BEHIND THE NUMBERS

Quality of Earnings Analysis

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Keurig Dr.Pepper (KDP)
Earnings Quality Update

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are maintaining our earnings quality coverage of KDP at 2- (Weak) and maintain our Top Sell rating.

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

Summary

KDP beat adjusted EPS results by 2-cents for 3Q21. We do not have the 10-Q yet, but noticed that earnings were helped by positive FX in Latin America while taking pricing as well. Historically, Latin America often experiences strong pricing of say 10% with FX of -15% offsetting that. **In the 3Q, KDP had 4% pricing and FX was a positive 11.3% which added 1-cent to EPS. We doubt that can continue for long.**

Beverage concentrates which are fountain drinks largely tied to restaurants saw negative volume growth of -0.6%. That surprised us as people are dining out more this year. **However, pricing growth of 11.4% carried the day. Pricing was $40 million against operating income rising $24 million. That added another 1-cent to EPS. The price increases and FX is likely why KDP boosted its revenue guidance by 1% but EPS growth guidance was unchanged.**

The restructuring plans seemed to be leveling off this year declining $12 million through June. Suddenly, they jumped by $14 million in 3Q and integration also rose $5 million in 3Q. KDP adds these back and it picked up another penny in this area.

We do not have the 10-Q yet to see how much of their payables have been factored – which we think has KDP refinancing its long-term debt into short-term debt. But, KDP is still pulling cash from payables ($332 million YTD). Since Bloomberg doesn't recognize payables as debt, KDP screens as though debt is lower than it really is. **Payables of $4.1 billion are currently 262 days.** Last quarter all but $1.0 billion were factored by KDP and sold payables stood at $2.9 billion. It may be over $3.0 billion now. **We would estimate their total debt to adjusted EBITDA to be 4.2x ($16.3 billion over $3.9 billion). KDP has this at 3.2x** as it excludes the factored payables and structured payables and also subtracts all its minor cash holding of $200 million (which is less than even their quarterly dividend payment).

Finally, investors should take note that KDP is now paying for marketing – it does not quantify this in the press release but noted that all of its units had to invest more in marketing y/y including "significant" increases for Beverage Concentrates and Latin America. We had seen KDP making its earnings estimates routinely by cutting marketing in recent periods and this is likely to be a headwind going forward. Coffee should continue to have tough comps from selling coffee-making equipment last year, and pricing was actually down in that unit in 3Q21.

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 Concern)- 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 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 upcoming quarters. 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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