BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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# Kellogg Company (K) EQ Update- 12/19 Qtr.

| Current EQ Rating* | Previous EQ Rating |
|---|---|
| 3+ | 3+ |

| |
|---|
| 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 an explanation of the EQ Review Rating scale, please refer to the end of this report

**We maintain our 3+ (Minor Concern) rating on K**. The quality of results has improved considerably since two years ago when the company was leaning heavily on receivables factoring and payables stretching. We were tempted to move our rating to a 4 (Acceptable) but the relatively high level of factored receivables and payable days outstanding prompt us to maintain the rating at 3 for now.

- K's reported trade receivables DSO jumped by a little over 5 days versus the 12/18 quarter. However, receivables factored under is Monetization and Foreign programs declined sharply, falling to 24.4 days versus 27.3 days which limited the increase in adjusted total DSO to 2.3 days. This is not an alarming increase although given the 7/29/19 divestiture of the cookie, pie crust and ice cream cone business, we would have expected to see a decline in DSO. Regardless, we see the reduced reliance on factoring as a positive for the overall quality of reported results.

- Accounts payable days rose by over 2.5 versus the year-ago period, breaking a string of year-over-year declines. This would not typically be a concern if it were not for the relatively high level of payables which are currently north of 100 days. Meanwhile, the percentage of total payables in the tracking system (which allows suppliers to sell their K receivables to third parties) continued to decline as did the percentage of outstanding payables sold by suppliers. Despite the jump in DPOs in the quarter, the huge tailwind from expanding payables enjoyed in 2017-2018 are gone.

- As expected, cash from operations for 2019 fell to $1.2 billion from $1.5 billion last year which was driven by a $500 million negative impact from divestitures. This amount not only included lost cash flow from the divested businesses but also taxes on the divestiture proceeds. The pre-COVID forecast called for cash flow to rebound to $15 billion in 2020 with free cash flow in the $1 billion range. This still puts the dividend consuming close to 80% of free cash flow which is on the high end for the major food companies. Proceeds from the divestiture allowed the company to reduce net debt which is currently 3 times adjusted EBITDA. The company had been borrowing for years to pay for share repurchases but the buyback was suspended in the 6/19 quarter and management indicated it would favor putting the excess cash flow to use in debt reduction in the near future.

- The company heralded its return to positive organic growth in late 2019. However, like most food companies, K walks a fine line between pushing growth through price increases versus volume growth. The 2.7% organic (FX and acquisition-adjusted) growth reported in 12/19 quarter was a product of 1.2% volume growth amplified by 1.5% pricing growth. However, volume growth in North America was a negative 1.2%, Europe a positive 0.6%, Latin America a negative 0.7% with a positive 6.5% from AMEA saving the day as the company enjoys strong growth in Africa. In addition, it has taken substantial investments in advertising and promotion to generate the low single digit organic growth and the investment is expected to wane in 2020.

# Explanation of EQ Rating Scale

| | |
|---|---|
| 6- "Exceptionally Strong" | Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises |
| 5- "Strong" | Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods. |
| 4- "Acceptable" | Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement |
| 3- "Minor Concern" | Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future. |
| 2- "Weak" | Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears. |
| 1- "Strong 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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