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Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

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Kraft Heinz (KHC) EQ Review Update-9/18 Quarter

Current EQ Rating*	Previous EQ Rating
2+	2+

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

We are maintaining our rating on Kraft Heinz (KHC) at 2+ (Weak)

KHC reported EPS of $0.78 in the 9/18 quarter, 3 cps below the Zack's estimate. While the company has ended its receivables securitization program, we continue to see red flags with the company's results.

- The company has completed the unwinding of both its US and international receivables securitization programs. There were no outstanding securitized receivables at the end of the 9/18 quarter, nor did the company exchange any for cash during the quarter. Adjusted accounts receivable DSOs were flat with last year, but cash flow growth will be weighed down in the next few quarters as the benefit from selling receivables is gone.

- Allowance for bad debt remained low at 1.2% of gross receivables compared to 3.0% last year. We estimate it would take $38 million (2.5cps) in charges to restore the allowance to the year-ago level.

- Accounts payable days (DSP) continue to rise year-over-year as the company extends the time it takes to pay suppliers.

Adjusted Receivables DSOs Flat Year-Over-Year

As we discussed in our 6/18 quarterly review, KHC unwound its US receivables securitization program in the 6/18 quarter, resulting in a rapid decline in receivables classified as sold. In the 9/18 quarter, it also unwound its international securitization program. As a result, there were no outstanding securitized receivables as of the end of the 9/18 quarter and the company received no cash in exchange for receivables during the period.

The following table shows accounts receivables days of sales (DSO) adjusted for the outstanding securitized balances for the last eight quarters.

	9/29/2018	6/30/2018	3/31/2018	12/30/2017
Trade Receivables	$2,032	$1,950	$1,044	$921
Reclassified as "Sold Receivables"	$0	$37	$530	$353
Receivables Exchanged for Cash	$0	$162	$659	$673
Adjusted Receivables	$2,032	$2,149	$2,233	$1,947
Sales	$6,378	$6,686	$6,304	$6,957
Adjusted DSOs	29.1	29.3	32.3	25.5

	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Trade Receivables	$938	$913	$886	$769
Reclassified as "Sold Receivables"	$427	$521	$588	$129
Receivables Exchanged for Cash	$673	$579	$612	$871
Adjusted Receivables	$2,038	$2,013	$2,086	$1,769
Sales	$6,280	$6,637	$6,324	$6,857
Adjusted DSOs	29.6	27.7	30.1	23.5

While adjusted DSOs had been rising around 2 days on a year-over-year basis for the last three quarters, they were essentially flat in the 9/18 period. While we view the stability of growth in receivables as good for the quality of reported revenues, cash flow growth will be weighed down in the next few quarters as the acceleration of the collection of receivables is completely gone.

Receivables Allowance Remains Low

While the overall level and growth of receivables looks good, we do note that the company's allowances for bad debts remain less than half their year-ago levels, as shown in the following table:

	9/29/2018	6/30/2018	3/31/2018	12/30/2017
Trade Receivables	$2,032	$1,950	$1,044	$921
Allowance- Applied to Trade Receivables	$24	$24	$24	$23
Gross Receivables	$2,056	$1,974	$1,068	$944
Allowance % of Gross Receivables	1.2%	1.2%	2.2%	2.4%

	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Trade Receivables	$938	$913	$886	$769
Allowance- Applied to Trade Receivables	$29	$28	$30	$20
Gross Receivables	$967	$941	$916	$789
Allowance % of Gross Receivables	3.0%	3.0%	3.3%	2.5%

Note that the trade receivables balances in the above table include only the amounts associated with the trade receivables that remain on the balance sheet. To put this decline in perspective, it would take about $38 million (2.5 cps) in charges to bring the allowance back up to 3% of gross receivables.

Accounts Payable Continues to Grow

We have highlighted in previous reviews that KHC's has been stretching payment terms and utilizing structured payable arrangements to boost cash flow. The following table shows the calculation of accounts payables days (DSPs) which adds back payables in structured payable arrangements that are booked in accrued liabilities to the trade accounts payable balance:

	9/29/2018	6/30/2018	3/31/2018	12/30/2017
Accounts payable	$4,312	$4,326	$4,241	$4,449
Structured Payables in Accrued Liabilities	$47	$88	$141	$188
Adjusted Payables	$4,359	$4,414	$4,382	$4,637
Cost of Sales	$4,271	$4,321	$4,059	$4,200
Days Payable	93.1	93.2	98.5	100.7

	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Accounts payable	$3,947	$3,888	$3,936	$3,996
Structured Payables in Accrued Liabilities	$0	$0	$0	$0
Adjusted Payables	$3,947	$3,888	$3,936	$3,996
Cost of Sales	$4,077	$4,204	$4,125	$4,398
Days Payable	88.3	84.4	87.1	82.9

We see that the year-over-year rise in DSPs continued into the 9/18 quarter.

One item that stands out is the sequential decline in structured payables in accrued liabilities. Remember that structured payable arrangements represent the company making third-party financing available to its suppliers whereby they can sell their receivables due from KHC. Consider the note on structured payables from the company's 10-Q filing:

> *"Additionally, we enter into various structured payable arrangements to facilitate supply from our vendors. **Balance sheet classification is based on the nature of the agreements with our various vendors.** For certain arrangements, we classify amounts outstanding within other current liabilities on our condensed consolidated balance sheets."*

Given that the balance sheet classification depends on the nature of the agreement, it seems that the decline in the amount of structured payables booked in accrued liabilities does not necessarily mean a reduced use of structured arrangements. Our standing concern with these rising payables balances is the question of how long the company can continue to boost cash flow growth by extending the time it takes to pay suppliers. With the company currently taking over 3 months to pay, our guess is not much longer.

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

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