4***

Keep in mind that the Fleet acquisition in the 3/17 quarter could have impacted the year-over-year comparison for the last two quarters if Fleet carried a higher level of receivables relative to sales. Still we would expect PBH management to bring Fleet's receivables collection time in-line quickly and the year-over-year difference in DSOs has persisted. Management was actually asked about this in the call and responded:

> "From a DSO perspective, really just timing-related. No change in terms of customers or ask from retailers in that regard."

If this is simply a timing issue, we will expect to see DSO come down in the 3/18 quarter, especially given the Fleet acquisition will be almost completely anniversaried by the end of the current quarter.

FIFO Inventories

The following table shows the calculation of inventory days of sales (DSIs) for the last six quarters:

	12/31/2017	9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016
COGS	$123	$114	$113	$110	$92	$91
Inventory	$115	$119	$119	$116	$101	$98
COGS YOY growth	33.3%	25.1%	28.5%	23.3%	10.6%	5.8%
Inventory YOY growth	13.8%	22.0%	27.8%	26.7%	25.1%	27.0%
COGS Seq growth	7.9%	0.7%	2.4%	19.8%	1.2%	3.5%
Inventory Seq growth	-3.8%	0.7%	2.7%	14.5%	3.0%	5.5%
Inventory DSIs	***85.3***	***95.7***	***95.8***	***95.5***	***99.9***	***98.1***

Ordinarily, we are concerned about DSIs increasing. However, the notable decline in the last two quarters, coupled with the warnings on retailer inventory destocking, make us wonder if this is insight into management's outlook for near-term sales.

Our main concern with the company's inventory is the fact that it uses the FIFO (first-in, first-out) method of inventory accounting. This method expenses older inventories against current sales and has the potential to overstate profits in periods of rising raw materials and labor costs. Current higher costs will essentially be delayed in hitting the income statement. This may be particularly relevant for the company as it pertains to its higher warehousing costs mentioned earlier. FIFO accounting would have delayed the impact of those higher costs hitting the income statement, thus shielding the 12/17 quarter from bearing the full impact of the cost increase. In addition, the lower inventories would seem to indicate lower production in the quarter and possibly higher per unit costs. The declining inventory balance brings all of the costs closer to being realized, meaning the 3/18 quarter may see higher costs than some are anticipating. This temporary benefit to gross margin becomes an even bigger red flag when viewed in the context of the decline in gross margin seen over the last several quarters.

Air Products and Chemicals (APD)

Air Products and Chemicals (APD) has undergone a complete transformation following activist investor Bill Ackman taking a 10% share in the company three years ago. Prior to that, APD had disappointingly low profitability and returns despite maintaining a leading position in the industrial gas market. Following the appointment of new CEO Seifi Ghasemi, APD undertook a massive plan to divest itself of non-core businesses, focus on its core industrial gas market, and grow its margins to best-in-industry levels. The company has accomplished all of these goals, and Ackman has since cashed in his original stake.

Going forward, APD plans to focus on cash flow growth through:

- mergers and acquisitions
- pursuing large projects
- embarking on an asset buyback strategy where instead of building facilities at customer locations, it will buy back existing facilities and run them for the customer

APD recently raised its dividend by 16%, the largest growth in its history, which gives it a forward yield of 2.6%. While the company is obviously in a cyclical industry, the dividend consumes only about 50% of free cash flow leaving it ample cushion to protect and grow the dividend.

We have no major concerns with the company's accounting. Despite the presence of some huge write-offs and restructuring charges, we are essentially giving the company a pass considering the scale of its divestment and exit of non-core businesses. However, we note a few observations below:

Large Write-Offs Over the Last Three Years

APD has taken several large asset write-offs over the last couple of years including the following:

-APD made a strategic decision to exit the energy-from-waste business. In 2Q'16, APD took a $945 million write-down related to two incomplete projects. In 1Q'17, the company determined that it was unlikely it would find a buyer for the assets or anyone to assume the leases and recorded an additional loss of $59.3 million.

-The company recognized $151.4 million in restructuring and cost reduction charges in fiscal 2017. $88.5 million related the to write-down the value of an air separation unit that was built mainly to provide oxygen to a discontinued energy-from-waste plant mentioned above, and the closure of a facility that manufactured LNG heat exchangers. Another $66 million was related to severance and other benefits from the elimination of 625 position in the industrial gas segment

-APD took a $145.3 million write-down to the value of goodwill related to its Latin American industrial gas business due to underperformance during the nine months ended 6/17. In addition, $16.8 million of intangible assets were also written off. This brings the total value of Latin American goodwill written off in the last three years to $417.2 million.

-As a result of economic conditions in Saudi Arabia, a 25%-owned equity affiliate recorded an impairment charge with APD's share totaling $79.5 million to reduce the carrying value of its investment. The charge appeared in the "equity affiliates" line on the income statement, thus bypassing the operating line. The remaining carrying value of the investment is $66.7 million.

-The company took realignment and reorganization charges of $180.1 million in fiscal 2015, mostly from asset write-offs and contract actions to shut down plant and exit an industrial gas product line.

-There have been other, more minor separation costs related to the decision to exit the Materials Technologies business totaling $30.2 million, $50.6 million, and $7.5 million in 2017, 2016 and 2015, respectively.

We ordinarily take a very dim view of ongoing charges. However, we are more patient given the context of the company remaking itself through the exit of non-core businesses. In addition, most of these amounts described above are related to specific assets write-downs where the asset appears to have been completely taken out of business, rather than endless, open-ended charges where operating expenses could be dumped and forgotten. Admittedly, these write-offs have been huge relative to company book value and certainly should not be considered non-events. Management has essentially declared its divestiture program complete and is moving forward as a new company. As such, future charges and write-downs should be viewed with less patience, particularly ones that related to goodwill impairment.

Move to LIFO Inventories a Positive

APD disclosed in its 10-K that:

> "Inventories valued using the LIFO method comprised 48.7% and 22.9% of consolidated inventories before LIFO adjustment at 30 September 2017 and 2016, respectively. Liquidation of LIFO inventory layers in 2017, 2016, and 2015 did not materially affect the results of operations."

As we have noted in other recent reviews, in a period of rising costs, the LIFO (last-in, first-out) method of inventory accounting offers a more accurate matching of current revenues with costs. Going forward, we view the fact that a higher percentage of inventory is being accounting for under LIFO as good for earnings quality if inventory balances do not begin to decline, as a decline could would be an indication of the "LIFO liquidation" the company references above.

Thoughts on Asset Buyback Strategy

One of the three main areas of future growth management is highlighting is what it refers to as asset buybacks. With many customers, the company currently constructs production facilities on customer property and supplies the customers' needs onsite. Through asset buybacks, APD will buy existing facilities from the customer and then operate them on behalf of the customer. There may be opportunities in this area and it will take time for these projects to become a material part of the overall business. However, thinking longer-term, we believe it will be important to monitor such factors as how much the company pays for these assets, assumptions of useful lives, and how depreciation on these facilities matches up with actual capital spending required to set up and maintain facilities which could feasibly be behind on upkeep and therefore and require extra spending.

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