BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Hormel Foods Corp (HRL) Earnings Quality Review

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are initiating earnings quality coverage of HRL with a 4- (Acceptable) rating.

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

Summary

HRL has realized less of a benefit from the pandemic than many of its packaged food company peers. This has partially been a result of the fact that the US foodservice channel accounts for about 25% of revenue which has been compromised as its restaurant and institutional customers have suffered in the lockdown environment. Also, labor shortages and other production issues have limited its ability to capitalize on strong consumer demand for its brands sold through retail channels including *Spam, Skippy,* and *Jennie-O* turkey products. These factors have led to organic revenue growth of -4%, 2%, and 6% in the 10/20, 7/20, and 4/20 quarters, respectively. The lackluster growth in the 10/20 period led to a 2 cps earnings miss and notable poor performance for the stock price through the end of 2020.

Overall, we consider HRL's reporting quality to be strong. It refrains from engaging in the non-GAAP nonsense most companies dabble in and its balance sheet is very clean with negative net debt. However, there are some near-term warning signs including rising DSOs and declining allowances as well as low finished goods inventories which could spell more disappointing top-line growth in the first half of FY '21.

What is weak?

- Account receivable days of sales (DSOs) have risen YOY by approximately 5 days in each of the last two quarters. While the company does not discuss this in its conference calls or SEC filings, we suspect this is at least partially due to collection delays and extension of payment times related to the pandemic. We note that the allowance for bad debt as a percentage of gross receivables fell to 0.6% in the 10/20 quarter from 0.7% in the year-ago period. This is unusual in the current environment and we note that the reserve is less than half that of Tyson Foods. Doubling the reserve would cost about 1.5 cps in EPS.

- HRL's effective tax rate in the fourth quarter fell to 15.9% from 21.0% last year. This was due to the impact of stock-based compensation as well as state tax settlements. Management did not give specific guidance on tax rates for the quarter. The YOY decline in tax rate added about 2.5 cps to EPS growth.

What is strong?

- To the company's credit, it has made only one non-GAAP adjustment to its earnings in the last two years which consisted of removing the gain from the divestiture of CytoSport in the 4/19 quarter which is both reasonable and conservative.

What to watch

- HRL has minority interests in several ventures, the largest of which is MegaMex Foods, as well as smaller international joint ventures. Results are reported under the equity method and appear as a separate line on the income statement. Collectively, profits from affiliates typically run about 3% of total company operating income. Fluctuations rarely impact EPS comparisons by more than half a cent per share, but this is an area to monitor in future quarters.

- The pandemic has led to delays in production which led to inventory shortages in the third quarter. Inventory began to recover in the fourth quarter, although finished goods days of sales continued to decline. Management seemed to indicate in the conference call that the risk of finished goods constraints could impact 1Q somewhat. However, raw materials inventories have risen which management attributed partially to weak foodservice sales. On a positive note, this could allow the company to manage costs on that side of the business by working those inventories down if restaurant demand picks up in the first half.

- HRL's key raw material is pork. About 95% of its hogs are purchased under long-term supply contracts which are linked to pork prices. This helps to balance the company's costs with its product pricing. Furthermore, the company's value-added products give it more pricing power which also mitigates its exposure to hog prices. The company notes in its 10-K that a 10% move in the cash hog market would have an "immaterial" impact on its results.

- The second key input for the company's products is turkey. HRL produces about 80% of its turkey requirements and contracts with independent turkey growers for the balance. Grain is a key cost for raising turkeys and HRL utilizes futures to hedge exposure to grain prices. According to the 10-K, as of 10/20, a 10 percent decrease in the market price for grain would negatively impact open grain contracts by just $7.2 million, or about a penny per share.

- HRL maintains corporate-owned life insurance policies as trading securities to fund certain executive retirement plans. The balances totaled $173 million at 10/20. The majority of these funds are in fixed-income instruments but some were included in equities which are marked to market every quarter. A 10% move in the non-fixed income portion would have an $8.4 million impact on results or about 1.2 cps.

Supporting Detail

Receivables Jumped in the 10/20 Quarter

The following table breaks out the calculation of accounts receivables days of sales (DSOs) for the last eight quarters:

	10/25/2020	7/26/2020	4/26/2020	1/26/2020
Revenue	$2,420.105	$2,381.457	$2,422.465	$2,384.434
Trade Receivables	$702.419	$648.991	$536.009	$562.483
DSOs	26.4	24.8	20.1	21.5

	10/27/2019	7/28/2019	4/28/2019	1/27/2019
Revenue	$2,501.513	$2,290.705	$2,344.744	$2,360.355
Trade Receivables	$574.396	$528.583	$537.447	$565.060
DSOs	20.9	21.0	20.9	21.8

HRL's DSOs have tracked in the 21 to 22-day range for the last three years before jumping by almost five days YOY in the 7/20 quarter followed by another 5.5-day jump in the 10/20 period. The company acquired Sandler's Smokehouse on 3/2/20 for $270 million. If the acquisition was going to impact the YOY trend in DSOs, it would have done so in the 4/20 quarter, so the sudden jumps in the last two quarters were likely not influenced much by the Sadler's deal.

Also, note that while revenues declined by 3.3% in the 10/20 quarter as weak foodservice sales coupled with production/inventory issues pressured the top line, receivables rose by more than 20%. The company did not explain this in its conference calls or SEC filings for those quarters. We suspect that this is at least partially due to collections issues or extending payment times for customers during the pandemic. Interestingly, the allowance for bad debts fell as a percentage of gross receivables to 0.6% in the 10/20 quarter from 0.7% in the year-ago period. Unfortunately, HRL discloses its allowance only on an annual basis, so we cannot see the quarterly trend. While we have seen some companies build their allowance percentages in the first and second quarters in response to the pandemic and begin dropping them as conditions have improved, we consider the allowance being below the year-ago level to be unusual. For reference, Tyson Foods' allowance for bad debts rose from 1% to 1.3% in the same time frame. HRL would have to more than double its allowance to match that percentage which would shave about 1.5 cps off EPS.

Inventory Status

HRL blamed its lackluster sales growth during the pandemic quarters on both poor foodservice sales and low inventory levels due to unusually high demand for retail products and production problems. The following table shows DSIs on a components of inventory basis for the last six quarters:

	10/25/2020	7/26/2020	4/26/2020	1/26/2020	10/27/2019	7/28/2019
Finished Products	$546.070	$506.814	$596.966	$628.124	$604.035	$665.028
Finished Products DSI	25.3	23.5	27.9	29.8	27.4	32.6
Raw Materials and WIP	$318.975	$274.485	$254.431	$249.954	$255.474	$254.629
Raw Materials and WIP DSI	14.8	12.8	11.9	11.9	11.6	12.5
Operating Supplies	$136.547	$129.952	$128.774	$111.781	$116.981	$122.712
Operating Supplies DSI	6.3	6.0	6.0	5.3	5.3	6.0
Maintenance and Parts	$71.170	$71.104	$69.820	$67.419	$65.872	$66.145
Maintenance and Parts DSI	3.3	3.3	3.3	3.2	3.0	3.2
TOTAL INVENTORY	$1,072.762	$982.355	$1,048.992	$1,057.277	$1,042.362	$1,108.514
TOTAL DSI	49.7	45.6	49.1	50.2	47.2	54.3

We can see that while total DSIs increased in the quarter versus last year, finished goods DSIs declined while raw materials DSIs rose. On the conference call, the company indicated that raw materials are more of a reflection of a buildup in products sold to the foodservice industry and that it is in a good position to capitalize on a resurgence of restaurant demand:

> *"The other factor is, it's an increase in raw material or raw materials in inventory and that primarily comes back from products that are generally sold through the foodservice industry. In some instances, that means that we won't have to go out and buy products. When you buy products on the open market, obviously you have fluctuations in those costs as product is put away and* ***as foodservice returns to strength, we would be able to draw down that inventory and perhaps manage our cost a bit better in the foodservice areas."***

However, the decline in finished goods inventory is a little more concerning. HRL has experienced both unusually high demand for retail products due to pantry-stocking and it has also faced production issues with COVID leading to labor shortages in its packing plants. The relatively low finished goods balance may be foreshadowing more problems for the first quarter in terms of product availability and production costs. Management contended early in the call that its inventories situation had improved:

> *"Finished goods inventory began the third quarter and at seasonably low levels. Strong demand for our retail items continued into the fourth quarter. Retail business and grocery products and refrigerated foods were most negatively impacted by this dynamic during the course. We are seeing a gradual improvement in inventory levels."*

However, it also seemed to concede during the Q&A on the call that finished goods inventory could still pose supply problems:

> *"**Our finished goods inventory is down. So, there is some constraints that we'll have in Q1.** Now Q1 is more of a quarter at which you sell more close to what you produce. It's not a quarter that you build inventory but it's also a quarter that normally you don't draw down a lot of inventory. So, it's going to have less of an impact in Q1 than perhaps it did in Q4, which is a period – a quarter in which you draw inventory down. You can't produce [a lot] of a product during the quarter."*

Management stated in the 10-K that while it expects higher sales and improved mix to lead to gross profit expansion in 2021, it expects "the higher cost structure related to COVID-19 to continue through the first half."

Therefore, we see the risk of disappointing growth lingering into 1Q.

Advertising Is Already Increasing

For the full fiscal year ended 10/20, HRL's advertising expense fell to 1.3% of sales from 1.4% in 2019 and 1.6% in 2018. Some of this decline was due to the 2019 divestiture of CytoSport which had relatively high advertising spending. Many packaged food companies have been able to cut advertising in the pandemic environment as retailers scrambled to buy anything to put on the shelves and consumers have not been in a position to be as selective as normal. This benefit is expected to reverse in the first half of 2021, but HRL already appears to be experiencing the headwind as in the 10-K, the company stated that advertising investments in the fourth quarter increased 14% to $29 million. The company also announced a planned increase in advertising to back its major brands in 2021.

AT&T (T)- Maintain BUY

We are maintaining our BUY recommendation on T.

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

Summary

AT&T's adjusted EPS came in at 75-cents for 4Q20 beating by 2-cents. On the surface, the guidance did not look strong calling for 1% revenue growth built by 2% wireless service revenue growth and free cash flow a bit below 2020 figures. Looking more closely, we noted that cash flow in 2020 included $2.2 billion from selling receivables and a lower capital spending figure. Adjusting for that, guidance looks stronger. Also, with $4 billion of Covid cost and lost revenues for 2020, we see some areas where AT&T could exceed guidance such as a return to some roaming fees from basically zero now, a spring with sports on Turner, and actually getting some revenue from new release movies. The focus was also on Debt/EBITDA of 2.7x up from 2019 – largely due to spending $2 billion on HBO Max and the $4 billion in Covid items which helped lower EBITDA by $4.8 billion. Guidance is for debt to fall by $10 billion in 2021, which would reduce the ratio to 2.5x again without EBITDA recovering at all. AT&T also was more vague on the subject as it is currently in a spectrum auction process. It is planning an investor day in 1Q21 that should add more color to the picture. We still think the sum of the parts here exceeds $40 per share with a 7% dividend and several areas of growth.

What is strong?

- Mobility revenue is still being hurt by a lack of roaming fees and late fees. Roaming relies on international travel and late fees were also waived as part of Covid relief for customers. AT&T's 2021 guidance was not greeted well after 4Q for 1% revenue growth that will be anchored by 2% growth at wireless. We think AT&T has already been achieving this guidance for wireless. Look at how much the lack of roaming and late fees has negatively impacted growth in 2020:

Wireless	4Q20	3Q20	2Q20	1Q20	4Q19
Service Rev.	$14,022	$13,883	$13,669	$13,968	$13,948
ARPU change	-1.9%	-2.1%	-1.1%	0.7%	0.4%
Roaming Rev Lost	$230	$270	$225	$0	$0
Y/Y Rev Change	0.5%	-0.4%	-1.1%	2.5%	1.8%
Roaming impact	1.6%	1.9%	1.6%		
Adj. Growth	2.1%	1.5%	0.5%	2.5%	1.8%

AT&T is not expecting to see roaming fees recover in 2021 until maybe somewhat in 4Q. Thus, 1Q21 should see another quarter of more than $200 million in lost revenue compared to a 1Q20. After that, service revenues will be apples-to-apples on comparison and this has been growing at 2% other than the worst period of Covid if the roaming fees are adjusted. To estimate roaming fees – AT&T highlighted the drop in ARPU in each period to be largely due to the loss of roaming fees. We multiplied that drop in ARPU by the number of post-paid customers and multiplied by 3 to estimate a quarterly revenue figure.

- Also, the number of customers and connections is already much higher to start 2021 vs. 2020 as 5G, FirstNet, and HBO Max have helped AT&T add more customers. Some of this is also expected to help ARPU as well. The focus for the company is to continue adding more customers, but it is simply starting from a larger base to drive growth in 2021 for its largest operating unit.

Wireless	4Q20	3Q20	2Q20	1Q20	4Q20	3Q19	2Q19	1Q19
Postpaid Subs	77,164	75,969	74,919	75,148	75,207	75,152	75,478	75,727
Prepaid Subs	18,102	18,100	18,008	17,808	17,803	17,740	17,434	17,012
All Subs/Connections	182,558	176,744	171,407	169,195	165,889	162,300	158,622	154,670
Y/Y Postpaid	2.6%	1.1%	-0.7%	-0.8%				
Y/Y Prepaid	1.7%	2.0%	3.3%	4.7%				
Y/Y All Connections	10.0%	8.9%	8.1%	9.4%				

They have already had the subscriber growth to drive revenue guidance and the ARPU growth is basically flat to positive adjusted for the roaming fees.

- Equipment sales are picking up (which normally are lower margin but add incrementally to profits). Equipment sales in 4Q have been $4.8-$4.9 billion for 3 years before hitting $6.1 billion in 4Q20. This was predicted earlier by AT&T that as more 5G phones became available, it should help them gain more customers and phone sales. Churn has dropped to the lowest level at the end of 4Q, and more than 60% of the post-paid people are on unlimited plans. All of that should help ARPU and grow mobility in 2021.

- Cash flow guidance looks solid taken in context. AT&T reported free cash flow of $27.4 million in 2020 and guided to free cash flow of only $26.0 million for 2021. There are three big parts driving that and cash from operations may improve from 2020.

Free Cash Flow	2021e	2020
Cash Flow Ops	44.0	43.1
Capital Spend	18.0	15.7
Free Cash Flow	26.0	27.4
Capital Spend	18.0	15.7
Vendor Financing	2.0	3.0
First Net Reimb.	1.0	1.0
Gross Capital Spend	$21.0	$19.7
Cash from lower A/R		$2.2

Total capital spending is expected to be higher by $1.3 billion from $19.7 billion to $21.0 billion. Of that amount, it will tap vendors to finance $1.0 billion less in 2021 than 2020, so that is a $2.3 billion larger outlay for 2021. Yet free cash flow is forecast to come in only $1.4 billion below the year before. Thus, cash from operations has to increase to make up the difference. It is also worth noting that in 2020, AT&T sold $2.2 billion in receivables to help cash from operations. That helped bump up free cash flow also. We think viewed in full, cash flow is expected to improve in 2021.

What is weak?

- Video again saw weakness with subscriber losses at a slower rate than last year offset by ARPU rising 5%. EBITDA fell from $4.5 billion to $4.0 billion. All signs point to AT&T running this largely for cash flow and cutting costs to offset decay. It also wrote off $15.5 billion of goodwill and intangibles in this area.

- The potential sale of DirecTV. This has been widely rumored and AT&T will not talk about it at the moment. However, it did separate its video unit from Broadband in 4Q saying it wants to be able to offer broadband customers a cleaner-looking deal without video bundling. The separation also led AT&T to write-off $15.5 billion of goodwill and other intangible assets related to video. Thus, there are signs that AT&T will monetize part or all of this asset and use the proceeds to retire more debt.

  This has been the anchor hung around AT&T for years now. It's basically less than 7% of total EBITDA but it is discussed more than wireless in the press. The acquisition clearly didn't work as originally intended and AT&T would take a loss on it. However, at this point, the stock reflects this situation. We actually think this unit could be valued at zero and AT&T is still undervalued.

What to watch

- AT&T bunded HBO Max with wireless plans and that allocates some of the $800 million spent on the Max rollout in 4Q to wireless. This is why service margins were down in 4Q y/y. We think an adjusted figure would be closer to 55%-56% margins with 2% growth in this area. In late July as the MAX rollout was picking up, John Stankey noted all the things coming together for wireless growth:

  > "*we are already seeing the dynamic of the attach rate of the better unlimited and the **higher ARPU unlimited plans increasing, and I made that point deliberately because this is where HBO Max and wireless come together nicely.** We're giving customers a reason to go up in the more robust unlimited plans, and we're already seeing that penetration increase. **We shared with you in October that that was an important driver through a combination of the incentives we would give people on the 5G network to buy into the upper end unlimited plans, as well as how Max complements those**, and we are seeing that success with Max, so check the box on the front end of that. **Once we have the right kind of equipment showing up on the 5G side, I think we will see that momentum continue and carry forward.***

- The EBITDA figure for 2020 includes $4 billion in Covid costs – just over $3 billion in lost revenues and just over $900 million in costs. The bulk of that is lost revenue at Warner from not releasing films and lack of sports programming when the NCAA tournament, baseball, many NBA games were all lost. The company also spent $2 billion rolling out HBO Max in 2020. Adjusted EBITDA fell by $4.8 billion in 2020 from $59.3 billion to $54.5 billion. That set off alarms that the Debt to EBITDA ratio rose to 2.7x even on slightly lower debt. Some of the Covid revenue will return in 2021. Also, debt is likely to decline by at least $10 billion in 2021. That would make the debt/EBITDA ratio 2.5x without EBITDA improving at all.

- We still think this is a good "sum of the parts" story. With several infrastructure investment funds buying data centers, warehouses for e-commerce, ports, water systems – shouldn't a huge high-speed broadband system and 5G wireless phone network be viewed as infrastructure? The value of AT&T at $29 is about $373 billion - $208 in stock, $147 in debt, $18 in retirement obligations.

- AT&T bought Warner for $110 billion or 10x EBITDA. It has good content assets and cable assets. Its HBO subscribers are up 25% in the last year. EBITDA was hit hard by Covid but seems likely to rebound. Content is in demand. We don't think it's a stretch that AT&T could see at least the same $110 billion in value.

- Broadband is growing with more customers and ARPU is up 4.6%. Margins are down as it is being bundled with HBO Max too and paying a fee to Warner. It has coverage for 60 million homes now and it's adding 2 million homes of coverage per year. Could someone pay 9x EBITDA without the HBO Max fee? That would be close to $55-$60 billion in value.

- Business line has been doing $13 billion per year in EBITDA for some time. It's not cutting edge tech, but it is generating solid cash flow. Sold at a cap rate of 15% and assuming $1 billion per month for 8-9 years – this is worth $50-55 billion also.

- Wireless has EBITDA without Covid and HBO Max payment of $31-$32 billion per year, growing at 2%. It has a 5G network that is just firing up for customers to pay for. Is this worth at least 4.8x EBITDA? At that price – these four units are worth the total enterprise value of $373 billion. If it's worth 6x, add $5 to the share price, at 7x add $9 to the share price of $29.

- That assumes zero value for the Latin America operation, DirecTV, Viro, and the advertising units, plus even legacy voice lines. These are still producing EBITDA. Video still did $4 billion in EBITDA in 2020. Can all this be worth another $2-$3/share?

- It appears to us that there is still good growth potential for wireless, broadband, and Warner going forward and AT&T intends to keep paying a 7% dividend, retire debt, and monetize some lesser assets to further reduce debt. All of that should work to the benefit of the stock price. Every $7 billion in lower debt adds $1 to the stock price too. It should be in a position to retire $10 billion per year. It will close soon on a $1.2 billion sale of Crunchyroll that will go toward debt repayment.

Mondelez International, Inc. (MDLZ) Earnings Quality Update 12/20 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

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

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

Summary

MDLZ's 4Q20 adjusted EPS of 67-cents beat forecasts by 1-cent. We would note that a lower tax rate and rounding added 0.9-cents to EPS, which is already accounts for the beat. More significantly, MDLZ claimed to lower Covid costs but boosted marketing. However, SG&A fell 120bp due to sales leverage. We are skeptical of this drop being sustainable as sales growth was weaker in 4Q at 3.2% organic vs. 4.4% in 3Q when SG&A only leveraged by 50bp. 3Q sales were helped by restocking retailer shelves that should have required less marketing. Also, MDLZ has noted that gum and candy are the weaker categories and those have higher margins – down 18% in both 3Q and 4Q. Gross margin did not leverage in 4Q down 80bp vs. up 20bp in 3Q. Every 10bp of this SG&A improvement is worth 0.4-cents. Thus, the drop in SG&A could have added more than 2-cents to 4Q. Guidance also looks weak as Covid-driven demand ends and appears tied to taking pricing, having gum recover, not losing sales as it culls SKUs, and posting a 3% growth rate against its toughest comp. Guidance points to a tough first half for 2021 and then MDLZ hopes to exceed guidance in 2H to make forecasts. The CFO even noted that gum's recovery may be slow, *"Our overall growth rate is negatively impacted by* ***Gum & Candy and continues to be challenged by reduced on-the-go consumption and mobility restrictions****. While we did not see material improvements in Q4 versus Q3,* ***we do expect gradual category improvement through 2021, but we are prudent in terms of those expectations."***

What is strong?

- Working capital appears to be back at normal levels. We will need to see how many receivables are sold to evaluate DSOs. However, DSIs for inventory appear to have emerged from Covid in line with the past as have DSPs:

	4Q20	3Q20	2Q20	1Q20	4Q19	4Q18
DSPs	128.0	127.5	139.3	119.1	128.6	125.2
DSIs	54.6	64.7	69.1	52.3	55.9	56.0

  4Q picked up about 1/3 of its cash from operations from releasing $520 million in working capital. Thus, we do not expect much working capital tailwind for 2021. That means earnings will need to produce the expected $3 billion in free cash flow forecast for 2021. Essentially flat with 2020. There was some discussion on the earnings call that to hit the free cash flow guidance would require some working capital tailwind. We would not count on that happening, but we still think MDLZ is likely close enough without it.

- The $3 billion figure for free cash flow is expected to pay for $2 billion share repurchases up from $1.4 billion in 2020. This is expected to help EPS growth reach high single-digit growth on 3% organic sales gains. In 2020, repurchases were worth 1.2% of EPS growth. MDLZ has the liquidity on hand to likely reach its $2 billion target even if free cash flow isn't quite enough to do the job. In fact, with the dividend at $1.7 billion, MDLZ was likely already planning to use cash on hand for repurchases in 2021. Cash is at $3.6 billion now vs. $1.3 billion after 4Q19.

What is weak?

- As expected, taking pricing in excess of commodity inflation came to an end in 4Q. Gross margin fell 80bp vs. up 20bp in 3Q. In 1Q20 and 2Q20, we think retailers were a bit more forgiving in this area and MDLZ was not that aggressive. Our view is that these costs can be passed through, and it can be lumpy, but excess pricing tends to even out. We do not have the figures for 4Q yet, but here is what we saw:

Op Income	4Q20	3Q20	2Q20	1Q20
Price Hikes	n/a	$129	$120	$119
Cost Inflation	n/a	-$63	-$102	-$108
Net Boost	n/a	$66	$18	$11
y/y Gross Margin chg.	-80bp	20bp	-90bp	-20bp
y/y Op. Income chg.	40bp	70bp	-80bp	-20bp

On the call, MDLZ noted 4Q saw a lag between pricing and inflation and that it expects inflation in 2021 to exceed that of 2020 due to higher grain, cocoa, and transportation costs. That may offset any pricing MDLZ does push through. As noted in the introduction, we are skeptical that SG&A saw a 120bp improvement in 4Q vs. 50bp in 3Q on lower sales growth due to weaker pricing gains and lower volume gains than 3Q – plus gross margin deleveraged considerably in 4Q. This level of SG&A improvement doesn't appear sustainable as marketing spending is rising.

- **Guidance is calling for 2021's revenue organic growth of 3% to be achieved with half coming from higher pricing. In prior years, when MDLZ has taken pricing in the 1.5% range, it posts negative volume growth.** We think retailers will focus more on price vs. cost inflation with Covid driven demand and restocking completed. **MDLZ also has one of the toughest volume comps ever at 3.6% for 2021. Even MDLZ said on the call that it will not match market share gains in 2021.** MDLZ is pointing to gum and candy as a tailwind and we will concede that should improve off a -18% growth rate. However, they are driven by travel demand, which should remain sluggish in 2021, are only 10% of sales, and the CFO noted that Latin America is the area most impacted by lower sales in that area. Latin America has been one of the most overstated areas for growth in recent years because its pricing has exceeded gains in all other regions in organic growth. However, the pricing growth has been completely eliminated by the FX hits due to hyperinflation. North America at 30% of sales just posted a 6.3% volume gain in 2020, and most other years, North America volume is negative:

Price Volume Growth	2020	2019	2018	2017
MDLZ Price	1,9	2.2	1.3	1.5
MDLZ Vol	1.8	1.9	1.1	-0.6
N.Am Price	2.3	2.3	1.1	-0.6
N.Am Vol	6.3	-0.1	-0.5	-1.8
Lat. Am Price	7.7	9.9	6.2	7.7
Lat. Am FX	-18.1	-13.5	-13.8	1.6
Lat. Am Vol	-7.5	-2.1	-2.6	-4.2

Another key to tracking North America sales trends is watching biscuit sales which are the bulk of sales for that region. MDLZ noted in 2Q that biscuit sales were up 11% and 24% in North America driven heavily by people staying at home. As restrictions started to ease, 3Q saw biscuits rise 12% in 3Q but 17% in North America. For 4Q, biscuits were up less than 7% and North American organic growth was down to 4.5%.

- **Investors should also remember that revenues are reported net of sales incentives and other trade promotions for retailers.** This is in addition to more traditional advertising that is part of SG&A. By MDLZ's own admission, it spent less money on advertising and promotion during Covid in 2020 at a time when sales growth was very high at 3.7% for 2020 and 3.2% for 4Q20. According to the CEO on the 4Q call, *"We faced costs relating to lockdowns, supply chain disruptions, adaptations to our ways of working as well as the need for increased PPE. But **<u>we were able to offset the majority of these costs through savings across areas like overheads, trade expense and nonworking media</u>**."* That sales growth may have had an extra tailwind with lower deductions for some of these trade incentives. As MDLZ plans to ramp up marketing more in 2021, this could become a headwind to the 3% sales growth forecast.

What to watch

- Marketing costs are expected to rise. We have been predicting this ever since Covid gave MDLZ and its other food companies a perfect storm of growing sales and falling advertising. **The company noted it increased advertising by 17% in the 2H of 2020 and sees that trend continuing in 2021. We noted that accrued marketing expense was up about $100 million from 3Q to 4Q. MDLZ believes it can offset rising marketing with falling Covid costs. That may be a problem in 1Q21 as Covid costs did not fully hit yet in 1Q20 and MDLZ had the panic buying driving a 12.2% in North American volume.** Also, keep in mind, advertising is a $1.2 billion expense for MDLZ in past years and it spends more on store promotions that are accounted for as a reduction in sales. In 2Q20, the height of Covid – MDLZ estimated it spent $100 million on that for 2Q and total Covid spending was $250 million for the year. It's tough to see the trade-off of a dollar for dollar exchange, as a bigger number grows vs. a smaller number declines. MDLZ is also only forecasting that Covid costs fall to one-third of 2020 levels – or about $160-$170 million and that may be more pronounced in 2Q and 3Q – not 1Q. If they are already growing marketing back at a 17% rate – that may well exceed the Covid cuts. And the CFO noted that the 3% organic growth forecast relies on continued growth in marketing.

- More headwinds for early 2021 in addition to the tough comps and perhaps having higher Covid costs in 1Q21 than 1Q20 – MDLZ said it expects poor results from emerging markets in non-BRIC countries in the first half of 2021. It called this out as a headwind it needs to overcome to reach the 3% sales growth figure. Much of guidance appears to call for a back-loaded year to reach forecasts.

- Guidance is calling for a tax rate of low-mid 20s for 2021. That may be a bit higher than the 22.4% MDLZ had for 2020. Guidance for high-single-digit growth in EPS is likely about 18-20 cents. A 100bp change in the tax rate is worth about 3-cents. Also, the repurchase may be worth 3-4 cents.

- In 2020, organic growth was 3.7% about 50-50 pricing/volume and gross margin fell by 40bp. That combination still allowed MDLZ to realize about 10-cents in incremental EPS. Now for 2021, organic growth is expected to be 3% with about 50-50 pricing/volume, but MDLZ expects higher commodity inflation. This source of EPS growth may be under more pressure in 2021 especially in the 1Q. And, volume gains are very tough for 1H. MDLZ said it believes it took pricing in excess of what it needs to offset FX losses in Latin America at the end of 2020 which will help 2021 gross margin. We're not seeing that. 4Q Latin American pricing was up only 6.4% vs. the FX hit of 16.6%. That compares to 3Q pricing up 8.2% and FX hurting 20.2%.

Texas Instruments Inc. (TXN) Earnings Quality Update 12/20 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We maintain our earnings quality rating of TXN of 5+ (Strong).

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

Summary

TXN posted EPS of $1.80 for 4Q20, beating forecasts of $1.55 by 25-cents and TXN's guidance of $1.20-$1.40. The market was disappointed by 1Q21 guidance of $1.44-$1.66, but it actually looks solid to us and the $1.80 was helped by some short-lived items. The company reported that it saw 16-cents in the quarter that was not in prior guidance related to a large inflow of royalty income. Demand recovering rapidly with a y/y increase in sales of 22% helped leverage some costs as well. Revenue came in at $4.08 billion vs. TXN's guidance of $3.41-3.69 billion. R&D coming in flat y/y against the 22% jump in sales added 4-cents and SG&A leveraged more than planned and added 5-cents to 4Q EPS. Also, TXN has a tax forecast of about 14%. In 3Q, it was 15% and a small headwind. In 4Q it came in low at 12.4% and that was 3-cents in EPS. Adjusting for that, TXN's reported EPS of $1.80 becomes $1.52 against high guidance of $1.40 and against a range of 1Q guidance of $1.44-$1.66. We can see some small headwinds coming in 2021 as a result of this, but much of this fits within TXN's normal operating plan. 4Q20 shows some of the lumpiness that can occur at TXN on the upside.

What is strong?

- Beating so much on revenues should have created operating leverage. Based on guidance, SG&A should have come in closer to 11.0% of sales but finished at 9.8%. That likely added about 5-cents to EPS. SG&A had an easy comp from 4Q19 when it was 12.3% of sales so some EPS pick-up should have been expected already. Also, R&D

leveraged as it was essentially flat y/y and guidance would have had it between 10.5%-11.4% of sales, but it came in at 9.5%. 1% of margin is equal to 4-cents in EPS.

- Discussing operating costs (SG&A + R&D) on the call, TXN reiterated that it expects to stay within a band of 20%-25% of revenues all the time and has been between 21%-22% for much of the last several years and that was true in 2020 at 21.8%. TXN just had an easy comp from 4Q19 when costs were 23.8% of sales and 4Q20 came in at 19.3% with the jump in sales. So returning to about 20%-21% will be a headwind in early 2021, offset by more earnings from higher sales.

- Gross margin also rose and sales also benefited from the TXN operating model of producing higher volumes, which spreads fixed costs over more output and lowers unit costs and carrying more inventory. When sales demand turned rapidly in 4Q, TXN had inventory on hand produced at lower cost. Having inventory on hand when competitors did not, meant TXN picked up more sales. We think this quarter really showed the strength of TXN's plan. TXN expected sales to be up less than 10% and they grew by 22% instead creating the operating leverage for SG&A and R&D. Plus, by having the inventory on hand and sourcing most of their own intermediate products – TXN saw gross margin rise by over 200bp.

- Inventories fell noticeably in 4Q with the jump in sales. Inventories finished the period at under $2 billion or 125 days. That's down y/y from 147 days and it was as high as 168 days in 2Q20. We would expect TXN to produce at full capacity to boost inventories going forward, which should help maintain gross margin. Historically, DSIs are normally in the 140s.

What is weak?

- TXN picked up EPS from a lower tax rate too. The effective rate was expected to be about 14% and it came in at 12.4% in 4Q20. This added 3-cents to EPS and should return to 14% going forward.

- TXN expects Capital Spending to be about 6% of revenues. In 2020, it was down y/y in every quarter except 4Q. Spending was only 4.5% in 2020 and 5.2% in 4Q20. TXN said it would get closer to normal in 2021 so we expect capital spending to be a $200-$300 million headwind for free cash flow in 2021.

- The inventory also could be a headwind in 2021. Had DSIs held at normal levels in 4Q, inventory would have been about $300 million higher. With rising sales, TXN may see a $300-$400 million headwind on free cash flow for 2021.

- TXN wants to pay out 100% of free cash flow as dividends and share repurchases. In 2020, FCF was $5.5 billion and TXN returned $6.0 billion to shareholders. The company has liquidity, but if there are headwinds on inventory and capital spending, offset with higher earnings. The level of share repurchases may drop in 2021.

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.

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