BEHIND THE NUMBERS
Quality of Earnings Analysis
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PepsiCo, Inc.(PEP)
Earnings Quality Update- 6/21 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 3- (Minor Concern)

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

Summary

PEP reported non-GAAP EPS of $1.72 for the 6/21 quarter which was 17 cps ahead of consensus while unexpectedly strong revenue growth was led by a huge rebound in North America Beverages. We do see some minor one-time benefits to results discussed below, but the earnings beat remains well intact even after these adjustments. However, we are leaving our rating the same given the expansion of the restructuring plan and erosion in core operating margins after adjustment for one-time factors which highlights the rising advertising spending and higher commodity costs.

What is strong?

- As we discussed in our 1Q review, the company reported a 6 cps gain from the unrealized gain in a publicly-traded investment. However, as expected, the sale of the investment in the second quarter resulted in a realized loss of 2 cps which was not adjusted out of non-GAAP results.

What is weak?

- PEP announced another extension of its 2019 productivity plan in the quarter. The company now expects the plan to result in a total of $3.15 billion in charges through 2026 with $2.4 billion of that resulting in cash expenditures. This is up from the previous estimate of $2.5 billion in charges expected to run through 2023 with $1.6 billion of that resulting in cash spending. Management noted that the plan expansion "reflects further initiatives to leverage new technology and business models to simplify, harmonize and automate processes; re-engineer our go-to-market and information systems; and simplify our organization and optimize our manufacturing and supply chain footprint." These sound very much like normal businesses activities to us.

- We also find it interesting that the new estimate for total charges rose by $650 million while the incremental cash spending rose by $800 million. This implies that more of the previously announced charges will result in cash expenditures than originally forecast which seems to indicate a material change in the type of spending – fewer non-cash write-offs and more cash amounts which could include ongoing expenses that should be viewed as operational. The company expects to incur about $400 million in charges in 2021 which is about 4% of adjusted pretax earnings. While we have certainly seen larger charges, the expanding size, scope, and changing cash composition of the plan erodes the quality of adjusted earnings in our minds.

- The allowance for doubtful accounts fell to 1.7% of gross receivables from the 2.1% from the previous quarter. While the company does not disclose provision expense, we estimate the decline in allowance percentage could have added over 2 cps to EPS in the quarter.

- The decline in "Other Pension and Retiree Medical Benefits Income" line on the income statement added about 2.3 cps to EPS growth in the quarter. However, this does not include pension service costs which rose due to the enhancement of pay credits for certain participants. Factoring in all costs of pension and postretirement benefits, lower costs added only about a penny per share to growth in the quarter.

- The adjusted effective tax rate fell from 21.9% in last year's second quarter to 21.3% this year which added over 1 cps to EPS growth. However, the rate was in line with the forecasted 21% tax rate for the year so we do not consider that to be an unexpected benefit.

- Like many companies we follow with Latin America exposure (namely SEE and MDLZ), PEP has been experiencing significant negative FX impacts in that segment which are added back when calculating organic growth rates. We have no problem with adjusting out FX normal impacts in general, but it distorts organic growth figures when the segment is experiencing rapid inflation which allows it to raise prices at an artificially high pace. The higher prices boost the organic growth figures, while the associated negative FX impact is taken out. Interestingly, while PEP has experienced negative FX impacts on its Latin America results ranging from 8% to 17% in the preceding four quarters, it only raised priced in the 1-4% range. However, the FX impact turned to a 9% drag on Latin American results in the 6/21 quarter, yet PEP raised prices by 12% which, when combined with a 4% organic volume growth, resulted in an organic growth rate of 16% for the segment. While PEP's recent results have not been distorted to the degree of SEE or MDLZ, we are skeptical that the company can continue to increase prices in Latin America at 2Q's pace for long without losing share. For reference, if we adjust organic growth in the segment to the 4% unit growth, total company organic growth falls to 11.8% from the headline 13%. While not dramatic, it could be a source of disappointment in the future.

What to Watch?

- PEP reported strong 13% organic revenue growth driven by 21% organic growth in North American Beverages courtesy of easy comps versus the year-ago period which was penalized by COVID-related restaurant and convenience store shutdowns. However, the company repeatedly cited increases in advertising as being key factors in its growth in the quarter.

- Core (non-GAAP) gross margin fell by 180 bps which management attributed primarily to the recently acquired Be & Cheery and Pioneer Foods operations which carry lower gross margins as well as the inclusion of an additional month of results from those operations to sync their reporting calendars. Management cited higher commodity costs as being a factor but is confident it can raise prices to cover it.

- Management touted core (non-GAAP) operating margin improvement of 70 bps. However, the 6/21 quarter contained only $35 million in COVID-related charges versus $378 million a year ago. The 6/21 quarter also contained a $39 million loss related to the sale of its publicly traded investment. After we adjust for these factors, core operating margin fell by 130 bps. This is eye-catching given what must have been a significant beneficial impact of operating leverage from the strong organic revenue growth. Some of this decline in margin was likely a result of the acquisition-driven change in mix which

impacted gross margin along with higher commodity costs. However, this is more evidence of higher advertising and the return of some costs which were put on hold during COVID.

- PEP does not disclose detail on sales promotions, but it did indicate that it was active on the promotional front during the quarter. Still, the company noted in its divisional revenue that North American Beverages and Quaker Foods both benefitted from the favorable settlements of promotional spending accruals compared to the year-ago quarter which was likely driven by strong sell-through at grocery and mass merchant channels last year. We estimate this added about 2 cps to growth in the quarter.

- Many companies curtailed their buyback activity during the pandemic to conserve cash and are now beginning to resume spending on repurchases. Interestingly, PEP spent $2.1 billion repurchasing shares during the pandemic quarters but did not repurchase any during the 6/20 quarter and plans no further purchases this year. Management stated its capital allocation strategy will focus on increasing capex to meet investment needs and growing the dividend. This is positive from the standpoint of our appreciation of dividends and our aversion to buying back shares at inflated prices. However, it also highlights a point we have made about PEP in previous reviews which is its cash flow after the dividend is simply not strong enough to support the buyback of the past. Note that in the past, the buyback has reduced the share count (and boosted EPS) by 1-1.5%.

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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