Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

August 9, 2018 | www.btnresearch.com

Kellogg (K) EQ Review Update- 6/18 Quarter

Current EQ Rating*	Previous EQ Rating
2+	NA

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

We initiate coverage of Kellogg (K) with a 2+ (Weak)

Our 2+ rating for Kellogg stems largely from its aggressive use of receivables securitizations and extension of payables through its payables tracking system. Both of these factors have shown considerable improvement in the last two quarters. Nevertheless, we are concerned that the unwinding of these trends will put pressure on both reported revenue growth and cash flow growth over the next couple of quarters.

Adjusted Receivables DSOs Declined as Securitized Balances Decline

We noted in our review of the 3/18 quarter that K significantly increased its use of various receivables securitization vehicles throughout 2017 in order to offset the cash flow impact of offering customers more generous payment terms. Adjusted receivable days of sales (DSOs) which included the outstanding securitized balances at the end of each period were skyrocketing through the 12/17 quarter, as shown in the table below.

	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Sales	$3,360	$3,401	$3,209	$3,273
Reported Receivables	$1,530	$1,601	$1,389	$1,512
Securitized Receivables	$962	$970	$1,120	$1,154
Securitized DSOs	26.1	26.0	31.8	32.2
Total Adjusted Receivables	$2,492	$2,571	$2,509	$2,666
Total Adjusted Receivable DSOs	67.7	69.0	71.3	74.3

	7/01/2017	4/01/2017	12/31/2016	10/01/2016
Sales	$3,175	$3,248	$3,097	$3,254
Reported Receivables	$1,427	$1,464	$1,231	$1,523
Securitized Receivables	$1,133	$1,014	$978	$806
Securitized DSOs	32.6	28.5	28.8	22.6
Total Adjusted Receivables	$2,560	$2,478	$2,209	$2,329
Total Adjusted Receivable DSOs	73.6	69.6	65.1	65.3

However, beginning in the 3/18 quarter, the company began to back off on its use of its securitization programs which can be seen in the 1.5-day YOY decline in the securitized DSO number in the 3/18 quarter followed by a 6.5-day YOY decline in the 6/18 quarter. Total adjusted DSOs were essentially flat YOY in the 3/18 quarter and declined by almost 6 days in the 6/18 quarter. Despite this decline in receivables, the company was able to report stronger than expected revenue growth in the 6/18 quarter.

There are many adjustments currently going on at K as it has eliminated its DSD (direct store delivery model) over the last several quarters. It is essentially delivering more of its products to customer warehouses rather than delivering directly to the store shelves. This leads to K charging customers less to reflect the lower level of service involved. As a result, sales and gross profits are under pressure, but this is being offset by lower delivery-related expenses. In the middle of all of this, the company is now backing away from securitizing receivables, which means it will either have to back off on generous payment terms for its customers or see a drain on its cash flow. The fact that total adjusted DSOs are declining seems to indicate it is offering less generous terms to customers and is still backing off on selling receivables. While we view this as a positive for earnings quality, it is leading to a significant headwind to cash flow growth. It also represents a potential headwind to sales growth if customers delay purchases due to a shortening of payment terms. These pressures should continue over the next couple of quarters.

Payables Continue to Rise but Pace Slows

We also noted in the 3/18 quarter review that K has utilize third-party financing arrangements it refers to as “receivables tracking systems” under which suppliers can sell their receivables from the company. This allows K to receive early-pay discounts while still delaying the time it takes to pay its bills. The following table shows the calculation of days payables (DSPs) as well as information regarding payables in the tracking system:

	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Cost of Sales	$2,151	$2,149	$1,888	$2,041
Payables	$2,306	$2,230	$2,269	$2,140
DSP	97.8	94.7	109.7	95.7
Payables in Tracking System	$834	$724	$850	$798
% of Total Payables	36.2%	32.5%	37.5%	37.3%
Payables Sold by Suppliers	$572	$547	$674	$582
% of Total Payables	24.8%	24.5%	29.7%	27.2%

	7/01/2017	4/01/2017	12/31/2016	10/01/2016
Cost of Sales	$1,950	$2,088	$2,121	$1,990
Payables	$2,057	$1,995	$2,014	$1,986
DSP	96.3	87.2	86.6	91.1
Payables in Tracking System	$769	$731	$677	$692
% of Total Payables	37.4%	36.6%	33.6%	34.8%
Payables Sold by Suppliers	$556	$543	$507	$513
% of Total Payables	27.0%	27.2%	25.2%	25.8%

We can see that days payable was growing rapidly year-over-year until growth slowed to 1.5 days in the 6/18 quarter. We can also see the percentage of payables sold by suppliers has also fallen year-over-year in the last two quarters as well. The company specifically addressed the beneficial impact of extending supplier terms in its 10-Q:

> *"Our cash conversion cycle (defined as days of inventory and trade receivables outstanding less days of trade payables outstanding, based on a trailing 12 month average), is approximately negative 6 days and negative one day for the 12 month periods ended June 30, 2018 and July 1, 2017, respectively. Compared with the 12 month period ended July 1, 2017, the 2018* ***cash conversion cycle was positively impacted by an increase in the days of trade payables outstanding attributable to extended supplier payment terms."***

We have noted this issue with virtually all of the major food companies. K's DSP of 96.3 is substantially above the group average of approximately 80. Again, we would note that virtually all of the DSPs of the group are near historical highs. The slowdown in DSP growth along with the leveling off of the percentage of payables sold indicates the game is coming to an end and a material benefit to cash flow growth will end with it.

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.

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.