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BTN Thursday Thoughts

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Newell Brands (NWL) – growth through acquisition detonates again

On April 15, 2016, Newell Rubbermaid became Newell Brands (NWL) after buying Jarden Corp. Those that have followed us through the years know that we never understood the fascination with either company as they annually wrote off assets and continually announced new restructuring plans– each larger than the last. Common sense should indicate that cutting fat and finding redundancies would be easiest and most effective during the first review–not the 5th time. NWL as a stand-alone company had less than $6 billion in annual sales, and has taken $1.4 billion of "one-time" items since just 2014 including inventory revaluations. Another sign of a cloudy earnings report, the word "normalized" appears 69 times in the 3Q'17 press release.

On the surface, we saw companies that sold items that few people need to replace often such as cookware, trashcans, coffee pots, camping stoves, etc. Moreover, they sold much of this stuff through retail outlets like Wal-Mart, where pricing pressure would be an issue. Wal-Mart squeezes Proctor and Gamble (PG) with $65 billion in sales on things people purchase many times per year. NWL items that had more rapid replacement sales like pens and glue were lower-priced as well. A collection of Calphalon cooking pots may cost $300-$400 vs. 3 pens for $1.50, and they were

focused on sales growth. Already, the company is planning to break up the Jarden acquisition and divest much of the assets.

There are numerous studies that point to failure for about 70% of acquisitions. One of my all-time favorite books that I always recommend on this subject is Michael Craig's *The 50 Best (and Worst) Business Deals of All Time*. The odds of success for an acquisition improve if a company buys another in the same industry, with similar products and customers. The odds for success fall when the companies are different and sell to different customers and products have little overlap.

So, let's look back on what was supposed to happen with the formation of Newell Brands. Here is the December 14, 2015 presentation announcing the deal. In the first four years of this deal, the combined company was going to find $500 million in cost savings over-and-above the latest Project Renewal restructuring Newell was already doing at the time. On the cost synergies, at the end of 2016, NWL was claiming $200 million achieved, but was combining that with results of Project Renewal as well. The combo of the merger synergies and Project Renewal were at $86 million for 2017 through the 3Q. The deal closed in 1Q'16. Thus, only 2Q'17 and 3Q'17 actually show apples-to-apples comps. In 2Q'17, margins were up 130bp y/y and they fell by 40bp y/y in 3Q'17. That is not showing the type of gains expected.

The revenue synergies were so big they were not quantified. Revenue synergies would come from increased scale over retailers and by offering complimentary brands that would be able to boost sales at better margin. Cross-selling each company's products was expected as well. In only 1.5 years of reported results, NWL is already blowing up this deal and planning to shed 7 of 16 divisions. As far as revenue synergies, NWL missed revenue targets four times already and cut guidance after 3Q'17.

The other reason for the deal was top management at both firms were coming to the board. Both Martin Franklin and Ian Ashken from Jarden are now resigning. That will leave NWL's original people in charge of the combined operation. This looks like a repeat of the Kraft/Cadbury deal. Kraft was rebuffed in attempts to buy several times before finally raising the price enough to convince Cadbury to sell. The goals were very similar- a much larger company would have huge buying power synergies, leverage with customers, and could save on overhead. Management was well-paid. Within a few quarters, the deal went sour and missed on targets. Suddenly, it made much more sense to have two smaller and more nimble companies and management was again paid to break things apart.

Earnings Quality Reviews

AT&T (T)

AT&T announced 4Q'17 results this week that were aided by $0.13 from the new tax law, which reduced deferred tax liability. This is basically the earnings beat. The company reported guidance for increased cash flow, earnings, and investment in 2018. Guidance for 2018 includes $0.45 in earnings from lower taxes and $0.06 from a larger write-down in copper lines reducing depreciation. That will be offset by $0.05 each from First-Net investments and higher interest expense, along with $0.04 in lower rate of return assumptions on the pension. Guidance from the new revenue recognition rules under ASC-606 was estimated to be a positive $0.10-$0.15 impact in 2018. These new rules essentially change the timing of when revenue under a contract is earned and also when costs such as sales commissions should be recognized. AT&T will essentially see a one-time boost as the change is made and as those initial contracts roll over – the transition impact will be muted.

Overall, AT&T is a company going through some sizeable transition and that is expected to continue for several more years. (That means many more quarters with numerous adjustments to focus on core earnings.) Essentially, the company has a copper phone system that is expensive to maintain that is seeing fewer customers every year. But, it cannot eliminate that until all the fiber investments are made. At some point, costs of the old system will continue to erode and the company's profitability will increase – that is the plan. At the same time, it bought DirecTV, which it is using to offer bundles and content to wireless subscribers. That boosts wireless margins and profits because churn is much lower and they don't have to invest as much to keep customers. However, DirecTV suffers from the same cord-cutting issues as basic cable, so it is not growing its regular business. New customers often pay less for DirecTV NOW than for the traditional satellite service. However, AT&T's fiber rollout also reduces costs.

The company is still viewed as a utility with an attractive dividend. We think it should be viewed more as a tech company these days. We say that because a utility model normally means a company spends heavily to develop a network and production assets and then becomes a cash cow with minimal capex for many years. A tech company's product life is simply not very long and it needs to reinvent its products on a continual basis. That means spending on R&D and capital investments stays very high. Look at AT&T's past- it rolls out fiber to towers, then fiber to homes, then it adds services to fiber. Now it wants to roll out 5G networks, expand fiber more, and buy Time Warner for more content to send on the fiber, add cloud DVR features to services. That doesn't sound like a utility model to us. And – it's expensive!

The company is still a cash machine producing about $39 billion per year in cash flow, spending about $21 billion in capital investments for free cash flow of $17-$18 billion. This is not at a problem stage yet. However, we are going to note on the surface that AT&T is showing signs that heavy reinvestment is not producing the same returns as in the past:

	2017	2016	2015	2014	2013
ROI	7.8%	10.0%	9.9%	12.9%	13.5%
CapX	$20.6	$21.5	$19.2	$21.2	$20.9

We are using operating income divided by year-ending capital for ROI – add about 90bp if you want to use average capital in 2017, either way the trend is still visible.

The big gap down in ROI occurs after the DirecTV acquisition for $31 billion in 2015. To be fair – capital spending is basically equal to depreciation. However, much of the capital spending is supposed to be expensive upfront and then minimal thereafter once the assets are in place – like a pipeline. Expensive investment with a heavy depreciation shield and growing cash flows is what fiber and towers should be doing. This is showing more signs of being a tech model, where heavy investment improves the product and speed allowing the company to keep the same customers with more features at basically the same or lower price and the goal for the company is to lower costs faster than that.

If you are buying AT&T for the dividend, it is still covered. The dividend is about $12 billion per year. Even after hefty capital spending, AT&T generates about $17-$18 billion in free cash flow. So, the dividend consumes about 70% of free cash flow each year. In 2018, free cash flow is expected to rise to about $21 billion, which would drop the payout ratio to about 57% and provide more cushion. That $21 billion is being helped by the lower tax rates and the fact that AT&T's pension funding needs are largely gone which will boost cash flow as they simply do not have to put cash into the plan. They are also penalizing the $21 billion by accelerating more capital spending which will rise to about $25 billion. So, the $21 billion in free cash flow sounds conservative to us.

The next question is can the dividend grow at more than 2%? The answer to that depends on several factors. If AT&T completes the Time Warner deal, it will issue more stock, which will boost the dividend about $2 billion annually. It also intends to pay down debt more quickly and that will consume free cash flow. Time Warner was generating about $4.5-$5.0 billion in cash from operations and has minimal capital spending. The tax cuts should boost that figure, and AT&T sees $1 billion in incremental EBITDA from cost savings and revenue goals – we would down play that as the businesses aren't that similar. In our view,

Time Warner's cash flow is already spoken for on the debt side and more of AT&T's current free cash flow will go toward a larger total dividend outlay with the new stock issued.

AT&T still has a huge rollout of 5G that will be based off the First-Net platform it is building for first responders. That deal comes with spectrum and capital spending will be reimbursed on a lagging basis. The company sees a $2 billion outflow there upfront due to timing – that is included in the $25 billion forecast for capital spending. That may allow capital spending in 2019 to decline and eventually the $2 billion will be recovered. So that is a potential positive for the dividend coverage and growth potential.

Other than that, AT&T has not shown that it can grow earnings much faster than single-digit because it is still fighting a falling ROI as it operates legacy businesses and is paying to rollout new businesses at the same time. It has shown good progress in boosting profit margins at wireless – the trick is to keep doing it without spending $31 billion.

Xilinx (XLNX)

Xilinx (XLNX) reported adjusted EPS of $0.76 in the 12/17 quarter, essentially in-line with analyst expectations. Revenue was just a shade ahead of analysts' targets after missing guidance the previous two quarters. We noted several items of concern in the quarter:

Deferred revenue drop

Over 50% of XLNX's revenue comes from the sale of products to distributors (namely Avnet). When XLNX books a sale to a distributor, it records a receivable and reduces its inventory. However, the revenue (and profit) associated with the sale is deferred until the distributor sells the product to the end user. This makes tracking trends in the deferred income account very important. The below table shows the calculation of deferred income days of sales:

	12/31/2017	9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Sales	$631	$620	$615	$609	$586	$579
Deferred Income	$33	$51	$44	$55	$54	$57
Sales YOY growth	7.8%	7.0%	7.0%	6.7%	3.4%	9.8%
Deferred Income YOY growth	-38.5%	-11.2%	-38.8%	5.4%	14.1%	-29.7%
Sales Seq growth	1.9%	0.7%	1.0%	4.1%	1.1%	0.7%
Deferred Income Seq growth	-35.3%	16.5%	-19.8%	1.8%	-6.6%	-19.8%
Deferred Income Days	**4.8**	**7.5**	**6.5**	**8.2**	**8.4**	**9.0**

Despite a 7.8% increase in sales, deferred income actually fell by almost 40% from the year-ago period. The decline was especially noticeable in the 12/17 period, as sales increased sequentially by 2% but deferred income fell by over 35%. The company disclosed in it 10-Qs that for both nine-month periods ended 12/17, distributors accounted for about 52% of sales. Such a sharp drop in deferred income is a concern, as it indicates that either the company became more aggressive in recognizing revenue on products shipped to distributors, or there was a slowdown in their acquisition pace which is a possible predictor of a slowing pace of future sales. XLNX discloses a days-of-sales inventory (DSI) number based on the combined inventory of XLNX and its distributors, which sheds a little more light on the issue. The below table shows the company's combined inventory DSI, our calculation of company DSIs and the implied level of DSIs held at the company's distributor customers.

	12/31/2017	9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016
XLNX + distributor DSI	118.0	116.0	111.0	127.0	117.0	113.0
XLNX DSI	113.5	106.4	102.2	111.5	105.4	102.2
Distributor DSI	4.5	9.6	8.8	15.5	11.6	10.8

There has been a sharp increase in inventories at XLNX at the same time inventory levels at distributors (and deferred income levels) have been declining.

CFO Lorenzo Flores addressed the buildup in XLNX inventories in the conference call:

> "So, in general, you'll see our inventory grow in anticipation of the business. We've had, I think there was one quarter in the past we actually had a higher dollar value of inventory. That was for specific business area. I think that was when we were getting ready to support Wireless ramp in the last generation. Again, I think that was the case. But we see, just in general, broader end

> market strength, particularly in our Advanced Products and that's where we're focusing our inventory build. So, I think the inventory number is quite consistent with what you'll see in the business. It should grow as the business grows. But in periods it will drain down a little bit and others it will build up a little bit, just depending on what we're actually seeing in the market."

The buildup in inventories at XLNX could be a sign that the company is expecting an acceleration in growth of Advanced Product in the next quarter. However, at the same time XLNX is building inventories, its distributors have cut inventories to a third of their level this time last year. There is the possibility that the pace at which product moves through the distribution network has accelerated. However, there is also the possibility that distributors are not expecting as big a boost in end-market demand as XLNX's inventories imply.

We would note that Avnet's total inventory DSIs have actually been increasing at the same time it appears to be cutting its holdings of XLNX's products.

Avnet DSIs

	12/31/2017	*9/30/2017*	*6/30/2017*	*3/31/2017*	*12/31/2016*
COGS	$3,919	$4,048	$3,976	$3,812	$3,687
Inventory	$3,286	$3,129	$2,825	$2,771	$2,698
COGS YOY growth	6.3%	11.0%	14.5%	7.0%	0.9%
Inventory YOY growth	21.8%	29.4%	10.3%	-2.0%	1.8%
COGS Seq growth	-3.2%	1.8%	4.3%	3.4%	1.1%
Inventory Seq growth	5.0%	10.8%	1.9%	2.7%	11.5%
Inventory DSIs	**76.5**	**70.5**	**64.8**	**66.3**	**66.8**

Obviously, XLNX's products are only a small portion of Avnet's total inventories, which contain a broad range of technology-related products. Nevertheless, the dramatic decline in XLNX's distributor inventory is obviously going against the grain of most of Avnet's suppliers.

There is obviously strong demand for the company's products, with strong recent sales growth in defense, auto and consumer markets. (Note that bitcoin mining is helping stoke the consumer demand.) Therefore, there likely has been a degree of acceleration through the distribution channel making us a little less concerned by the drop in deferred income as we ordinarily would be. Nevertheless, this is a definitely an item worth keeping an eye on in upcoming quarters.

Another point of interest is that while the balance sheet discloses only the deferred income, the company discloses in the footnotes the breakout of deferred sales and deferred costs associated with sales to suppliers as shown in the following table:

	12/31/2017	*9/30/2017*	*6/30/2017*	*3/31/2017*	*12/31/2016*	*9/30/2016*
Deferred revenue	$48.0	$70.2	$62.1	$74.2	$71.4	$75.1
Deferred costs	$15.0	$19.2	$18.3	$19.6	$17.8	$17.7
Deferred income on sales to suppliers	$33.0	$51.0	$43.8	$54.6	$53.6	$57.4
Implied Margin	68.8%	72.6%	70.5%	73.6%	75.1%	76.4%

It is interesting that the gross margin products held by distributor customers has steadily fallen over the last few quarters. This is consistent with the shift towards Advance Products which carry lower gross margins than its Core Products and indicates the degree of pressure that will be on the company's margins in upcoming quarters.

Johnson Controls (JCI)

Johnson Controls (JCI) reported adjusted EPS of $0.54 in the 12/17 quarter, about a penny ahead of consensus estimates. JCI is currently in a rebuilding phase. After the Tyco-Johnson Controls merger in 2015, the company spun off its Adient auto seat business in late 2016 and recently sold its Scott Safety business in the 10/17 quarter. This was in addition to several other immaterial acquisitions and divestitures made in the 2016-2017 timeframe. Other changes include reshuffling the Board and instituting a new management incentive compensation arrangement with targets based on organic revenue growth, EBIT grw and free cash flow conversion rates.

One of JCI's most touted targets is a free cash flow conversion rate of at least 80% in 2018. To that end, the company has established a cash management office tasked with finding ways to save cash and improve working capital. In the 12/17 quarter, accounts payable days-of-sales (DSOs) spiked to 60 from about 44 in the year-ago quarter, which may be evidence of the new team at work. However, we are concerned about quarterly increases in receivables and inventories.

The following table shows DSOs for the last six quarters:

	12/31/2017	*9/30/2017*	*6/30/2017*	*3/31/2017*	*12/31/2016*	*9/30/2016*
Sales	$7,435	$8,136	$7,683	$7,267	$7,086	$6,254
Accounts Receivable	$6,731	$6,666	$6,443	$6,094	$6,057	$6,394
Sales YOY growth	4.9%	30.1%	49.1%	53.5%	50.9%	-28.5%
Accounts Rec. YOY growth	11.1%	4.3%	257.0%	253.9%	252.4%	11.2%
Sales Seq growth	-8.6%	5.9%	5.7%	2.6%	13.3%	21.3%
Accounts Rec. Seq growth	1.0%	3.5%	5.7%	0.6%	-5.3%	254.2%
Accounts Receivable DSOs	**82.6**	**74.8**	**76.5**	**76.5**	**78.0**	**93.3**

In the 9/17 quarter, the company completed two divestures for which it received $44 million. These were not material to results. Also, in the 3/17 quarter, the company sold its South African ADT security business for $129 million, (which was also not material) as well as making another tiny divestiture in the 12/16 quarter.

In the 12/17 quarter, JCI sold its Scott Safety business to 3M for $2 billion. According to the 10-K, the carrying value of Scott's receivables at 9/17 was $100 million and inventories were $75 million.

The above table shows that despite the reduction of $100 million from the 12/17 sales of Scott, receivables still increased by 1% sequentially and over 11% year-over-year. This resulted in a 4-day increase in DSOs compared to last year. Given all the reshuffling going on, the comparison to last year is not as clean as we would like, but there nevertheless was a clear disproportionate upward move in receivables in the period. There was no discussion of this in the conference call, so we will be interested to see the 10-Q when released to see if any light is shed on this. Keep in mind that just three days of receivables amounts to over $200 million in revenues which is a large amount of the observed year-over-year increase in sales in the quarter. Given the company's focus on boosting cash flow, we would expect to see a marked decline in receivables in the 3/18 quarter. While this may boost cash flow, it will not negate any headwind to sales from easier terms being used to lure sales into the 12/17 quarter.

As with receivables, there was a noticeable increase in inventories in the quarter as well:

	12/31/2017	9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016
COGS	$5,266	$5,623	$5,252	$4,986	$4,972	$4,566
Inventory	$3,459	$3,209	$3,384	$3,138	$2,943	$2,888
COGS YOY growth	5.9%	23.1%	40.7%	44.7%	44.6%	-36.5%
Inventory YOY growth	17.5%	11.1%	415.9%	368.4%	354.9%	21.5%
COGS Seq growth	-6.3%	7.1%	5.3%	0.3%	8.9%	22.3%
Inventory Seq growth	7.8%	-5.2%	7.8%	6.6%	1.9%	340.2%
Inventory DSIs	**59.9**	**52.1**	**58.8**	**57.4**	**54.0**	**57.7**

As noted above, the impact of divestitures in the last four quarters has far outweighed the impact of acquisitions, and the 12/17 sale of Scott Safety would have reduced inventories by $75 million on a sequential basis. Despite that, inventories posted a 7.8% sequential rise, resulting in inventory days-of-sales (DSIs) jumping by almost 6 days. This is a significant increase and certainly at odds with the mission of reducing working capital. There was no discussion of this on the call, so we will be interested to see the 10-Q and the breakdown of inventory composition. If all of the buildup is centered in raw materials and work-in-process, it will be an indication that the company is gearing up for an acceleration in sales. However, it will be a concern if most of the increase was in finished goods.

Lancaster Colony (LANC)

We warned in the January 18th issue of *BTN Thursday Thoughts* about LANC's elevated level of receivables going into the 12/17 quarter and the potential revenue headwind that could represent. On 1/25, the company's revenue came up over 5% short of analysts' estimates, leading to a significant earnings miss. Receivables as of 12/17 were back down, comparable to the year-ago level on a days-of-sales basis. Therefore, out level of concern with LANC is reduced.

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