BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Keurig Dr. Pepper Inc (KDP) EQ Review

(yet another reason to be wary of MDLZ)

Current EQ Rating*	Previous EQ Rating
2-	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 KDP with a 2- (Weak) rating

KDP has been a popular stock after its 2018 merger and integration of Dr. Pepper with the Keurig coffee business. We wonder if this isn't a case of a small float with two investors holding about 75% of the stock creating some scarcity issues for the stock. Even with Maple and Mondelez selling 2.6% of the stock in a secondary, they will remain sizeable shareholders. MDLZ owns $5.2 billion of this company.

There are positives to report. We agree that the integration is not the run-of-the-mill restructuring of writing down asset values and laying off some surplus HQ employees. KDP is consolidating supply chains, distribution, production, and we are not seeing issues with its goals to pull $600 million in costs out of the system - $200 million per year from 2019-2021. The plans have been more involved than what we see on companies on their 5th major restructuring.

Focusing on the accounting issues, if this EQ report looked solely on traditional earnings quality metrics, it would probably be rated a 4 (Acceptable). However, we see much larger concerns with the balance sheet and cash flow statements. The falling Debt-to-EBITDA ratio needs to be adjusted for a massive increase in payables, new borrowings on Structured Payables, and sale-leasebacks adding to new lease payments. Many issues make the debt more onerous than it appears and the debt rating is on negative watch.

Also, the level of intangibles that are NOT being amortized is greatly overstating GAAP and adjusted earnings. In addition, we have a tough time justifying the carrying value of these assets - $30 billion are the result of the Dr. Pepper deal. The DPS assets only generate about half the company's operating earnings at about $1.3 billion to support those intangibles.

Adding back recurring items to adjusted EPS is only about 9-cents vs. reported adjusted EPS of $1.22. We wonder if a company integrating acquisitions and promising large synergies is at greater risk from even a small problem because of how much debt and intangibles exist here and we can envision liquidity events materializing rapidly – that is why we rate it a 2- (Weak).

- **Financed debt fell by $1.3 billion in 2019 – however accounts payable stretching generated $876 million of the cash flow.**

- **Accounts payable stand at 233 days up from 165 last year. KDP set up a factoring program for suppliers to sell their obligations from KDP and collect cash faster. $2.1 billion of the $3.2 billion in payables have been factored.**

- **Commercial paper is another $1.2 billion in financing – so we see the company tapping $4.3 billion in short-term financing to retire debt. The debt rating is on negative watch and the Debt-to-EBITDA of 4.5x becomes 5.3x adjusting for**

the payables. What happens if KDP has a problem maintaining this much short-term financings and has to rapidly retire some of it?

- **The company is also calling credit card debt "Structured Payables" which looks like working capital and is not adding it in as debt. Plus, asset sales are generating cash to retire debt, but KDP is leasing back those assets and lease obligations are rising rapidly too.**

- **$12 billion of the debt is represented as bonds and is part of the total company's debt to EBITDA ratio of 4.5x. However, those bonds are only guaranteed by the Dr. Pepper assets, which is about half the cash flow. Plus, DPS cash flow was spiked in 2019 by stretching payables by $679 million.** We see this as a structural risk that may be more widely seen if KDP has a hiccup in integration, has its debt downgraded, or has to reverse some of the payable growth.

- **Intangible assets are $44.3 billion of total assets of $49.5 billion. Goodwill is $20 billion and only $2.0 billion of the remaining intangibles are being amortized. The amortization lives are very long at 20 years and if the remaining intangibles were treated that way, adjusted EPS of $1.22 would have a 6-cent hit from the $2.0 billion and 59-cent hit from the other $22.1 billion.**

- **Impairment tests for all these intangibles raise some concerns and the auditor calls it a Critical Accounting Matter.** We think this could be a significant risk that focuses investors more on the balance sheet and the financing.

- **ROI is under 10% at KDP even using adjusted EBITDA and giving them credit for the remaining $400 million in forecasted synergies. We think ROI is actually closer to 7%-8%. It is using hurdle rates of only 7.5%-13.0%** to value these intangibles. We consider that very low.

- **Much of the intangibles are tied to DPS also – about $30 billion. Again, DPS is only about half the cash flow of the company and that was juiced in 2019 with payables being stretched.**

- **We have a difficult time justifying the carrying value of DPS intangibles. Even giving the company credit for all synergies coming in just for DPS as opposed**

to being realized throughout the company with integration plans and using low hurdle rates – we think a best-case scenario for valuation is under $25 billion. Minor problems in earnings could lead to a sizeable impairment in our opinion.

- **The income statement has minor issues. We can go along with adding back restructuring charges and other one-time events. But, we found about 9-cents of items that should not be helping adjusted EPS in our view** - adding back amortization of 6.4 cents, adding back stock compensation of 1.2 cents, while failing to remove a gain on an asset sale of 1.6 cents.

- **We see some minor EPS risks if KDP cannot boost pricing on concentrates sold to Coke and Pepsi bottlers as much in the future – about 2-cents in EPS there.** Also, depreciation lives look long and it has exceeded cap-ex for years. That may correct as the company plans to ramp up capital spending in 2020-22.

- **There are still anti-trust lawsuits against KDP relating to pricing of the K-Cup pods for coffee. When and how those are resolved is unclear.** We will note that an outcome there may impact the company on pricing in its coffee unit. That could be a risk, but we are not going to assign odds.

Debt Paydown Claims Are Misleading in Our View

Following the 4Q earnings, KDP has said the following multiple times, "And our free cash flow in 2019 was exceptionally strong at $2.4 billion, enabling us to reduce debt by $1.3 billion." In addition, it talks about how it paid off $531 million of structured payables too.

On the basic numbers, that is all true:

$ in billions	2019	2018
Cash from Ops	$2.5	$1.6
CapEx	$0.3	$0.2
Asset Sales	$0.2	$0.0
Free Cash Flow	$2.4	$1.4
Comm. Paper	$1.2	$1.1
Term Loans	$1.4	$2.6
Sr. Notes	$12.0	$12.2
Total Debt	$14.6	$15.9

Looking more closely, we see several issues to examine more closely and we will in sections that follow.

- Cash from Operations benefited from stretching payables by $876 million.

- Free Cash Flow benefited from asset sales of $247 million – most definitions of free cash flow would exclude this and that would make FCF $2.1 billion.

- The Structured Payables of $531 million were paid off. However, KDP borrowed a new $330 million in this area.

- The Senior Notes of just under $12.0 billion are only guaranteed by the operations acquired in the DPS Merger. Of the $2.4 billion in operating income in 2019, the guarantors only produced $1.35 billion of that total.

Payables Could Create a Liquidity Issue

When we looked at payables, we were amazed to see them rising so rapidly against fairly flat sales. They are up to 233.5 days:

	4Q19	3Q19	2Q19	1Q19	4Q18	3Q18
Sales	$2,934	$2,870	$2,812	$2,504	$2,813	$2,732
COGS	$1,241	$1,245	$1,186	$1,106	$1,268	$1,367
Payables	$3,176	$2,976	$2,909	$2,558	$2,300	$2,229
Qtrly DSO	233.5	218.1	223.8	211.0	165.5	148.8

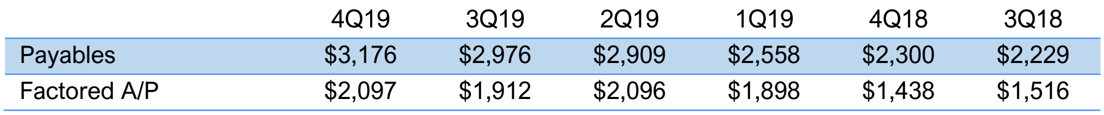
Adjusting for this one item, free cash flow would decline to $1.5 billion. On the call, KDP noted that it generated $1.40 in free cash flow for every $1.00 in income during

2019. There may be a problem maintaining that level of cash flow as the company noted that it believes it can continue to produce in excess of $1.00 in free cash flow for every $1.00 in income – but did not claim the $1.40 is repeatable.

Next question – how is this even possible to stretch payables this much without the suppliers rebelling? The answer is the payables can be factored by the suppliers. KDP set up this program. From the 10-K:

> ***"As part of our ongoing efforts to improve our cash flow and related liquidity, we work with our suppliers to optimize our terms and conditions, which include the extension of payment terms.*** *Excluding our suppliers who require cash at date of purchase or sale, our current payment terms with our suppliers generally range from 10 to 360 days.* ***We also entered into an agreement with a third party administrator to allow participating suppliers to track payment obligations from us, and if voluntarily elected by the supplier, sell payment obligations from us to financial institutions.*** *Suppliers can sell one or more of our payment obligations at their sole discretion and our rights and obligations to our suppliers are not impacted. We have no economic interest in a supplier's decision to enter into these agreements and no direct financial relationship with the financial institutions. Our obligations to our suppliers, including amounts due and scheduled payment terms, are not impacted."*

This program is huge and growing too. $2.1 billion of the payables have been sold by the suppliers at this point:



	4Q19	3Q19	2Q19	1Q19	4Q18	3Q18
Payables	$3,176	$2,976	$2,909	$2,558	$2,300	$2,229
Factored A/P	$2,097	$1,912	$2,096	$1,898	$1,438	$1,516

Here's the problem. The company warns that if its debt rating is cut, it could lose access to this factoring program for suppliers. From the 10-K:

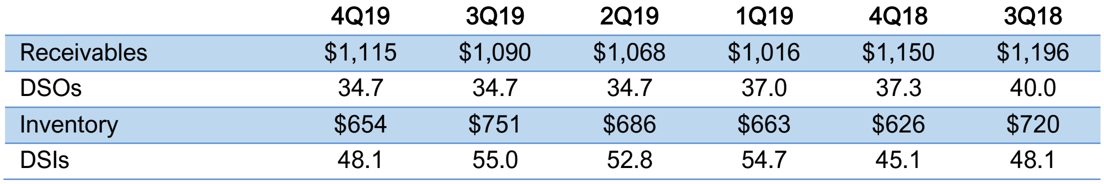
> ***"a significant downgrade in our credit ratings could impact our accounts payable program*** *and may reduce flexibility of our business to engage in certain transactions, such as the execution and renewal of certain leases"*

The company's debt rating was cut in 2018 to Baa2/BBB and Moody's has KDP on negative watch. **We think the company has a risk that it could need to come up with over $2 billion in cash very quickly to retire these payables. There is a $3.15 billion credit line available, but if the company borrows $2.1 billion from a bank – it would magically be viewed as debt again.** Suddenly, net debt would be seen as $16.7 billion instead of $15.9 billion at the end of 2018.

It's possible, KDP would need to pay its accounts more rapidly overall. Assuming the $2.1 of factored payables were retired, the DSO on payables would still be 79 days. Something impacting the factoring program could be a huge negative to free cash flow too.

We would also wonder if the debt is downgraded, would the market stop rolling over its commercial paper? The company has $1.24 billion in that area too, which can rise to as much as $2.4 billion. It's worth noting that KDP increased the commercial paper balance in 2019 too. **The company is carrying $75 million in cash and has over $4.3 billion financed with very short term methods: payables and commercial paper.**

The other working capital items are not helping cash flow much at all so the only one playing a large roll is payables:



	4Q19	3Q19	2Q19	1Q19	4Q18	3Q18
Receivables	$1,115	$1,090	$1,068	$1,016	$1,150	$1,196
DSOs	34.7	34.7	34.7	37.0	37.3	40.0
Inventory	$654	$751	$686	$663	$626	$720
DSIs	48.1	55.0	52.8	54.7	45.1	48.1

In our view, KDP's cash from operations is closer to $1.95 billion – simply adding depreciation and amortization to net income. Free Cash Flow is closer to $1.62 billion subtracting capital spending. And the debt isn't being paid down as rapidly as indicated – it is simply being refinanced to payables. Free cash flow also has to finance rising capital spending as the $330 million in 2019 is expected to be $550-$600 million in 2020. Plus, the dividend consumes $850 million of free cash flow.

There are Other Areas of Debt Being Refinanced Not Counted in Debt Either

KDP has another payable on the balance sheet called Structured Payables. The company describes this almost like a big credit card that it can pay for items on a deferred basis:

> *"The Company entered into an agreement with a supply chain payment processing intermediary, for the intermediary to act as a virtual credit card sponsor, whereby* ***the card sponsor will pay amounts on behalf of the Company and sell the amounts due from the Company to a participating financial institution.*** *The card sponsor will then bill the Company the original payment amount, plus interest for a term not to exceed one year.* ***The agreement permits the Company to utilize the third party and participating financial institutions to make a broad range of payments, including commercial payables to suppliers, business acquisitions, purchases of property, plant and equipment, and employee-related payments.*** *Structured payables have equal priority with accounts payable and are treated as non-recourse obligations. The Company records interest for the period the structured payables obligation is outstanding and reflects the proceeds and payments related to these transactions as a financing activity on the Consolidated Statements of Cash Flows."*

This goes through the financing section, so it does not impact operating cash flow or free cash flow. However, the company noted on the call that the strong free cash flow allowed it to pay down $531 million in Structured Payables. What wasn't discussed was KDP borrowed a new $330 million in Structured Payables.

To us, a credit card balance is debt. However, this source of funding is not being treated as debt. It looks like working capital, but we see it as another area wither KDP is raising cash with very short-term financing.

Asset sales are another area to examine. In 2019, the company realized $247 million in cash from selling various assets. It is adding this to free cash flow. In early January 2020, two more asset sales happened and generated $200 million in cash.

Here's the problem we see with this – these are sale-leaseback transactions. At the end of 2018, the company had future operating lease payments of $312 million. In

2019, it entered new leases that will consume $730 million in lease payments in the future. So, is total aggregate cash flow going up or down here? They collected $247 million in cash and owe $730 million over time. There are finance leases here too that inflate free cash flow because the interest expense lowers net income and free cash flow, but the principal payments occur in the financing section also and do not have a negative impact on free cash flow.

We would argue that debt/obligations are not declining at the rate the company is claiming. Payables growth of $871 million, Structured payables of $330 million, and an increase in $730 million in future lease payments all happened in 2019 against the company's news of $1.3 billion in debt payments and $531 payments on Structured Payables. This is close to a wash.

Much of the Debt is Not Guaranteed by All the Subsidiaries of the Company

We showed earlier that KDP is reporting debt of $14.6 billion, which is $14.58 billion net of $75 million in cash. They are reporting adjusted EBITDA of $3.22 billion for a debt to EBITDA ratio of 4.5x. That is down from 5.4x in 2018 and before the DPS deal it was 3.6x in 2017.

Simply adding $2.1 billion in payables and $330 million of Structured Payables to the debt figure, the ratio would 5.3x.

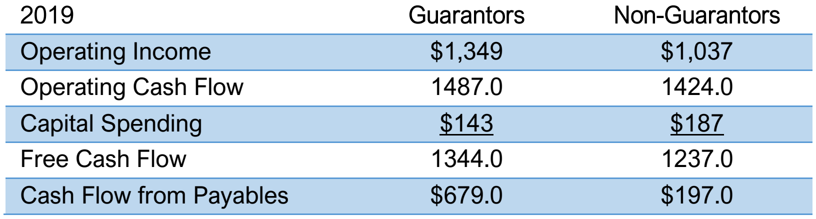
Here's the next issue – of the reported $14.6 billion in debt, just under $12.0 billion is in the form of Senior Unsecured Notes. $4 billion were assumed as DPS debt and $8.0 billion more were issued to fund the acquisition. Investors should be aware of this note in the 10-K:

> *"The Notes are fully and unconditionally guaranteed by certain direct and indirect subsidiaries of the Company (the "Guarantors"), as defined in the indentures governing the Notes. The Guarantors are 100% owned either directly or indirectly by the Company and jointly and severally guarantee, subject to the release provisions described below, the Company's obligations under the Notes.* ***None of the Company's subsidiaries organized outside of the U.S., immaterial subsidiaries used for charitable purposes, any of the subsidiaries of Maple prior to the DPS Merger or any of the subsidiaries***

> ***acquired after the DPS Merger (collectively, the "Non-Guarantors") guarantee the Notes.***"

What this means is basically only the operations of the former DPS company are guaranteeing the Senior Unsecured Notes. Specifically, the notes are at the Parent Level. The coffee and other operations are called out as non-guarantors for the Debt. We do not want to make a case that the parent company cannot access the cash flow at all the subsidiaries or cannot borrow money from them.

Instead, if the market starts to perceive a higher risk of a liquidity event related to commercial paper or payables or debt ratings – there is actually a smaller amount of cash flow supporting $12 billion of the debt here:



2019	Guarantors	Non-Guarantors
Operating Income	$1,349	$1,037
Operating Cash Flow	1487.0	1424.0
Capital Spending	$143	$187
Free Cash Flow	1344.0	1237.0
Cash Flow from Payables	$679.0	$197.0

The DPS results are where payables were stretched considerably in 2019. Adjusting for that, free cash flow is closer $650-$750 million at DPS. That is the source of cash flow that is legally available to service $12 billion in bonds if there is a liquidity problem.

In our view, the company's actual debt is much higher than the reported 4.5x adjusted EBITDA as much of it has been moved to short term payables and the company is also using commercial paper to finance its capital structure too. The risk here is if the debt ratings are cut or some other event causes KDP to have to wind down these short term sources of cash, it may cause investors to focus on this structural risk for the bonds too.

The Intangible Assets at KDP Pose Several Risks

Of the $49.5 billion in total assets and $23.3 billion in equity – KDP has Goodwill of $20.2 billion and other Intangibles of $24.1 billion. The company was formed by merging companies that were also built via acquisitions.

The first problem we have is almost none of these assets are being amortized. Most acquisitions we look at have Goodwill and the question focuses on how appropriate is the amount of the purchase price assigned to Goodwill because it will not be expensed. Normally, the other intangibles are amortized and reduce earnings. Not at KDP! Of the $24.1 billion in other intangibles, it assigned $19.9 billion to "Brands" with the Dr. Pepper, Core, and Big Red purchases – which it considers to have indefinite lives and therefore does not amortize it – it's just like Goodwill. Over $45.4 billion of assets here are assumed to have had zero cost as the purchase prices and integration costs are considered one-time in nature and there is either no amortization or the amortization is added back.

Second, the $2.0 billion of intangible assets that are amortized are believed to have very long lives. Of the $2.0 billion, $1.15 billion is acquired technology. It is being amortized over 20 years. Customer relationships are another $638 million and those are amortized over 8-40 years. Total amortization is only $126 million per year. So, the EPS impact of all of the acquisitions is a mere 6.4-cents after tax.

KDP reported GAAP EPS of 88-cents in 2019. Adjusted EPS was $1.22. Forget the Goodwill, if the remaining intangible assets were amortized over 20-years too, It would cost KDP about 59-cents in EPS along with the 6-cents from assets that are amortized. That is over half the company's adjusted EPS.

Third, the impairment tests on the non-amortizing assets is also raising some red-flags. Let's start with ROI. Total capital here is $37.8 billion. Income from operations in 2019 was $2.4 billion for an ROI of 6.3%. Want to use adjusted EBITDA and assume no amortization or capital spending? Adjusted EBITDA is $3.2 billion for an ROI of 8.5%. Part of the plan at KDP is to pull $600 million of cost out of the company with its integration and restructuring. $200 million has already been achieved in 2019 figures. Let's add $400 million to both operating income and Adjusted EBITDA – the ROI range becomes 7.3%-9.6%. Interest on the bonds is generally between 3.5%-5.0% so they are out-earning the cost of capital there. The dividend is $0.15 per quarter and pretax is $1.1 billion, which is a sizeable amount of operating income or EBITDA. **We think the ROI even with their synergies being realized is still not that strong.**

The hurdle rates KDP is using to test for impairments is even more aggressive in our view. They are using 7.5%-13.0% for these assets. We look at a bunch of companies and most of them tout minimum ROIs to justify investing in a new asset to be 15% or higher. We think KDPs hurdle rates are very low.

Also, we are having a tough time justifying the carrying value of the Dr. Pepper related intangibles. Looking at total company cash flow against total intangibles makes the impairment tests easier to meet. However, the bulk of intangibles are actually tied to only half the company.

Going back to the Guarantor financial statements in the 10-K as a proxy for DPS – we see there is $8.2 billion in Goodwill there and $16.9 billion in intangibles. On closing, KDP had $9.9 billion in Goodwill and $20.1 billion in intangibles for those assets. So, we are going to look at DPS cash flow supporting somewhere between $25-$30 billion in intangibles.

We know that operating income there was $1.35 billion and Free Cash Flow about the same with half of that coming from stretching payables. We know KDP expects to pull another $400 million out of costs in the next two years and they expect to see lower amounts of payable stretching along with higher capital spending of $1.4-1.5 billion over the next 3-years. We're just going to approximate some favorable results for the next five years and use a terminal value for DPS:

DPS forecast	2019	2020	2021	2022	2023	2024
Operating Income	$1,349	$1,549	$1,749	$1,836	$1,928	$2,025
Operating Cash Flow	1487.0	1050.0	1250.0	1312.5	1378.1	1447.0
Capital Spending	$143	$300	$300	$300	$250	$250
Free Cash Flow	1344.0	750.0	950.0	1012.5	1128.1	1197.0
Op Inc PV @10%		$1,402	$1,433	$1,362	$1,295	$20,250
FCF PV @ 8%		$693	$810	$797	$820	$14,962

We are only trying to illustrate the big picture here. If we are within $5 billion in valuation, we think the risk here can be seen. These assumptions have operating income rising by $200 million in 2020 and 2021 and 5% thereafter. We do not believe DPS can unlock another $600-$700 million of cash from stretching payables and made the baseline $850 million in cash flow in 2019 and added $200 million in cost savings for 2020 and 2021 and then grew it at 5% thereafter. We think those are generous assumptions to give 100% of the synergies to DPS since the synergies are supposed to impact all of the company with better utilization of distribution assets, better buying power, and combining overhead functions.

Here's the problem. Using operating income and a 10% hurdle rate (basically the mid-point of discount rates given) and 8% hurdle rate (near the bottom of the range) for free cash flow – we have the value the forecasts between $18-$26 billion. But that value is supporting $25-$30 billion of intangible assets. Also, if the $200 million in synergies are split 50-50 between DPS and other operations, that lowers the forecasted value of DPS by $3.5-$4.0 billion. If DPS does not beat forecasts consistently for several years, there may be an impairment issue.

Deloitte & Touche highlighted the DPS asset values as a Critical Audit Matter. They relied heavily on KDP forecasts and looked at analyst reports to assess the various data in accepting the current valuations. We think the risks to be aware of for KDP and a potential impairment are:

- What if stretching payables does not produce sizeable cash flow going forward?
- What if the growth at DPS is actually strong – but other parts of the business get a large percentage of the expected synergies instead of DPS?
- What if the hurdle rate rises above 10%
- Does even a minor miss on growth forecasts have implications for this asset which is carrying the bulk of intangibles and debt?

Income Statement Has Minor Issues

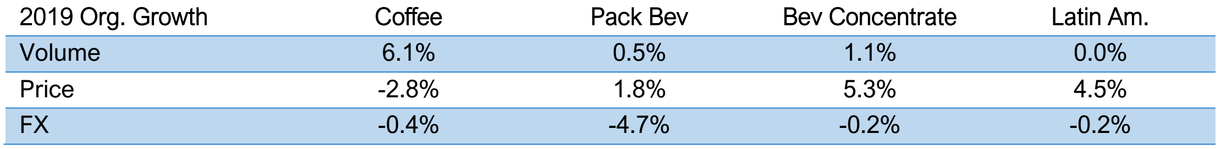
As we have been saying, the risks here appear to be heavily weighted toward the balance sheet. On income, the company adjusts for numerous one-time items related to integration and merger costs. Thus, GAAP EPS rises from $0.88 to an adjusted $1.22. As noted above, the largest boost to both sets of EPS is simply not amortizing the remaining other intangibles that are not Goodwill. On a 20-year amortization period, that would cut EPS by 59-cents.

Where we do have a problem with adjusted EPS is the company is adding back recurring items. It adds back the amortization of the few intangibles it believes have a finite life and that is 6.4-cents of adjusted EPS. Stock compensation is also added back even that that happens every year and that is 1.2-cents.

Then, in the discussion of segment earnings for adjusted results, we saw that Packaged Beverages had a $30 million gain on asset sales as part of the sale-leaseback transactions. The adjusted results say income grew by $92 million and was helped by this $30 million gain. We would consider that to be one-time in nature and sounds like it should be omitted from adjusted results. That added 1.6 cents.

All of that together is 9-cents so in our view adjusted EPS should be $1.13 vs. the reported $1.22.

On organic sales growth – we prefer to see volume growth overpricing and KDP is showing that for coffee and is more mixed on the other beverages:



2019 Org. Growth	Coffee	Pack Bev	Bev Concentrate	Latin Am.
Volume	6.1%	0.5%	1.1%	0.0%
Price	-2.8%	1.8%	5.3%	4.5%
FX	-0.4%	-4.7%	-0.2%	-0.2%

A few points to address here. There is only one year of DPS being in this equation. **KDP is focusing on expanding distribution and production for the newly acquired products going forward. That may swing growth more toward volume in those divisions. It even raised revenue growth guidance for 2020 by 1%. We would question the ability to take pricing at those levels for beverage concentrate as much of the concentrate is sold to Coke and Pepsi bottlers.** We believe they would have some ability to push back. Also, the largest retail customer for KDP is Wal-Mart, which would offer private label products that compete with KDP and would resist price increases. Looking at just Beverage Concentrates, KDP noted that higher input costs would have justified some of the higher price. But adjusted income grew by $96 million and $70 million came from higher prices. **A price increase of only 2.5%, would have cost KDP about 2-cents in EPS.**

We would also argue that the depreciation lives look long too. The bulk of PP&E is Machinery and Equipment at 59% of the total and includes trucks and has a depreciation schedule of 2-21 years. Depreciation has still been exceeding capital spending in the last two years as well.

	2019	2018	2017
Depreciation	$358	$233	$142
Capital Spend	$330	$180	$66

This is a red flag because even with the expense side being helped by assuming a long life for assets, having capital spending below that figure can indicate KDP is using older equipment. The company has said it is going to ramp up capital spending to $550-$600 million in 2020 and $1.4-$1.5 billion for the next 3-years. So that may alleviate some of this concern.

Litigation Risk Is Present but Difficult to Assign Possibilities

Many years ago, when this was called Green Mountain Coffee Roasters, the company faced an issue with the patent expiring on K-Cups in 2012. The K-Cups were the bulk of sales and retailers were asking for lower pricing and private-label versions. The company was losing cases of patent infringement too. One of the ways they sought to respond to this problem was buying up coffee licensees. That allowed the company to be the only source of K-Cups for those various coffee brands. They are still doing this and announced that the deal for Starbucks coffee in K-Cups will now work via Nestle.

In 2014, Keurig began to get sued for anti-trust issues alleging it had monopolized the single-serve coffee brewers and pods. Those cases have been combined into one multidistrict litigation whichis waiting resolution still. In 2019, McLane filed a similar lawsuit on the same grounds. The lawsuits want monopoly damages and likely want to lower the price of K-Cups as an end result.

Evaluating lawsuits is not our forte. We are simply going to note that the company states that it manufactures 75% of the single-serve coffee pods in the US under the K-Cup design. Coffee results are 38% of sales and 51% of operating income. Thus, an outcome to the litigation that hurts pricing or lowers profits does pose a risk here. We are not going to assess odds.

Mohawk (MHK) EQ Update 12/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3+	2-

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 are raising our earnings quality rating to 3+ (Minor Concern) from 2- (Weak).

MHK reported adjusted EPS of $2.25 which topped the Street estimate by 5 cps. We see both positive and negative one-time items in the quarter. We are concerned by amortization of contract costs falling to zero (+13 cps), but rising stock-based compensation expense (-2 cps) and a rise in "all other" expense (-8 cps) offset much of this benefit. Inventory remains elevated and it will take a couple of quarters to resolve during which time there could be some negative surprises as higher costs from lower production rates work their way through the FIFO layers. Nevertheless, the buildup in inventory seems to have peaked.

We note the following impacts on the quarter:

On the downside:

- MHK capitalizes the cost to obtain new contracts (store fixtures, displays, etc) and amortizes that amount over the time frame of the contract. We noted after our review of the 9/19 quarter that MHK saw a material increase in amortization expense related to contract costs. However, this situation reversed dramatically in the 12/19 quarter as the company recorded a slight credit in amortization versus $12 million of expense in the year-ago quarter. The estimated amount of capitalized costs in the quarter was in-line with the quarterly trend rate for the last several quarters. The swing in amortization expense added over 13 cps to EPS in the quarter which we would expect to reverse in upcoming periods. (See full report for more details)

- The allowance for bad debts as a percentage of gross receivables rose slightly on a sequential basis to 3.9% from 3.8%. However, it remains well below the year-ago level of the mid-4% range and we estimate it would take approximately 9 cps in charges to return it to that level.

- The company incurred another $50 million in restructuring charges "*for restructuring and integration costs of which most was non-cash and divided relatively evenly among completing US carpet realignment and rightsizing the Company's wood manufacturing footprints in Flooring North America and Flooring Rest of the World..*"

On the upside:

- Rising inventories have been a concern for several quarters. However, this situation is improving as DSIs rose by only one day over the year-ago quarter. However, the steps to correct the problem (reduced production) have led to higher costs as expected. Also, on a related inventory matter, pre-buying ahead of tariff increases earlier in the year led to a buildup of rebates which will result in a 15 cps benefit to be recognized over the first three quarters of 2020. This is expected to offset recent price reductions.

- We noted after the review of the 9/19 quarter that the "all other" component of other income/expense was a material positive boost to growth in the quarter. However, this reversed sharply in the 12/19 period draining almost 8 cps of earnings growth from earnings. We are not certain of what drove the increase in the line item.

- Rising stock-based compensation was a 2 cps headwind in the quarter.

- In the 12/19 quarter, the company recorded a $5.2 million recovery from a previous impairment of its net investment in a manufacturer and distributor of ceramic tile in China. This added about 7 cps to GAAP EPS but was adjusted out of the non-GAAP numbers.

Amortization of Costs to Obtain Contracts Falls to Zero

MHK capitalizes the cost of setting up a new contract with a customer and amortizes them over the term of the contract. These costs can include new displays and other in-store items. We noted after our review of the 9/19 quarter that MHK saw a material increase in amortization expense related to contact costs. However, this situation reversed dramatically in the 12/19 quarter as seen in the following table:

	12/31/2019	9/28/2019	6/29/2019	3/30/2019	12/31/2018	9/29/2018
Beginning Balance of Capitalized Contract Costs	$54.900	$67.900	$59.034	$57.840	$57.051	$50.400
Quarterly Amortization of Capitalized Contract Costs	$0.070	-$14.479	-$16.362	-$11.048	-$12.090	-$7.629
Amount Capitalized (Plug)	$14.069	$1.479	$25.228	$12.242	$12.879	$14.280
Ending Balance of Capitalized Contract Costs	$69.039	$54.900	$67.900	$59.034	$57.840	$57.051

We see that the company recorded a slight credit in the 12/19 quarter compared to a $12 million amortization expense in the 12/18 period. This would have added over 13 cps to EPS in the period. While MHK does not disclose the amount capitalized in a quarter, we can estimate that amount as a plug number using the beginning and ending balances and the disclosed amortization expense. We can see that there was a heavy period of capitalization in the 6/19 quarter and very little in the 9/19 quarter. The rate of capitalizing costs returned to a more normal level in the 12/19 quarter. We see no reason for the sudden drop off in amortization expense and expect it will experience a bounce in the next quarter. Therefore, we view the decline in expense as a very material, non-recurring benefit.

Stanley Black & Decker (SWK) EQ Update 12/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3+	3-

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 are raising our earnings quality rating to 3+ (Minor Concern) from 3- (Minor Concern).

- Provision for doubtful accounts expense fell to $5.3 million in the 12/19 quarter versus $11.2 million in the 12/18 quarter. This added a little more than 3 cps to EPS growth in the period. However, this drove the allowance as a percentage of gross receivables to 7.8% versus 6.8% in the 9/19 quarter and 6.5% in the year-ago quarter. Looking forward, the 3/20 quarter faces an even easier comparison as the 3/19 quarter also contained an unusually high provision expense of $18.3 million. This, coupled with the high allowance percentage which could minimize the need for provision expense, will likely make for an even bigger tailwind from lower YOY provision in the upcoming quarter. This tailwind should disappear starting in the June 2020 quarter with a return to more normal provision expense comparisons.

- As noted in prior reviews, SWK restarted its receivables factoring program in the fourth quarter of 2018. At the end of the 12/19 quarter, the company had $100 million in receivables sold (removed from the balance sheet) but still outstanding. This is essentially flat with the year-ago level which implies there was no masking of a receivables buildup. DSOs adjusted for the sold receivables declined by more than 4 days versus last year's fourth quarter. While this bodes well for conservative revenue recognition, the decline in receivables resulted in a boost to operating cash flow growth of $138 million in

2019 compared to a use of cash of $48.8 million in 2018. This $187 million beneficial swing from receivables accounted for well over half the reported $244.8 million increase in cash from operations in 2019. With trade/note receivable DSOs adjusted for factored receivables at 35 days, this source of cash flow growth, while very legitimate, is likely nearing an end.

- Inventory DSI levels fell by almost 7 days to approximately 80.5, continuing the decline started in the 9/19 quarter following the completion of the *Craftsman* rollout. We have discussed in previous reviews how the company had built inventory to support the *Craftsman* rollout and the support of new *Stanley* product introductions. Management accelerated the reduction in inventory in the 12/19 quarter by cutting production levels in the Tools & Storage business. This increased cost levels, putting pressure on gross margin in the quarter. While we view the normalization of inventory as a positive, we would caution that the company utilizes the LIFO method to account for its US inventories which account for about half the total. While total inventory balances declined by 5% year-over-year, the amount of inventory accounted for under LIFO declined by more than 8%. (SWK does not disclose the value of LIFO inventories quarterly.) While LIFO does provide a realistic matching of current sales with current costs, cutting production and eating into older LIFO layers of inventory can lead to expensing older, lower-cost inventory against current sales. With less than a quarter of inventories on hand, there is not much time for a buildup in older inventories to magnify that effect and the fact that the company is already citing the impact of higher costs from production cuts bears this out. However, there is still a possibility that a mild "LIFO liquidation" could have cushioned the blow from production cuts.

- SWK closed a deal to buy CAM, a leading provider of fasteners to the aerospace industry for $1.5 billion with $200 million contingent on the 737 returning to production. After an expected $185 million of cash tax benefits, the final deal is valued at $1.1-$1.3 billion. We will review the details of the transaction when available.

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 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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