BEHIND THE NUMBERS
QUALITY EQUITY INCOME SOLUTIONS

BTN Thursday Thoughts

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"You know, at one time, there must've been dozens of companies making buggy whips. And I'll bet the last company around was the one that made the best damn buggy whip you ever saw. Now how would you have liked to have been a stockholder in that company?"

Lawrence Garfield in *Other People's Money (1991)*

Altria (MO) – Tobacco Part 1

A few weeks ago, I actually saw an old copy of the book *Barbarians at the Gate,* by Bryan Burrough, about the buyout of RJR Nabisco. It made me smile because I had forgotten that the driving force behind the deal was despite growing cash flow and great brand names, no one could get past the idea that Nabisco owned a tobacco company and tobacco had no future, was worth next to nothing, and the idea of smokeless cigarettes had just proven to be a failure. This was 30 years ago! Even during the battles of who would win control, there were proposals of having someone else buy the tobacco business. How many people predicted that the food business would run into bigger problems before tobacco? How many people predicted that tobacco stocks would be some of the top performing equities in the last 10 years and investors would cheer the high dividends? And who would have thought that smokeless would be touted again as the new growth opportunity?

We are going to look at the tobacco industry in the coming weeks from three angles: a US-only company – Altria, an International- only company – Philip Morris, and a hybrid that has grown via acquisitions – British American. Our focus will be on earnings quality, sustainability of operations, and risk factors. Because most people own these stocks for yield with some growth, we will also discuss that issue as well.

As a general overview, we do believe there is some evidence that points to the people of the 1980s being on the right track – albeit much too early and missing the opening up of emerging markets and the fall of communism to create volume growth internationally. We're not sure how many growth catalysts remain for these companies when looking at what drove some of the earnings growth in the last ten years. All of these reports will point to issues that pertain to the industry overall in addition the specific company.

Litigation in the US – is Altria winning? One of the bullish arguments for US tobacco is the litigation front is under control. After many settlements, MO now sees 42% of its revenue paid to various governments as fees and taxes to buy peace. Passing those costs on to consumers has raised prices to the point where cigarette sales are about half where they were before these deals.

Volume losses are still happening and getting worse. Boosting prices and higher taxes are cutting demand. In the past Altria gained market share to offset the decay, but it had many brands willingly giving up share. Now, it has to take share from Camel and Newport who are trying to take it from Marlboro – the dying brands aren't here anymore.

MO also benefited from boosting prices, but as the battle for market share intensifies, does that allow the same level of price gains? Also, higher taxes are also boosting prices already and hurting volumes. The power of pricing on recent cash flow has been significant and may be tough if that weakens even a little.

The dividend and share buybacks already exceed all of Free Cash Flow. The tax cuts will make that picture better and the buybacks in 2017 will enable dividend per share growth without the same jump in cash outlays. However, we see a company trying to start new business lines and planning to spend more in those areas as the key business weakens. We expect the dividend in 2018 to be fine, but expect the repurchases to slow.

There's not much left to fix. MO has been successful in cutting some costs and streamlining. However, many of these are still fairly immaterial as it works to transition business from a very high margin business to a low margin one and deal with competition in both.

If This is Winning What Does Losing Look Like?

One of the overriding fears for decades in the US Tobacco industry has been never-ending lawsuits that would eventually overwhelm the companies and force them into bankruptcy like asbestos producers. The bulls argued that they never lost and were always able to run out the clock and through appeals and new court motions could outlast plaintiffs. There is a famous internal legal memo that laid-out the plan as a parody to George Patton's war strategy: "The goal in litigation is not to spend all of our money, but to force the plaintiffs to spend all of their money." The bears argued it was still only a matter of time and payments would need to be made.

Flash forward to the 1990s and suddenly states noticed that they could sue the tobacco companies as well to recover health care costs of smokers. The states had much deeper pockets than a random family in Tennessee suing for $1 million. And, they sued for much more. Without going through all the history, the outcome was the domestic cigarette industry settled with the states and agreed to pay them over $200 billion in the first 25 years of the settlement starting in 2000. The payments were allocated to each producer based on market share and took into account volume declines and adjustments were made to incorporate payments to newer companies that didn't exist long before the deal. This is called the MSA (Master Settlement Agreement).

On top of that, governments at the state and federal level also noticed that they could tax tobacco as well via excise taxes. Over the years, these taxes have jumped continually, and cities have also entered the mix. This industry website tracked tax increases from the states between 2000-2017. Many have seen taxes double and triple. California raised the tax by $2 per pack last year.

So, the tobacco companies cheered another win, but they are writing some large checks:

$ in billions	2017	2016	2015	2014	2013
Altria Revenue	$25.60	$25.70	$25.40	$24.50	$24.50
MSA payments	$4.70	$4.90	$4.80	$4.60	$4.20
Excise Taxes	$6.10	$6.40	$6.60	$6.60	$6.80
Income taxes*	$3.10	$2.90	$2.60	$2.40	$2.50
Shareholders *	$5.80	$5.30	$4.90	$4.40	$4.60

We used a 35% tax rate for income taxes for these years and computed it without gains/losses for asset sales or early debt extinguishment. So, they never lose in litigation, but the various governments now take essentially 42% of revenues from Altria annually and another 21% of income. Moreover, the excise taxes are rising faster than college tuition. We found a CDC report from 2009 that showed excise taxes in the US from 1995-2009. The federal tax was only 24-cents per pack and the states were essentially 33-cents in 1995. By 2009, they were $1.01 and $1.20. Today, they are $1.01 and $1.60 and cities have started to add taxes as well up to $4 in some places.

There are two other ways to look at this. The good side - government is making the most money from tobacco so there are reasons to doubt that they ever completely blow it up. The down side is all these taxes and fees boosted cigarette prices substantially and higher prices drive down demand. The World Health Organization among other groups have done many studies and found that raising prices on cigarettes quickly cuts demand. They have advocated boosting taxes at low-end and high-end to prevent people from trading down. Russia went from almost no taxation to a goal of reducing smoking by 25% in 2020. Its first round of tax hikes cut volumes by 14% followed by a 12% drop on the second round of tax increases.

MO also sees periods of rising taxes hurting sales volumes as it notes in the 10-K

> *"Tax increases are expected to continue to have an adverse impact on sales of the tobacco products of our tobacco subsidiaries through lower consumption levels and the potential shift in adult consumer purchases from the premium to the non-premium or discount segments or to other low-priced or low-taxed tobacco products or to counterfeit and contraband products.*
>
> *Such shifts may have an adverse impact on the sales volume and reported share performance of tobacco products of Altria Group, Inc.'s tobacco subsidiaries."*

The Volume Trends Continue to Worsen

The anecdotal evidence of tobacco use falling is widely known, but it's still amazing to see the size of the decay. In 1995, US tobacco sales were 481 billion cigarettes with Altria selling 222 billion or 46% and Marlboro was 145 billion or 30% of the US market.

Billions of sticks	2017	2016	2015	2014	2013
Total US cigarettes	230	241	247	246	255
Total Altria cigarettes	117	123	126	125	129
Total Marlboro cigarettes	100	105	108	108	111

The total market is over 50% gone in just over two decades. Moreover, the decay appears to be accelerating:

y/y change in cigarettes	2017	2016	2015	2014
Total US	-4.40%	-2.40%	0.10%	-3.40%
Total Altria	-5.10%	-2.50%	0.50%	-3.00%
Total Marlboro	-5.00%	-2.60%	0.00%	-3.10%

The problem for Altria is for all the talk of e-cigarettes, vapor and heated tobacco, cigarettes and snuff still drive this ship:

Segment Op Inc.	2017	2016	2015
Smoking tobacco	$8,408	$7,768	$7,569
Smokeless tobacco	$1,300	$1,177	$1,108
Wine	$147	$164	$152
Other	-$51	-$99	-$169

What Altria is trying to do is use the cash flow from the decaying smoking business to grow the innovative side. So, cigarettes and cigars are 86% of operating income before corporate expenses and financing, and snuff (which has its own excise taxes and regulations) is 13% of income. The new products are still negative – they are improving – but this transition is a very lofty goal.

We also think that cigarettes demand at MO could get worse more quickly going forward. When we look at the cigarette market, we have to give Altria's management some sizeable praise. Into a declining market, they have generally been taking market share. In 1995, Altria had 46% of the US market and it has 51% now. Marlboro results are even better, rising from 30% of the US market in 1995 to 43% now.

We think that past success came from taking share from dying and essentially liquidating brands. For example, think of *Winston* cigarettes formerly owned by RJ Reynolds and recently sold to Imperial Brands. Winston rolled out in 1954 and was the top selling cigarette in the US during the 1960s. It was bigger than *Marlboro*. When it was sold to Imperial Brands as part of the Reynolds/British American merger, Winston had a 1.8% market share in the US. The brand had seen serious decay and so did others like *Salem*, *True*, and *Doral* among others. We have looked at this before with Reynolds who purposefully stopped supporting many brands in the last 10 years and let them run-off. As much as overall cigarette volume decay has been, it was nothing close to what these "other" brands at Reynolds experienced:

RAI other	2014	2013	2012	2011	2010
y/y change	-11.60%	-14.80%	-11.80%	-16.40%	-21.80%

These lesser RAI brands went from 16% US market share in 2009 to 7% in 2014. This type of change was going on at numerous companies and the share being forfeited was going to Marlboro. The problem is who are they going to take share from now? British American is reporting that its four largest brands: Camel, Pall Mall, Newport, and American Spirit, grew their market share by 40bp in 2017. We think Altria will need to fight with other big brands to retain share at this point and will not see long periods where it gains share overall. That catalyst may be played out.

We'll address this more in other reports too, but we also wonder if someone actually wanted to smoke more cigarettes, could it even be done? Smoking is banned in hotels, bars, restaurants, sporting events, offices, trains, planes, taxis, boats, parks… People huddle in the cold or heat 100 yards from entrances behind trash dumpsters to smoke these days. There's some considerable walking time added to and from a smoke break.

Is Altria Too Dependent on Price Hikes?

Cigarettes are one of those odd products that raising the price a little bit hurts demand, but the price hike can more than offset some lower volumes. Removing the excise tax and the MSA payments from the equation, MO would have had $19.5 billion in revenue and $16.7

million in gross profit for a gross margin of 85%. It sold 5.85 billion packs of cigarettes in 2017 (dividing the number of cigarettes sold by 20 per pack). A 10-cent change in price per pack would be a $585 million change in operating income as the bulk of that would flow straight to cash flow.

Again, praise to MO management – as they have been doing this to offset the lower volumes in recent years. Often, they can get some pricing pushed through at the same time various governments are touting tax increases. Here are some of the recent price increases achieved:

- Effective September 24, 2017, PM USA increased the list price on all of its cigarette brands by $0.10 per pack.
- Effective March 19, 2017, PM USA increased the list price on Parliament by $0.12 per pack. In addition, PM USA increased the list price on all of its other cigarette brands by $0.08 per pack.
- Effective November 13, 2016, PM USA reduced its wholesale promotional allowance on Marlboro by $0.02 per pack and L&M by $0.08 per pack. In addition, PM USA increased the list price on Marlboro by $0.06 per pack and on all of its other cigarette brands by $0.08 per pack, except for L&M, which had no list price change.
- Effective May 15, 2016, PM USA increased the list price on all of its cigarette brands by $0.07 per pack.
- Effective November 15, 2015, PM USA increased the list price on all of its cigarette brands by $0.07 per pack.
- Effective May 17, 2015, PM USA increased the list price on all of its cigarette brands by $0.07 per pack.

The problem is smokers may not notice 7-cents here and 10-cents there, but eventually they start to see the odometer flip over in pricing and ask, "When did the price per pack increase by $1.00?" This race to boost prices along with states boosting taxes (which are added to prices) while other companies are no longer giving away market share would seem to be nearing an end, in our view. Altria and others are also now pushing e-cigarettes and non-smoking nicotine products as a replacement for traditional cigarettes. And as noted above, even MO thinks higher prices hurts its demand. And just these pricing actions add up to more than 50-cents per pack since 2015.

Since 2014, MO is selling 8 billion fewer cigarettes, or 400 million packs. Let's assume that the MSA and excise taxes are priced in as gross revenue and the MSA payment just comes out again in Cost of Goods Sold as a wash. Then in 2014, MO's selling price was $2.13 based on $13.3 billion in revenue divided by 125 billion cigarettes * 20 per pack. In 2017, the selling price becomes $2.53 per pack or 19% growth in 3-years.

The company effectively picked up $2.5 billion in revenue from the price hikes ($2.53 * 2014 volume) and lost $1.0 billion to the lower volumes for a net plus of price hikes of $1.5 billion. Volume fell from 125 billion to 117 billion -6.4%. Volume loss of 16% would have made this a wash – the price increase would have offset the lost units sold and not grown revenues. The situation is not that ugly yet. But, we worry that volume losses could accelerate if MO cannot hold/grow market share like it did in the past against dying brands and that price hikes may be tougher to achieve when competing against others who are trying to take market share.

The Dividend and Repurchases Already Consume All of Free Cash Flow

$ in billions	2017	2016	2015	2014	2013
Cash Ops	$4,922	$3,821	$5,843	$4,663	$4,375
Cap Exp.	$199	$189	$229	$163	$131
Acquisitions	$415	$45	-	$102	-
Free Cash	$4,308	$3,587	$5,614	$4,398	$4,244
Dividends	$4,807	$4,512	$4,179	$3,892	$3,612
Repurchases	$2,917	$1,030	$544	$939	$634
Net Cash Flow	-$3,416	-$1,955	$891	-$433	-$2
Dividend Paid % FCF	112%	126%	74%	88%	85%

The dividend is tight and has been growing at 7%-8% annually. There are a few other positives in paying it though. First, the tax rate is falling from 35% to a forecasted 24% this year. The 11% drop is worth about $1.0-$1.1 billion. Altria expects to spend about one-third of that amount on new products, so there should be about $700 million in additional cash flow. That alone would push the dividend payout under 100%. Second, there is another unit here called PMCC that is a leasing company for things like airplanes, power plants, and real estate. This unit stopped writing new business in 2003 and is producing cash flow also:

$ in millions	2017	2016	2015	2014	2013
PMCC Cash	$133	$231	$354	$369	$716

A third reason is cash on hand. In 2016, the purchase of SABMiller by Anheuser Busch Inbev resulted in a $3.2 billion net cash inflow to Altria for its SABMiller stake. Much of that cash paid for the heavy repurchase level of MO stock in 2017. At the end of 1Q18, the company had $2.2 billion in cash, which is a bit misleading as accrued settlement payables were up about $1 billion in the quarter – we would list actual cash on hand as closer to $1 billion also. Essentially, debt is about $13 billion and EBITDA is $9-$10 billion per year so the balance sheet is not very leveraged either. In fact, the sterling balance sheet and the fact it owns $19.3 billion in Anheuser-Busch InBev and that position is 18% of MO's share price gives extra cushion for the dividend.

For the next few years, MO will probably be able to pay the dividend and still grow it too. But, we do not see the cash flow to sustain the share repurchases also. The tax cuts reset the figure and the heavy repurchases in 2017 will reduce the share count where the dividend per share can rise with much less growth in the total cash outlay. However, we expect cigarettes to be the driving force here for many more years and if volume decay is picking up, higher excise taxes hurt volume more, and competition limits price increases; the cash flow after the tax cuts will quickly peak and start to decline.

What More Is There to Fix?

When we look at several other areas that can help or hurt margins, we think MO has already picked some of the good things and will see more of the higher costs going forward. For example:

Part of the government regulation and settlements substantially curtailed marketing activities for MO. They even lost the ability to pay for prime locations in many retailers to display cigarettes. They spend money on volume-based incentives for customers and offer discounts on occasion, but only list advertising spending at $29 million – that's for the whole company, which also sells wine and e-cigarettes. By comparison, BUD spent $64 million in 2016 just on a marketing program to remind people of the harmful effects of drinking. As MO rolls out new products, we fully expect marketing to rise, perhaps not materially, but it will be a headwind. R&D will also be an issue, it is now $241 million up from $186 million in 2015. The company promises more spending in this area and will use some of the new tax savings here.

We will even give MO kudos on its pension plan with realistic discount rates of 3.7% which will likely start to rise and reduce pension expense going forward as well as cut the pension underfunding. Already, the plan is almost fully-funded with $8.0 billion in assets against $8.5 billion in liability. That should be a tailwind going forward.

The company has already consolidated facilities and cost overhead costs. Some of this will benefit 2018. For example, it spent $150 million to streamline manufacturing and align capacity with lower volumes in 2016. This is expected to produce $50 million in annual savings by the end of 2018. MO also spent $132 million to streamline its structure and believed it achieved its goal of $300 million in savings by the end of 2017.

We will not begrudge this type of work and only want to again point to materiality. All of this adds up to about 2% of sales (adjusted down to take out excise taxes and settlements). That's significant, but MO has a 65% operating margin. And the bigger picture of things is their high margin business is in decay and they are trying to expand a business that currently loses money. Thinking about the new products, they have aspects that the FDA has to approve. There is more marketing needed, perhaps new distribution. That market is not as consolidated either, so pricing, promotion, and incentives are likely needed. Growing the low margin business as the high margin one declines is going to be tough to offset.

Litigation Is Still Lurking

Of the 118 Page 10-K for Altria, 48 pages talk about litigation and settlements. So, this remains an issue for MO. And, it is not as though they are winning all these cases, they are losing quite of few and following the motto discussed above – they appeal and prolong the process in many cases. Often, cases are assigned percentages of blame based on the smoker's activities, and various company market shares in the past. So, a decision may come back as a $2 million award, but the smoker was found to be 60% at fault and the tobacco companies 40%, and based on market share, Altria is 35% of the 40% or $280,000. That may get reduced on appeal or a lower settlement proposed and accepted.

As a result, Altria does record litigation costs as it is incurred – settlements paid and legal fees. However, it often does not reserve for future settlements in cases still active because it has determined that it is not probable that a loss occurred, MO is unable to estimate the size of loss in an unfavorable outcome. That's different than saying, MO has not lost many of these cases – they just haven't recorded the liability yet.

In the last few years, they still spent money on defending these cases and on payments to plaintiffs:

$ in millions	2017	2016	2015	2014	2013
Defense Costs	$179	$234	$228	$230	$247
Settlements	$80	$105	$150	$44	$22

The company expects these costs to continue at historic rates. That alone would point to this increasing $50-$100 million over 2017 levels. We agree that the litigation does not appear as open-ended as it did before, and it has been corralled into a few large groups. The size of these cases varies from $30,000 to a few million and there are quite a few. But, payments here could be something that gets larger than those seen in 2016 and 2017 and could more than offset some of the restructuring actions noted above.

Conclusion:

Altria is trying to grow a new nicotine business to replace one that is slowly dying. We are not convinced that will be very easy as the tobacco companies have been talking about non-smoking cigarettes for decades now and they are still in the infancy with the market much less consolidated. The bigger risk is actually replacing an extremely high margin product with one that has no margin.

Past efforts by Altria to manage its decay have been admirable as it has been able to push through price increases and take market share. We believe much of that potential is now played out as the industry has consolidated around a few huge players all with top-tier brands. There are not many liquidating brands to take share from. As a result, a plan of boosting prices to offset volume decay and slowing volume decay by gaining market share may no longer be feasible.

Government continues to take a larger share of the tobacco revenues and that continues as well, effectively boosting prices and hurting volumes more. Through all of this, MO has boosted its dividend. However, it is now pushing the limits on that with the dividend nearly 100% of free cash flow after tax reform. We expect the dividend to benefit from 2017's share repurchase and restructuring. We do think the sign to watch will be the share repurchase level. As that slows, it should leave less wiggle room for the dividend.

Review of Eaton (ETN)

Our analysis of ETN's recent results turned up a few minor items of concern investors should note:

- Inventory DSIs jumped by three days in each of the last two quarters. This is not overly concerning by itself given the reacceleration in sales growth. We note that most of the buildup in inventories has been in raw materials and finished goods, which is evidence of the rising costs the company is experiencing.

- However, in the 12/17 quarter, the company changed its method of accounting for US inventories to the first-in, first out (FIFO) method from the last-in, first-out (LIFO) method. The switch to FIFO added about a penny to EPS in the 12/17 quarter absent a one-time tax drag from the TCJA. While the company's disclosures indicate that using the FIFO method would have offered only minor benefits to EPS over the last couple of years, the current environment of rising costs, coupled with its apparent ability to negotiate higher prices with its customers is the optimum environment for FIFO. When these conditions reverse, FIFO will become a drag on reported profits which could catch investors off guard if they are not taking the change into consideration.

- Payables days of cost of sales have risen to multi-year highs. While some of this is likely due to the rising inventory levels, it also appears the company has stretched payables to maximize cash flow which likely cannot continue at the current pace.

- ETN recently finished a multi-year restructuring program at the end of 2017. While the company has taken material charges over the last several years, much of this was directly related to the integration of significant acquisitions. We are not overly concerned about the company abusing charges as a serial restructurer, but we will be skeptical if major future plans are announced anytime soon.

Inventory DSIs Up- No More LIFO

As a matter of introduction to a discussion of ETN's inventories, we note that prior to the fourth quarter of 2017, ETN accounted for most of its US inventories under the last-in, first-out method (LIFO) with the remainder accounted for under the first-in, first-out (FIFO) method. Under the LIFO method, the most recently added inventories are expensed against current period sales whereas under FIFO, the oldest inventories are matched against current sales. Thus, in a period of rising costs, FIFO will result in lower cost of sales, higher inventory balances, and higher profits than LIFO would in the same situation. In the fourth quarter of 2017, the company announced that it was moving to FIFO accounting for 100% of its inventories and gave the following explanation:

> *"During the fourth quarter of 2017, the Company changed its method of accounting for certain inventory in the United States from the LIFO method to the FIFO method. The FIFO method of accounting for inventory is preferable because it conforms the Company's entire inventory to a single method of accounting and improves comparability with the Company's peers."*

With this in mind, we note that ETN's inventory days of sales (DSI) have been up in the last two quarters:

	3/31/2018	12/31/2017	9/30/2017	6/30/2017
Adjusted COGS	$3,573	$3,535	$3,466	$3,448
Adjusted Inventory	$2,745	$2,620	$2,560	$2,493
DSI	70.1	67.6	67.4	66.0

	3/31/2017	12/31/2016	9/30/2016	6/30/2016
Adjusted COGS	$3,307	$3,319	$3,374	$3,422
Adjusted Inventory	$2,442	$2,346	$2,424	$2,422
DSI	67.4	64.5	65.6	64.6

The above numbers contain several adjustments to make as much of an "apples-to-apples" comparison as possible. COGS amounts from the 3/18, 12/17, 3/17 and 12/16 quarters are from recent financial statements that have been restated for the change to FIFO accounting. All other COGS amounts are from note 14 of the company's 2017 10-K that provides adjustments for the accounting change. The 3/18, 12/17 and 12/16 inventory amounts are likewise from recent filings that are adjusted for the change. ETN does not provide a restatement to inventory amounts on a quarterly basis in the 10-K, so we simply added back the originally reported LIFO reserve to inventory to arrive at a decent approximation of FIFO inventories in those periods.

We see in the table that the adjusted DSI amounts have been rising year-over-year for the last few quarters with the increase more pronounced in the last two. Admittedly, sales growth has accelerated in the last three quarters from roughly flat to 8% in the most recent quarter, so some of this increase in inventory levels is likely to fulfill increased order activity. Nevertheless, it is likely that some of the increase is also due to rising costs building up in inventory which will be delayed from hitting the income statement due to the use of FIFO accounting. The move to 100% FIFO will also magnify this impact.

In the interest of pinpointing the source of the increase in inventories, the following table shows a breakdown of the components of inventory in the last two quarters:

	3/31/2018	12/31/2017	9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Raw Materials % of inventory	37.1%	36.4%	37.5%	37.1%	36.2%	37.5%	37.5%
In-Progress % of inventory	19.1%	18.0%	17.0%	17.3%	17.1%	16.8%	17.8%
Finished Goods % of inventory	43.8%	45.6%	45.6%	45.6%	46.7%	45.7%	44.7%
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Note that the 3/18, 12/17 and 12/16 amounts have been restated for the accounting change while the other periods represent the originally reported inventory component computed as a percentage inventory before the LIFO-charge.

We can see that for the last two quarters, finished good inventories have fallen as a percentage of total inventory both year-over-year and sequentially. At the same time, raw materials and in-progress inventories have increased. We are usually more concerned about an increase in finished goods inventories as it can indicate the buildup is due to lower than expected sell-through. However, with FIFO inventories in a rising cost environment, we are more concerned that this is an indicator of higher cost inventory building up that will be delayed in hitting the income statement.

According to ETN's 10-K, its major raw materials include "iron, steel, copper, nickel, aluminum, brass, tin, silver, lead, titanium, rubber, plastic, electronic components, chemicals and fluids." These are all at 5-year highs and there are no indicators that they will experience a significant drop-off anytime soon. Management indicated that it does not expect price/cost will be a negative factor in 2018, but this is a due to the company being able to raise prices to offset rising costs rather than the expectation of moderating costs themselves. Consider the following quote from ETN's CEO made in the 3/18 quarter conference call:

> *"Secondly, I'd say that inside of our businesses, we have already either taken or announced price increases in each of our businesses that essentially offset or more than offset the commodity inflation that we anticipate and can see at this point.*

As we take a look at commodities in general, they're certainly running at higher levels than we planned originally. But our teams have gotten out in front. We've already, as I mentioned, taken price increases or announced price increases. And we're fairly confident that we don't expect commodity price inflation to be a drag on margins at all for us this year.”

If the company is able to continue to increase prices aggressively, it may very well be able to offset the impact of rising raw materials, particularly as they will be delayed to an even higher degree by the increased use of FIFO accounting.

Reasons Given for the Move Away from LIFO

Management addressed the move to eliminate LIFO accounting in the 12/17 quarter call.

Richard Fearon, ETN CFO:

“Somebody asked ‘why did you make this change.’ Well, the great majority of our peers are only on FIFO and in fact, in most of the rest of the world you have to be on FIFO. The reason that our US operations have been on LIFO is up until a couple of years ago, our income taxes were on LIFO and the rule was if you were on LIFO for income taxes, you had to be on LIFO for book. But as we looked at most of the rest of our peers being on LIFO and we looked at the extra time and trouble it took to make these complex calculations to move to LIFO, it seemed to us that the better move was simply to move everything to FIFO. It has a one to two cent impact in any given year and in our K [2017 10-K filing] we will show you the impact over the last five years, but it is a 1-2 cent positive-negative swing in any given year.”

It is true that most of the company’s peers are on 100% LIFO or average cost, which approximates LIFO. The following table shows the inventory accounting methods used by the other members of the S&P 500 Electrical Components and Equipment Industry Group:

Emerson Electric (EMR)	FIFO/Average Cost
Rockwell Automation	FIFO/Average Cost
Ametek (AME)	84% FIFO/16% LIFO
Acuity Brands (AYI)	FIFO/Average Cost

In addition, the following table shows the EPS impact of the switch to 100% FIFO as disclosed in the company's 2017 10-K:

Quarter	Reported Diluted EPS Under FIFO/LILFO	Diluted EPS Adj. to 100% FIFO	Difference
9/17	$3.14	$3.14	$0.00
6/17	$1.15	$1.15	$0.00
3/17	$0.96	$0.96	$0.00
12/16	$1.12	$1.12	$0.00
9/16	$1.15	$1.14	-$0.01
6/16	$1.07	$1.07	$0.00
3/16	$0.88	$0.87	-$0.01

The company also disclosed in the 12/17 press release what earnings would have been in that period if it had not changed its accounting method:

Quarter	Reported Diluted EPS under 100% FIFO	Diluted EPS Under Previous FIFO/LIFO	Difference
12/17	$1.43	$1.42	$0.01

The company's change to 100% FIFO benefitted 12/17 EPS by a penny. We agree with management that this is not especially material and we are not contending that the decision to move to 100% FIFO was part of a grand plan to manipulate earnings. However, as we noted above, the current rising cost environment coupled with the ability to raise prices on customers is exactly the environment in which FIFO inventory offers the largest benefits to earnings versus LIFO. **The disadvantage comes when the company is no longer able to raise prices on its customers, either because of a drop in demand, or a decline in spot raw materials prices cuts into its ability to negotiate price increases with customers. At that point, the company will still have the higher cost inventories on the books that have to cycle through the income statement which could easily result in a 1-2 cent drag investors are not expecting. With ETN turning its inventories every 60-70 days, this impact is not as large as it is with a company like Tiffany (TIF) which has much longer turns, but it is still something investors should be aware of.**

Payables Rising

ETN's accounts payables days (DSP) have been trending upward the last few quarters as seen in the following table:

	03/31/2018	12/31/2017	09/30/2017	06/30/2017
COGS*	$3,573	$3,530	$3,469	$3,450
Accounts payable	$2,203	$2,166	$2,039	$1,885
Accounts payable DSPs	56.3	56.0	53.6	49.9

	03/31/2017	12/31/2016	09/30/2016	06/30/2016
COGS*	$3,307	$3,328	$3,371	$3,419
Accounts payable	$1,891	$1,718	$1,790	$1,802
Accounts payable DSPs	52.2	47.1	48.5	48.1

**Note COGS are as reported and differ from the COGS adjusted for the change in inventory accounting used in the discussion in the previous section.*

The 9/17 quarter saw DSPs jump five days over the year-go quarter with a nine-day jump in the 12/17 quarter and a four-day jump in the 3/18 quarter. Some of this was obviously due to the increase in inventories, but the fact that these jumps in payables on a days of cost of sales basis were all significantly larger than the increases in inventory days noted in the previous section indicates that some of the increase was simply the company stretching payables with its suppliers. With payables at a 5-year high relative to COGS, it appears this source of cash flow growth may be close to running out of steam.

Restructuring Complete

In 2015, ETN announced a restructuring initiative to reduce its cost structure. The company spent $129 million, $211 million and $116 million on restructuring activities in 2015, 2016 and 2017, respectively. Roughly 75% of these amounts were related to workforce reductions with the balance related to plant closings and other costs. ETN expects annual savings of $518 million beginning in 2018.

The below table shows ETN's special charges since 2012:

	2017	2016	2015	2014	2013	2012
Acquisition Integration Charges	$4	$4	$47	$154	$154	$44
Transaction Costs					$9	$178
Restructuring Costs	$116	$211	$129	$54		$50

The integration charges are related to a series of acquisitions made from 2012-2014, primarily the acquisition of Cooper. However, these integration charges not only include transaction costs such as investment banking fees, but also $20 million, $95 million and $36 million of restructuring charges related to the integration of Cooper taken in 2015, 2014 and 2013, respectively. This is in addition to the $54 million of restructuring charges recorded separately in 2014.

These charges have all been recorded in various line items on the income statement and then added back in non-GAAP presentations of earnings. Given the pre-2014 charges were mostly related to a major acquisition, we do not view ETN as having been a serial restructurer over this whole period. As far as the 2015 restructuring plan goes, the amounts have been material, ranging from 5-8% of charge-adjusted operating profit. However, the plan has ended on time and we are not concerned the company has taken advantage of the restructurings to manipulate earnings assuming no major future restructurings are announced soon.

Incorporated in Ireland

On a side note, because of the Cooper acquisition, ETN is incorporated in Ireland. As such, much of the dividend to US investors is treated as a return of capital. Management addressed on the 12/17 conference call that some onlookers had claimed the new tax law would impact the tax treatment of the dividend going forward and indicated that nothing would change. When the company declared its May 2018 dividend, it affirmed that it estimates all the 2018 dividend will be treated as a return of capital for US tax purposes.

Ocean Yield (OCY NO, OYIEF) Update

Ocean Yield (OCY NO, OYIEF) continues to add to its fleet by acquiring four smaller containerships that will arrive in 3Q18. This transaction is unique for two reasons. First, containerships are seeing rate increases and should that should make Ocean Yield's counter party even stronger over time. Costamare (CMRE) is a similar company that specializes in owning and chartering out containerships. In its last quarter, it had two ships that rolled off very long charters before the downturn in rates in 2015 and 2016 - those were rechartered at lower rates. However, thirteen other ships saw their charter rates increase on renewal. They also reported no idle ships and the industry idle rate is under 1.5%, down from 8% about two-years ago with a small order book.

One area where there remains some pressure is in the very large ships - with capacity greater than 14,000 TEUs. Those ships were the most frequently built in the last upswing and contributed to the idle fleet spiking. They can be tough to fill completely and the economics for profit requires container ships to sail as full as possible. The other reason the very large ships have some pressure is they are too big for many ports around the world and tend to crowd into the same places. The ships Ocean Yield just purchased are 3,800 TEU in capacity and that is where the industry may be in undersupply according to Alix Partners, an industry consulting firm. The smaller ships also can serve many small and mid-sized ports as well, so the routes are not as crowded.

Overall, this is another small deal, but one that adds to more growth and should allow the dividend to continue rising.

More Evidence of Tough Times for Name-Brand Companies

The Wall Street Journal documented this week the uphill battle US grocery stores are facing to grow while under pressure from new competition including Amazon's Whole Foods and European discounters like Aldi. The article suggests that a "key growth opportunity for US chains is private-label brands, which account for only around 15% of packaged food and household products, compared with over 40% in the UK." These pressures are not new to the packaged foods companies like Kraft Heinz (KHC) and Mondelez (MDLZ) and consumer products companies like Procter and Gamble (PG), Colgate (CL) and Kimberly-Clark (KMB). However, the article drives home the point that these pressures are nowhere near coming to an end for these companies.

Disclosure

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