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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Kellogg (K) EQ Update-12/18 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 lower our earnings quality rating to 2- (Weak).

- Receivables factoring continues to decelerate, and receivables adjusted for factored and securitized balances were down almost 7 days of sales versus last year's December quarter. While a decline in DSO is good for cash flow growth, we remain concerned that the company will have to begin to loosen its credit terms again in order to maintain top-line growth.

- Days payable fell approximately 2 days versus the 12/17 quarter and the percentage of payables sold by suppliers has declined in three of the last four quarters, implying the benefit of stretching its payables is over.

- Adjusted operating cash flow growth was negative in 2018 and the company is forecasting flat free cash flow in 2019. Management is still expecting working capital improvements to continue despite its aggressive use of third-party financing and its new warning in the 10-K that any reversal of payment terms would adversely impact working capital management. The dividend currently consumes almost 80% of free cash flow and debt-to-EBITDA is 3.7.

- Accrued advertising and promotional expense declined from the 12/17 quarter despite the company touting "substantially" higher advertising and promotional spending in 2018 which is expected to carry into 2019. This could be an indication of an underestimation of future promotional redemptions which would have artificially benefited the 12/18 quarter. If the accrual had simply remained flat with the year-ago quarter, it would have resulted in about 5.5 cps in higher expenses in the period.

- Management noted that the fair value of its Multipro goodwill approximated carrying value and the fair value of its Kashi goodwill was 9-12% above carrying value. This is not overly alarming given the young age of the transactions that produced the goodwill.

- Project K is forecast to end in 2019 bringing to an end $1.6 billion in restructuring spending. We will view it as a significant negative for earnings quality if the plan is expanded or a new one is announced.

Receivables Factoring Continues to Decelerate

As we have discussed in past reviews, in 2017 K aggressively expanded its use of receivables factoring and securitizations in order to offset the cash flow impact of offering longer payment times to its customers. However, the company discontinued its securitization program at the end of 2017 and while it increased its pace of factoring in 2018, it has not offset the wind down of the securitizations.

The following table shows the calculation of securitized/factored receivables days (DSOs) and total adjusted receivables DSOs for the last eight quarters:

	12/31/2018	9/30/2018	6/30/2018	3/31/2018
Sales	$3,317	$3,469	$3,360	$3,401
Reported Receivables	$1,375	$1,612	$1,530	$1,601
Securitized & Factored Receivables	$993	$965	$962	$970
Securitized/Factored DSOs	27.3	25.4	26.1	26.0
Total Adjusted Receivables	$2,368	$2,577	$2,492	$2,571
Total Adjusted Receivable DSOs	65.1	67.8	67.7	69.0

	12/30/2017	09/30/2017	07/01/2017	04/01/2017
Sales	$3,185	$3,246	$3,175	$3,248
Reported Receivables	$1,389	$1,512	$1,427	$1,464
Securitized & Factored Receivables	$1,120	$1,154	$1,133	$1,014
Securitized/Factored DSOs	32.1	32.4	32.6	28.5
Total Adjusted Receivables	$2,509	$2,666	$2,560	$2,478
Total Adjusted Receivable DSOs	71.9	74.9	73.6	69.6

We can see that the trend in year-over-year declines in total adjusted receivable DSOs continued into the fourth quarter. This implies that the company's extension of generous payment terms to customers has abated over the last year. We therefore find this disclosure in the risk section from the 2018 10-K interesting:

> *"We utilize extended payment terms for customers and suppliers supplemented with third party financing programs to assist in effectively managing our core working capital.* ***If the extension of payment terms are reversed or financial institutions terminate their participation, our ability to maintain current levels of core working capital could be adversely impacted.***
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> *Our principal source of liquidity is operating cash flows supplemented by borrowings for major acquisitions and other significant transactions.* ***We utilize third-party financing programs to offset the negative impact of offering extended customer payment terms. In addition, in combination with extending supplier payment terms, structured payables programs are available to our suppliers which enable suppliers, at their sole discretion, to enter bilateral agreements to sell Company payment obligations to designated third-party financial institutions.***
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> ***Changes in financial markets or interest rates could make these third party financing programs less attractive to the financial institutions purchasing trade accounts receivables and Company payment obligations thereunder and these financial institutions may seek to terminate their participation****. In the event of such termination or if our extended payment terms are reversed, our ability to effectively manage core working capital could be adversely impacted."*

We have noted in past reviews that we were surprised that the reversal in extending payment times for customers has not resulted in problems with sales growth and we still believe the company may have to begin to extend more generous terms in upcoming quarters to meet targets.

Days Payable Continue to Decline

As noted in the above disclosure, K has been boosting cash flows by extending payment terms with its suppliers which has been facilitated by making third-party financing available to certain suppliers. However, the year-over-year increase in days payable ended in the 6/18 quarter and continued through the 12/18 quarter as seen in the table below:

	12/31/2018	9/30/2018	6/30/2018	3/31/2018
Cost of Sales	$2,228	$2,293	$2,151	$2,149
Payables	$2,427	$2,367	$2,306	$2,230
Days Payable	**99.4**	**94.2**	**97.8**	**94.7**
Payables in Tracking System	$893	$889	$834	$724
% of Total Payables	36.8%	37.6%	36.2%	32.5%
Payables Sold by Suppliers	$701	$664	$572	$547
% of Total Payables	28.9%	28.1%	24.8%	24.5%

	12/30/2017	09/30/2017	07/01/2017	04/01/2017
Cost of Sales	$2,043	$2,074	$1,950	$2,088
Payables	$2,269	$2,140	$2,057	$1,995
Days Payable	**101.3**	**94.2**	**96.3**	**87.2**
Payables in Tracking System	$850	$798	$769	$731
% of Total Payables	37.5%	37.3%	37.4%	36.6%
Payables Sold by Suppliers	$674	$582	$556	$543
% of Total Payables	29.7%	27.2%	27.0%	27.2%

We also see that the percentage of total payables that are in the tracking system as well as the percentage of total payables that have been sold by suppliers has declined in three of the last four quarters. The boost to cash flow growth from stretching payable appears to have ended.

Cash Flow Forecast Requires Continued Working Capital Improvement

The following table shows K's adjusted operating cash flow for the last three years adjusted for the change in accounting for receivables securitizations:

	12/31/2018	12/30/2017	12/31/2016
Operating Cash Flow	$1,536	$403	$1,271
Collections of Deferred Purchase Price on Securitized Receivables	$0	$1,243	$501
Adjusted Operating Cash Flow	$1,536	$1,646	$1,772
Capex	$578	$501	$507
Free Cash Flow	$958	$1,145	$1,265
Dividends	$762	$736	$716
Dividend % of Free Cash Flow	79.5%	64.3%	56.6%
Stock Repurchases	$320	$516	$426
Cash After Buyback	-$124	-$107	$123

Operating cash flow received a boost from lower cash taxes courtesy of tax reform and certain discrete tax items, but this was more than offset by higher spending from a $250 million voluntary contribution made in 2018.

The weak cash flow performance has been a result of a weak top line coupled with higher investments in strengthening and restructuring the company's portfolio of brands. 2019 will enjoy a lower pension contribution, but management is forecasting free cash flow to be roughly flat due to lower tax benefits, higher capex (by roughly $50 million) and continued investments.

As management pointed out in the 4Q conference call, even this modest forecast for cash flow growth requires the above-discussed improvements in working capital to continue:

> "We also, you'll recall, made a voluntary cash contribution to our pension funds, increasing their funded levels. And we again improved our core working capital which came down by 50 basis points as a percentage of sales on good payables management. **This durability and good working capital management is important as we ramp up capital expenditures further in 2019 around growth oriented investments…**"

As we discussed above, we are skeptical that the company can continue to squeeze cash out of its payables as it is dependent on both stretching suppliers and finding cheap financing for its third-party financing programs. On the receivables side, the company appears to have actually tightened up payment times on its customers which could backfire by pressuring sales. We would not be surprised to see the company begin extending more generous terms to customers to keep top-line growth positive in 2019 which will be a drag on cash flow growth. While it could conceivably accelerate its factoring of receivables again, it remains to be seen if it can do so on acceptable terms. Also, given the degree to which the company ramped its adjusted receivables in 2017, the market might look negatively on the company doing the same in 2019.

Accrued Advertising Down

K has been increasing its spending on advertising and promotion. According to the 10-K, advertising expense in 2018 was $752 million versus $732 million last year. However, consider the company's comment on advertising in its MD&A section of the 10-K:

> *"Currency-neutral adjusted operating profit was up slightly compared to the prior year due to cost savings that funded and* ***offset a substantial planned increase in advertising and promotion investment…"***

We don't consider a 2.7% increase in advertising expense on a 5.4% sales increase to be a "substantial increase." Promotional expense is not disclosed, but we suspect there was a large increase in promotional activity given management's comments. Likewise, the company was very clear that 2019 will be another year of promotional investment in its brands. We are therefore puzzled by the fact that the company's accrued advertising balance actually declined in the 12/18 quarter as shown in the following table:

	12/31/2018	9/30/2018	6/30/2018	3/31/2018
Accrued Advertising & Promotion	$557	$583	$570	$597
Sales	$3,317	$3,469	$3,360	$3,401
Accrued Advertising & Promotion Days of Sales	15.3	15.3	15.5	16.0

	12/30/2017	09/30/2017	07/01/2017	04/01/2017
Accrued Advertising & Promotion	$582	$552	$512	$464
Sales	$3,185	$3,246	$3,175	$3,248
Accrued Advertising & Promotion Days of Sales	16.7	15.5	14.7	13.0

Advertising costs are expensed the first time advertising takes place. Promotional payments include costs such as coupons and other cash redemption offers. These costs are recognized at the time of sale based on estimates of historical redemption experiences and patterns which requires a great deal of management judgment. Given the references to increased advertising and promotional spending which is forecast to continue into the next year, we would have expected to see the accrual balance continue to rise. If future promotional costs were underestimated, it could have artificially benefitted profits in the 12/18 quarter and will require the future recognition of higher expenses when the promotional redemptions are made.

Even if advertising and promotional accruals had remained flat with the year-ago level, it would have required the recognition of $25 million (over 5.5 cps) in additional expense in the quarter.

Goodwill

K disclosed the following in its 10-K regarding the buffer between fair value and carrying value for key components of its goodwill balance:

> *"Additionally, we have $207 million of goodwill related to our Kashi reporting unit, which was primarily a result of establishing Kashi as a separate operating segment in 2015, which required an allocation of goodwill from our U.S. Snacks operating segment. The 2018 fair value of the Kashi reporting unit was estimated primarily based on a multiple of net sales and discounted cash flows. The percentage of excess over fair value was approximately 12% and 9%, in 2018 and 2017, respectively, using the same methodology on a year-on-year basis. The use of modestly different assumptions in the valuation could have resulted in an impairment."*
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> *"We also have $616 million and $798 million of goodwill and other intangible assets, respectively, related to our Multipro operating segment as a result of the acquisition of this business in May 2018. Consistent with our expectations given the recent acquisition, the 2018 fair value approximates carrying value for both goodwill and the indefinitely lived assets. The use of modestly different assumptions in these valuations could have resulted in an impairment."*

The lack of spread between fair and carrying value of the Multipro assets is a reflection of the fact that carrying value was established when the JV assets were consolidated in 2018. Likewise, the estimate of the value of the Kashi assets was made in 2015 so the approximate 10% buffer there seems reasonable and the likelihood of a material write-down there seems low.

Project K

Project K is expected to wind down in 2019 with $50 million in charges expected this year. This brings the total amount since plan inception to $1.6 billion. We will consider any extension of the plan or announcement of a new initiative to be a negative for earnings quality.

Explanation of EQ Rating Scale

6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's 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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