BEHIND THE NUMBERS
Quality of Earnings Analysis

February 23, 2024

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

The Coca-Cola Company (KO)
Earnings Quality Update

We are maintaining our earnings quality rating of KO at 3- (Minor Concern).

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

Summary

KO's 4Q23 adjusted EPS of $0.49 hit the estimate and the full-year adjusted EPS was $2.49. The company still looks overly dependent on, pricing but is calling for organic growth of 6%-7% in 2024 which is down from the 12% posted in 2023. We see several areas where KO picked up EPS that may not repeat.

- Pricing was up 9% in 4Q and 10% for 2023. If the pricing had been up only 8% and 9% in those periods, KO's EPS would have been 2 cents lower in 4Q and 8 cents lower for 2023. Some of the pricing gains were from earlier hikes that are still annualizing. A big part (discussed below) is KO boosted prices in places where FX is normally a sizable headwind and simply was not in 2023. Their guidance is for the FX headwind to ramp up in 2024. This looks like a place where KO could disappoint.

- Depreciation has declined for several years now. This added 0.7 cents to 4Q23 EPS and 2 cents to 2023 full-year EPS. However, capital spending is rising from 2020 levels and guidance for 2024 is $2.2 billion.

KO Depreciation	2023	2022	2021	2020	2019
Depreciation	$1,018	$1,125	$1,262	$1,301	$1,208
CapX	$1,852	$1,484	$1,367	$1,177	$2,054

- Stock compensation dropped $6 million y/y in 4Q, only helping by 0.1 cents, but was down $102 million for the year adding 1.9 cents. There was some catching up after 2020, but the $254 million recognized in 2023 looked low to us. This shouldn't become a big headwind in 2024, but likely won't be a tailwind.

- Interest income is real money and increases EPS, but it should not be considered operating income. This rose by $124 million and $458 million for 4Q23 and full year 2023. That added 2.3 cents and 8.5 cents.

- On cash flow, we see that KO has set up a factoring system for suppliers to sell the KO payables and collect cash earlier. KO has boosted the time it takes to pay its suppliers in recent years:

KO Payables	2023	2022	2021	2020	2019	2018
Accounts Payable	$5,590	$5,307	$4,602	$3,517	$3,804	$2,719
Adj. COGS	$18,465	$17,817	$15,410	$13,498	$14,659	$13,125
Days Payable	110.5	108.7	109.0	95.4	94.7	75.6
Amount Factored	$1,421	$1,351	$882	$703	$784	n.a

Ten days of payables has added about $500 million to cash flow in recent years. The bigger question is can Coke stretch it further? The amount factored was $1,421 and $1,351 for 2023 and 2022, which is 25% of total payables. It used to be 20% was factored. Falling costs may cause the total payables to decline too and become a cash flow headwind. Free cash flow was $9.75 billion and $9.5 billion in the last two years and the dividend is $8 billion. Now cap-ex is rising in 2024. Can they match past cash flow growth from higher payables?

- KO has also been pulling cash from receivables. It started to sell receivables in 4Q20. It does not list the amount of receivables sold at the end of the year, only the amount sold during the year. This has grown rapidly:

KO Receivables	2023	2022	2021	2020	2019	2018
Accounts Receivable	$3,410	$3,487	$3,512	$3,144	$3,971	$3,685
Amount Factored	$17,704	$10,709	$6,266	$185	$0	$0
Fees paid	$83	$27	$5	$0	$0	$0

When receivables are sold, they are normally derecognized from the balance sheet. KO does not give an ending year figure so we cannot compute DSOs. However, notice that despite price hikes helping sales by 10% recently, the receivables still on the books have gone down since pre-Covid levels and since 2021. KO factored an additional $7 billion in receivables in 2023 than in 2022. This is benefitting cash flow, but we can't fully quantify it. Also, note that the fees to do this are going up. In 2023, the net change in fees was a 1-cent headwind for EPS.

- The basic components of pension cost have been a headwind for KO due to higher interest cost and lower expected rate of return. This was a 0.5-cent headwind for 4Q23 and 3.2-cent headwind for 2023. For 2024, KO cut the interest assumption by 50bp, which may mitigate some of this.

What to Watch:

- Coke is calling for more FX headwinds in 2024. That would be normal compared to what they have been experiencing the last two years. The company has enjoyed enormous pricing gains, especially in Latin America and not given them back as FX losses. As we show below, this could unwind a large amount of revenue growth. Also, Coke may face pricing pressure because its currency-neutral results simply pull out translation gains/losses and hedging gains/loss for sales that are made. It cannot quantify sales Coke lost because it was priced at too high of a premium vs. local products. **(See Below).**

- Coke lost its transfer-pricing dispute with the IRS in November. It is working on an appeal in Tax Court now and may appeal behind that. The dispute involves the years 2007-09 and Coke now has a payment to make of as much as $5.8 billion. This has implications for reported taxes for years post 2009 to move the total bill to $16 billion and even Coke says it could boost its tax rate by 350bp. The company reports free cash flow of $9-$10 billion and pays $8 billion in dividends. It also repurchases shares. These tax issues could derail the share buybacks **(See Below).**

An FX Normalization Returning Would Dampen Recent Growth

KO reported strong pricing in the past too – but much of that was given back in FX losses? In 2020, KO saw negative pricing and negative FX. This bounced in a big way for 2021 coming out of Covid.

Total KO	2023	2022	2021	2020	2019	2018	2017	2016	2015	2014	2013
Coke price chg	10%	11%	6%	-2%	5%	2%	3%	3%	2%	1%	1%
Coke FX	-4%	-7%	1%	-2%	-4%	-1%	-1%	-3%	-7%	-2%	-2%
Net pricing	6%	4%	7%	-4%	1%	1%	2%	0%	-5%	-1%	-1%
Latin America											
Latin Am price chg	16%	17%	12%	2%	13%	10%	8%	13%	9%	8%	10%
Latin Am FX	-3%	-5%	0%	-14%	-10%	-9%	0%	-18%	-23%	-10%	-8%
Net pricing	13%	12%	12%	-12%	3%	1%	8%	-5%	-14%	-2%	2%
Asia Pacific											
Asia/Pac price chg	5%	3%	-2%	-2%	0%	0%	-1%	-2%	3%	4%	2%
Asia/Pac FX	-5%	-9%	3%	0%	-1%	1%	-4%	1%	-14%	-8%	-7%
Net pricing	0%	-6%	1%	-2%	-1%	1%	-5%	-1%	-11%	-4%	-5%
Europe											
Eur/ME price chg	19%	16%	6%	-5%	4%	3%	3%	2%	1%	4%	5%
Eur/ME FX	-12%	-14%	1%	-2%	-9%	-1%	-2%	-3%	-9%	2%	0%
Net pricing	7%	2%	7%	-7%	-5%	2%	1%	-1%	-8%	6%	5%

- If we consider 2020 and 2021 to represent an absurdly low year with a recovery, it still looks like over time, KO nets out to about 1% pricing in most years.

- 2022 and 2023 look like the exceptions. The company has openly pointed out that it took pricing due to inflation in 2022 and 2023.

- But look at the key parts of FX. Asia is normally about 0% or negative for net pricing for Coke and that has not changed.

- Historically, Latin America has seen the highest pricing gains of any region. However, until 2022 and 2023 – FX more than offset all the pricing and KO often reported negative net pricing here.

- Europe's net pricing looks to be basically flat over 10 years until 2023.

There are several reasons why this is important in our view. KO reports organic growth without FX hits – simply volume and pricing change. The company's volume growth has slowed already to low single-digit. Pricing gains are weakening already too, which KO expects to continue. It said on the earnings call that 90% of its pricing in 2023 was annualizing prior price hikes – it didn't represent new ones. It also called out some mix changes that added some timing-related pricing gains and that does not sound like it will repeat.

It also said that hyperinflationary countries were about 3% of the pricing. We consider this an area where organic growth that excludes FX hits can be very misleading. A company is telling investors that its strongest growth is really coming from the weakest places on the earth because pricing rose 50% y/y and the -70% FX hit is ignored. (We made those numbers up to prove the point.)

It also means KO could have a tougher time raising prices overseas if the local currency is falling in value, which would squeeze margins and sales. KO touts "Currency Neutral" results, which remove the movements of FX and hedging programs when foreign results are translated into dollars. Currency neutral results cannot quantify sales that didn't happen due to higher prices on KO products as the local currency depreciated and consumers bought more of the cheaper local products instead. Look at the fat spread between Pricing and FX that Coke has enjoyed overseas in the last two years and ask yourself if this is sustainable.

Coke	4Q23	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22
Latin Am PX	14%	15%	17%	18%	26%	12%	12%	19%
Latin Am FX	-8%	4%	-4%	-5%	-7%	-6%	-1%	-6%
Eur/ME PX	24%	19%	14%	22%	15%	19%	21%	6%
EUR/ME FX	-14%	12%	-9%	-13%	-16%	-16%	-13%	-9%
Asia/Pac Px	10%	1%	5%	5%	7%	4%	-3%	6%
Asia/Pac FX	-5%	-4%	-5%	-8%	-14%	-10%	-8%	-5%
Volume	3%	2%	1%	1%	2%	4%	4%	11%

- Latin America is 13% of sales. Coke enjoyed double-digit net pricing growth in this region in six of the last eight quarters with pricing growth that far exceeded the FX hits. It even had a tailwind from FX in 3Q23. 4Q23 had 8% net pricing. Notice in the first table, that Latin America is normally a net price loser.

- Europe at 18% of sales had a strong recovery off of 2022 results. But does that continue? History would say no. Plus, they just posted 10% and 31% net pricing gains in 4Q23 and 3Q23.

- Asia at 12% of sales performed about as expected. 4Q23 looks like a rebound on an easy comp. Normally, Asia is net price loser for KO too, or at best a 0%.

The Tax Dispute May Be Coming to a Negative End

KO disclosed in its 10-K that the IRS ruled against KO in its transfer-pricing case for 2007-2009. Transfer pricing involves the allocation of revenues and costs between Coke entities in the US and in foreign markets. This case involves the IRS reallocating $9 billion of income to KO's US operation resulting in an additional $3.3 billion in US income taxes. This tax case was delayed pending the outcome of a similar matter against 3M and the Tax Court found in favor of the IRS in February 2023. That led to the Court finding against Coke on November 8, 2023. The total amount with penalties and interest is now $5.8 billion.

Coke is working on an appeal with the Tax Court, which would then go to the Court of Appeals. This is important for four reasons:

- KO's recent free cash flow is $9-$10 billion and its dividend is $8 billion. It is also buying back shares – this case could halt share repurchases for 2-3 years. The company may need to post the $5.8 billion to appeal above the tax court.

- If the IRS wins, it may decide to apply the new transfer-pricing rules to years 2010-2023, which Coke estimates the total cost could be $16 billion.

- The new rules on transfer pricing could raise KO's tax rate by 3.5% going forward too – (about $450 million per year or 10 cents in EPS).

- KO only has a reserve set up for $439 million so there could be more charges to earnings.

Explanation of EQ Rating Scale

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 Concern)- 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 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 upcoming quarters. 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

Behind the Numbers, LLC is an independent research firm structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. All research is based on fundamental analysis using publicly available information including SEC filed documents, company presentations, annual reports, earnings call transcripts, as well as those of competitors, customers, and suppliers. Other information sources include mass market and industry news resources. These sources are believed to be reliable, but no representation is made that they are accurate or complete, or that errors, if discovered, will be corrected. Behind the Numbers, LLC does not use company sources beyond what they have publicly written or discussed in presentations or media interviews. Behind the Numbers does not use or subscribe to expert networks. All employees are aware of this policy and adhere to it.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.