BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Kellogg (K) EQ Update 9/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3+	2+

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

*For a more detailed explanation of the EQ Review Rating scale, please refer to the end of this report

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

K reported adjusted EPS of $1.03 topped consensus estimates by 12 cps. We note below that a lower than expected tax rate likely added more than 2 cps to EPS in the period. The upgrade in our rating largely reflects the normalization of both the receivables balances and the structured payables program. However, we caution that cash flow remains under pressure from the absence of those items as well as the divestiture, restructuring spending and investment, and higher capex.

- Trade receivable DSOs rose by 1.2 days over the year-ago quarter to 37.9 while sold but outstanding receivables were essentially flat at 25.5 days. As we have discussed in previous reviews, the huge boost to cash flow from receivables factoring and the boost to sales from extending more generous payment terms to customers has been over for the last few quarters. While we are not overly concerned with the 1.2-day increase in receivables in the quarter, this metric should be monitored going forward for evidence of increasing payment terms.

- The multi-year Project K restructuring program is winding down and expected to be completed in 2019. However, the company announced in the 6/19 quarter that it was

launching a reorganization plan for Europe that will result in $40 million in charges mostly related to severance and termination benefits, relocation costs, and third-arty legal and consulting fees. Likewise, a similar reorganization plan for North America was announced with a $30 million price tag and similar expense categories. We are not overall concerned about the earnings quality impact of these initiatives given there relatively small scope, focus and time frame.

- The company's effective tax rate fell to 17.9% in the 9/19 quarter from an unexpected reversal of a tax accrual. The effective tax rate for the six months ended 6/19 was 20.5% with the company guiding for a full-year rate of 21% at the time. We estimate that analysts would have likely been expecting an approximate 20% effective rate in the quarter, implying the lower rate could have provided an approximate 2.5 cps boost to earnings above expectations.

- The company used proceeds from the sale of the cookie business to reduce net debt to around 3 times EBITDA. However, cash flow growth remains under pressure from the divestiture, restructuring spending and investments, the absence of the receivables factoring and a continuing decline in payable days as the structured payable program is no longer expanding.

- We note that accrued advertising jumped to 4.7% of trailing 12-month sales in the quarter, up from 4.4% in the previous quarter and 4.4% in the year-ago quarter. This was a sizeable jump and implies an 11 cps drag on earnings if we assume a similar percentage of sales to the 9/18 quarter. There was no mention made in the 10-Q or conference call regarding the overall level of promotional and advertising spending. While management cited a new campaign on *Special K* and *Mini Wheats* in North America, most of the discussion centered around delays in advertising spending in cereal : "Our promotional activity as measured by the percentage of units sold on promotion in a scanner data didn't climb all the way back to year-ago levels yet and we also delayed some advertising activity in part to enable us to activate additional capacity for certain products. Where we have most return to normal brand activity is in the taste fund segment which underwent its pack harmonization back in Q1. This quarter, our taste fund segments brands collectively grew consumption and share." We suspect the company has already accrued for future advertising spending to the detriment of the 9/19 quarter which may provide an artificial tailwind to future quarters.

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 recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

Disclosure

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