Full Profile

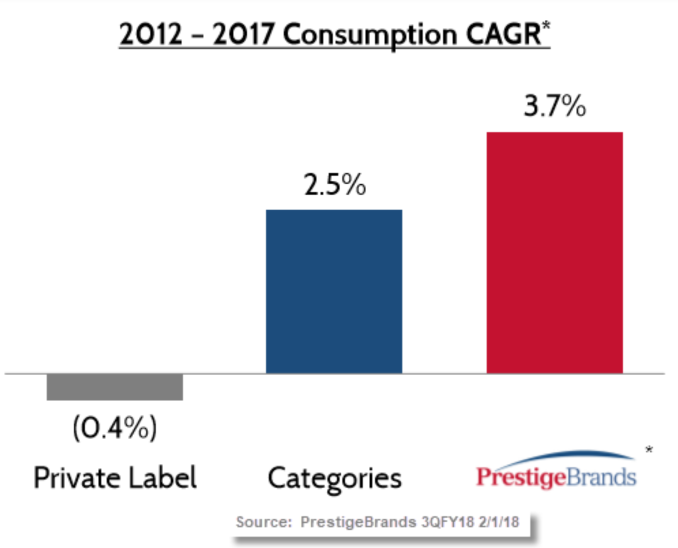
Prestige Brands Holdings, Inc. (PBH)

February 12, 2018

Rev/Employee: $1.83 M	**Number of Employees: 530**	**Avg ROIC: 3.81%**	**Pharmaceuticals**

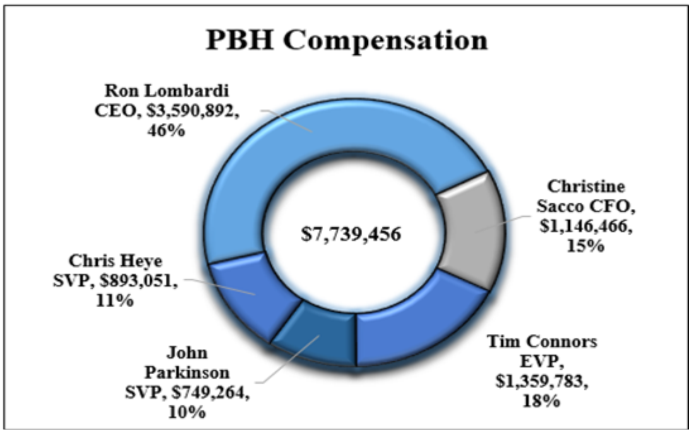
PBH: Serial Deals, Sluggish Growth

Prestige Brands Chairman, President & CEO Ron Lombardi (53) has continued to acquire major consumer brands that are struggling to grow. We think the CEO's strategy is sound, but this financially oriented CEO lacks the retailing and marketing talent to deliver. Management's operating returns have been modest and we think the Board has been lax in adjusting incentive metrics to drive accretive returns rather than just more deals. Over the past decade, first as CFO and now as CEO, he has assembled a portfolio of over 80 brands (Chloraseptic, Dramamine, Efferdent, Luden's) spanning eight categories across pharmacy shelves ranging from cough drops to feminine hygiene. CEO Lombardi says his firm is a consumer sales and marketing firm at its heart, but we think the business model is really one of serial acquisition and that his executive team lacks the marketing skill to generate substantial organic growth. Management will benefit substantially from the 2018 corporate tax reduction, but we expect most of the cash flow benefit to be absorbed by reducing the 5.4x EBITDA leverage ratio.



Executive Team Skills Fit CEO Lombardi's strategy is predicated on serial acquisitions of OTC pharma products with strong brands, but sluggish sales, that can be reinvigorated. We worry that the CEO is primarily a finance person, not a consumer marketer, and we think that's a problem when it comes to organic growth in a highly competitive sector. Lombardi has a strong finance resume and it includes prior CFO and COO roles and we like that he worked in a private equity controlled firm (Waterbury Int'l.). Because of the CEO's relatively narrow financial experience we particularly don't like that he holds all three "triple title" important roles in the corporation of Chairman, President & CEO and think the firm notably lacks a strong marketing person with proven results. Lombardi is a CPA with an MBA from American Int'l College. We worry that the many deals during Lombardi's tenure at PBH have increased the top-line, but generally failed to deliver operating leverage to investors and that private label store brands increasing undermine the PBH pricing model. The CEO says his serial acquisitions at PBH are not part of a roll-up strategy because integrating them into existing franchises is not his goal. Rather, he says, he's looking to broaden his portfolio "..we don't do M&A to increase cash flow or earnings, those are by-products of us doing M&A to build out a portfolio that will sustain long-term organic growth improvements to the existing businesses." The most recent acquisition (Fleet, makers of Summer's Eve) fits the profile and Lombardi says it makes about 85% of his brand portfolio above average growers targeting 3% growth rates (with the remaining 15% being managed purely for cash flow). CEO Lombardi says that PBH's segment of business has not yet moved online because his consumers need the products in an immediate time frame to treat their ailments and we think that's a valid competitive advantage. We like that PBH products are generally less susceptible to promotional pricing because of their immediacy-of-use factor, but only 25% of the firm's brand names are ranked 1 or 2 in their respective category, which we think makes the other 75% much more susceptible to private label store brand price competition. Lombardi was promoted up to CEO in June of 2015 and was previously the firm's CFO for 4.5 years. His successor, Christine "Chris" Sacco (42), was brought in as CFO in September 2016, following David Marberger's departure (after only 8 months) for the CFO role at ConAgra Brands. CFO Sacco did not have any prior public company experience, but does know the industry and has strong accounting skills. She previously worked at Boulder Brands for eight years, including the last 4 years as CFO (prior to its acquisiton by Pinnacle Foods in January 2016). She started her career as an auditor at Ernst & Young. We worry that the CFO has struggled to deliver acquisition integration synergies with the Fleet acquisition and that DSO trends are negative. CFO Sacco has a CPA and a BS in Accounting from St. Thomas Aquinas College. EVP, Sales & Marketing Tim Connors (50) has been with PBH since April 2010. He initially started as the firm's CMO, but been in his current role since 2011. Prior to joining PBH, he worked at Matrixx Initiatives (consumer healthcare) for 5 years and held similar marketing roles at a series of large consumer products companies including Benckiser, Nestle and Clorox. SVP, International John Parkinson (64) is an Englishman and one of the longest tenured PBH executives. He has been the head of international (ex US & Canada) since 2005, but we note a decline in his share of the firm's results (8.9% of FY’15 revenue to 8.4% in FY’17, despite 2 acquisitions). He is a former ConAgra executive where he worked for 5 years, including as a Business Director in Asia Pacific. SVP Chris Heye (54) joined PBH in 2016 as the head of Canadian sales, Women’s Health, and Strategic Planning. We don't think Heye has the right background for success in consumer products marketing. He previously was the CEO of 3 privately-held companies, Cyclo Industries, Sargent Art, and Pulvitec a specialty chemicals company from 2012-2016.

Compensation and Alignment Analysis Management pay at PBH is reasonable, but we don't like the sales and EBITDA metrics used to determine both cash bonuses and management's long term equity "LTIP" vesting. Both metrics unduly reward serial acquisition growth that may not be accretive for investors. We also note that management's total cash pay (salary + bonus) is roughly 50% of the total pay package and think the plan should be more heavily weighted to LTIP elements. CEO Lombardi’s total pay last year was worth about $3.6 million. He is paid an $850k salary (with a 100% bonus target) and received a $975k cash bonus with $1.8 million in equity last year. CFO Sacco’s pay was pro-rated since she was hired in September of 2016. She receives a $487k salary and received $713k in equity, with her bonuses totaling $73k. Her predecessor and former CFO Marberger’s base salary was $500k, and his bonus and equity were targeted at the same 60% and 150% as Sacco currently has. Upon joining PBH, CFO Sacco also received a $713k equity grant in a good performance mix of 67% options/33% time vesting restricted stock RSUs. EVP Connors, SVP Parkinson, and SVP Heye were paid a combined $3.1 million ($1.1 million salary, $622k bonus, $1.4 million equity, $41k other pay) in 2017. Management's annual cash bonuses are based on two metrics, net sales and adjusted EBITDA (20/80% weights respectively) that we think overly incentivize further serial acquisitions and top line growth. EBITDA is highly subjective in excluding M&A charges and we think the Board should add a measure of ROIC to improve management's alignment with outside investors. The management equity LTIP is currently split evenly between performance stock PSUs, options (that time vest ratably over 3 years), and RSUs (that cliff vest after 3 years). The current plan is reasonable, but we prefer the old LTIP equity mix of 67% PSUs/33% RSUs. We note that the PSUs vest based on a 50/50% mix of EBITDA and net sales targets, over a 3 year period. We think these metrics are biased toward M&A incentives for the CEO and the team rather than accretive operating results. The management team all received significant $2-$2.5 million stock awards in 2016 and also were paid Fleet Integration Bonuses amounting to another 10% of the team's target cash bonus last year, based on the Board’s assessment that there was “significant effort required and put forth by our management team”. We note that CFO Sacco received a Fleet Integration Bonus based on June results, despite joining PBH in September 2016 while the deal was completed in January.



Equity Ownership Analysis We don't like that the management team has a minor equity stake in their own firm. Directors and officers as a group beneficially own about 721k shares, or 1.4% of the Company. CEO Lombardi is the only material stockholder on the management team with a beneficial stake of about 310k shares of PBH. This represents a modest 3x his FY ’17 total compensation and we note that the Board guidelines are for the CEO to own at least 4x his base salary ($3.5 milion). CFO Sacco holds only 9k shares, although we note she must get to 3x her $487k salary, which requires more than quadrupling her share total at the current price. SVP Heye owns just 8k shares, although he is only coming upon his 2nd anniversary with PBH. He also has to boost his stake in order to meet his 2x holding requirement. EVP Connors and SVP Parkinson own a combined 252k shares, totaling 0.4%. The senior executives have 374k options, although CEO Lombardi holds about 55% of the total. With a $35.94 weighted average strike price (range from $11.27 to $57.18) these at-the-money options currently provide good alignment with shareholders. Insider selling has not been meaningful.

Capital Allocation Practices We think management's serial acquisition strategy has only been modestly accretive over the years. For that reason, we like that CFO Sacco says that they are shifting the firm's emphasis this year to paying down debt rather than new acquisitions. Management's absolute debt totals have risen from under $1 billion at the end of FY ’13 (67% debt/total capital) to about $2.22 billion (73%) at the end of FY ’17 and just over $2 billion currently. YTD through the third quarter of 2018, management has paid down about $145 million in debt. We like that the firm has disposed of five brands that did not meet their market targets in 2017. CFO Sacco says she will announce the plan for the expected additional $10 million to $15 million in cash flow resulting from US corporate tax cuts in May, which we expect will mainly go toward debt reduction. Fleet was their most recent acquisition in women's health. The $825 million acquisition added attractive brands, but they did not come cheap, at 11.8x adjusted EBITDA, and we note that one product (Summer's Eve douche) represents about 65% of TTM sales for Fleet. PBH has higher leverage than most of its consumer product peers with Q3 ’18 net leverage of 5.4x EBITDA, although we note most of the debt matures after 2022. The CEO says the firm's strong free cash flow justifies this multiple, but we think it makes PBH vulnerable to price and volume competition across the industry. CFO Sacco has been using PBH’s free cash flow to repay $145 million in debt, down to about $2.08 billion (a 63% debt/total capital ratio). CapEx needs are modest, with an expected $10 million to $15 million this year, but we expect steady upward pressure on marketing expenditures to support the brands.

Material Fiduciary Issues We think the PBH Board needs younger Directors with relevant CPB experience, with 4 out of 7 current Directors in their late-60s/early-70s. Chairman Lombardi (53) is the only Director under 60 years of age. Gary Costley, PhD (73) is the Lead Director and has been on the Board for almost 14 years. He is the former president of Kellogg's North American operations where he worked for over 24 years (ending in 1995). Walmart is PBH’s largest customer, and its share of revenue is growing, from 18.1% in FY’15 to 21.1% in FY’17.