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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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# Kellogg Company (K)- EQ Review

We continue our examination of the quality of the food industry's earnings with a review of Kellogg's (K) recent results. We note the following issues:

- Kellogg rapidly expanded the use of its receivables securitization programs throughout 2017. DSOs including securitized balances outstanding rose by 6 days and 9 days on a year-over-year basis in the 12/17 and 9/17 quarters, respectively. However, the company scaled back its use of its factoring programs in the 3/18 quarter, and adjusted DSO fell by almost a day. This is an area to watch closely in the quarters ahead and any resumed escalation in the program should be viewed with concern.

- K has also rapidly expanded its accounts payable balances in recent quarters with the aid of the increased utilization of programs under which suppliers are able to sell invoices due from the company to third-party financial institutions. This allows K to capture early payment discounts while still stretching payment over longer periods. Days payables rose by more than 7 days over the 3/17 quarter. We estimate that the stretching of payables has added in excess of $250 million to cash flow growth in the trailing-12 period.

- The high-end of management's free cash flow forecast for 2018 implies growth of about $200 million. However, the company should realize a benefit of over $160 million from lower cash restructuring costs alone, implying little in the way of operational improvements. In addition, the company is contemplating making a voluntary contribution of $200-$300 million to its pension plan which could further eat into cash flow.

## Receivables Have Levelled Out, But Securitizations Have Been Boosting Cash Flow

In 2016, K started a program called the Extended Terms Program under which it offered customers the option to extend their payment terms in exchange for the elimination of early payment discounts. In order to compensate for the delay in receipt of cash payments from customers, the company began two programs to sell accounts receivable balances. The Monetization Program simply sold trade receivables to third-party financial institutions while the Securitization Program utilized a wholly-owned funding company to purchase the receivables prior to transferring them to other financial institutions. During the 3/18 quarter, the Securitization Program was terminated due to "declining customer interest in an extended-terms program, and recent changes to accounting guidelines that no longer treat the advances from the securitization in a way that preserves Cash Flow, defined as Cash from Operations less Capital Expenditure, and require burdensome administration…" At the same time, the company initiated another Monetization Program under which it continues to sell receivables directly to third-party institutions which allows it to avoid recording a portion of the receivables collected as financing cash flows rather than operating. As receivables sold under both types of arrangements are removed from the company's balance sheet upon sale, we will add back outstanding balances at the end of each period to reported trade receivables amounts to get a better picture of the development of receivables:

| | 3/31/2018 | 12/31/2017 | 9/30/2017 | 6/30/2017 |
|---|---|---|---|---|
| Sales | $3,401 | $3,209 | $3,273 | $3,187 |
| Reported Trade Receivables | $1,601 | $1,389 | $1,512 | $1,427 |
| Factored Receivables | $970 | $1,120 | $1,154 | $1,133 |
| Adjusted Trade Receivables | $2,571 | $2,509 | $2,666 | $2,560 |
| | | | | |
| Reported DSOs | 43.0 | 39.5 | 42.2 | 40.9 |
| Factored DSOs | 26.0 | 31.8 | 32.2 | 32.4 |
| Adjusted DSOs | 69.0 | 71.3 | 74.3 | 73.0 |

| | 3/31/2017 | 12/31/2016 | 9/30/2016 | 6/30/2016 |
|---|---|---|---|---|
| Sales | $3,248 | $3,097 | $3,254 | $3,268 |
| Reported Trade Receivables | $1,464 | $1,231 | $1,523 | $1,473 |
| Factored Receivables | $1,014 | $978 | $806 | $517 |
| Adjusted Trade Receivables | $2,478 | $2,209 | $2,329 | $1,990 |
| | | | | |
| Reported DSOs | 41.1 | 36.3 | 42.7 | 41.1 |
| Factored DSOs | 28.5 | 28.8 | 22.6 | 14.4 |
| Adjusted DSOs | 69.6 | 65.1 | 65.3 | 55.6 |

We can see that adjusted accounts receivable balances were rising rapidly through the end of 2017, but have since begun to level out, with the 3/18 quarter days sales outstanding (DSO) registering a slight year-over-year decline and a 2.3-day sequential decline. Even though revenues were likely receiving an artificial boost from the extension of payment terms, the company still managed to meet analysts' sales targets in the 3/18 quarter despite the decline.

The rising utilization of adjusted receivables balances was almost certainly a significant tailwind to revenue growth in 2016-2017 as the Extended Terms Program lured customers to make early purchases. However, the demand for the program has apparently waned, which is likely weakening that tailwind. Regardless, receivables appear to have reached a zenith and we would view any renewed disproportionate growth with considerable skepticism.

## Rising Payables Boosting Cash Flow

In addition to its receivables securitization program, K has also been using an accounts payable tracking system under which suppliers are able to sell amounts due from the company to third-party financial institutions. This allows K to realize early payment

discounts with its suppliers while simultaneously boosting cash flow by paying the financial institutions back over a longer period. The following table shows the company's accounts payable days (DSP) for the last eight quarters:

| | 3/31/2018 | 12/31/2017 | 9/30/2017 | 6/30/2017 |
|---|---|---|---|---|
| COGS | $2,149 | $1,888 | $2,041 | $1,922 |
| Accounts payable | $2,230 | $2,269 | $2,140 | $2,057 |
| Accounts payable DSPs | 94.7 | 109.7 | 95.7 | 97.7 |

| | 3/31/2017 | 12/31/2016 | 9/30/2016 | 6/30/2016 |
|---|---|---|---|---|
| COGS | $2,088 | $2,121 | $1,990 | $1,998 |
| Accounts payable | $1,995 | $2,014 | $1,986 | $1,988 |
| Accounts payable DSPs | 87.2 | 86.6 | 91.1 | 90.8 |

One can clearly see the disproportionate rise in payables for the last several quarters which has been a material benefit to recent cash flow growth. We estimate the increase in payables added over $250 million to cash flow in the trailing-12 period ended 3/18. As we have noted with other food and consumer products companies that are stretching working capital, there is nothing wrong with maximizing cash flow, but investors cannot expect this type of improvement to continue, as suppliers can only be pushed to extend payment so far. Also, the financial institutions buying these amounts due from K must be demanding some type of discount which either the supplier or K must absorb, so there is no way that this is a free lunch for K.

## Lower Cash Restructuring Charges Account for All of Forecasted Cash Flow Improvement

K management has forecast that its cash from operations in 2018 will be $1.7-$1.8 billion with roughly $500 million in capital spending. For reference, the following table shows trailing 12 cash flow data for the last six quarters:

| | 3/31/2018 | 12/30/2017 | 9/30/2017 | 7/01/2017 | 4/01/2017 | 12/31/2016 |
|---|---|---|---|---|---|---|
| T12 Operating Cash Flow | $1,663 | $1,646 | $1,728 | $1,634 | $1,834 | $1,628 |
| T12 Capex | $503 | $501 | $505 | $526 | $493 | $507 |
| T12 Free Cash Flow | $1,160 | $1,145 | $1,223 | $1,108 | $1,341 | $1,121 |
| T12 Dividends | $741 | $736 | $733 | $728 | $722 | $716 |
| Dividend % of FCF | 64% | 64% | 60% | 66% | 54% | 64% |
| T12 Net Stock Repurchases | $391 | $516 | $516 | $430 | $353 | $426 |
| Cash After Buyback | $28 | -$107 | -$26 | -$50 | $266 | -$21 |

In 2017, K reported operating cash flow of $1.6 billion with $501 million in capex, leading to free cash flow of $1.1 billion. At the high end, the company's forecast of $1.3 billion in free cash flow represents less than $200 million in improvement. However, the company also has forecast $175 million in cash restructuring payments in 2018, which is down from $339 million in 2017. This $164 million reduction in cash restructuring accounts for the bulk of the forecasted improvement, implying that even at the high-end, the company's forecast is not indicating much in the way of operational cash flow growth.

In addition, management has stated that it may make a $200-$300 million cash contribution to its pension plan in 2018 which would result in a decline in cash from operations.

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