BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

November 8, 2018 | www.btnresearch.com

Kellogg (K) EQ Review Update-9/18 Quarter

Current EQ Rating*	Previous EQ Rating
2+	2+

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

We are maintaining our rating on Kellogg (K) of 2+ (Weak).

K reported adjusted EPS of $1.06 which was a penny below the Zack's estimate. Revenue came in slightly ahead of targets. The miss was largely due to higher-than-expected inflation coupled with higher marketing and brand-building costs. The company also disappointed the market by lowering EPS guidance for the full year while boosting sales guidance. Our concerns noted in the previous quarter remain:

- Accounts receivables sold or securitized at the end of the 9/18 declined from the year-ago period. This led to accounts receivable days of sale (DSO) adjusted for sold receivables declining by 7 days. As we have noted before, K appears to have reigned in its extension of payment terms with customers which it aggressively used in 2017 yet is still meeting sales targets. However, we note it is spending more on "brand building" to do so.

- Accounts payable days (DSP) were flat with the year-ago quarter after rising rapidly in 2017 as the company has leveled off on the use of its structured payable programs. This resulted in cash provided by payables declining by $26 million in the 9/18 quarter versus a year ago. While free cash flow looks more than sufficient to cover the dividend, the cushion could narrow in 2019 absent the company resuming its receivables sales and payables extension.

- Project K charges should fall off in 2019 and we will be skeptical of the extension of any restructuring plans next year.

Adjusted Receivables Trend Lower with Lower Receivables Sales

We discussed in our review of the 6/18 quarter that both the origination of new accounts receivable as well as the sale of receivables began to slow in at the beginning of 2018. This led to a decline in days of sales (DSO) for both sold receivables balances as well as total adjusted receivables (reported receivables plus outstanding balances of sold receivables.) This trend continued into the 9/18 quarter:

	9/30/2018	6/30/2018	3/31/2018	12/30/2017
Sales	$3,469	$3,360	$3,401	$3,209
Reported Receivables	$1,612	$1,530	$1,601	$1,389
Sold Receivables	$965	$962	$970	$1,120
Sold Receivable DSOs	25.4	26.1	26.0	31.8
Total Adjusted Receivables	$2,577	$2,492	$2,571	$2,509
Total Adjusted Receivable DSOs	67.8	67.7	69.0	71.3

	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Sales	$3,246	$3,175	$3,248	$3,097
Reported Receivables	$1,512	$1,427	$1,464	$1,231
Sold Receivables	$1,154	$1,133	$1,014	$978
Sold Receivable DSOs	32.4	32.6	28.5	28.8
Total Adjusted Receivables	$2,666	$2,560	$2,478	$2,209
Total Adjusted Receivable DSOs	74.9	73.6	69.6	65.1

Total adjusted receivables at the end of the 9/18 quarter declined from the year-ago level leading to a 7-day decline in total adjusted receivable DSOs. The company no longer appears to be extending more generous payment terms to customers, yet it continues to meet and exceed its sales targets. We note that it is requiring more “brand building” to do so. The anniversary of the termination of the Securitization Program and the overall decline in the pace of receivables sales will hit in the 3/19 quarter. It will be interesting to track the trends in DSOs beginning in that quarter to see if the company continues to be disciplined in its use of credit terms to customers.

Days Payable Now Flat

The normalization in accounts payable growth we noted in our previous quarterly review continued into the 9/18 period. The table below shows the calculation of days payable (DSP) and the percentage of payables that are in the company's payables tracking system:

	9/30/2018	6/30/2018	3/31/2018	12/30/2017
Cost of Sales	$2,293	$2,151	$2,149	$1,888
Payables	$2,367	$2,306	$2,230	$2,269
DSP	94.2	97.8	94.7	109.7
Payables in Tracking System	$889	$834	$724	$850
% of Total Payables	37.6%	36.2%	32.5%	37.5%
Payables Sold by Suppliers	$664	$572	$547	$674
% of Total Payables	28.1%	24.8%	24.5%	29.7%

	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Cost of Sales	$2,074	$1,950	$2,088	$2,121
Payables	$2,140	$2,057	$1,995	$2,014
DSP	94.2	96.3	87.2	86.6
Payables in Tracking System	$798	$769	$731	$677
% of Total Payables	37.3%	37.4%	36.6%	33.6%
Payables Sold by Suppliers	$582	$556	$543	$507
% of Total Payables	27.2%	27.0%	27.2%	25.2%

Recall that the company was previously accelerating the use of its structured payable arrangements (tracking system) whereby certain suppliers could sell their receivables from the company to third-party credit companies to accelerate their receipt of cash. This allows K to delay paying suppliers while still capturing early-pay discounts. This was resulting in a rapid increase in payables and DSPs which began to level off in the 6/18 quarter. In the 9/18 quarter, the growth in payables fell more in-line with cost of sales growth leading to flat year-over-year DSP growth. Likewise, we can also see that that the year-over-year growth in the percentage of total payables in the tracking system has now leveled out (37.6% at 9/18 versus 37.3% at 9/17). This is resulting in a drag on cash flow growth. In the case of the 9/18 quarter, cash generated by accounts payable fell to $39 million from $65 million in the year-ago quarter. This drag on cash flow growth should continue into the first half of next year assuming the company does not resume its delay in paying suppliers.

To examine operating cash flow on a trailing-12 basis, we must adjust the reported operating cash flow for the 9-month period ended 9/17 to add back the cash flow from

retained interest on sold receivables which is now reported in investing cash flows in 2018. In addition, the 2018 period includes a one-time $250 million contribution to the company's pension plan. These adjustments are shown in the following table:

	9 mos ended 9/18	9 mos ended 9/17
Reported Operating Cash Flow	$926	$190
Add back of retained interest	$0	$945
Adjusted Operating Cash Flow	$926	$1,135
Pension Contribution	$250	
Adjusted Operating Cash Flow	$1,176	$1,135

These adjusted 9-month numbers result in a trailing-12 cash from operations figure of $1.69 billion which more than covers the trailing-12 capex number of $516 million and the current trailing-12 dividend of approximately $750 million. Regardless, the cash dividend coverage will likely narrow further in 2019 absent any renewal in receivables sales or payment term extensions.

Project K Charges Should Wind Down

The company still maintains that Project K savings will be $600-$700 million in 2019 and that charges associated with the plan will be minimal after 2018. We bring this up simply because we will be skeptical if another huge plan is announced at the first of the year.

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.

Disclosure

BTN Research is a research publication structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. Information included in this report is derived from many sources believed to be reliable (including SEC filings and other public records), but no representation is made that it is accurate or complete, or that errors, if discovered, will be corrected.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.