BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Anheuser-Busch InBev (BUD) EQ Review

Current EQ Rating*	Previous EQ Rating
3-	na

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

*For an explanation of the EQ Review Rating scale, please refer to the end of this report

We initiate earnings quality coverage of BUD with a 3- (Minor Concern) rating.

BUD is one of the Large-cap stocks that has not seen a nearly full price recovery since May. Some of the reasons behind that are the continued focus on its debt level and just how quickly will business recover for bars and sporting events. We have followed this from afar as a large investment for Altria (MO), which has yet to write down the carrying value of its BUD investment to fair market value. We thought the SABMiller deal may have been a Bridge Too Far in terms of debt load and lack of cash flow to sustain the dividend, which now has been cut twice.

We are looking at BUD on pre-COVID results and the assumption that it can return to that level of business over time. Interestingly, BUD's accounting appears conservative in several areas regarding the income statement. For a company with adjusted EPS of $3.99, we aren't complaining about the adjustments. We found another 22-cents of items that helped EPS that investors may want to be aware of.

The bigger issues with BUD are balance sheet related in our view. Debt reduction is largely coming from asset sales, which in turn lowers cash flow. It may take several more years for BUD to approach the goal of Net Debt/EBITDA at 2.0x. The level of free cash flow is simply very small even after the dividend cuts. That means a modest return of capital to shareholders for some time too. The balance sheet and cash flow are also supporting a huge intangible asset figure on an ROI of about 9% pre-COVID.

- **Normalized EPS is actually just adding back one-time items like restructuring charges, legal issues, and asset write-downs. BUD is not adjusting EPS to add back stock compensation, amortization, and other recurring items. That is a positive in our view.**

- **We still have some issues with EPS as BUD earned 6-cents of its $3.99 in 2019 from gains on assets sold. It added another 16-cents from cutting marketing expenses in dollar terms as it focuses on raising prices.**

- **Lack of amortization of intangibles is another complaint for the income statement. There is $170 billion in intangible assets an only $2.4 billion are being amortized.**

- **BUD does a great job with FX and Hyperinflation discussion and disclosure. It breaks this down in revenue, costs, income, and EPS. EPS was hurt by 27-cents in 2019 from FX which included 6-cents from Argentina's hyperinflation.** BUD also singles out the South American segment where investors can clearly see FX is hurting revenues and squeezing margins.

- **Our minor issue on FX and hyperinflation is BUD still claims total organic growth is 4.3% on 1.1% volume growth to point to its efforts to boost prices are working well. Pulling South America and its hyperinflationary price hike out of the mix, lowers the 4.3% figure to 3.1%.**

- **Debt reduction has come almost exclusively from asset sales. Asset sales cut the debt figure, but also cut cash flow. The net ratio is still about 4x EBITDA. After the SABMiller deal, free cash flow was $13-$15 billion with $5 billion in capital spending. The dividend was consuming $9 billion.**

- **The cash flow figures include $3 billion in synergies and BUD cut the dividend to $5 billion – and reduced it again in 2Q20 to maybe $2.5-$3.0 billion). There just isn't much cash flow left to cover debt reduction.**

- **Investors may want to focus on this area. Even with another dividend cut, it may take years to reach the debt paydown target –** before factoring in COVID. That means less cash for shareholders as dividends and stock repurchases. We also see that BUD is not close to its initial goals on growth or total sales since the merger, which is another reason the cash flow isn't here to retire debt rapidly.

- **We found another $21 billion in contingencies facing BUD too.** These include deferred consideration for acquisitions, the underfunding pension fund, and several tax disputes. **We do not believe BUD will have to fund all of this at once or even the full $21 billion ever. However, we think investors should view some of this a possibility and it would need to be paid out of the smaller free cash flow figure – not EBITDA.**

- **The intangibles have not had an impairment, but ROI is only about 9% pre-COVID at BUD.** It considers units where goodwill is under 9x EBITDA to be unlikely candidates for a write-down. **However, 51% of Goodwill is for Columbia, South Africa, and the rest of Africa and Middle Americas. It is using hurdle rates that are lower than those countries' 10-year bond rates in many cases.** That hurdle rate may be too low and may be more likely to rise going forward.

Normalized EPS vs GAAP Is Adjusting for Actual One-Time Items

Long time readers know that we do not have a major issue with a company calling out something like a legal settlement or repaying debt early calling the accelerated recognition of deferred debt issuance costs as one-time events. Where we have problems is when companies want to add back stock compensation or FX expenses that occur every year as one time in nature. BUD's reporting isn't perfect, but it is higher quality than many others:

BUD	2019	2018
Profit from Cont. Ops GAAP	$8,747	$3,839
less Non-Controlling Interest	-$108	-$32
Add Non-Recurring Taxes	$6	-$233
Add One-Time Financial Chgs	-$882	$1,982
Add Restructurings	$323	$692
Normalized Profit	$8,086	$6,248
GAAP EPS	$4.32	$1.91
Normalized EPS	$3.99	$3.11

- The restructuring looks one-time to us. It is actual integration payments along with one-time costs to settle legal issues and issue shares.

- The one-time financial charges include some actual one-time events too. In 2019, there was a $188 million charge to write down the value of a subsidiary due to Zimbabwe hyperinflation and a $34 million charge to settle a tax dispute.

- The remaining financial charges relate to changes in derivative values and mark-to-market issues for hedges. In 2018, this produced $2.0 billion in losses and in 2019, the marks reversed to become $1.1 billion in income.

We do not have a problem with these adjustments. We also give BUD credit for not adding back amortization or stock option expense. There are three things we would take issue with:

- In other operating income, **BUD has gains on the sale of property added in for both sets of EPS.** We would put that more into the one-time category. **In 2019 this was $172 million. That added 6-cents to EPS in 2019 and 3-cents in 2018.**

- **BUD is helping EPS by cutting its "sales and marketing expense**." It is falling in absolute terms from $8.3 billion in 2017 to $7.8 billion in 2018 to $7.3 billion in 2019. **This generated 16-cents to EPS in 2019 and 18-cents in 2018.** The company's goal is to drive people to pay higher prices for premium beer. That may be tough with COVID, but it normally requires advertising as part of the cost of pursuing premium prices. We expect marketing to fall during 2020 and

won't necessarily consider that a red flag given bars and sporting events were closed. But, longer-term, we would expect marketing to be a headwind.

- **For a company that was built via several acquisitions, it amortizes almost none of the cost.** It is carrying $128 billion in goodwill that is not being amortized. It has another $42.5 of intangible assets and only $2.4 billion of that is being amortized. Amortization of these assets was $445 million in 2019 or a 16-cent headwind to both sets of EPS. Even amortizing the brands and distribution rights over 40-years, would be costing EPS another 36-cents.

FX, Hyperinflation, and Organic Revenue Issues

We have seen several companies who make a point of touting their organic revenue growth defined solely as price x volume while often ignoring FX impacts and acquisition/divestiture items. BUD actually does a good job in this area:

- It often points out that it gets 70% of its revenues in non-US dollars.
- BUD notes that it tries to lock in its expected exposure to key currencies in Brazil, Argentina, and Mexico
- The company provides some sensitivity analysis around FX issues where possible.
- It does not pull out FX in adjusted results.
- It highlights in total and segment results – where the FX issues are occurring, and it carries the FX impact all the way through costs to income.
- It further provides tables showing the impacts of hyper-inflation so it can be isolated for the impact on EPS.

So, while we follow some companies like Sealed Air where at first glance investors would think South America is the engine driving the whole company – we give BUD some applause for trying to honestly call attention to what is real growth and what is inflation driven.

BUD provided this data for 2019 and 2018:

Impact of FX	2019	2018
Revenues	-$2,664	-$1,823
EBITDA	-$1,123	-$955
Income Cont. Ops	-$582	-$684
EPS	-$0.27	-$0.26

Furthermore, BUD provides disclosure for just the hyperinflation impacts that tend to show up as FX losses. In 2019, hyperinflation hurt EPS by 6-cents and in 2018, it was lower by 11-cents. It also has South America isolated on its own where half the FX hit came from:

South America	2018	FX	Org Growth	2019	Org. Growth
Volumes	135.6		3.8	139.7	2.8%
Revenues	$10.2	-$1.4	$0.9	$9.8	9.0%
Gross Profit	$6.4	-$0.9	$0.2	$5.8	3.2%
EBIT	$3.7	-$0.5	-$0.1	$3.2	-2.8%
EBITDA	$4.7	-$0.6	$0.0	$4.1	0.4%

The organic growth without the FX (and minor acquisitions/divestiture impact) is shown. However, the actual results with the FX hits is also shown. Plus, the hefty FX adjusted revenue growth is shown alongside falling profits. The adjusted EBITDA margin fell 403bp. That is all great disclosure in our view.

The one place we have an issue is BUD still does point out its focus on boosting prices to drive margins and earnings growth. It notes that 2019 revenue grow 4.3% on only 1.1% volume growth. But looking more closely, the places they are getting the most pricing are in the inflationary spots with FX issues that offset it. The cuts to marketing discussed in the prior section may have an impact here going forward:

2019 BUD	Rev Growth	Volume	Pricing	FX impact	FX in $
Total BUD	4.3%	1.1%	3.2%	-5.0%	-$2,664
North Am.	0.2%	-2.4%	2.2%	0.0%	-$49
Middle Am.	7.2%	3.8%	3.4%	-3.3%	-$381
South Am.	9.0%	2.8%	6.2%	-13.5%	-$1,383
EMEA	3.4%	3.4%	0.0%	-6.3%	-$528
APAC	1.9%	-2.9%	-1.0%	-4.7%	-$314

Just pulling the organic growth from South America out of the 4.3% company growth rate, would cut organic growth to 3.1%. Given that total organic growth in South

America was $924 million but it is offset with $1.4 billion in FX losses – we think this adjustment should be made also for the discussion of real organic growth. **Also, Middle America's 3.4% pricing impact is essentially wiped out by the negative 3.3% FX issues. The only place with clean price hikes is North America and it has negative volume.**

Debt Pay Down Is Almost Exclusively Coming from Asset Sales

Before the SABMiller deal, BUD had essentially a debt/EBITDA ratio of 2.3-2.5x. Debt was $42 billion, and EBITDA was $18 billion. It paid $124 billion for SABMiller with $6.7 billion in normalized EBITDA. Simultaneously, it sold several parts of the company: the SAB stake in Miller/Coors, Some SAB European brands, Some SAB Eastern European brands, SAB's stake in China Snow beer, and the African bottling operation. That lowered net debt and EBITDA. When those deals were complete, BUD reported Net Debt at $104.5 billion and normalized EBITDA in 2017 of $22 billion for a ratio of 4.75x. The asset sales generated $24.6 billion in cash.

The focus was still to pay down debt further going forward, but there simply wasn't much free cash flow left:

BUD	2019	2018	2017	2016
Cash from Ops	$13.4	$14.2	$15.4	$10.1
CapX	$5.2	$5.0	$4.7	$5.0
Dividends Paid	$5.0	$7.8	$9.3	$8.5
Net Change in Debt	-$8.0	-$4.7	-$10.0	$62.7

In 2017, the asset sale proceeds helped cover the debt repayment and in 2018, BUD used more of the cash from prior borrowing and asset sales to pay down debt. It also cut the dividend in half in 2018 to reduce that cash outflow going forward and preserve cash flow for further debt retirement.

In 2019, even with the lower dividend, BUD needed another asset sale to enable debt reduction – the sale of a portion of the APAC unit in Hong Kong for $5.6 billion to cover the difference between free cash flow after the dividend.

In 2020, BUD has cut the dividend again and completed the sale of Carlton & United Breweries in Australia for $11 billion in June. It drew its revolver for $9 billion and issued $11 billion in bonds as well and likely that incremental borrowing is offset by a rise in cash on the balance sheet. We do not see a liquidity problem here with COVID and coming out of COVID.

We see four problems:

- BUD's target is to cut Net Debt/EBITDA to 2.0x. Net Debt should be about $80-$85b now after the Carlton sale (assuming the new bonds and revolver are offset by the cash raised). EBITDA before COVID was $21 billion – so Debt is still at 4x EBITDA

- It is still not in a position to retire debt in meaningful amounts from operations. Free Cash Flow is about $9 billion and if they cut both dividends in half to about $2.5 billion – it will take 7-years to reach that goal. That's still much faster than when the dividend was consuming $5 billion in cash before the latest cut.

- The company claims it already achieved synergies from the SAB merger of $3.2 billion – so those are in the $21 billion EBITDA figure.

- Any time BUD sells assets – it cuts debt, but it also lowers EBITDA. Plus, they are selling assets for a lower multiple of EBITDA than they paid for SAB. They paid over 18x EBITDA for SAB, the largest sales happened at multiples of 11x, 9x, and 15x.

Given that COVID will mean lower sales and earnings for a while and BUD wants to preserve liquidity; that may slow debt repayment and make the effective debt/EBITDA figure rise. BUD's order of cash usage is 1) investment in the operating business, 2) debt repayment, 3) mergers/acquisitions, and 4) shareholder payments via dividends and repurchases.

It is probably worth remembering that at the time of the SAB deal, many of the divestures were already known, but BUD talked about reaching $100 billion in sales by 2020 driven by Africa. Some of this goal was likely what was supposed to be

retiring debt and/or boosting EBITDA to lower the debt/EBITDA ratio. That would have required about 9% sales growth for several years. BUD is nowhere close to these forecasts:

- Revenue in 2019 came in at $52.3 billion. Taking out the Carleton deal cost BUD only $1.4b in sales.

- Volume growth was only 1.1% and adding back FX charges and adjusting for divestments – dollar growth was 4.3%. In 2018, Volume growth was only 0.3%, adding back FX and adjusting for divestments – dollar growth was 4.8%. We think that is being helped by inflation in South America.

- African sales are in the EMEA unit where total volume growth was 3.4%, helped by South Africa at mid-single-digit gains, Tanzania and Mozambique were down, other countries were up. In 2018, EMEA volumes were up 2.3%, but South Africa was down by mid-single digits, and Africa without South Africa was down low-single digits.

- EMEA dollar revenues fell 5% and Normalized EBITDA margins fell 290bp. In 2018, EMEA dollar revenues rose 4.1% and Normalized EBITDA margins fell 100bp.

Many Potential Contingencies Remain that Could Consume Cash Flow

None of these issues are very large by themselves. Many have been outstanding disputes for several years as well. We doubt that BUD would need to suddenly write a check for all of this at any one time and any payments may be stretched out over time. We would consider any one of these to be fairly immaterial. However, we think investors should be aware that:

- In total, these various contingencies represent a material amount of liabilities.

- They should not be viewed in the context of BUD having a pre-COVID EBITDA of $21 billion. Instead, we think they should be viewed in the

context that Free Cash Flow has been $8 billion with a dividend of $5 billion (now perhaps $2.5 billion).

- Any contingency payments need to come out of the remaining $3-$5 billion available that is supposed to be retiring debt.

We are simply going to list these and not try to assess timing or probability.

- Deferred consideration for prior acquisitions - **$1.6 billion**
- The Pension plan is underfunded by **$2.7 billion**. This rose last year on a 100bp drop in the discount rate. Also, BUD has been paying about $300 million per year into the pension plan, which would already be reflected in the free cash flow figures.
- Tax matter on foreign earnings in Brazil – estimated exposure **$1.8 billion** – probable loss $13 million.
- Tax matter on InBev Goodwill in Brazil – estimated exposure **$2.5 billion**.
- Tax matter on BAH Goodwill in Brazil – estimated exposure **$2.2 billion**.
- Tax matter on CND Holdings Goodwill in Brazil – estimated exposure **$0.3 billion**.
- Tax loss offset dispute in Brazil – estimated exposure **$0.1 billion**.
- Disallowance of non-deductible expenses for Brazilian taxes – estimated exposure **$1.2 billion**.
- Disallowance of taxes paid abroad – estimated exposure **$2.5 billion**.
- Dispute over Presumed Profit method of calculating taxes – estimated exposure **$0.5 billion.**

- Dispute over Interest on Capital deduction – estimated exposure **$1.0 billion.**

- Dispute over Free Trade Zone Credits – estimated exposure **$1.0 billion**.

- Excise tax dispute – estimated exposure **$0.4 billion**.

- Three disputes over legality and differences in assessment of tax credits – estimated exposure **$2.5 billion** in total.

- Dispute over non-compliance in a tax incentive agreement – estimated exposure **$0.1 billion.**

- Tax dispute over bonus payments to customers – estimated exposure **$0.6 billion**.

- Mexico tax dispute over intercompany transactions – estimated exposure **$0.3 billion.**

In total, this is $21.3 billion in contingencies. We didn't list a minor one in Australia as that may have transferred with the sale of Carleton. Most of these disputes are in Brazil. We again want to emphasize that we do not think all of these will need to be paid in full. However, it may not be unreasonable to forecast that BUD will make payments of $0.5 - $1.5 billion per year for 2-4 years. And in our view, the cash flow to cover those payments isn't very big and it is now impaired by Covid.

Virus issues straining the government may also lead Brazil to make an offer to BUD – let's clear the decks – and offer a settlement of all these disputes for a one-time payment of $3-$5 billion. That is pure speculation on our part, we are simply looking at all of this in total and thinking, BUD is unlikely to lose all of these, but it probably doesn't win every dispute either.

What About the Carrying Value of the Intangibles?

As noted earlier, BUD is carrying $42.5 billion of intangibles with $40.0 billion not being amortized and another $128 billion of Goodwill. Those items are over 70% of assets and 200% of equity. Despite making several divestitures at EBITDA multiples lower than what BUD paid for SABMiller – there have not been impairments. Despite offering a plan to grow sales at 9% compounded for several years to reach $100 billion in revenues and missing – there have not been impairments.

Normalized EBITDA is basically $21 billion and has been that level for three years. We also know that the basic business needs about $5 billion per year in cash flow. Debt and Equity were $180 billion at the end of 2019. That makes ROI 8.9% on EBITDA less capital spending. At this point, we know COVID is hurting EBITDA and we know net debt has fallen after the Australian sale. We are not going to speculate other than guidance would indicate that ROI is lower now with COVID. Based on 2018, ROI was 9.1%. We are going to view that as what the non-COVID BUD is doing for ROI – basically 9%.

BUD considers the operating units where Goodwill is less than 9x EBITDA to be unlikely to suffer an impairment. For those that have Goodwill above 9x EBITDA, it does a discounted cash flow analysis. There are four main regions where this next step comes into play accounting for 51% of Goodwill:

Region	Goodwill	% total Goodwill	W.A.C.C
Columbia	$18.6	15%	6%
Rest Mid Am	$25.3	20%	9%
South Africa	$13.5	11%	7%
Rest of Africa	$6.7	5%	10%

BUD does not believe a 1% change in the discount rate would create an impairment. We have an issue that the discount rates may be more than 1% too low. South African 10-year bonds are over 9%, Columbia's are over 6%, Mozambique is over 10% to point to a few of those places. And shouldn't a beer company with considerable marks due to FX changes have a higher hurdle rate than the 10-year bond? A recession may also move those rates higher by more than 100bp.

By comparison, the other intangibles are 55% located in the US. Columbia (9%), Rest of Middle Americas (10%), South Africa (9%), Rest of Africa (3%) make up 31% so there are still some issues. BUD uses a similar process to value the intangibles and test for impairment. Low interest rates may be lowering hurdle rates and helping avoid an impairment. But we think a company with a 9% ROI when things were great may still have an impair

Explanation of EQ Rating Scale

Rating	Description
6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

Disclosure

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