BEHIND THE NUMBERS
QUALITY EQUITY INCOME SOLUTIONS

BTN Thursday Thoughts

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> But, there were some who saw it coming. While the whole world was having a big old party, a few outsiders and weirdos saw what no one else could… These outsiders saw the giant lie at the heart of the economy, and they saw it by doing something the rest of the suckers never thought to do: They looked.
>
> - *The Big Short* (2015)

Quality of Earnings Previews

At Behind the Numbers, we spend a great deal of time wading through financial statements looking for instances where the numbers don't match the narrative. With earnings season in full swing, we will begin including regular previews of select companies scheduled to releases earnings next week based on our analysis of their earnings quality through their last reported quarters.

All of the below-mentioned companies will report earnings before next week's *Thursday Thoughts*. **Please note that none of the below reviews represent a complete analysis of the company, nor constitutes a full blown "sell recommendation." Rather, these are companies that displayed some classic warning signs in recent quarters that call into question their ability to maintain growth at recent paces**. We are in no way making a prediction that these companies will disappoint next week. However, we believe that investors who own these

stocks should be aware of these issues. As the opening quote implies, wise investors should always look, preferably with skeptical eyes.

ResMed (RMD)

ResMed (RMD) is a leading provider of equipment and software for the treatment of breathing-related sleep disorders. Currency-adjusted revenues rose by 11% in the 9/17 quarter and adjusted EPS rose by 6%. Overseas growth and anticipation of new product releases has propelled the stock to all-time highs, resulting in a premium valuation of 28 times next year's earnings. We have not done any recent work on the company's markets and prospects for new products. However, an analysis of recent results turned up several signs we believe investors should be aware of and pay attention to in the upcoming quarterly results to be announced on 1/22.

Accounts receivable DSOs have been rising the last few quarters

RMD's accounts receivable have been rising noticeably faster than sales for the last few quarters. The following table shows information on sales and receivables and the calculation of accounts receivable days of sales outstanding (DSOs):

	9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016	6/30/2016	3/31/2016
Sales	$524	$557	$514	$530	$465	$519	$454
Accounts Receivable	$431	$451	$414	$384	$347	$382	$358
Sales YOY growth	12.5%	7.3%	13.3%	16.7%	13.1%	14.5%	7.4%
Accounts Receivable YOY growth	24.3%	17.9%	15.5%	15.7%	6.1%	5.4%	3.7%
Sales Seq growth	-5.9%	8.3%	-3.1%	14.0%	-10.3%	14.3%	-0.1%
Accounts Receivable Seq growth	-4.3%	8.9%	7.7%	10.6%	-9.1%	6.7%	8.0%
Accounts Receivable DSOs	**75.2**	**73.8**	**73.4**	**66.1**	**68.1**	**67.2**	**72.0**

While reported sales grew by 12.5% in the 9/17 period, receivables increased at twice that pace, resulting in DSOs jumping to 75.2 days in the 9/30 quarter compared to 68.1 in the year-ago period. A similar disproportionate increase was seen in the 6/17 quarter. RMD did acquire Brightree in the 6/16 quarter, but the impact of the acquisition would have already been factored into the 9/16 quarter. Management noted the sequential increase in DSOs in its 10-Q, but gave no explanation for it. The subject was raised briefly on the conference call. When asked about the increase in DSOs and DSIs (which we will discuss in the next section) the company gave the following explanation:

> "Sure, yeah. Last year's cash flow was, if you compare that to the year before, it was very strong cash flows. And we're working through getting some good improvements in working capital balances.
>
> So this year I think on the receivable side, we've seen good revenue growth. So that's been driving on the receivables. And working capital – working balances around inventories and so on just looking to really rebuild through with a lot of new product launches and so on has been happening. So, yeah, I think it's sort of a little bit of a building in working capital level what was a pretty low base I guess the year before."

It is possible for an increase in sales towards the end of a period to result in an increase in DSOs as revenues are increased, but there is not time to collect the receivables by the end of the period. The concern is whether the company could have driven such an increase by offering special terms to its customers, (medical products distributors, hospitals, nursing homes, etc.) to pull sales into current periods at the expense of the next. RMD has been posting sales growth numbers that are exceeding expectations, meaning revenue manipulation does not appear necessary on the surface. Nevertheless, such a distinct increase in receivables bears watching going forward. We estimate that the increase in accounts receivable could have added in excess of $0.05 per share to earnings in the last couple of quarters. We will be alarmed if DSOs do not show signs of moderation in the next quarter as management has promised.

Inventory DSIs jumped with a concentration in finished goods

Inventories also increased out-of-line with sales in the last two periods, as seen in the below table:

	9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016	6/30/2016	3/31/2016
Gross Profit	$306	$324	$300	$309	$269	$301	$260
Inventory	$300	$268	$260	$253	$254	$224	$233
Gross Profit YOY growth	13.5%	7.4%	15.3%	16.0%	12.8%	16.2%	3.4%
Inventory YOY growth	18.4%	19.5%	11.6%	6.6%	-1.8%	-9.1%	3.4%
Gross Profit Seq growth	-5.6%	8.0%	-3.0%	14.8%	-10.7%	16.0%	-2.5%
Inventory Seq growth	12.0%	3.3%	2.7%	-0.3%	13.1%	-3.6%	-1.9%
Inventory DSIs	***89.7***	***75.6***	***79.1***	***74.7***	***86.0***	***67.9***	***81.8***

Days sales of inventory (DSIs) rose to 89.7 in the 9/30 quarter, up from 86 in the year-ago period. What is more disturbing is that all of the increase was centered in finished goods:

	9/30/2017	**6/30/2017**	**3/31/2017**	**12/31/2016**	**9/30/2016**	**6/30/2016**	**3/31/2016**
Raw Materials days	21.4	21.3	25.1	22.1	22.2	20.3	25.7
In-Progress days	1.5	1.2	1.3	1.0	1.6	1.2	0.9
Finished Goods days	**66.9**	53.1	52.7	51.6	**62.2**	46.4	55.2
Other Inventory days	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Inventory DSIs	89.7	75.6	79.1	74.7	86.0	67.9	81.8

Finished goods DSIs rose by almost 5 days over the year-ago period while raw materials days actually fell. Ordinarily, such an increase would be very concerning, as it would indicate that there was an unexpected buildup of finished product that management will have to discount to move later. As noted above, management related the buildup to new product releases. It is plausible that the increase could be due to the current quarter's release of its new *AirMini* travel CPAP. As with receivables, we will be looking for a moderation in DSIs going forward.

Warranty expense benefitted the last two quarters

RMD accrues for warranty costs at the time of sale and discloses warranty reserve development in its footnotes. Warranty expense and total reserve balances are shown in the table below:

	9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016	6/30/2016	3/31/2016
Sales	$523.66	$556.69	$514.20	$530.40	$465.45	$518.65	$453.88
Warranty expense	$3.80	$4.57	$6.39	$3.61	$5.24	$5.73	$4.11
Warranty expense % of sales	0.73%	0.82%	1.24%	0.68%	1.13%	1.10%	0.91%
Warranty Reserve Ending Balance	$19,956	$19,558	$20,187	$16,914	$17,578	$15,043	$12,283
Warranty Reserve % of T12 sales	0.94%	0.95%	1.00%	0.86%	0.93%	0.82%	0.69%

Despite the low teens sales growth in the last two quarters, warranty expense has actually declined. In the case of the 9/17 quarter, warranty expense as a percentage of sales fell by 40 bps, which was a material benefit to earnings growth and profit margins. The warranty reserve as a percentage of sales is actually towards the high end of recent experience, so it does not appear management is recklessly drawing it down to unrealistically low levels to

boost results. Nevertheless, the decline in the expense as a percentage of sales added about 1 to 1.5 cents to earnings in the last two quarters and this benefit is unlikely to continue.

Rise in prepaid expenses

The following table shows prepaid expenses and other current assets for the last 7 quarters:

	9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016	6/30/2016	3/31/2016
Prepaid exp. and other cur. assets	$115.02	$103.22	$104.57	$95.03	$92.23	$81.74	$90.50
Prepaid expense days	20.0	16.9	18.6	16.3	18.1	14.4	18.2

Prepaid expenses and other current assets can contain a broad range of items, and the company does not give a detailed breakdown of the account. The concern is that the company has spent cash on an operating item, but the expenditure has not been expensed on the income statement yet, thus artificially benefitting earnings. The prepaid balance is the highest it has been in at least three years, both on an absolute basis and on a days-of-sales basis. Given the uncertain nature of the account, we are not overly alarmed at this point, but this item bears watching as it could be an indication that the last quarter benefitted from artificially low expense recognition.

Conclusion

As the following table shows, RMD has been beating consensus estimates for the last few quarters by 1-3 cents per share.

Quarter	Reported EPS	Zacks Estimate	Surprise
9/17	$0.66	$0.65	$0.01
6/17	$0.77	$0.75	$0.02
3/17	$0.71	$0.70	$0.01
12/16	$0.73	$0.70	$0.03

While currency adjusted revenues rose by 11% in the most recent period, lower selling prices, unfavorable foreign currency exchange for expenses, and a rising share count cut the growth in adjusted EPS to just 6%. To be fair, the company experienced higher foreign currency and other losses in the 9/17 period that cost it about 1.4 cents in the quarter. However, we have identified as much as 5-7 cents per share in one-time benefits in the last two quarters. While growth may receive a boost from the release of new products, so much

of the upside coming from non-operational factors increases the risks that the consensus view on the company is overly optimistic.

Kimberly Clark (KMB)

Kimberly Clark (KMB) is another favorite among dividend investors given its multi-decade history of increasing its dividend and its perceived safety as a consumer staples company. (This time of year, we are reminded that people will always have to blow their noses.) However, market penetration, increased competition from generics and pressure from a consolidated retail base have all conspired to keep growth down at KMB. This can be easily seen in its 9/17 quarterly results which saw sales volume growth of 1%, being almost offset by price declines. KMB has been fighting the lackluster top-line, pricing pressure and rising input costs with its FORCE cost reduction program, which has allowed it to essentially tread water at the operating profit line over the last couple of years.

The company has also cut capex and milked working capital to keep its free cash flow coverage of the dividend in an acceptable range:

	9/30/2017	9/30/2016	9/30/2015
T12 Operating Cash Flow	$2,937	$3,026	$2,231
T12 Capex	$784	$840	$1,107
T12 Free Cash Flow	$2,153	$2,186	$1,124
T12 Dividends	$1,347	$1,301	$1,266
Div % of FCF	62.6%	59.5%	112.6%

KMB manages to add another 1-2% to EPS growth via its share buyback program. In recent periods, the company has been able to cover the buyback with cash flow after the dividend. However, our analysis of the 9/17 quarter turned up a couple of red flags investors should watch going forward.

Accounts receivable DSOs jumped in the 9/17 quarter

KMB has actually missed analysts' revenue targets in the last several quarters, but has managed to essentially meet or exceed earnings estimates through more aggressive cost cutting. This makes the two-day jump in accounts receivable seen in the 9/17 quarter more disturbing:

	Quarter Ended: 9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016	6/30/2016	3/31/2016
Sales	$4,640	$4,554	$4,483	$4,544	$4,594	$4,588	$4,476
Accounts Receivable	$2,360	$2,221	$2,224	$2,176	$2,222	$2,249	$2,255
Sales YOY growth	1.0%	-0.7%	0.2%	0.1%	-2.6%	-1.2%	-4.6%
Accounts Receivable YOY growth	6.2%	-1.2%	-1.4%	-4.6%	-2.7%	-1.6%	0.5%
Sales Seq growth	1.9%	1.6%	-1.3%	-1.1%	0.1%	2.5%	-1.4%
Accounts Receivable Seq growth	6.3%	-0.1%	2.2%	-2.1%	-1.2%	-0.3%	-1.1%
Accounts Receivable DSOs	**46.4**	**44.5**	**45.3**	**43.7**	**44.1**	**44.7**	**46.0**

Receivables have been trending down for the previous five quarters, but suddenly rose by more than 6% in the third quarter on a 1% increase in revenue. While not a gargantuan jump in DSOs, given the flat trend and weak sales growth, the uptick definitely stands out. There is no specific mention of the increase in the company's 10-Q or quarterly conference call. If receivables had grown in line with revenues, it would have taken about $115 million off of revenue, resulting in a more than 1% decline. It is possible that these revenues were pulled forward into the third quarter and will put an even greater burden on fourth quarter sales growth.

Accounts payables are increasing

KMB management is pulling out all the stops to save money, and that has included putting pressure on its suppliers. The following table shows the calculation of days payable (DSPs) for the last 7 quarters:

	Quarter Ended: 9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016	6/30/2016	3/31/2016
Sales	$4,640	$4,554	$4,483	$4,544	$4,594	$4,588	$4,476
Accounts payable	$2,729	$2,629	$2,571	$2,609	$2,454	$2,448	$2,442
Sales YOY growth	1.0%	-0.7%	0.2%	0.1%	-2.6%	-1.2%	-4.6%
Accounts payable YOY growth	11.2%	7.4%	5.3%	-0.1%	-2.5%	-5.8%	-2.4%
Sales Seq growth	1.9%	1.6%	-1.3%	-1.1%	0.1%	2.5%	-1.4%
Accounts payable Seq growth	3.8%	2.3%	-1.5%	6.3%	0.2%	0.2%	-6.5%
Accounts payable DSPs	**53.7**	**52.7**	**52.3**	**52.4**	**48.7**	**48.7**	**49.8**

DSPs have shown significant year-over-year increases in the last three quarters. Keep in mind that DSPs are at a five-year high, so this does not represent a bounce off an unusually low level. Such an increase in payables clearly shows that management is pushing its

suppliers to extend payment terms, keeping the company's cash in its possession for longer. While this is certainly good financial stewardship, it calls into question how much longer the company can squeeze incremental cash flow growth from that source. Also, keep in mind that the cash flow benefit of increasing payables has been partially offset by the cash use of rising receivables.

Capital spending cuts

Referring to the first table, we see that the company has cut capital spending significantly in the last three years. For the full year 2017, the company is now expecting capital spending to come in below its initial projected range of $850-$950 million. The low end of that range represents a meaningful increase from 2016's $771 million. In fact, quarterly spending on capex has increased in each of the last two quarters, marking an end to the benefit of capex cuts to free cash flow.

KMB reports on 1/23.

Lancaster Colony (LANC)

Lancaster Colony (LANC) has a lot going for it. The sleepy little salad dressing company has increased its dividend for more than 60 years, pays regular, one-time dividends, shies away from reckless share buybacks and boasts a balance sheet with a positive net cash position. Nevertheless, we are concerned by the company's accounts receivable days of sales outstanding (DSOs) increasing by more than three days from the year-ago period:

	9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016	6/30/2016	3/31/2016
Sales	$299	$290	$294	$327	$291	$284	$288
Accounts Receivable	$83	$70	$75	$71	$71	$66	$70
Sales YOY growth	2.6%	1.9%	2.1%	0.6%	-0.9%	2.4%	9.3%
Accounts Rec. YOY growth	17.3%	5.9%	6.9%	17.6%	-4.7%	5.7%	1.2%
Sales Seq growth	3.1%	-1.3%	-10.1%	12.2%	2.4%	-1.1%	-11.4%
Accounts Receivable Seq growth	18.6%	-6.8%	5.1%	1.1%	7.1%	-6.0%	15.6%
Accounts Receivable DSOs	**25.3**	**22.0**	**23.3**	**19.9**	**22.1**	**21.2**	**22.3**

Sales growth has been difficult for the company to come by in recent periods, with 2.6%, 1.9% and 2.1% growth posted in the last three quarters. While some of that growth has come from the company's November 2016 acquisition of Angelic Bakeries, the acquisition

did not drive the DSO increase in the 9/17 quarter, as witnessed by the flat year-over-year DSO growth seen in the 3/17 and 6/17 quarters. It is this low-growth environment that prompts us to highlight the increase in DSOs. Management stated in its conference call that:

> "In general, accounts receivable remain in line with expectations and largely reflect increased sales volumes for the quarter. Consistent with past quarters, our collection and agings remain solid."

However, the liquidity section of the company's 10-Q seemed to have a slightly different take on the matter:

> "The decrease (in operating cash flow) was due to lower net income and higher working capital requirements, primarily in receivables, ***which resulted from the timing of shipments and related payment terms to suppliers***."

We have not spoken with management for an explanation to that statement, but one could certainly read into it that there were one-time factors that resulted in revenues being recognized in the September quarter at the expense of the upcoming December quarter. We estimate that the disproportionate increase in receivables could have added as much as $10 million to September quarter sales, which would have essentially eliminated the reported increase in revenues. This is important, as LANC's September revenue already fell shy of analysts' estimates in each of the last two quarters as it was. In addition, the receivables increase could be $10 million that will no longer benefit the December quarter. Analysts are expecting a 3.4% increase in revenue in the December quarter (to be reported on 1/25), which will be even more difficult to achieve without those revenues.

Disclosure

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