BEHIND THE NUMBERS
Quality of Earnings Analysis
February 25, 2022

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Keurig Dr. Pepper Inc. (KDP)
Earnings Quality Update- 12/21 Qtr.

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 rating of KDP at 2- (Weak) and maintain on our Top Sell list.

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

Summary

KDP hit 4Q21 non-GAAP EPS estimates of $0.45. We are not impressed as it guided to a tax rate for the year of 23.5%-24.0% and were at 23.7% through the first three quarters of the year. 4Q came in at 20.0% which was down 350bp y/y and added 2 cents to EPS. Continued excessive price hikes in Latin America of 8.8% with only an FX hit of 0.7% added as much as 0.7 cents (likely about half that) and rounding added 0.2-cents. Its productivity add-backs are growing too, eroding earnings quality.

KDP guided to a back-loaded 2022 with sales and adjusted EPS both growing at mid-single-digit rates. This will be achieved with high-single-digit growth in 2H22. The slowdown in growth also includes an extra week of coffee system sales in 4Q22. KDP also expects a tax rate for 2022 of 22%-22.5%.

- Gross Margin declined from 55.9% to 53.8% y/y for 4Q. This is a red flag in our opinion as KDP uses FIFO accounting, which should help in periods of cost inflation. KDP took price hikes of 6.7%-8.8% in three of the units with coffee seeing pricing decline 0.6%. The company has been working on productivity improvements designed to source products cheaper, reduce bottlenecks in the supply chain, and boost margins for years now. It should be seeing some improvement in our view.

- We also question when the productivity plan has been operating for years already – why is the expense rising now? Nearly every plan like this we have seen, the first few quarters see the largest expenses as employees are laid off, contracts reworked, new investments are made in computers/equipment… Then the size of the expense declines. In the case of KDP, this started as a rounding error but four years later the cost is increasing:

Productivity Chgs	4Q	3Q	2Q	1Q
2021	$48	$44	$38	$33
2020	$25	$31	$19	$54
2019	$20	$35	$33	$9
2018	$3	$10	-$5	$22

KDP adds back almost anything it considers "one-time" to non-GAAP EPS. We think some of this could be considered ongoing expenses that are being added back for items involving the outside computer people who come by every quarter to upgrade something, training costs for staff, and management salary and travel time on the project. In a quarter where KDP only met forecasts even with help from the tax rate, it suddenly added back 3 cents from productivity plans vs. the normal 1-2 cents.

- Coffee sales may be at the root of KDP's problems. Its brewer equipment sales were helped by Covid and just posted a -10.8% volume change for 4Q21. That's after a drop to 2.2% in 3Q21. There are comps of 61% growth y/y for 1Q22 and 29% in 2Q22. This is also supposed to be a "razor and razor blade" business as customers buy new coffee pods for the brewer machines – growth there has slowed:

	4Q21	3Q21	2Q21	1Q21
Pod Vol. Growth	2.7%	6.3%	0.2%	13.7%

For 4Q, KDP blamed the lack of inventory saying its demand was too strong. However, in 2Q it blamed unfavorable shipment timing for the drop to only 0.2% growth and it's not like there was a huge rebound in 3Q either. On the call, KDP indicated it would be low on inventory going forward too and that may not recover until after 2Q22.

Also in coffee, KDP noted that pricing competition on pods is strong saying they are seeing "continued moderation in strategic pod pricing." That could continue to pressure pricing. Also pressuring pricing is the company paying fines to retailers for failing to deliver product on time. KDP just posted volume growth of 0.1% with pricing down 0.6% for 4Q21. It's not as though KDP was getting strong pricing before the inventory issues: pricing was -2.6% for 1Q21, +0.4% for 2Q21, and -1.1% in 3Q21.

KDP saw operating margins fall 400bp for coffee and it cut marketing spending in the quarter too.

- We have noted in the past that KDP has been refinancing its debt into future lease expense through the use of sale-leaseback transactions. Lease costs grew 16% y/y in 2021. Not much else is growing at that rate for KDP. Also, free cash flow ignores the $54 million in principal payments KDP owes on financing leases.

- KDP continues to slow-pay its trade creditors and has them factor the KDP payables. Payables are now $4.3 billion which is 243 days on 4Q21 COGS. KDP touts its free cash flow, but investors should take notice that Payables and Accruals grew by $762 million in 2021 which darwfs the rise in receivables of only $152 million and inventory of only $133 million (and don't forget – they admit they are low on inventory). $3.2 billion of the payables are factored, which represents very short-term debt that KDP has used to refinance its official debt. Their ratio is net debt of $11.46 billion over adjusted EBITDA of $3.97 billion or 2.9x. We think adding back the structured payable of $142 million and the $3.2 billion in factored debt is appropriate and would make the ratio 3.7x. We also wonder if that program continues as structured if interest rates increase. KDP may look back and think "It would have been very nice to have the $3 billion financed at a fixed 3.5% rate for 5-7 years rather than scrambling to refinance out of 30-day paper as rates increase." EBITDA is also inflated by the lack of accounting for the financing lease principal payment and lower marketing which we will discuss below. That would take the ratio to 3.9x.

- Marketing and R&D fell during Covid. KDP sure didn't grow them back much in 2021:

	2021	**2020**	**2019**
Revenue	$12,683	$11,618	$11,120
Marketing	$540	$489	$670
R&D	$66	$69	$81

Adjusted EPS for the year was $1.60. The $130 million in lower marketing is 7 cents. If these costs were the same 6.8% of revenue as 2019, EPS would have been lower by 14 cents.

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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