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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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# Mondelez Intl. (MDLZ)- Initiate with NEUTRAL

We are initiating Mondelez (MDLZ) with a NEUTRAL rating. We have been following the company as an EQ report since last June with a low 2- rating based on the company stretching payables and factoring receivables to boost cash flow. In addition, the company has been restructuring continuously and has generated the bulk of earnings growth from boosting prices. Other areas show signs of being stretched too and may be unable to produce the same level of EPS growth as in the past.

There are two key reasons why we are not making this a SELL recommendation at this time. First, while the operating model does not generate enough cash flow to support the company's cash needs, it hasn't run out of sources of liquidity yet. It still has $1.1 billion in cash on hand, availability on its revolver/commercial paper, and a 13.8% stake in Keurig

Dr. Pepper worth $5.4 billion. Second, forecasts expect almost nothing in the way of growth. The company is guiding to 2%-3% organic growth but will face a 3% headwind from FX. EPS is expected to grow 3%-5% but face a 3% headwind from FX too. At over 18x EPS (or 17x subtracting the KDP stake), we can see some negative catalysts forming, but the timing does not appear to be imminent yet.

- **The long-term plan laid out for shareholders of 3% sales growth fueling faster EPS growth and then dividends growing faster than EPS has a hole. The cash need to fund the dividend and share repurchases is $3.9 billion and rising vs. the company's goal of generating $3 billion in free cash flow.**

- **Recent cash flow looks healthy but has been stretched by reducing receivables and extending payables. That resulted in nearly $500 million of cash flow in 2018.** Also, inventory has not grown as much as the impact of higher costs until 2018, that source of cash flow may be turning.

- **Advertising and R&D also have helped earnings and cash flow and the company plans to increase both. That could become another nearly $200 million headwind on cash flow**. Also, the coffee investment is likely to produce less cash flow than in recent years.

- **MDLZ still faces cash payments for restructuring and pension funding that will reduce cash flow.** The capital spending level has been elevated during the 7th round of restricting and should come down, to help free cash flow. It may not drop enough to offset the loss of the recent tailwinds in costs and working capital.

- **MDLZ as part of Kraft started with 20% operating margins back in the 2000-2002 time frame. After making numerous acquisitions, spin-offs, and seven major restructurings designed to lower costs and boost profits at a cost in the multiple billions, margins fell considerably and only sit now at 16%-17%.**

- **The constant recurring restructuring has us asking questions.** How was the first one so cheap, and the seventh one so expensive – was the still so much fat to uncover by then? How many on-going costs were lumped into restructuring and removed from adjusted figures? If lower margin units were culled and higher margin units added – shouldn't margins be much higher than when all this started?

- **Price hikes appear to be MDLZ's key to growth and margins. The company faces a headwind from FX nearly every year which makes its products more expensive in many cases and it has lost volume in 4 of the last 5 years.** Yet, its forecasts and recent results rely heavily on boosting prices. Pricing is rising faster than input costs. Pricing has been over 100% of income growth in most of the recent years. This may be the largest potential issue.

- **MDLZ is plugging its cash funding shortfall to shareholders with debt. Net debt is up almost $4 billion since 2015.** With pricing driving earnings, the debt figure looks manageable. Also, MDLZ still has $1.1 billion in cash and a large investment it could monetize. However, if pricing gains slow or reverse this could become an issue. MDLZ also has some sizeable maturities over the next 3 years.

## Basic Cash Flow Story and Goals for MDLZ

During the last year, the company has laid out its long-term picture several times for investors. It is looking to produce 3%+ organic revenue growth per year which translates into high single-digit EPS growth annually. It expects to grow its dividend faster than EPS and generate $3 billion in free cash flow.

On the surface, some of this does not appear outrageous because the company has been achieving some of these targets. Dividend growth has long been above 10% annually and a hefty share repurchase program has aided EPS growth:

| | 2018 | 2017 | 2016 | 2015 |
|---|---|---|---|---|
| Dividend/shr | $0.96 | $0.82 | $0.72 | $0.64 |
| Dividend growth | 17.1% | 13.9% | 12.5% | 10.3% |
| Shares | 1,486 | 1,531 | 1,573 | 1,637 |
| EPS growth from Repo | 3.2% | 2.9% | 4.1% | 4.4% |

The first problem arises as these two cash needs are running above $3 billion per year:

| | 2018 | 2017 | 2016 | 2015 |
|---|---|---|---|---|
| Dividends | $1,359 | $1,198 | $1,094 | $1,008 |
| Repurchases | $2,020 | $2,174 | $2,601 | $3,622 |
| Total | $3,379 | $3,372 | $3,695 | $4,630 |

The dividend is likely expected to come in at $1.08-$1.10 this year, which would make it close to $1.6 billion, assuming MDLZ repurchases another net 40 million shares. To purchase a net 40 million shares, MDLZ has to offset dilution from options and buy 50 million shares. The stock price has been $42-$43 in past years but now trades at $47. The cost of buying a similar number of shares would be over $2.3 billion. The cash need to continue meeting these forecasts is $3.9 billion and rising vs. MDLZ's goal of generating $3 billion in free cash flow to pay for it.

Free cash flow has also not been running at $3 billion:

| | 2018 | 2017 | 2016 | 2015 |
|---|---|---|---|---|
| Cash from Ops | $3,948 | $2,593 | $2,838 | $3,728 |
| Cap. Ex. | $1,095 | $1,014 | $1,224 | $1,514 |
| FCF | $2,853 | $1,579 | $1,614 | $2,214 |
| Acq/Divest | -$527 | $604 | $57 | $5,258 |

We will examine this further in this review as some of the recent numbers appear unlikely to last. Moreover, with the exception of selling its coffee unit in 2015, the net of acquisitions and divestitures has not been enough to help the $3 billion free cash flow situation either. **Guidance for 2019 is for $2.8 billion of free cash flow due to tax issues.**

Nor has 3% organic revenue growth been happening:

| | 2018 | 2017 | 2016 | 2015 |
|---|---|---|---|---|
| Price Growth | 1.3% | 1.5% | 1.6% | 3.9% |
| Vol. Growth | 1.1% | -0.6% | -0.3% | -2.5% |
| Organic | 2.4% | 0.9% | 1.3% | 1.4% |
| FX | -1.4% | 0.3% | -4.6% | -12.0% |

Plus FX, while not viewed as part of organic revenue changes, has routinely been a drag on growth.

## Working Capital and Advertising Stretched to Help Cash Flow Already

When the company posted $3.9 billion in cash from operations in 2018, we think investors believe a sustainable free cash flow of $3 billion is doable. However, a key reason we started following MDLZ was it was reporting some sizeable changes in working capital. (We will

not cover all this in as much detail as the EQ reports from August 2, 2018 and February 14, 2019 – please review those reports for more information.)

In summary, the company has been factoring receivables for about $800 million. That is cash that was pulled forward. Factored receivables had been about $600 million in most quarters and running about 8-9 days of total receivables. In recent quarters, this has bumped up to $700-$800 million and 11 days of total receivables. That appears to have topped out at that level based on recent trends.

In addition, total days of receivables (those on the balance sheet and factored) really had not changed much in recent years moving +/- one day looking at the figures. Suddenly, in 4Q18, the factored receivables stayed flat at 11 days while the amount on the balance sheet dropped 5 days. In 2018, MDLZ pulled in $257 million of cash from operations by shrinking its receivables. We do not think that can be repeated again.

Second, MDLZ has been stretching payables. They were high to begin with but in the last two years have moved from 114 days to as high as 134 days. MDLZ finished December at 125 days up nearly 5 days from the year before. In 2018, MDLZ pulled in another $236 million in cash from stretching payables. We're skeptical how much further this can go as well.

Those two items are nearly $500 million of 2018's free cash flow. At the same time, inventories have not been nearly the drag on cash flow, that one would expect. MDLZ lists the impact of rising input prices on earnings and it also is looking to boost sales:

| | 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| y/y Inventory chg. | -$204 | -$18 | $62 | -$49 | -$188 |
| Impact of higher costs | -$42 | -$181 | -$126 | -$186 | -$384 |

The company has improved its focus on working capital management, and we will give it some credit here. However, it appears that inventory started to reflect the years of higher costs in 2018 and become a bigger drag on cash flow at the same time we question the sustainability of pulling more cash from receivables and payables. Working capital has been a key source for operating cash flow for years:

| | 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| Inventory | -$204 | -$18 | $62 | -$49 | -$188 |
| Receivables | $257 | -$24 | $31 | $44 | $184 |
| Payables | $236 | $5 | $409 | $659 | $387 |
| Total W/C | $289 | -$37 | $502 | $654 | $383 |
| CFO reported | $3,948 | $2,593 | $2,838 | $3,728 | $3,562 |

The company deconsolidated its coffee unit in 2015, which lowered sales and lowered gross spending on advertising and R&D. However, since then, it has continued to pick up earnings and cash flow from cutting these areas further as a percentage of sales.

| | 2018 | 2017 | 2016 |
|---|---|---|---|
| Advertising | $1,173 | $1,248 | $1,396 |
| R&D | $362 | $366 | $376 |
| Sales | $25,938 | $25,896 | $25,923 |
| Adv % Sales | 4.5% | 4.8% | 5.4% |
| R&D % Sales | 1.4% | 1.4% | 1.5% |

MDLZ is now saying it will focus on boosting spending in both areas to support the 3% organic revenue growth target. From 2016 levels, MDLZ pulled $237 million in costs from this area. Net of taxes, this represented about $180 million in earnings and cash flow in 2018. And while we're mentioning coffee – MDLZ is now a stockholder in Keurig Dr. Pepper. While it recognized $180 million in distributions from coffee in 2018 as part of that transaction and a dividend; going forward, the dividend is 15-cents per quarter or $115 million to MDLZ. That's a $65 million headwind.

Adding this up, working capital could become a drag on cash flow in the near future and become a $200 million negative against last year's $289 million positive. Simply returning to 2016 levels of investment in adverting in R&D is probably another $180 million drag on cash flow and the coffee another $65 million.

## Restructuring Liabilities remain, Pension Funding, and Capital Spending Too

Again, looking at the big picture – we can understand how MDLZ is coming up with its forecast of producing $3 billion of free cash flow per year. Operating earnings in 2018 adjusted for all one-time items like restructuring, tax law changes, and hedges were $4.3 billion. The company is forecasting $450 million for interest expense this year and let's give

them a 24% tax rate – that nets out to $2.94 billion in income. Add in $115 million of coffee dividends and $820 for depreciation and amortization and presto – that's $3.9 billion in cash from operations.

The company has been spending $1.0-$1.2 billion in capital investments and sees that falling to about $900 million or slightly below. That's free cash flow of $3.0 billion. The drop in capital spending would move it more in line with depreciation and amortization and we do not consider that an aggressive move.

The first problem is MDLZ needs $3.9 billion and growing to maintain its other goals of EPS growing faster than sales and dividends growing faster than EPS, which require share repurchases. That already exceeds the cash flow by $900 million under perfect conditions.

The second problem is MDLZ has been augmenting cash flow with lower working capital, which may be about to reverse and become a drag on cash flow. Plus, higher advertising and R&D should hurt that $4.3 billion in operating income too and become a drag on free cash flow.

The third problem is there are more cash payments to deal with. We will explore the history of restructuring at MDLZ later in this report, but there have been on-going restructurings here before it spun-off Kraft Foods and every year since. Under the current plan, there remains $373 million in accrued liabilities to settle – basically all related to wages/severance. That's likely to be cash payments as will future announced restructurings.

The pension plan is fully funded in the US and underfunded by about $1.1 billion overseas. Some of this was helped by a jump in discount rates. The US plan went from 3.7% to 4.4% which is more than rates really moved here. The overseas plans had the discount rate jump from 2.20% to 2.45%, which comes against the backdrop of European rates remaining extremely low. Interesting the discount rate to calculate expense rather than liability declined in both areas 51bp and 11bp respectively.

Pension expense has been $148 million in 2018 and $172 in 2017. Contributions have been exceeding the expense figure at $362 million and $505 million. The net impact is pensions have been a consumer of cash flow in the amount of $200-$300 million per year. This figure probably comes down going forward a bit more, but it likely still going to consume cash.

None of these items by itself is a dire situation. But, if several start working against the company on a regular basis, suddenly it adds up to a problem. Especially when they are starting with a 30% shortfall to maintain the shareholder plans for dividend and repurchases.

## Restructuring Is A Way of Life at Mondelez

Mondelez as part of Kraft acquired Nabisco in late 2000 and spun out of Philip Morris in 2001. The company announced an integration plan that would cost $200-$300 million. The goal was to eliminate duplicate expenses, streamline operations and save $600 million annually by 2004. By 2002, this program was increased to $379 million.

In 2004, the company rolled out a 3-year restructuring program designed to leverage its global scale, reduce the cost structure, and optimize capacity utilization. The cost was forecast at $1.2 billion and savings were projected to be $400 million by 2006.

In 2006, the 3-year plan was expanded to a 6-year plan that would cost $2.5 billion with savings of $700 million annually by 2009. In 2007, the savings forecast was boosted to $1.2 billion annually by 2009.

Let's just review these plans. The first plan should have boosted margins by about 200bp by 2004 ($600mm of savings over 29.5b in revenues). The second plan should have boosted margins by 330bp ($1.2 billion of savings over $36.1b in revenues). The company intended to focus some of these savings into new programs that would mitigate some of that margin gain. However, despite continually buying and selling other businesses and one would assume that was also designed to sell less similar businesses where costs were tougher to cut and buy more similar businesses where margins could easily grow- profitability still slid. For example, Post Cereal was spun off in 2007 while the company bought the biscuit business of Danone. Our view is that deals would be made with the goal of helping margin more.

| Old Kraft | 2009 | 2008 | 2007 | 2006 | 2005 | 2004 | 2003 | 2002 | 2001 |
|---|---|---|---|---|---|---|---|---|---|
| Sales | $40,386 | $42,401 | $36,134 | $34,356 | $34,113 | $32,168 | $31,010 | $29,723 | $29,234 |
| Adj. Op Profit | $5,528 | $4,946 | $4,545 | $5,113 | $5,318 | $5,312 | $5,924 | $6,441 | $6,108 |
| Op. Margin | 13.7% | 11.7% | 12.6% | 14.9% | 15.6% | 16.5% | 19.1% | 21.7% | 20.9% |

We added back the restructuring, implementation, write-off changes to operating profit. Because of spin-offs, the revenue figures and income figures for continuing operations change in some years when looking backwards. We kept the reported number for the year listed. The company was definitely complaining of headwinds from rising input costs during these years and we remember the price of wheat, corn, oil etc. all rising from 2004-08.

Margins should have had a 500bp tailwind over this period and margins collapsed 700-1000bp.

In 2010, Kraft bought Cadbury and sold its frozen pizza business. At the time, Cadbury was already running its own restructuring plan, which Kraft kept going. In addition, the company announced a $1.5 billion integration plan that was expected to save $750 million annualized by 2013. In 2011, that savings forecast was boosted to $800 million. Some other cost savings plans were also adopted that cost $318 million in 2009 and $170 million in 2010.

By 2012, it was time for another large restructuring and Kraft announced a $1.1 billion plan over 3 years. Later in the year, that was boosted to $1.5 billion and the spin-off of Kraft Foods was announced that formed Kraft Foods and Mondelez International. We know commodity prices were more subdued, which should have helped recover some of that headwind from 2004-2008. Instead, with three more rounds of integration, cost savings ideas, and beginning another major restructuring – margins did not recover:

| | 2013 | 2012 | 2011 | 2010 |
|---|---|---|---|---|
| Sales | $35,299 | $35,015 | $54,365 | $49,207 |
| Adj. Op Profit | $3,460 | $4,235 | $6,657 | $6,493 |
| Op. Margin | 9.8% | 12.1% | 12.2% | 13.2% |

Again, we added back "one-time charges." It is widely known that the Cadbury acquisition was disappointing for Kraft and then the spin-off happened in late 2012. So, we grant that there is some turmoil going on during these four years. But, management authorized another $3+ billion in restructuring during this time all designed to boost margin.

Finally, Mondelez is on its own to start 2013. It finishes the 2012-2014 $1.5 billion restructuring. It immediately follows that up with a $3.5 billion restructuring for 2014-2018.

The company also sold its coffee business that had been 11% of sales and deconsolidated the results in 2015. By looking at the results of the equity method investments – the operating

margin is essentially 8%. Removing a lower-margin business should help results and it finally did:

| MDLZ | 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| Sales | $25,938 | $25,896 | $25,923 | $29,636 | $34,244 |
| Adj. Op Profit | $4,376 | $4,116 | $3,773 | $4,352 | $3,906 |
| Op. Margin | 16.9% | 15.9% | 14.6% | 14.7% | 11.4% |

We will discuss later that we believe much of the margin gain is coming from price hikes and would not take much regression there to shrink margins again. But we do think investors should consider three points:

First, the easiest time to find low-hanging fruit and complete fat to cut should be the earliest rounds of restructuring. Notice how the first plan that involved essentially the Mondelez/Kraft company acquiring Nabisco was the smallest restructuring plan of the whole set. Not only that, the smallest plan $200-$300 million had the largest multiple of savings – targeting $600 million of improved cost structure. Yet, subsequent plans came in at $1.2 billion, $2.5 billion, $1.5 billion, $1.5 billion, and finally $3.5 billion for stand-alone Mondelez.

Second, how many on-going costs were put into the restructuring charges that were added back to income as "one-time" in nature? Do you think management had travel and salary allocated to these multi-billions in costs? How about tech people who wrote new software or staff that spent weeks with investment bankers? If they tried new production at other facilities to explore consolidation, did those normal operating costs go into restructuring? We shall see going forward after the largest restructuring ever for Mondelez has ended.

Third, removing the lower margin coffee operation should have helped and it appears that it did. Also, in the later years, Mondelez became much more professional in grouping charges that it viewed as "one-time" to make it easy for analysts. Until the last 3 years, this was strictly listed as restructuring related. Of late, it has included mark-to market hedging costs, malware problems, etc. Those weren't added back in the early years, which may have overly flattered more recent margins. On top of that, they've spent nearly two decades cutting costs and spinning off low-margin units, yet margins are lower now than when they started.

That all sort of knocks down the recent management boasts:

*"During the last 5 years, we have gone through a significant restructuring and a cost focused approach, which has created a solid foundation for investment. These strengths of our company are amplified through our unique group of people who have an incredible capability to really make a difference when they put their minds to it. Witness to that has been our margin improvement over the last 5 years."*

## Pricing Is Key to MDLZ Recent Results

In recent years, pricing gains have been positive and more than offset volume issues and FX headwinds:

| Revenues | 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| Price | 1.3% | 1.5% | 1.6% | 3.9% | 5.1% |
| Volume/Mix | 1.1% | -0.6% | -0.3% | -2.5% | -2.6% |
| FX | -1.4% | 0.3% | -4.6% | -12.0% | -5.2% |
| Net | 1.0% | 1.2% | -3.3% | -10.6% | -2.7% |

We do think the first thing to notice is the FX drag that occurs in many years and MDLZ is forecasting it again for 2019. The forecast for 3% organic growth to recur annually is based on only price and volume. But, each year, the organic growth comes against the prior year's actual sales that were impacted by FX. That really reduces the compounding impact. If sales actually rise 3% per year – then they would be 16% higher after 5-years. That would boost earnings and cash flow more easily too. But, if the 3% growth is really a 1% number on average and one negative year of 2%, then five years later sales are essentially flat. That is what is happening here in our view. Look at the sales figure for the last three years when organic growth has been positive and the coffee business has already been deconsolidated:

| | 2018 | 2017 | 2016 |
|---|---|---|---|
| Sales | $25,938 | $25,896 | $25,923 |

The other thing to keep in mind is the FX impact is only showing translation issues after a sale is made. It does not show the sale that is lost because a foreign product was cheaper. If it is very common for MDLZ to have headwinds from FX – it should make taking pricing more difficult. We have seen this issue come up in numerous consumer goods companies:

soap, soft drinks, beer, dairy. Raising prices and then effectively having them raised again by FX is difficult to do continuously. If all competitors are facing higher raw materials, then boosting price is not as negative of an issue because all products are likely seeing the same effect.

The other point to remember is price increases are a bigger driver of earnings growth because there are fewer incremental costs associated with them. No extra manufacturing occurs, no extra inventory supplies are purchased, no other physical thing has to be transported. Thus, when looking at revenue changes, pricing can look more benign. Look at the components of MDLZ income growth:

| | 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| Adj. Op Income | $4,321 | $4,119 | $3,953 | $3,490 | $3,658 |
| Income Growth | $257 | $346 | $463 | -$65 | $198 |
| Pricing | $332 | $370 | $415 | $1,146 | $1,582 |
| Input costs | -$42 | -$181 | -$126 | -$186 | -$384 |
| Volume | $43 | -$160 | -$9 | -$248 | -$971 |

In 2016 and 2014 we used the reported figures for those 10-Ks, in subsequent years they were adjusted by the company to reflect changes in the portfolio such as the coffee being deconsolidated and eventually sold.

We are showing the above table because it looks clear to us that MDLZ has been driving margin and operating income via higher prices. The input costs have been a headwind, but nothing close to the amount of pricing the company is taking. Pricing has routinely been more than 100% of the total income gain. The fact that volume growth has been negative in most years is also a sign that customers can find local substitutes. And for all the work in restructuring, MDLZ is touting the popularity of Oreos and Triscuit crackers for sales growth. Those brands go back generations. Kudos for MDLZ for still keeping them popular but how many people haven't seen an Oreo at this point?

Remember MDLZ's long term picture – 3% organic sales growth with earnings growing faster than sales and free cash flow above $3 billion. The FX over time does become a drag on that plan as we stated above – 3% organic growth every year against a flat prior year does not create a compounding sales figure. Without price hikes – revenue growth is hurt more and earnings do not leverage to the same degree. The last three years, pricing gains have only been 1.3%-1.6% and it still is driving all of earnings growth.

The company is forecasting another year of FX headwind. How long can MDLZ boost prices for weaker currency markets and still make sales? Pricing is definitely showing signs that it is losing some power by becoming a smaller increase for four years in a row.

## Mondelez Is Filling the Holes with Borrowing

We know MDLZ is running a deficit on cash flow. We also know it is pulling cash from working capital. Yet it is still borrowing more money. Net debt is up almost $4 billion since 2015.

| | 2018 | 2017 | 2016 | 2015 |
|---|---|---|---|---|
| S-T Debt | $3,192 | $3,517 | $2,531 | $236 |
| L-T Debt | $15,180 | $14,135 | $14,668 | $15,162 |
| Less Cash | $1,100 | $761 | $1,741 | $1,870 |
| Net Debt | $17,272 | $16,891 | $15,458 | $13,528 |
| Adj cash flow | $5,132 | $4,935 | $4,536 | $4,449 |
| Debt/cash flow | 3.4 | 3.4 | 3.4 | 3.0 |

Our adjusted cash flow is operating earnings without one-time items as reported by MDLZ plus depreciation and amortization. That has been heavily influenced by taking more pricing than the input prices have been rising as we already discussed. If pricing is not as strong going forward, here is another area where rising debt could suddenly look worse because adjusted cash flow would turn flat or down.

Debt is one of those catalysts that few people care until overnight – they all do. To us, MDLZ has liquidity right now. The cash balance has been high as a result of pulling money from working capital and stands at $1.1 billion. MDLZ also has the $5.4 billion stake in KDP. They could seek ways to monetize that either selling shares or borrowing against them. It has capital lines and commercial paper available too. It has been utilizing them to pay debt and reissue new bonds in an orderly manner. The maturity schedule remains fairly high too:

| | |
|---|---|
| 2019 | $ 2,648 |
| 2020 | $1,544 |
| 2021 | $3,334 |
| 2022 | $726 |
| 2023 | $1,822 |

None of that is an immediate trigger, but the debt that is maturing in 2019 -2021 involves more cash than MDLZ has on hand. If the company needs to borrow annually at the same time issue debt every year, this could become a problem – but not one we see hurting right now.

What we think is clear is MDLZ needs a way to raise more external cash annually to reach its goals. Otherwise, it needs to lower the share repurchase plan in a large way and take its lumps. That is probably the next shoe to drop in our view. It would preserve the dividend – which they could still easily cover but would start to slow dividend growth and EPS growth if the share count is no longer falling.

# Goodwill in the Wake of Kraft Heinz

Kraft Heinz (KHC) shocked the market last week by reporting not only disappointing adjusted earnings, but also a write-down of $15.4 billion to its massive goodwill and intangibles balances. To top it off, it disclosed an SEC subpoena from October examining its procurement accounting practices. The stock has lost over 30% of its value since the announcement as investors come to terms with the fact that the massive goodwill write-down is clear evidence that the bull story based on creating shareholder value by acquiring brands and slashing costs has simply not materialized.

Growth through acquisition has been the “go to” strategy of most packaged food and consumer products companies due to the simple fact that these markets have been flat at best for years. KHC is certainly not the only player in these markets with massive goodwill on its balance sheet. We thought it would be helpful to take a closer look at makeup of goodwill and intangibles of large “big brand” companies with the largest percentage of goodwill to total assets and assess the likelihood of material write-downs in the foreseeable future.

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## The List

The following list shows a selection of the largest big brand companies where goodwill and intangibles comprise more than 50% of total assets. We note that there are many companies

with goodwill and intangibles balances less than 50% of assets that are still at risk of a material write-down. However, the largest ones are the most logical place to begin a review.

| Company | Goodwill & Intang % of Total Assets |
|---|---|
| Kraft Heinz (KHC) | 86.1% |
| JM Smucker (SJM) | 78.0% |
| McCormick (MKC) | 72.2% |
| ConAgra Brands (CAG) | 70.8% |
| Church & Dwight (CHD) | 70.3% |
| General Mills (GIS) | 69.8% |
| Mondelez International (MDLZ) | 61.7% |
| Campbell Soup (CPB) | 59.5% |
| Procter & Gamble (PG) | 58.9% |
| Kellogg (K) | 52.9% |

Note that we have earnings quality ratings on all of these companies as well as a NEUTRAL rating on CAG (upgraded on 1/10/19 from our original SELL issued on 8/9/2018). We have also issued a NEUTRAL rating on MDLZ which documents many problems we see with the company.

***This report will focus on the top four companies after KHC, all of which have goodwill and intangibles balances greater than 70% of total assets. (SJM, MKC, CAG, CHD).***

## So, What Happened at Kraft Heinz?

*Behind the Numbers* has a long history of being critical of KHC's never-ending cycle of acquiring companies, taking huge restructurings and write-offs, and later spinning off the acquired assets. Meanwhile, margins actually showed declines along the way. This history is explored in the Mondelez (MDLZ) piece elsewhere in this issue.

Prior to the most recent implosion, we had an EQ rating of 2+ (Weak) on KHC. Note that we are awaiting the release of the 10-K before updating our EQ rating on the company. Problems we had identified in previous EQ Reviews included:

- Working capital manipulations including receivables securitizations and stretching accounts payable to boost cash flow.

- The 11/17 restatement of past earnings for improper accounting of operating cash flows and the identification of a material weakness in internal controls over financial reporting

- Decline in allowance for bad debts

- Massive, recurring restructuring charges and goodwill write-offs coupled with warnings from the company of deteriorating fair value of goodwill and intangibles.

- High debt levels and elevated ratio of dividend to free cash flow.

KHC's 2/21/19 earnings release not only contained a 10 cps adjusted earnings miss, but also a $15.4 billion write-down to the value of goodwill and intangibles which represented 15% of those account balances and an eye-opening 13% of total assets. In addition, the company announced an October SEC subpoena into its accounting practices focusing on the area of procurement and contracts with its vendors along with a $25 million charge related to its own internal investigation into the matter. While an SEC subpoena is nothing to slough off, especially for a company that had to restate results and identify a material weakness in internal controls just a year ago, we believe the key issue to focus on for now is the ramifications of the goodwill write-down.

## Ramifications of the Write-Down

To understand the ramifications of the write-down, one needs to ponder what intangible assets represent. When a company acquires another company or its assets, the purchase price must be allocated among the various asset and liability accounts. In theory, when management determined the price it was willing to pay for a company, it considered the present value of the cash flows it expected to be able to generate with the acquired assets. This would include estimates of the synergies it hopes to achieve through actions such as consolidating the acquired company's operations with its own, introducing acquired products into new distribution channels, co-marketing efforts, etc. In almost all cases, this estimated intangible value comprises a material part of the overall purchase price. For accounting purposes, this "excess purchase price" is allocated among the goodwill and intangibles balances and allocated even further in the footnotes among items such as customer lists and trademarks.

All goodwill is not evil. However, for a company in a market that is showing little or even negative growth, a large and rising goodwill balance deserves special attention, and this is very true of the big consumer brand companies. Big brands have faced a growing mountain of problems for years including consolidation of their customer base which shifts power to the customers and away from suppliers, competition from generics as more consumers see them as a viable option, and international markets that are closer to saturation and less brand loyal. These companies have historically boasted premium valuations relative to their growth rate based on the premise that "people will always buy toothpaste." With many now struggling to report positive organic growth, most have had to resort to serial restructurings and growth through acquisition strategies. It has almost been amusing to watch these companies trade assets back and forth with brands changing hands multiple times in just a few years. It has been common to see one company breathing a sigh of relief for unloading a failing brand from a disappointing acquisition while the acquiring company is cheering how well its newly acquired gem is growing.

All of these deals assume aggressive benefits from synergies and cost-cutting. As noted above, all of these assumptions wind up as components of goodwill and intangibles. **A write-off like KHC's represents management finally coming to terms with the fact that the assumptions made in determining the purchase price years ago were wildly optimistic. In short- management overpaid for the acquired assets and they now must be written down to reflect reality.**

In the case of KHC, the negative impact was further magnified by its hefty debt balance which required a growing cash flow stream to pay down. With the future of those cash flows now called into question,

## Things to Consider When Evaluating Goodwill and Intangibles

We found it interesting that KHC's management stated in the 4Q press release that:

> *"During the fourth quarter, as part of the Company's normal quarterly reporting procedures and planning processes, the Company concluded that, **based on several factors that developed during the fourth quarter, the fair values of certain goodwill and intangible assets were below their carrying amounts. As a result, the Company recorded non-cash impairment charges of $15.4 billion to lower the carrying amount***

***of goodwill in certain reporting units,*** *primarily U.S. Refrigerated and Canada Retail, and certain intangible assets, primarily the Kraft and Oscar Mayer trademarks."*

We have to respectfully disagree that 13% of the company's total assets are now worthless because of something that just popped up in the fourth quarter. This was a problem which has been festering for years and finally reached a point that no reasonable forecast of discounted future cash flows could justify the carrying value. It is difficult to tell exactly when a company will reach that point, but there are several red flags we can watch for:

- Goodwill and intangibles balances are large and growing
- Disappointing growth emanating from the acquired operations
- Big expectations for value added by cost-cutting at acquired operations. This is especially true when the assets have already been previously acquired and restructured by another company or owned by private equity firms that have stripped them bare. How much more efficiency is left to wring out via cost-cutting?
- Never-ending restructuring charges that result in no or minimal improvements to margins

We will keep all of these items in mind as we take a closer look at four big brand companies with the largest goodwill and intangibles balances relative to assets.

## J.M. Smucker (SJM)

SJM's goodwill and intangibles as a percentage of total assets is 78% as of 1/19. This is the second-highest total of the big-brand companies behind pre-blowup KHC's 86%.

Risks

- Pet Food represents the largest component of goodwill and intangibles and is comprised of assets from the 2015 Big Heart deal and the 2018 Ainsworth deal. Big Heart has already experienced write-downs as many of the acquired brands have struggled. The original deal assumed generous margin improvement despite these assets being owned by private equity prior to purchase. More write-downs seem possible.

- Two-thirds of Ainsworth's sales are from *Rachel Ray's Nutrish* premium pet food. This area is currently growing and we are not as concerned about a near-term write-down from this area. However, competition is increasing in the segment and the bulk of the assets are centered around one brand which could increase the risk of longer-term disappointment.

- We are less concerned about a large write-down from the Coffee and Consumer Foods portion of goodwill.

## What's in Goodwill and Intangibles?

The following table shows the trend in goodwill and intangibles balances versus total assets for the last five trailing 12-month periods:

| | 1/31/2019 | 01/31/2018 | 01/31/2017 | 01/31/2016 | 01/31/2015 |
|---|---|---|---|---|---|
| Goodwill | $6,438.90 | $5,949.40 | $6,084.70 | $5,944.90 | $3,134.90 |
| Intangibles | $6,759.00 | $5,970.80 | $6,262.00 | $6,715.00 | $2,973.90 |
| Total Assets | $16,927.60 | $15,329.20 | $15,811.70 | $16,281.50 | $9,095.60 |
| Goodwill/Intang % of Total Assets | 78.0% | 77.8% | 78.1% | 77.8% | 67.2% |

The company offers the following breakdown of goodwill by segment as of 1/19:

| Goodwill by Segment | |
|---|---|
| US Retail Pet Food | $2,469.20 |
| US Retail Coffee | $2,090.90 |
| US Consumer Foods | $1,456.50 |
| International and Away from Home | $422.30 |
| TOTAL | $6,438.90 |

We will look at each segment of goodwill below:

***Pet Food***

US Retail Pet Food is the largest component of goodwill. While the company does not break out intangibles by segment, we can see that the large jumps in intangibles in 2016 and 2019 coincide with SJM's pet food acquisitions indicating the large majority of intangibles emanates from this area.

*Big Heart Deal*

The spike in total goodwill and intangibles 2015 to 2016 was a result of the acquisition of Big Heart in early 2015. Big Heart was the pet food division of Del Monte Foods and includes the *Milk-Bone, Kibbles 'n Bits* and *Meow Mix* brands. A private equity firm had previously acquired Del Monte and sold off its flagship canned food division prior to selling Big Heart to SJM for $5.8 billion. At the time of the deal, Big Heart was generating an estimated $2.3 billion in sales and $450 million in EBITDA. Management also forecasted $200 million in annual synergies to be realized within 3 years and for sales growth to be 4-5% for several years after the deal.

Looking back, the forecast for $200 million in synergies seems very aggressive considering 1) Big Heart has been owned by a private equity firm whose job was to eliminate any excess expense and 2) EBITDA margins were already almost 20%. Consider that in 2017, Blue Buffalo, a premium pet food maker, was producing EBITDA margins of around 24. To almost double that with $200 million in cuts seems very optimistic.

*The Ainsworth Deal*

The second jump in goodwill and intangibles from 2018 to 2019 was a result of the company's mid-2018 acquisition of Ainsworth. Two-thirds of Ainsworth's sales are generated by the *Rachel Ray's Nutrish* brand of premium pet food while the balance contains such premium brands as *Nature's Recipe*. Ainsworth was a privately-held company that was expected to generate $800 million in sales after its first year of operation and pre-synergy EBITDA of $85 million. Annual cost synergies are expected to be $25 million the first year and $55 million after that. While the forecasted synergies are large relative to current EBITDA, they seem more reasonable than those for Big Heart given the fact that the company was smaller and privately-held prior to the deal and could conceivably have more fat to cut.

SJM has already taken write-downs to the value of its goodwill and intangibles in the last three years. We cited the company's warning of the potential impairment for its Pet Food goodwill in our 12/6/18 EQ Review of SJM. That was followed by a $107.2 million charge in the 1/19 quarter for impairment to related trademarks, as explained by the company below:

> *"We review goodwill and other indefinite-lived intangible assets at least annually on February 1 for impairment, and more often if indicators of impairment exist.*
>
> *During the third quarter of 2019, we began our annual planning cycle, inclusive of a strategy review within our strategic business areas. Our planning process was not complete as of January 31, 2019; however, we have made some decisions related to certain brands resulting in a reduction in our long-term forecasted net sales of certain indefinite-lived trademarks within the U.S. Retail Pet Foods segment, excluding the acquired Ainsworth business. As a result of the reduction in long-term forecasted net sales for these indefinite-lived trademarks and narrow differences between fair value and carrying value as of April 30, 2018, we performed an interim impairment analysis on these trademarks as of January 31, 2019, which resulted in an impairment charge of $107.2. This charge was included as a noncash charge in our Condensed Statement of Consolidated Income.*
>
> *As of January 31, 2019, we do not believe that our Pet Foods reporting unit or any of the remaining indefinite-lived trademarks within the U.S. Retail Pet Foods segment are more likely than not impaired.* ***The trademarks subject to the interim impairment analysis performed during the quarter do not represent a significant percentage of the Pet Foods reporting unit's forecasted segment profit. In addition, we anticipate growth from other brands, inclusive of the recently acquired Ainsworth business, will mostly offset the declines noted on the impaired trademarks evaluated during the quarter. The U.S. Retail Pet Foods segment goodwill and indefinite-lived intangible***

***assets of $2,469.2 and $1,496.1 , respectively, remain susceptible to future impairment charges given the narrow differences between fair value and carrying value. As we continue our planning process during the fourth quarter, any significant adverse changes to the current year or forecasted net sales or profitability, as well as any significant adverse changes in strategy, would result in additional impairment charges which could be material."***

The brands picked up in the Big Heart acquisition have been a disappointment from the start due to slower than expected growth in the traditional pet food segment. However, Ainsworth competes in the premium brand segment which is currently experiencing good growth. Consider management's comments below regarding 9-month results which illustrate the bifurcated trends in the Pet Food segment:

*"The U.S. Retail Pet Foods segment net sales increased $525.5 in the first nine months of 2019, reflecting the $546.2 contribution from Ainsworth. Excluding Ainsworth, net sales declined $20.7, driven by unfavorable volume/mix, which reduced net sales by 1 percentage point, as declines for the Natural Balance and Gravy Train brands were partially offset by gains for the Meow Mix and Nature's Recipe brands. Segment profit increased $34.4, driven by the addition of Ainsworth. Excluding Ainsworth, segment profit decreased $24.0, as the impact of higher input costs was only partially offset by reduced marketing expense, primarily related to the Natural Balance and Nature's Recipe brands. In response to a sustained increase in input costs, we implemented a list price increase on select pet food products sold in the U.S. effective February 2019."*

We still see a significant risk of write-downs from the Pet Food segment in the future. The legacy Big Heart business is hardly firing on all cylinders and remains susceptible to the market continuing to shift to premium brands. Meanwhile, competition in the premium market is increasing with the prime example being General Mills' purchase of the premium *Blue Buffalo* brand which is reportedly doing very well with consumers. Also keep in mind that the bulk of Ainsworth was represented by a single brand: *Rachel Ray's Nutrish*. Any drop in popularity there could lead to disappointment and as the company warned, the recent timeframe on the acquisition means there is little cushion between carrying value and fair value, increasing the chance of an impairment.

### ***US Retail Coffee***

US Retail Coffee is primarily made up of the company's *Folgers and Dunkin Donuts* brands acquired in 2008 and the *Café B*ustelo brand acquired in 2011. While *Folgers* has experienced a challenge from competition from premium blends, overall the division is still showing growth.

> "*The U.S. Retail Coffee segment net sales increased $16.1 in the first nine months of 2019. Favorable volume/mix contributed 3 percentage points, driven by the Dunkin' Donuts , 1850 , and Café Bustelo brands, partially offset by declines in Folgers roast and ground coffee. The favorable volume/mix was partially offset by lower net price realization, which reduced net sales by 2 percentage points, primarily driven by the Folgers brand. Segment profit increased $48.9, primarily due to lower input costs and favorable volume/mix, partially offset by an increase in marketing expense, the majority of which related to the 1850 launch, and lower net price realization."*

We are not as concerned by a material unexpected impairment related to this segment.

***US Consumer Foods***

Consumer Foods is represented by iconic brands such as *Jif, Carnation* and *Eagle Brand*. Sales growth remains positive in this segment, but profit growth is hit or miss as higher input costs and pricing pressure negatively impacts growth. However, given the age and relatively solid positioning of these brands, we are not as concerned about a meaningful write-down from this segment.

## Debt and Cash Flow

SJM's financial picture is definitely better than KHC's as the following table shows:

| | 1/31/2019 | 01/31/2018 | 01/31/2017 |
|---|---|---|---|
| Total Debt | $6,275.10 | $4,942.50 | $5,087.00 |
| EBITDA | $1,448.40 | $1,341.80 | $1,511.20 |
| Debt/EBITDA | 4.3 | 3.7 | 3.4 |
| Dividend % of Free Cash Flow | 42.2% | 38.7% | 34.8% |
| Cash for Repurchases | $5.30 | $425.50 | $452.30 |
| Dividend + Repo % of Free Cash Flow | 42.8% | 85.8% | 82.2% |
| Cash for Acquisitions | $1,903.00 | $0.00 | $0.00 |

Forward debt/EBITDA is below 4x with a full year of the Ainsworth deal included. The dividend consumes well under 50% of free cash and the company has scaled back the buyback to focus on reducing leverage.

## Summary

Given the size, uncertain future and narrow margin between fair value and carrying value, we believe there is a material risk of further write-downs from the company's pet food segment. Further deterioration in the Folgers or foods segments seem less likely but still possible, particularly if there is continued deterioration in the instant coffee market.

# McCormick (MKC)

McCormick (MKC) has the second-highest goodwill and intangibles balances relative to assets of the companies we are reviewing. We also note that we currently have an EQ rating of 3- (Minor Concern).

- Approximately 70% of the company's goodwill and intangibles balances are a result of the 8/17 acquisition of RB Foods from Reckitt Benckiser.

- The difference between fair value and carrying value for the RB Foods assets is narrow owing to the fact that the deal is less than 2 years old. While this gives less room for error, we note that the *Frank's* and *French's* brands picked up in the deal appear to be performing well and we are not especially concerned with a near-term write-down at this point.

- Fair value of the remaining brand names and trademark intangibles exceeds 25% of carrying value reducing concern of a material write-down from non-RB Food assets.

## What's in Goodwill and Intangibles?

The following table shows MKC's trend in goodwill and intangibles as a percentage of total assets:

| | 11/30/2018 | 11/30/2017 | 11/30/2016 | 11/30/2015 | 11/30/2014 |
|---|---|---|---|---|---|
| Goodwill | $4,527.90 | $4,490.10 | $1,771.40 | $1,759.30 | $1,722.20 |
| Intangibles | $2,873.30 | $3,071.10 | $424.90 | $372.10 | $330.80 |
| Total Assets | $10,256.40 | $10,385.80 | $4,635.90 | $4,472.60 | $4,414.30 |
| Goodwill/Intang % of Total Assets | 72.2% | 72.8% | 47.4% | 47.7% | 46.5% |

While the company does not give a complete itemized list of goodwill by segment, it does provide goodwill associated with some of its key brands which include:

| Goodwill by Segment | |
|---|---|
| RB Foods | $2,320.00 |
| Zatarain's | $106.40 |
| Lawry's | $48.00 |
| Kamis | $33.20 |
| Stubb's | $27.1 |

Clearly, the 8/17 acquisition of RB Foods from Reckitt Benckiser generated the bulk of the company's goodwill and intangibles balances. The RB Foods brands include *French's*, *Frank's RedHot,* and *Cattlemen's*. Sales adjusted for currency grew by 2% in the quarter, but the company blamed inventory destocking by customers for the weak results and pointed to a 5% increase in end consumption of its products in the period with the *French's* and *Frank's* brands accelerating throughout the year. This reduces the concern that the RB Foods assets are in danger of a write-down near-term.

The company stated in its 10-K with regards to its goodwill balances:

> *"An impairment charge would be recognized to the extent the carrying amount of goodwill exceeds the implied fair value. As of November 30, 2018, we had $4,527.9 million of goodwill recorded in our balance sheet ($3,398.9 million in the consumer segment and $1,129.0 million in the flavor solutions segment).* ***Our fiscal year 2018 testing indicated that the estimated fair values of our reporting units were significantly in excess of their carrying values. Accordingly, we believe that only significant changes in the cash flow assumptions would result in an impairment of goodwill."***

The company's intangibles balances consist mostly of trademarks and brand names;

> *"As of November 30, 2018, we had $2,646.9 million of brand name assets and trademarks recorded in our balance sheet, and none of the balances exceeded their estimated fair values at that date.* ***Excluding the brand names associated with the 2017 RB Foods acquisition, and those brand names discussed below, the percentage excess of estimated fair value over book values for our major brand names and trademarks was 25% or more as of November 30, 2018."***

The brand names picked up in the RB Foods deals have a much more narrow gap between fair value and carrying value due to the recent timing of the deal. As noted above, these

brands appear to be performing well which minimizes our concern of the likelihood of a write-down in the near future.

MKC has taken a string of restructuring charges in the past, as seen in the following table:

| | 11/30/2018 | 11/30/2017 | 11/30/2016 | 11/30/2015 |
|---|---|---|---|---|
| Sales | $5,408.90 | $4,834.10 | $4,411.50 | $4,296.30 |
| Adjusted Gross Margin | 43.8% | 42.0% | 0.0% | 0.0% |
| Adjusted Operating Margin | 17.4% | 16.3% | 14.9% | 14.3% |
| | | | | |
| Restructuring Charges | $38.80 | $99.30 | $16.00 | $65.50 |
| Restructuring Charges % of Op Profit | 4.1% | 12.6% | 2.4% | 10.7% |

In 2018, $16.3 million related to completion of cost-reduction initiatives with $22.5 million related to integration costs for the RB Foods deal. Likewise, $77.1 million of the $99.3 million in charges were integration-related. According to the 10-K, these integration costs

> *"primarily consisted of outside advisory, service and consulting costs; employee-related costs; and other costs related to the acquisition. In 2017, these expenses consisted of amortization of the acquisition-date fair value adjustment of inventories of $20.9 million that was included in cost of goods sold; outside advisory, service and consulting costs; employee-related costs; and other costs related to the acquisition, including the costs related to the bridge financing commitment of $15.4 million that was included in other debt costs."*

Given the size of the deal, the makeup and size of these costs seem reasonable. Also, the higher margins of the acquired business have driven charge-adjusted margins upwards. We do not currently see hidden signs of problems with the profitability of the RB Foods brands that threaten a write-down in the near-term.

## Debt and Cash Flow

MKC's debt to EBITDA at the end of 2018 was over 4x due to the RB Foods deal. Management has a goal of reducing it to under 3x by 2020.

| | 11/30/2018 | 11/30/2017 | 11/30/2016 | 11/30/2015 |
|---|---|---|---|---|
| Total Debt | $4,696.40 | $5,027.10 | $1,447.20 | $1,394.40 |
| Adjusted EBITDA | $1,158.70 | $967.00 | $826.10 | $769.90 |
| Debt/EBITDA | 4.1 | 5.2 | 1.8 | 1.8 |
| Dividend % of Free Cash Flow | 41.9% | 37.5% | 43.2% | 44.4% |
| Cash for Repurchases | $62.30 | $137.80 | $242.70 | $145.80 |
| Dividend + Repo % of Free Cash Flow | 51.5% | 59.3% | 91.3% | 76.0% |
| Cash for Acquisitions | $4.20 | $4,327.40 | $120.60 | $210.90 |

The dividend consumes just over 40% of free cash and the buyback has been suspended, so the debt reduction goals seem plausible. Regardless, the high debt level does increase the risk profile. If the slowdown in growth was due to temporary inventory destocking issues, then we should see growth return in the next couple of quarters. However, continue disappointing top-line growth or expansion of restructuring activity should be viewed with concern especially given the high debt.

# ConAgra Brands (CAG)

CAG's goodwill and intangibles balances amounted to 71% of total assets at the end of the most recent quarter. We currently have a NEUTRAL rating on CAG with a key point of the story being the unrealistic expectations surrounding the company's acquisition of Pinnacle Foods which accounts for the bulk of the company's goodwill and intangibles. Note that we initiated coverage of CAG with a SELL on 8/9/2018 and upgraded it to NEUTRAL after the sharp drop after the most recent quarter.

CAG is no stranger to the impairment charge. The company took $1.92 billion, $1.56 billion and $596.2 million in impairment charges in 2016, 2015 and 2014, respectively. Much of this was related to the company's ill-fated Ralcorp deal which took all of two years to completely implode.

Risks

- The bulk of goodwill and intangibles is the result of the recent Pinnacle Foods deal. We refer clients to our 8/18 report for more detail where we examined the deal in detail

- The Pinnacle deal was based on CAG boosting margins by 700 bps through aggressive cost-cutting and synergies. However, Pinnacle was itself a roll-up that did extensive restructurings of its acquired companies and boosted margins as much as 1000 bps in some cases. How much room is left for CAG to improve? We believe there is a very real risk of an eventual material write-down emanating from this area.

- CAG paid more for Pinnacle than Pinnacle paid for the companies it acquired.

- CAG regularly takes charges to the remaining portions of its goodwill. Growth remains anemic in most segments which leaves open the possibility of a material negative surprise emerging.

- Debt is over 5x EBITDA. The company has plans to reduce that to 3.5x by 2021, which requires $2.7 billion with assumed Pinnacle synergies but $3.5 billion without.

## What's in Goodwill and Intangibles?

| | 11/25/2018 | 11/25/2017 | 11/25/2016 | 11/25/2015 | 11/25/2014 |
|---|---|---|---|---|---|
| Goodwill | $11,167.20 | $4,457.00 | $4,248.70 | $4,685.50 | $7,616.80 |
| Intangibles | $5,132.20 | $1,298.20 | $1,260.90 | $1,383.90 | $3,114.90 |
| Total Assets | $23,006.80 | $10,400.10 | $11,425.00 | $15,994.60 | $19,501.70 |
| Goodwill/Intang % of Total Assets | 70.8% | 55.3% | 48.2% | 37.9% | 55.0% |

The company offers the following breakdown of its goodwill balance:

| Goodwill by Segment | |
|---|---|
| Pinnacle Foods | $6,667.70 |
| Grocery & Snack | $2,594.30 |
| Refrigerated & Frozen | $1,095.20 |
| Foodservice | $571.00 |
| International | $238.90 |
| Total | $11,167.10 |

We can see that over half of goodwill originated with the Pinnacle deal. While the company does not break out intangibles by segment, the large jump in 2018 indicates that about 75% of intangibles also originated with Pinnacle.

### *Pinnacle*

The Pinnacle goodwill and intangibles balances have all the red flags we would look for pointing to a likely eventual write-down of goodwill. CAG has forecast enormous margin improvements related to cost-cutting and synergies through integrating Pinnacle. However, Pinnacle itself is roll-up play consisting of several companies it acquired in its own acquisition string. Along the way, it had already boosted the operating margins materially at is acquired operations. Margins at some of its acquired companies were in the low teens at the time of acquisition before Pinnacle quickly boosted them to the 20% range. Major restructurings were undertaken including relocating R&D facilities, consolidation of manufacturing and the closing of redundant plants. We believe much of the inefficiency has

already been squeezed out of these companies by Pinnacle, making further improvement by CAG difficult.

Also, CAG paid 15.8 times EBITDA for Pinnacle which is higher than what Pinnacle paid for many of the companies it acquired, offering further evidence that CAG overpaid for the deal. Meanwhile, volume growth at some of Pinnacle's key brands such as frozen foods was non-existent prior to the acquisition by CAG. We encourage clients to review our previous work on CAG for more detail on these items.

As a result of the above issues, we believe there is a significant risk that CAG will ultimately have to incur material impairment charges on the goodwill and/or intangible balances associated with the Pinnacle acquisition.

***Grocery & Snack***

CAG's grocery and snack brands include *Marie Callender's, Reddi-Whip, Hunt's, Healthy Choice, Slim Jim* and *Orville Redenbacher's*. These brands have been in the company's stable for many years along with other smaller brands picked up in various acquisitions. The company seems to regularly take small to medium sized charges to its portfolio of brand assets. In fiscal 2017 (ended May), the company took $343 million in charges spread among its international and grocery segments. 2016 saw $50 million in impairment charges related to its *Chef Boyardee* brands. In 2015, the company took another $20.9 million in charges against the remaining portion of its Private Label brands held in snack foods along with $4.8 million for its *Poppycock* brand. We don't see growth reigniting at in any of these old brands which means we have likely not seen the last of the charges from this division. There is also the risk that like KHC, the company will have to finally make assumptions that could lead to one-large impairment write-down, but it is difficult to assess the level of risk with the information we have.

## Debt and Cash Flow

CAG is currently levered at 5.1 times EBITDA based on forecasted numbers. Management plans to reduce leverage to 3.5 times by fiscal 2021. However, as we pointed out in our original warning, this will require the company to pay down $2.7 billion in debt and it will only be generating $500-$700 million in free cash flow after the dividend. In that time, the

company will also have to spend about $350 million to produce its hoped-for synergies. Finally, the $2.7 billion debt paydown assumes the company realizes the margin expansion assumptions which we believe are very aggressive. For perspective, the paydown jumps to $3.5 billion without the synergies. Therefore, any significant disappointment surrounding future cash flows at acquired companies, particularly Pinnacle, would have a significant negative impact on the company's future leverage position.

# Church & Dwight (CHD)

CHD's goodwill and intangibles balances represent over 70% of its total assets at year-end. We remind clients that we currently have an EQ rating of 2+ (Weak) on CHD which reflects our concern about the lack of visibility into the company's receivables factoring program, recent increases in inventory and its recent switch to FIFO inventory accounting for the 20% of inventories previously accounted for under LIFO.

Risks

- We estimate that approximately $420 million in goodwill and $800 million in intangibles are the result of last year's acquisitions of the *Waterpik* assets. This area is currently growing, unlike many of the stagnant food brands discussed elsewhere.

- We estimate that approximately $350 million in goodwill and a similar amount of intangibles resulted from the 2012 acquisition of Avid Health, a maker of gummy vitamins. This area has struggled to grow as competition has increased in recent years. The company specifically warned in 2017 that fair value for these assets was falling near carrying value, but this has reversed in 2018. For perspective, cutting the value of these assets in half would represent about 5% of total assets. Management seems to have taken action to revive growth which has been successful so far, but this area seems the most likely to produce a material write-down in the foreseeable future and should be watched closely going forward.

- Unlike many big brand companies, CHD does not have a recent history of taking regular write-downs to its goodwill and intangibles.

## What's in Goodwill and Intangibles?

The following table shows the balances and their percentage of total assets for the last five years:

| | 12/31/2018 | 12/31/2017 | 12/31/2016 | 12/31/2015 | 12/31/2014 |
|---|---|---|---|---|---|
| Goodwill | $1,992.90 | $1,958.90 | $1,444.10 | $1,354.90 | $1,325.00 |
| Intangibles | $2,274.00 | $2,320.50 | $1,431.80 | $1,269.50 | $1,272.40 |
| Total Assets | $6,069.20 | $6,014.80 | $4,354.10 | $4,256.90 | $4,359.20 |
| Goodwill/Intang % of Total Assets | 70.3% | 71.1% | 66.1% | 61.7% | 59.6% |

In addition, the company provides the following breakout of goodwill by segment:

| Goodwill by Segment | |
|---|---|
| Consumer Domestic | $1,633.20 |
| Consumer International | $223.70 |
| Specialty Products | $136.00 |
| | $1,992.90 |

Unlike recent acquisitions at some other big brand companies, CHD's recent deals have included picking up more specialized products in potentially higher growth areas than its core baking soda business. From looking at previous 10-Ks, we were able to piece together that of the $1.8 billion in goodwill in the consumer segments, over $420 million was from last year's acquisition of *Waterpik* with about $800 million in intangibles picked up in the deal. The 2012 acquisition of Avid Health, a maker of children's gummy vitamins added about $345 million in goodwill and a similar amount in intangibles. As we will see below, these assets are more than capable of disappointing. However, they are at least not a #3 brand in a commodity food market segment competing for evaporating supermarket shelf space.

CHD also does not have a history of taking large goodwill write-offs and excessive restructuring charges. The company discloses the following in its 10-K regarding the carrying value of its goodwill and intangibles:

> *"We determined that the fair value of all other intangible assets for each of the years in the three-year period ended December 31, 2018 exceeded their respective carrying values based upon the forecasted cash flows and profitability.* ***In 2017 there was a personal care trade name that, based on recent performance, had experienced sales and profit declines that had eroded a significant portion of the excess between fair and carrying value, which could potentially result in an impairment of the asset. In 2017, this excess had been reduced due in large part to an increased competitive***

> ***market environment therefore resulting in reduced cash flow projections. The performance of the tradename improved in 2018, thereby increasing the excess between fair value and carrying value. This indefinite-lived intangible asset could still be susceptible to impairment risk.*** *While management can and has implemented strategies to address the risk, significant changes in operating plans or adverse changes in the future could reduce the underlying cash flows used to estimate fair values and could result in a decline in fair value that could trigger future impairment charges of this asset."*

The personal care asset the company is referring to is likely it gummy vitamin brands. Consider the following comment the company made in its 10-K regarding the space:

> *"In addition, the gummy vitamin category has grown from eight competitors to 30 in the last five years. We continue to evaluate and vigorously combat these pressures through, among other things, new product introductions and increased marketing and trade spending. However, there is no assurance the categories will not decline in the future and that we will be able to offset any such decline."*

Clearly gummy vitamins is a particular area of challenge for CHD and it is taking steps to remain competitive in the space. As noted above, much of the company's gummy vitamin presence was a result of the 2012 Avid Health deal which we estimate added about $700 million in combined goodwill and intangibles. This portion of the company's acquired assets seem to be the most vulnerable to a near-term write-down should the company be unable to mount a sustained comeback in this segment. To put this in perspective, cutting the value of the associated goodwill and intangibles in half would result in an approximate $350 million charge which represents a little over 5% of total assets. Given that the company seems to have staged a recovery in the assets for now, we view this as a relatively low risk at the moment, but warrants scrutiny in the future.

## Debt and Cash Flow

Of the four companies we reviewed, CHD has the least concern with regards to debt. The company had very low leverage prior to the *Waterpik* acquisition in 2017 which only raised its debt to EBITDA to 2.8x. As if the end of 2018, debt to EBITDA is already down to 2.3x and the company has adequate free cash to cover the dividend and still make significant debt repayments.

# Macy's (M) 4Q18 Review – Maintain Buy

Macy's released 4Q results this week with some positives and negatives to report. The company beat forecasts for EPS handily but gave guidance for a weak first quarter and forecast results should improve throughout 2019. We think this stock is worth over $60 eventually and the 6.2% dividend gives ample reward to wait for higher earnings and some multiple expansion. We believe the story remains intact for comp sales that rise annually, creating operating leverage, and faster EPS growth. Essentially 2% comp growth on flat gross margin is worth about 50-cents in annual EPS by our estimates. SG&A reductions as new investments are completed are worth 25-cents in EPS for every $100 million of cost cuts that are already in place and will be revealed as heavy levels of new investment slows. At 7x EPS and a high dividend yield, this still looks very cheap.

- **The sales comp came in at 2% for the 4Q and 2.4% for 2018 hitting January guidance targets. Two negative items cost the 4Q comp 70bp** – a fire in a mega fulfillment center in 4Q hurt sales by creating delays and making some inventory unavailable during parts of Christmas shopping and a promotion that in the past was extended to all customers was only offered to loyalty members. Neither situation is likely to repeat.

- **4Q results also saw margin pressure as staffing levels were raised to serve a forecasted 2.3%-2.5% growth rate is sales but came in at 2.0%.** Also, gross margin was hurt by free shipping not leveraging as transactions rose, but dollars per transaction fell. The company also worked down some inventory after Christmas.

- **Gross margin is expected to fall y/y in 1Q with a tough comp and inventory clearing. Margins pressure will also come from heavy investment in new store make-overs in early 2019 that boosts SG&A.**

- **Guidance for 2019 appears low in our opinion at flat to +1% comp sales. There are simply too many areas that have proven to be drivers of sales that are rolling out to additional stores and entering comps.** Backstage is boosting total sales in initial stores by 5% and Backstage are running at double digits and will enter comps in 2019. Growth 50 will expand to 150 stores in 2019. Stores with that treatment are growing faster and the 150 stores already represent 2/3 of sales done in physical stores. Online sales are still growing at double digits, online pick up at stores is boosting store sales,

Vendor Direct is looking to double SKUs and that is already growing sales, and Loyalty programs are creating customers who shop more and spend more.

- **Even management expects to see margin leverage in 2019 after a period of heavy investment early on.** They are cutting management numbers to save another $100 million that will materialize during 2019. Rollout of more Backstage and Growth 50 will concentrate in the first half of 2019 and add to SG&A, but that should mitigate in the second half. Macy's is working to leverage its supply chain to allow it to move inventory more quickly between stores to carry fewer total seasonal items that need to be discounted if unsold while avoiding lost sales due to out of stocks. That should improve gross margins too.

- **Leverage targets are being met and should be complete in 2019 with share repurchases becoming the next use of free cash flow.** Macy's has reached its target for debt/EBITDA and is at the low end of the range. It now wants to reach 2.5-2.8x on EBITDA that excludes gains on asset sales. We believe that would be met if debt fell $400 million in 2019. With a dividend of about $475 million, free cash flow of about $1 billion should make that possible. As investment activities are completed, lower SG&A and cap-ex should boost EBITDA and Free Cash Flow – pushing the debt ratio lower in 2020 and giving cash for share repurchases.

## Summary of 4Q18 – Comp sales came in a 2% adjusted for 53rd week in 2017

We believe many areas of Macy's continue to show improvement and it is becoming more obvious in the sales:

| Adj. Comps | 4Q | 3Q | 2Q | 1Q | Annual |
|---|---|---|---|---|---|
| 2018 | 2.0% | 3.3% | 0.5% | 4.2% | 2.4% |
| 2017 | 1.4% | -3.6% | -2.5% | -4.6% | -1.9% |

The 4Q17 had a 14th week and 2017 a 53rd week. The 2017 comps vs. 2016 are adjusted to 13 and 52 weeks. The reported 13 weeks in 2018 vs. 14 weeks in 2017 result in a comp of 0.7% which would make the year a 2.0% figure. Under either situation, Macy's hit the

guidance given on January 11 for 2.0% annual comp growth unadjusted for the extra week and beat the 2.3% guidance with the adjustment.

Guidance had been cut in January. Macy's started 2018 forecasting flat to 1.0% on comps, boosted that after 3Q18 to 2.3-2.5% and then reduced to 2.0% in early January. Two things happened here, which in total are estimated to be a 70bp negative for 4Q comps. There was a fire in one of the mega centers which caused some inventory to be unavailable for online sales and caused delays as fulfillment had to be transferred to other centers at a busy time. Also, in the 2017 holiday season, a key pre-Christmas promotion was made to all customers. During 2018, the promotions focused on loyalty members only. They could have boosted sales further had they expanded the size of the promotion and Macy's will increase the exposure of this promotion in 2019.

Gross margin fell 110bp in the 4Q. We believe this will be a wild card and show some volatility. In the 4Q, it was caused by having higher total transactions, but the value per transaction was down. That meant shipping costs rose with transactions but did not leverage as well with lower retail dollars per shipment. This is an area where Macy's will permanently invest some of its cost savings – free shipping. It is offered to Platinum and Gold loyalty customers, higher price points, and to people who ship to the stores for pick-up. The last part is leading to higher additional sales made at the stores. Also, the company had higher mark-downs after Christmas in the 4Q which hurt gross margin. That is an area where the volatility will bounce around in our view.

SG&A saw some pressure from adding more hours and staff when the forecast for sales was 2.3%-2.5% for the year and having sales grow at only 2.0% instead.

## Guidance Appears Low for 2019

The company laid out a weak 1Q19 and results that will improve each quarter through the year. Guidance is for flat to 1% comps for the year. The company plans to clear more inventory in the 1Q19 and that should pressure pricing for the sales figure and there is a tough comp from 1Q18 at 4.2%.

Also, gross margin was exceptionally strong in 1Q18 so there is a tough margin comp, which they do not expect to top with some pricing promotions and rising fulfillment costs will not leverage as easily if the comp is lower:

| Gross Margin | 4Q | 3Q | 2Q | 1Q | Annual |
|---|---|---|---|---|---|
| 2018 | 37.5% | 40.3% | 40.4% | 39.0% | 39.1% |
| 2017 | 38.6% | 40.3% | 39.6% | 38.3% | 39.1% |

The company also expects a heavy roll-out in the early part of 2019 for more Backstage stores within Macy's locations as well as the $3 million per store investment for Growth 50. While they seek to minimize disruption, it still involves areas where inventory is moved, some floor space is not available for selling, and work crews in place. That should also disrupt 1Q sales a bit and pressure margin.

However, we still see too many areas where sales growth should continue to rise faster than Macy's outlook to have comps finish 2019 between 0%-1%. For example:

**Backstage sales are boosting sales for the total store they are located in by 5% as it drives sales in other departments.** Backstage was initially rolled out in smaller and lower performing stores and in less than 50 locations as the company experimented with the concept, made changes, and worked to optimize the performance. For the few Backstage locations over 1 year old – same-store sales are reporting double-digit growth. **The company added 120 Backstage stores in 2018 that will be entering comps throughout 2019. It will add 45 more Backstage locations in 2019 too. That will put them in about one-third of Macy's stores.** If Backstage drives a 5% comp at one-third of stores at points during 2019 – even if the rest of the stores do a 0% comp – total comps would still rise 1.6%.

**The Growth 50 program is now the Growth 150 program.** These are stores that have added new facilities, fixtures, food/beverages, greater selection, more staff training, virtual reality, etc. Macy's built out the first 50 of these stores in 2018 and will do 100 more in 2019 now that they have tested the results and found what works and what does not. **These stores are showing higher repeat customer shopping and are outperforming the rest of the store portfolio. This will be in approximately one-quarter of the stores by the end of 2019. These 150 stores already produce two-thirds of bricks and mortar sales.** If Backstage can produce a comp over 1% for the full portfolio, and this area is producing better results too on two-thirds of store sales – it should add to the comp.

Online sales and BOPS/BOSS (Buy Online Pickup Store or Buy Online Ship to Store). **Online sales are growing at double-digit rates still. 7% of total online involves store pick up and that is growing. Macy's has found that online sales picked up at the store result in an additional 25% more spending as the customer stays to buy more.** All of this should get a

further push from Vendor Direct which is allowing customers to buy directly from suppliers through Macy's online channels. This boosts inventory selection, more brands, more sizes without making the inventory investment to carry all of it at the store. This has already become 10% of online sales in 2018. Macy's is doubling the number of SKUs there for 2019.

The loyalty program is also showing strength. **The platinum loyalty shoppers are already 30% of total sales. They shop more frequently and spend 10% more.** These results are beating Macy's forecasts and the sales trends are getting stronger. Macy's has 3 million signed up at the Bronze level since it was introduced last spring with forecasts to add 4 million more in 2019. We also think sales and the loyalty program could grow as Macy's moves from 20% to 40% of merchandise that is private label or brand-name but exclusive to Macy's.

Our view is that Macy's is an operating leverage story. It has suffered sales losses over the years, closed many laggard stores and has reduced costs. If it can grow the top-line over the next two-three years, EPS could rise rapidly. Moreover, as we noted in January, the growth rate required for 50-cents in EPS growth is essentially 2% sales comps on a flat gross margin. They hit that comp in 2018. Given the momentum behind some of the positive changes, it appears doable in 2019. If physical disruption in the stores is largely complete in 2019 and use of Vendor Direct and Loyalty shoppers increases further, it is probably not too tough to see that still producing sales gains in 2020 and beyond.

## Margin Leverage Is Still Expected in 2019

Macy's announced that it will lay-off more people in management to streamline costs further and generate about $100 million in annual savings from lower wages. That will start to flow into earnings in greater amounts throughout each quarter in 2019.

Another interesting part of building such a huge supply chain model to deal with growing online sales at double-digit rates, increased shipping to stores, Vendor Direct, and stocking Backstage, all after having closed about 100 stores in prior years has been that it allowed the company to boost sales. As noted above, while many of these initiatives are new, they are already generating incremental sales at the physical stores. The company also talked about new test programs to more quickly move inventory among the stores. That would do two things – 1) prevent lost sales from out of stock if store B doesn't have the item, but store D does, 2) reduce the quantity of inventory for particular items among the entire store base

and prevent mass seasonal mark-downs. The first helps sales. The second helps margin by selling less seasonal inventory on discount.

The company also mentioned the $200 million in lower SG&A that is already producing compared to levels seen before all store closings and rethinking the retail model. As we noted in January – this $200 million is a net figure of $850 million of cost savings with $650 million of it being reinvested. This will be another year of heavy investment. For example, the Growth 50 stores cost about $3 million each to get that treatment – some of that is capital spending but other parts are going through SG&A. Macy's will modify 100 stores in that manner in 2019. We still expect things such as incentive pay for employees, higher technology spending, more marketing to permanently absorb some of the $850 million every year. However, we do believe that as these significant store models are completed and employee training is completed, Macy's will simply run out of new places to spend all the cost savings and SG&A costs will decline more. The lower wages from streamlining managers should flow start flowing through in 2019.

When we read the plans and guidance for 2019, we came away with gross margin pressure in 1Q19 based on a tough comp and some higher promotional mark-downs to clear inventory. Gross margin will then improve throughout the rest of the year. Rolling out so many new Backstage and Growth 50 stores early in the year means heavy SG&A in 1Q and 2Q that subsides in 3Q and 4Q.

If the sales comps continue to be positive and the fixed costs leverage better at the same time the new investments in 2019 start to slow – that could lay the groundwork for boosted guidance later in 2019.

## Leverage Continues to Decline and Shares are Next

Macy's first goal was to get its Debt/EBITDA ratio to between 2.5-2.8x. That has been achieved. Macy's paid down about $1.15 billion in debt during 2018. The ratio currently stands at 2.5x.

The next goal is to reduce adjust the EBITDA down to remove gains from asset sales (primarily real estate). On that ratio, Macy's is 2.9x and would still like to be at 2.5-2.8x. The company's guidance for 2019 is essentially $1b in income and $975 million depreciation and amortization. Adding back taxes and interest would produce EBITDA of about just

under $2.5 billion. The company expects $100 million in asset sale gains so take those out but add back about $340 million in rent expense to reach an adjusted EBITDA just over $2.7 billion.

To reach 2.8x on the adjusted ratio, Macy's would need to reduce debt by about $400 million more during 2019. That should also be more than doable. As noted above $1.975 billion is Macy's forecast cash from operations and if it wants to reduce inventory – then working capital should have a minimal risk of reducing that figure. The $100 million in asset sale gains would reduce cash from operations but cash from the sale would flow back in investing activities. The company predicts $1 billion in capital spending with the heavy build out in 2019. So free cash flow should be between $900 million to $1 billion.

From that free cash flow, Macy's dividend is $465 million, so it's covered 2 to 1. Paying down an additional $400 million looks certainly doable to meet the company's goal of getting leverage down to 2.8x without asset sale gains boosting EBITDA. And, that is in a year when investment spending pushing up SG&A is high and capital spending is inflated.

Going forward, we would expect the heavy spending on Growth 50 and roll-out of more logistics to reduce capital spending and SG&A. The company will likely still focus some attention on debt, but the EBITDA figure would be higher via lower SG&A and continue pushing debt ratio lower. Some lower capital spending would combine to drive free cash flow up. Even assuming no growth at Macy's simply lower SG&A spending of about $200 million and $200 million in lower capital spending would boost free cash flow about $350 million. Even the CFO says it would turn attention to returning more cash to shareholders after hitting its leverage goal:

> *"In terms of power using our excess cash in 2019, again we're planning to use the excess cash to get closer to our target leverage range of 2.5 times to 2.8 times when looking at it without asset sale gains, so that will be our first priority. And then beyond that, we'll then see how the cash position develops. And if warranted, we will evaluate share repurchases next. That something that we'll have to discuss with our board for 2019, but we're just going to have to wait and see, how the cash develops over the course of the year, Kimberly."*

# Explanation of EQ Rating Scale

| Rating | Description |
|---|---|
| 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 recent 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.

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