BEHIND THE NUMBERS
Quality of Earnings Analysis

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Keurig Dr Pepper Inc. (KDP) Earnings Quality Update 12/20 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 2- (Weak) rating.

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

Summary

KDP missed forecasts by 1-cent with adjusted EPS of $0.39 for 4Q20. It is worth noting that it enjoyed a lower tax rate that boosted EPS by 1-cent too. The company blamed some headwind on a $30 million gain from a sale-leaseback in 4Q19. But that gain was obviously known when KDP set guidance for 4Q20 and there were also two losses totaling $17 million on other asset sales from 2019. We also note that with the 10-K we can see that it cut marketing by $181 million during the year and R&D by $12 million. That is 10-cents in EPS during 2020. This has been helping EPS too and certainly helped in 4Q as well. KDP lists lower marketing as a driver for earnings growth in every division in 4Q.

What is strong?

- Coffee maker sales were up in 28% in 4Q. That in turn helped spur pod sales growth of 7.4%. It will be interesting to see if these additional equipment sales continue the coffee growth. Also for such strong demand, pricing was down 1.3%. We would believe that after initial pantry stocking for these new machines, volume growth will match actual coffee drinking.

- Concentrate sales could help 2021. This was the area most hit by Covid with lower restaurant sales. Volume growth remained negative at -4.5% vs. -4.8% in 3Q and -11.4% in 2Q, but easy comps here could help KDP hit guidance of 3%-4% sales growth.

What is weak?

- Payables rose again! Payables are now $3.74 billion up $564 million from 4Q19 while cost of goods sold rose a mere $112 million. Days Payables now are at 252 days up from 234 last year. The amount factored was $2.6 billion.

- We still see growing payables as KDP's way of refinancing its bank/bond debt and claim it is deleveraging. In 2020, KDP says its debt is $13.4b against adjusted EBITDA of $3.7b for a ratio of 3.6x. However, if we add in the $2.6b in factored payables and the company credit line called a "structured payable" – the ratio is 4.4x. KDP has been refinancing from long-term debt to short-term debt with the factoring set-up.

- There are several catalysts that can unwind this short-term debt in our view which can happen if the debt is downgraded and it is on negative watch:

    - Cash from operations of $2.46 billion was 25% higher from payables rising $624 million. KDP is reporting that its dividend of $1.07 billion annualized will be less than 50% of free cash flow. Cash flow was also inflated by the CARES Act deferring $59 million in 2020 and the use of financing leases moving $52 million of the lease payment to the financing section – Without all that recurring, Cash from Operations falls to $1.7 billion and capital spending was $461 million for free cash flow of $1.26 billion. The new dividend is $1.07 billion for an 85% payout ratio.

    - The marketing spending needs to return. KDP pulled nearly $200 million out of that area in 2020. It is forecasting 3% sales growth - $350 million – it had a 27% adjusted margin – that's less than $100 million in incremental cash flow against a $200 million boost in marketing. That should push cash flow down too.

    - We have noted that ROI here is very low. Total capital is $40 billion counting the $2.6 billion in factored payables. Adjusted EBITDA was $3.7b and that includes $200 in marketing cuts. Adjusting that to $3.5b gives an ROI of 8.8% and that doesn't include that KDP has a growing lease expense after several sale-leaseback deals. Plus, KDP sees pressure from commodity, wage, and logistics costs coming.

  - We noticed that KDP cut the discount rates in 2020 to value its intangible assets as well. The discount rate fell to 6-10% from 2019's 7.25%-13%. As a result, they boosted the fair market value of their intangibles to $29 billion against the carrying value of $19.7 billion. However, a 50bp increase cuts $3 billion off the fair market value. If there are cash flow pressures such as not being able to pull another $624 million out of payables and or interest rates increase – we don't think the discount rate changes by 50bp – it may go up 200-300bp.

What to watch

- Latin America results continue to be overstated in our view with KDP touting growth before FX hits. Looking at the four divisions, coffee had -1.3% pricing, packaged beverages +1.8% on pricing, concentrates -1.3% on pricing, but Latin America had 6.0% pricing gains. Latin America also had a 6.0% hit on negative FX.

- For all the sale-leaseback transactions in late 2019 and early 2020 that generated cash used by KDP to retire debt, we still believe lease costs should be rising more. Operating Lease expense rose from basically $20 million per quarter in 2019 to $28 million per quarter in 2020. But, KDP has guided to more leases that have not commenced in every quarter of 2020 and after 4Q it was still $625 million in leases. Those are expected to begin in 1Q21 and 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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