BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

Behind the Numbers

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Altria Group, Inc. (MO)
Earnings Quality Update

We are maintaining our earnings quality rating of MO at 2- (Weak).

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

Summary

MO's 4Q22 adjusted EPS of $1.18 beat by 2 cents. Investors cheered guidance of 3%-6% 2023 EPS growth fueled by another $1 billion share repurchase that should drive 2%+ of that forecast. As MO spends the cash it receives from Philip Morris as quickly as it comes in, it may be opening another hole in the boat.

- The IQOS patent issues were not ruled on until November 29, 2001, so 4Q21 still had at least two months of spending for the IQOS rollout – that was 1.5-2.0 cents in EPS in expense that didn't occur in 4Q22.

- MO added back 1.2 cents in litigation costs to EPS in 4Q22 and a drop in tax rate added 0.8 cents. Litigation is a recurring expense here.

- Pension income in the 4Q was flat y/y at $31 million vs. $33 million. We are surprised the interest cost assumption only moved from 2.0% in 2021 to 2.5% in 2022 Even another 50bp would have cost MO about 0.5 cents in 4Q22. The discount rate to determine PBO rose from 3.0% to 5.6%, so we would expect to see a higher interest cost assumption in 2023. This could add $150 million headwind to 2023 earnings – about 6 cents.

- Remember, the menthol ban in California only started on December 21, 2022 – 10 days of 4Q22. It's now a full headwind for all of 2023. California smokers may have stocked up before the ban too, minimizing volume loss in 4Q. The federal government continues to move forward with a national ban of menthol and cutting nicotine levels in cigarettes.

- Another $100 million writedown in the value of JUUL due to higher discount rates (and likely a review of weaker future cash flows). That reduces the value to $250 million from the original $12.8 billion.

- Auditors are watching for impairments at Skoal moist snuff too and list this as a critical audit matter. Skoal's trademark is $3.9 billion and most of the $5.2 billion goodwill at MO is for oral tobacco products. Volumes decay is happening here too. Even MO was talking about using higher discount rates to value assets just like it did with JUUL.

- Volume losses continue to accelerate for MO on tobacco volumes at -11% for 4Q22. Even management sees headwinds in 2023 from higher prices impacting smokers, they even admit people are smoking less. **(See Below).**

- Heated tobacco changes are great for late 2022 and 2023 as MO sold its share of the Philip Morris JV to roll out IQOS in the US for $2.7 billion. It is spending that money freely repurchasing shares. **(See Below).**

- PM may be able to speed a rollout of IQOS in the US because it does not have to worry about cannibalizing a traditional cigarette market like MO did. Now, PM can grab market share without regard to a partner trading 100% profit of cigarettes for a share of heated tobacco sales. History shows PM can take share quickly with heated tobacco. Can MO handle a large gap down in cigarette volumes in late 2023-2025 on top of its losses to higher prices? **(See Below).**

Volume Losses for Smoking Continue to Grow

We have addressed this in the past and we consider this the biggest risk to MO's operating model. It no longer loses smokers at a 2% rate – it's now compounding down by double-digit rates:

Altria Cigarette Vol. Growth	4Q	3Q	2Q	1Q
2022	-11.0%	-10.0%	-10.0%	-8.0%
2021	-8.0%	-7.0%	-4.5%	-3.5%
2020	-1.0%	-1.0%	-2.0%	-3.5%
2019	-6.0%	-7.0%	-7.0%	-7.0%

MO has always responded to this by increasing prices to offset the volume decay. However, as we noted last quarter (we don't have the data for 4Q22 yet), smoking revenue gains from price hikes no long offset revenue losses from lower volume:

MO Smoking Rev	3Q22	2Q22	1Q22
Pricing Growth	$480	$570	$411
Volume Decay	-$584	-$757	-$404

The company noted on the earnings call that some of the higher pricing in 4Q came from reduced promotional spending which nets against sales. That was true in three of the four quarters in 2022. And investors should also note that MO is seeing faster decay in volumes than the industry as a whole – so it is losing market share:

Vol. Decay	4Q22	3Q22	2Q22	1Q22
Altria	-11%	-10%	-10%	-8%
Industry	-9%	-8%	-8.5%	-6.5%

Inflation rates are coming down, but prices for gas, food, and many other consumer items remain higher now than in 2020 and 2021. That squeezes consumer wallets for disposable income to buy cigarettes. On the call, management noted that people are smoking fewer cigarettes per day and many are trading down from Marlboro at least part of the time to a cheaper brand. We will add that as people have returned to offices and work from home less often – they run into all the places where they cannot smoke more often too. Plus, the menthol ban in California has not impacted results yet.

Heated Tobacco Deals Should Help in 2023, but May Hurt Next Year

In October 2022, MO sold its JV rights to its partner Philip Morris (PM) for $2.7 billion. This JV was to sell IQOS devices – (heated tobacco and replacement heat sticks) in the US market. The rollout had already started in 2020 and 2021 in a few cities. It was derailed when the IQOS device was found to violate patents held by British American Tobacco and courts ordered the JV to halt all sales in late November 2021.

MO is spending this cash (the last $1.7 billion will be paid by July 2023) to fund share repurchases and retire some debt. In addition to the $2.7 billion in cash, PM intends to restart product supply for IQOS and HeatSticks for the US market in 1H23 and file a Premarket Tobacco Product Application in 2H23. Until April 30, 2024, MO can reintroduce this product in the US if PM gets the needed approvals. Until April 30, 2024, MO could earn some royalties.

There are several problems that could then start to go wrong for Altria if PM's plans work out:

- PM could roll out heated tobacco much faster than MO was doing it. Heated tobacco cannibalizes regular cigarette volumes and it does it quickly. Here is how it played out in Japan and Korea when Heated Tobacco hit the markets:

	2019	2018	2017	2016	2015
Japan Cigarette Vol.	158.0	167.3	171.5	179.0	182.3
PM Cig Vol	26.6	30.8	34.9	43.9	45.7
PM Heated Vol	25.8	21.4	31.3	7.1	0.0
Korea Cigarette Vol	68.6	69.5	70.6	73.6	67.3
PM Cig Vol	10.5	12.0	13.5	15.5	14.2
PM Heated Vol	4.6	5.4	1.4	0.0	0.0

- Notice that PM crushed its own traditional cigarette volumes in both markets down 42% from the year before heated tobacco was introduced in both countries. However, the heated tobacco allowed it to actually grow volumes in Japan in a declining market and hold total volumes in Korea.

- The US market is very different for PM – it doesn't sell cigarettes here. It won't be cannibalizing its own product. Instead, it will cutting volumes sold by MO and British American Tobacco.

- Without MO as a partner, PM gets 100% of the revenue too. It also won't have MO slow-playing the roll-out to only a few cities as it works to manage its cigarette decay and ensure that lost customers convert to IQOS where it would still get a percentage of that new pie.

- PM said on its 3Q22 conference call that it believes it can earn 3x the level of profit per unit in the US because of the high pricing already established by MO and others. Moreover, it values the US market at $20 billion and it bought the share it doesn't own for $2.7 billion. It could likely undercut traditional cigarettes on price and gather more market share that way too. What if MO loses volume and pricing power in addition to its already accelerating decay?

MO is already setting up a new JV with Japan Tobacco to introduce its heated tobacco product in the US. The first problem is it does not expect to file its Premarket Tobacco Product Application until 1H25. It may not be in a position to sell its own heated tobacco until PM has been in the market for 18 months. This new JV unleashes many of the same problems we have seen at MO's other diversification efforts:

- Traditional cigarettes in the US allow MO to earn 100% of the cash earnings. It has little marketing, it is still cutting promotional spending, all the distribution is already in place, and it doesn't need to build new production facilities.

- With Japan Tobacco, MO will lose 100% of cigarette earnings and only get 75% of earnings from heated tobacco. MO is already spending money to build out this JV just like it was doing with PM. This product should require more marketing and more training so it may not be as profitable on a pack vs. pack basis either. This isn't as bad as JUUL where MO was trading 100% cash cigarette earnings for a 35% stake in vapor equity earnings – but unless more people overall use heated tobacco than are currently smoking cigarettes – MO's smoking operating income should decline.

- Japan Tobacco is in the same position as PM – it has no cigarette market in the US to protect. It will be the junior partner here. Does MO try another slow roll-out with the Ploom product in an effort to keep regular cigarette smokers longer?

Lancaster Colony Corporation (LANC)
Earnings Quality Update

We are maintaining our earnings quality rating of LANC at 4+ (Acceptable)

Observations on the quarter:

- The tax rate was 22.8% in the quarter, down from 24.2% last year. Management called for a FY 23 tax rate of 24% after the September quarter so this quarter's 22.8% was likely below what analysts were modeling which would have been an approximate 2 cps tailwind. Management is now calling for 23% for the full year.

- Inventory levels continued to come down. The company built higher levels of stock coming out of Covid to assure availability to meet demand. This has trended down the last couple of quarters as shown in the table below showing DSI components for the last sixteen quarters:

DSI by Inventory Component	12/31/2022	9/30/2022	6/30/2022	3/31/2022
Raw Materials DSI	14.2	17.6	14.5	16.4
Finished Goods DSI	20.0	29.2	22.7	28.2
Total Inventory DSI	34.2	46.8	37.2	44.6
	12/31/2021	9/30/2021	6/30/2021	03/31/2021
Raw Materials DSI	15.6	14.8	15.4	13.7
Finished Goods DSI	27.4	33.9	23.0	21.1
Total Inventory DSI	43.0	48.6	38.4	34.8
	12/31/2020	9/30/2020	6/30/2020	3/31/2020
Raw Materials DSI	14.3	14.8	13.5	14.9
Finished Goods DSI	23.1	24.8	19.9	20.9
Total Inventory DSI	37.4	39.6	33.4	35.8
	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Raw Materials DSI	14.1	14.1	11.4	13.5
Finished Goods DSI	18.5	21.4	20.5	21.0
Total Inventory DSI	32.6	35.5	31.9	34.6

DSIs are now approaching pre-COVD levels. While lower production levels hampered cost leverage in the quarter, higher inventory should support gross margin in coming quarters. LANC utilizes FIFO/Average Cost accounting for inventories and it turns them very rapidly so it should be in a good position to realize the benefits of any decline in raw materials prices.

- To its credit, LANC does not offer a non-GAAP earnings figure. However, non-operational items impacted the comparisons in the quarter as last year's December quarter contained unusual benefits from a change in contingent consideration and was negatively impacted by an impairment charge. Both quarters also contain Project Ascent costs which are trending down. After all these items are removed, the operating margin fell from 12.5% to 12.3% compared to the GAAP figures which show an increase from 10.6% to 10.8%. The company has caught up in passing along higher costs to customers via higher pricing but this does create a dilutive effect on margins. Note that the company may have experienced cost inflation to a higher degree than some of its peers as its raw materials are skewed towards eggs and soybean oil which experienced unusually high inflation in the fourth quarter.

- Profits benefitted from lower spending on consumer promotions recorded in SG&A. Management cautioned that it expects to see higher spending in the back half which will be a drain on profit growth. Note that management indicated on the call that promotional trade spending recorded as a reduction of sales (rather than SG&A) was roughly flat in the quarter. Given that the company hopes to continue pushing through price increases and retailers are starting to talk about demanding price concessions, we would expect trade promotion activity to increase as well which would impact sales growth and profits.

- LANC began disclosing its accrued distribution costs as a separate item in its footnotes in the 9/22 quarter. These are included in accrued liabilities on the balance sheet and represent estimates of unbilled amounts to shipping carriers. They are shown below:

	12/31/2022	9/30/2022	6/30/2022
Accrued Distribution	$10.3	$15.0	$11.9

We don't have a year-over-year trend to get a solid sense of timing on these accruals. It is possible that the higher figure in the 9/22 quarter was a result of the timing of upcoming holiday shipments. For more insight we can view the trends in the accrued liabilities account as well:

	12/31/2022	9/30/2022	6/30/2022	3/31/2022
Other Accrued Liabilities	$48.5	$55.5	$50.6	$52.1
Other Accrued Liabilities Days	9.3	12.0	10.2	11.6

	12/31/2021	9/30/2021	6/30/2021	03/31/2021
Other Accrued Liabilities	$45.1	$52.0	$63.6	$57.6
Other Accrued Liabilities Days	9.7	12.2	15.0	14.5

	12/31/2020	9/30/2020	6/30/2020	3/31/2020
Other Accrued Liabilities	$52.6	$52.6	$54.8	$46.3
Other Accrued Liabilities Days	12.9	13.9	15.5	13.1

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Other Accrued Liabilities	$47.1	$52.1	$43.0	$38.4
Other Accrued Liabilities Days	12.2	14.2	12.1	10.9

Accrued liabilities have a history of trending down sequentially in the December quarter. However, they are down on a days of sales basis compared to the pre-Covd 2019 period. There has also been inflation in shipping and handling costs which makes the decline seem a little more unusual. Given the lack of visibility, we are not ready to raise alarm bells over this yet, but it is something to keep an eye on in upcoming quarters. Note that $4 million represents 11 cps.

- Note that amortization expense has been down about 2 cps in the last three quarters following the 3/31/2022 write-down of the Bantam intangible. The company has one more quarter of this tailwind left.

Mondelez International, Inc. (MDLZ)
Earnings Quality Update

We are maintaining our earnings quality rating of MDLZ at 2- (Weak).

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

Summary

MDLZ reported adjusted EPS of $0.73 in 4Q22, which beat estimates by 3 cents. We still think the company is too dependent on Latin American pricing, but it has built up its inventory again:

- The company saw 3Q's abnormally low 18.8% tax rate reverse in 4Q to 25.0%. In 3Q, this added 3.7 cents to EPS and in 4Q it was a 4.3-cent headwind. For the year, the tax rate was 22.0% and MDLZ is guiding to low-mid 20s for 2023.

- MDLZ continues taking amazing levels of price hikes in Latin America. After 25.8% in 3Q, it was 30.2% in 4Q. Some of the pricing is designed to offset FX hits from countries like Mexico, Brazil, and Argentina. When we see this situation at other companies we often see a 20% pricing gain and a -28% FX hit. For MDLZ, they only reported a 4.9% FX hit against the 30.2% price hike.

    - Latin America was only 10.8% of total organic sales for MDLZ – but it was 20% of the total company's pricing gain.

    - Looking at the other foreign markets – we saw the normal FX relationship. AMEA had 7.3% pricing gains and -11.9% in FX hits. Europe saw 12.6% higher pricing and gave back -11.2% in FX. Latin America's 30.2% against a 4.9% FX hit just doesn't look sustainable.

    - MDLZ just reported organic growth (pricing + volume) of 15.4% for the 4Q and 12.3% for the year. It announced it has pushed through more pricing for Europe to start the year and Europe is 38% of sales vs 11% for Latin America. Yet, guidance for 2023 is for organic growth of only 5%-7% and it expects volume to be a positive figure. This sounds like it expects pricing gains to decline considerably.

- Every 500bp of lost Latin American pricing is 1.9 cents in quarterly EPS. This continues to look like the place where MDLZ is picking up the EPS to beat forecasts, and guidance does not sound like it should continue. That is further bolstered by guidance of only a 1% headwind from FX for 2023 vs. the 6.6% headwind seen in 2022.

- Guidance is also forecasting another year of double-digit cost inflation with especially strong cost pressure in Europe. MDLZ is only talking about Europe for big price hikes next year and total guidance of probably 4%-6% in pricing doesn't bode well for Latin America's 20%-30% pricing gains continuing.

- Inventory rose to $3.4 billion, up $673 million y/y. That is up 11 days in DSIs to 99. That gets the company back where it should be. Some of this may be due to sales disruptions in Europe where volumes were down as they worked on price increases. While MDLZ is guiding to double-digit cost inflation, we see commodity prices declining in many areas. Low inventory concerned us because we thought MDLZ was trying to preserve gross margins by selling lower-cost inventory at higher prices while not purchasing the same number of units at higher costs. The concern was that MDLZ would buy more inventory at even higher costs and it wouldn't be able to keep passing higher prices through. Gross margin has been falling despite hefty pricing gains and lower-than-normal inventory:

	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20
Gross Margin	36.0%	37.4%	37.9%	38.8%	37.2%	38.4%	40.0%	39.6%	39.2%

- The 10-K should be out next week and we can check some additional items relating to operating income change in dollars from pricing vs cost inflation, and operating leverage from pricing vs. more fixed costs like depreciation and pensions. We will give credit to MDLZ for announcing it is boosting advertising and promotional spending to support its longer-term growth plans and pricing. Several other companies we follow in this industry continue to say that they will find a way to avoid doing that even though retailers are asking for more support.

Sysco Corporation (SYY)
Earnings Quality Update

We are maintaining our earnings quality rating of SYY of 3- (Minor Concern)

Summary

SYY reported non-GAAP EPS of 80 cps for 2Q23 which missed consensus estimates by 4 cps. The company also lowered its full-year guidance to $4 to $4.15 from the previous range of $4.09-$4.39 which is a 16.5 cps reduction at the midpoint. The miss and guide down were a result of lower-than-expected unit growth and higher-than-planned operating expenses.

- Management stated on the call that a third-party forecasting group foresaw industry case volume growth (ex SYY) of 5% for the quarter. However, industry growth ended up being only 1%. This was blamed on the expected boost from lapping the impact of Omicron in November and December failing to materialize. SYY reported that case volume growth in total US Foodservice business was 5.2%. However, remember that the company changed the way it calculates the case volume figure to include volume from specialty businesses which are seeing their recent growth boosted by acquisitions. Here are the cash volume growth figures under the old calculation compared to the growth figures under the new method:

	12/31/2022	10/1/2022	7/2/2022	4/2/2022	1/1/2022
US Foodservice Volume- New Disclosure					
Total USFS	5.2%	7.3%	12.0%	24.7%	27.3%
US Foodservice Volume-Old Disclosure					
Total USFS			5.4%	18.8%	22.5%

  Note that the new method was adding 5-7% to reported case volume growth compared to the old method as a result of including volume from the Greco and Coastal acquisitions. While the Greco acquisition deal lapped in 1Q23 and would have not artificially boosted 2Q23 results, the Coastal acquisition could continue to boost this number through 3Q.

- We have noted in past reviews that the company was getting 1-3 cps in benefit from lower provision for bad debts as a percentage of sales after adjustment for non-GAAP credits.

However, adjusted provision expense was about 0.04% of sales in 2Q23, about even with the year-ago level, so the benefit has disappeared. Still, we note that provision expense as a percentage of sales pre-Covid typically ran in the 0.12%-0.13% range. We also note that the allowance for bad debt is back down to 1.7% of gross receivables which is in line with the pre-Covid experience. This coupled with a potential impact of a slowing economy on its customer base could result in the quarterly provision as a percentage of sales increasing. If the expense simply returns to the 0.12% range, it would be a 2 cps headwind in future quarters.

- Adjusted Other Expense rose by 4 cps. This does not include the $315 million pension remeasurement charge related to the company transferring certain pension liabilities to a single premium group annuity contract. However, the remaining pension expense was higher due to the impact of higher interest rates. This is expected to add $15 million per quarter to costs for the remainder of the year which is part of the higher costs factored into the lowered guidance.

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

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