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Keurig Dr. Pepper (KDP) EQ Update- 6/20 Qtr.

Current EQ Rating*	Previous EQ Rating
2-	2-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

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

We are maintaining our earnings quality rating at 2- (Weak)

The 2Q20 results still show a great number of the negative issues we have been pointing out. KDP reports that its adjusted EPS of $0.33 beat by 1-cent. We think the company picked up in excess of 2 cents from cutting marketing and not having lease costs from recent sale-leaseback transactions in the quarter. In the real world, Latin America had a disastrous quarter with sales down 15% and operating income down 19% - but KDP adjusted its way into 1.4% sales growth and a 30% growth in operating income for the quarter. We think they picked up some EPS there too:

- **Accounts Payable at $3.38 billion are higher again vs. 1Q.** Cost of Sales rose considerably in 2Q (up 9.8% y/y on a 1.8% increase in sales), which lowers the DSPs for payables from the record high of 254.5 days to the second-highest level now of 236.7 days. **If we adjust the COGS for COVID items and a common Mark-to-Market item that KDP adds back, DSPs were 245.9 days. KDP still pulled in $139 million in cash flow by stretching the payable figure in dollar terms in 2Q. That is 21% of their operating cash flow in the quarter.**

- **This is a company that touts its free cash flow. It has been obvious that stretching payables has been a key to the company reporting higher cash flow.** It was 21% of operating cash flow in 2Q20, 15% in 1Q20, 35% in 2019. **They also leave out finance lease payments, which hit in the financing section, not the operations section**. That inflated free cash flow by $24 million in 2020 so far **and KDP adds back asset sales as part of free cash flow which was $202 million in 2020 so far**. Adjusting for just these items – Free cash flow of $988 million falls to $561 million.

- **KDP also helped its cash flow with two other items that are not quantified. The company noted that it reduced marketing in the quarter.** In 2019, marketing was $670 million or 6.0% of sales. It shows up in SG&A – which in the 2Q, fell in dollar terms on KDP's adjusted figures from $913 million to $836 million y/y. We think a drop in marketing spending was a big part of this improvement that will return in future quarters. Marketing grew in 2019 and was growing in 1Q20 too. **Every 1% of sales that marketing declined was worth $28.6 million in 2Q20 – or 1.6-cents in EPS**. **Sales incentives/rebates are another form of marketing that show up as a reduction in sales. In 2019, KDP said a 10% change would be $36 million.** It is possible KDP picked up some earnings there too. KDP called out lower marketing as a reason for operating margin gains for 3 of the 4 units.

- **We have been pointing out that KDP has not been paying down debt as much as it is moving to new forms of debt that are not counted as leverage in traditional measures such as payables and operating leases. The asset sales KDP has been making are basically sale lease-back transactions.** We found the following note in the 1Q20 10-Q:

  *"As of March 31, 2020, the Company has entered into leases that have not yet commenced with estimated aggregated future lease payments of approximately $610 million. **These leases are expected to commence between the second quarter of 2020 and second quarter of 2021**, with initial lease terms ranging from 7 years to 20 years."*

  Thus, there were operating lease payments that were not hitting in 2Q20 – that are likely about $10-$15 million per quarter. That added to cash flow too and on EPS – another 0.6-0.8 cents for the quarter.

- **We do not buy that KDP's debt figure is down to 4.0x adjusted EBITDA. There is $2.3 billion in payables that could unwind on KDP if its debt rating falls. There are**

new lease obligations of over $1 billion. And KDP still owes $182 on structured payable they exclude from the debt total. **That would add $3.5 billion to the debt total and make the Debt/adjusted EBITDA ratio 5.0x.** The company's 4.0x figure also ignores that the bulk of the debt is only guaranteed by the Dr. Pepper assets and cashflow and that is only half the company. That inflates the effective Debt/EBITDA figure considerably too.

- As we warned, KDP lost their pricing power. For the company, volume was up 4.3% with pricing down 1.4%.

2Q20	Volume	Price	FX	Net
Coffee	8.3%	-2.5%	-0.4%	5.4%
Packaged Bev	6.6%	-0.3%	-0.1%	6.2%
Bev Concentrate	-11.4%	-4.8%	-0.3%	-16.5%
Latin America	-4.7%	6.1%	-16.3%	-14.9%

- **Latin America spun as an improving business?** We know inflation and devaluing currency issues cloud the Latin American results. **KDP is touting that sales growth was actually 1.4%, not -14.9% due to its prowess in taking pricing and ignoring the FX hit.** Does anyone really believe this is a growing business? Volume was down 4.7% on top of a negative volume figure of 1.4% in 2Q19. Then, is a 6.1% pricing gain coming because people are clamoring for product or because the FX loss was 240% greater than the price hike? On income, Latin American operations declined from $26 million to $21 million due to FX impacts and lower volume and that $21 million was helped by cutting marketing and restructuring. To get to the figure KDP is touting that on an adjusted basis, income grew from $20 million to $26 million on a constant currency basis they had to do the following:

  - Add back $3 million in FX hits in the quarter
  - Subtract $6 million in items from 2Q19 income – none of which are specified. The only language is that 2Q19 income declined from 2Q18 primarily due to a $5 million rebate paid by a supplier in 2018 and that 2Q19 was hurt by higher inflation.
  - Add back $2 million more to 2Q20 results – none of which are specified either. Restructuring costs sound like part of it.

We would consider FX to be part of life with that division and would not give them credit for $3 million there. We also would view the marketing decline as something unlikely to be sustained. Plus, 2Q19 sounds like an easy comp to begin with for this unit. $3 or $4 million is not even a rounding error for EPS so we would focus more on this situation as a symptom of KDP's aggressively defined "adjusted EPS."

- Adjustments to EPS at KDP go beyond most other companies we look at. Several companies don't add back restructuring or FX impacts. For 2Q20, GAAP EPS of $0.21 was raised by almost 60% to $0.33 by adding back 10-items. Those 10-items did not include calling out the size of the marketing cuts, the size of the cuts in travel/entertainment, or the delayed lease expense. We give KDP low marks for overall earnings quality on several points:
    - Stock option expense is a recurring item – they add it back
    - KDP records basically zero cost of an acquisition beyond interest expense (and it adds that back to EBITDA too). It only amortizes a small part of the acquired assets and adds back that expense along with all restructuring and integration expenses. It's as though the company doubles in size for free.
    - Mark to Market changes for inventory, restructuring, and legal bills occur regularly and are also added back. Restructuring and Productivity charges, in particular, are material and can include a number of ongoing expenses too such as training, updating software, maintenance, management time, meeting changing regulatory rules, etc.
    - FX has a real cost here – by ignoring it – KDP is touting that a unit with negative volume growth and huge declines in sales is actually growing.

Explanation of EQ Rating Scale

Rating	Description
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 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.

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