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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

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Kraft Heinz (KHC) EQ Update- 12/19 Quarter

Current EQ Rating*	Previous EQ Rating
3+	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 upgrading our earnings quality rating to 3+ (Minor Concern) from 2- (Weak).

- KHC's debt rating was downgraded to junk status last week by Fitch over concerns that the company's decision to keep its dividend at 40 cps per quarter and the expected 8% decline in EBITDA in 2020 would prevent the company from reducing its leverage ratio to under 4 quickly enough.

- Despite the downgrade, we estimate the dividend will still consume only about 76% of free cash flow in 2020 leaving about $500 million left over for debt reduction. Management expects 2020 to be a year to stabilize and serve as a base for future growth. Its basic turnaround plans include reducing the number of SKUs, focusing on higher-growth brands and exiting or divesting slower ones, supply chain cost reduction, and scaling back lower ROI marketing programs and focusing on ones with higher ROIs. Given the established nature of many of its brands (Heinz, Kool-Aid, Jell-O) it does not seem far fetched to expect the company to achieve low single-digit EBITDA growth in 2021 which could see the net leverage ratio below 4x. Well-executed

divestitures could further boost debt reduction efforts as well. We also observe that investors are getting an almost 6% dividend yield while they wait.

- KHC wrote down $473 million of goodwill related to the Australia-New Zealand and Latin America reporting units and $273 million of intangible assets related to the *Maxwell House* brand in the fourth quarter. As of 12/19, $13.4 billion of intangibles with fair values less than 10% greater than their carrying value with another $3.6 billion with fair values between 10-20% greater than carrying value. The company has even warned that intangibles balances with fair values that exceed carrying value by more than 20% could be subject to write-down as much of those values were determined at the time of the 2015 Heinz acquisition and there is a possibility of changes in assumptions that could conceivably lead to a downgrade in the future.

- Furthermore, part of the reason for the fourth quarter write-downs was an increase in the discount rate utilized in the valuation calculation to reflect an increase in risk perceived by investors related to the stock price decline. Could the debt downgrade and associated stock price drop be cause for a higher discount rate? Finally, the company noted that lower market rates keeping a lid on the discount rate increase helped offset some of the negative inputs in the fair value calculation in the fourth quarter. It also warned that future market interest rate increases could increase the likelihood of future write-downs. All of these factors make us believe we have not seen the last of write-downs on par with the fourth quarter and should the company's turnaround plans not materialize, there could very well be more $1 billion-plus charges in the future on par with last year's first quarter.

- The company had previously identified a material weakness in internal control related to its procurement functions. As of the 12/19 10-K, the company had yet to mark these issues as resolved. We are not especially alarmed by this as management is dealing with multiple problems. We also observe that given all the scrutiny surrounding the company's accounting, we expect management is seeking to be as conservative as possible and would be quick to identify any problems it might discover.

- We note that since our original assignment of a 2- (Weak) rating in 2018, the company has unwound its receivables securitization program and has scaled

back its payables factoring programs which are both improvements to the quality of reported results.

Cash Flow Should Be More than Sufficient to Cover the Dividend

As noted above, Fitch recently downgraded KHC's debt to junk status (BB+) over concerns that the company's commitment to keep its dividend at its 40 cps quarterly rate will not allow it to deleverage quickly enough. Fitch stated:

> *"The downgrade reflects Fitch's view that Kraft's leverage will remain elevated above 4x for a prolonged period due to ongoing EBITDA challenges and limited near term debt reduction potential. Following Kraft's commentary around 2020 operating headwinds which would suggest a nearly 8% EBITDA decline and its commitment to maintain its dividend as announced Feb. 13, 2020, Fitch estimates the company may need to divest up to 20% of its projected 2020 EBITDA to support debt reduction necessary to reduce leverage to below 4.0x versus 2019 leverage of 4.8x."*

Despite the downgrade, we see KHC's dividend as well-protected. The company posted adjusted EBITDA of $6.1 billion in 2019. During the call, the company cited several specific headwinds that will result in a decline in EBITDA in 2020, which are shown in the following table:

2019 Adjusted EBITDA	$6,064
Company Guidance of YOY EBITDA Impacts	
Divestitures	-$110
Incentive Compensation	-$140
Commodities, Distribution, Supply Chain	-$150
FX	-$60
Estimated 2020 EBITDA	$5,604
less	
Cash Interest	-$1,306
Cash Taxes	-$974
Estimated 2020 Operating Cash Flow	$3,324
Capex	$750
Estimated 2020 FCF	$2,574
Cash Dividend	$1,954

Divestitures made in 2019 will cut $110 million while the return of previously suspended incentive compensation will add $140 million to costs. Higher commodity and supply chain inflation will drain another $150 million which FX is expected to be a $60 million headwind. This implies 2020 EBITDA of $5.6 billion. If we leave cash interest and tax expense flat with 2019 levels and assume a neutral working capital impact, we get an estimated operating cash flow figure of $3.3 billion. Management stated during the call that it does not anticipate a significant cash spend related to restructuring activities, and it expects capex of $750 million in 2020 which will result in $2.5 billion of free cash flow. The dividend at the current 40 cps quarterly rate will consume $1.9 billion in cash. This is consistent with the company's contention on the call that *"…our free cash generation as a percentage of net income should go up, and we continue to expect to generate healthy levels of cash flow, at least $500 million in excess of our normal dividend payout in 2020."*

While a 76% free cash flow dividend payout is not especially conservative, the dividend certainly appears safe and leaves room for debt reduction. Approximately $1 billion in debt comes due in 2020 but this can be more than covered by the company's $2.3 billion in cash and equivalents. KHC's total net debt to adjusted EBITDA is about 4.4x. Assuming the company uses all of the $500 million in excess free cash after dividend to pay off debt and using the $5.6 billion estimate for 2020 EBITDA, the net leverage ratio will rise to about 4.7 by the end of year and will decline about 0.2 per year assuming EBITDA remains flat at the lower 2020 level.

However, the company has made it clear that it will be looking for strategic opportunities to divest certain brands which could significantly boost the debt-reduction effort. Given all these factors, the dividend appears to be safe at this point in time.

Management indicated that it looks for 2020 to be a year to stabilize and represent a base from which to grow. While it disappointed investors in the fourth quarter call by delaying details for its turnaround strategy, it has identified 1) SKU reduction with a focus on growing brands and discontinuing less attractive brands, 2) supply chain cost reduction and 3) scaling back marketing programs with low ROI as some of the areas of focus for next year and beyond. It is early in the process but given the popularity of many of the company's brands (*Heinz, Kool-Aid, Jell-O*) our initial thoughts are that it is not far fetched to expect the company to be able to eke out at least low single-digit EBITDA growth in 2021. Two years of $500 million in debt reduction per year and a return of EBITDA to $6 billion could put net debt/EBITDA below 4x by the end of 2021.

Status of Goodwill and Intangibles

We have documented KHC's massive write-offs of goodwill in 2018 and early 2019. These charges continued into the 12/19 quarter as its year-end review showed that it was more likely than not that the carrying value of its Australia and New Zealand, Latin American Exports and Northeast Asia reporting units were above their fair value. This was driven by weaker than expected growth, new management, and the 2020 operating plan which established a revised set of expectations for the coming years due to market factors which will reduce revenue and margins. This led to a $473 million goodwill write-down taken in the fourth quarter for the Australia and New Zealand and Latin America reporting units and a $278 million write-down of the intangible asset associated with the *Maxwell House* brand.

KHC also warned in the 10-K that the upcoming combination of its EMEA, Latin America, and APAC zones into one reporting unit as well as moving the Puerto Rico business from the Latin American zone to the United States zone will trigger an impairment test that will make remaining goodwill associated with these units ($278 million) subject to additional impairments.

Even after all the writedown, goodwill of $36 billion and intangible assets of $49 billion account for about half of total assets and almost all of shareholders' equity. As of the end of the year, $13.4 billion of intangible assets associated with *the Kraft, Planters* and *ABC* brands had fair values that were less than 10% above carrying value while another $3.6 billion associated with the *Oscar Meyer, JetPuffed* and *Quero* brands were had fair values of 10-20% above carrying value. 20% is not a very big cushion as the company warns in the 10-K regarding its reporting unit goodwill:

> *"Our reporting units that were impaired in 2018 and 2019 were written down to their respective fair values resulting in zero excess fair value over carrying amount as of the applicable impairment test dates.* ***Accordingly, these and other individual reporting units that have 20% or less excess fair value over carrying amount as of their latest 2019 impairment testing date have a heightened risk of future impairments if any assumptions, estimates, or market factors change in the future.***
>
> ***Although the remaining reporting units have more than 20% excess fair value over carrying amount as of their latest 2019 impairment testing date, these amounts are also associated with the 2013 Heinz acquisition and the 2015 Merger and are recorded on the balance sheet at their estimated acquisition date fair values. Therefore, if any estimates, market factors, or assumptions, including those related to our enterprise strategy or business plans, change in the future, these amounts are also susceptible to impairments."***

On the subject of assumptions, it is also worth remembering that one of the reasons for recent cuts to fair value estimates was due to higher discount rate assumptions to reflect perceived higher risk due to the company's stock price decline. (A higher discount rate reduces the present value of expected future cash flows.) This leads us to wonder if the recent stock price decline coupled with the debt downgrade could increase the likelihood of future writedowns. It is also worth remembering that the recent fair value calculations have benefitted from a decline in overall market interest rates reducing the discount rate. This was visible in the company's comment in the 10-K regarding the *Maxwell House* writedown:

> *"The reduction in fair value of the Maxwell House trademark was driven by expectations of near-term net sales and profitability declines outlined in the 2020 annual operating plan in response to consumer shifts from mainstream coffee brands to premium coffee brands.* ***These shifts in expectations were***

> ***partially offset by declines in market driven discount rates observed in the fourth quarter of 2019. Should market interest rates increase in future periods, the likelihood for further impairment will increase****. We determined the factors contributing to the impairment loss were the result of circumstances that arose during the fourth quarter of 2019. This brand had a carrying value of approximately $823 million after the recorded impairment."*

This highlights another risk of higher market rates for companies with large amounts of goodwill and intangibles with narrow spreads between fair values and carrying values.

In summary, it looks as if KHC remains at risk of seeing write-off activity similar to the fourth quarter for the foreseeable future. However, should the company's turnaround plans not bear fruit and results continue to erode, there is potential that significant amounts of goodwill and intangibles related to key Kraft brands as well as acquired Heinz brands could lead to more billion-dollar surprises.

Status of Material Weakness

KHC's accounting department has been put through the wringer in the last two years. In late 2017, the company was required to restate two 10-Qs due to failing to properly apply ASU 2016-15 for the accounting of cash flow. This led to the identification of a material weakness in internal control over financial reporting. This was followed by the 2/2019 announcement of the $15.6 billion write-down of goodwill and intangibles and an SEC investigation into improper handling and accounting of its procurement procedures. More restatements followed.

The company continued to cite a material weakness in financial control in its 2019 10-K stating:

> *"As previously disclosed in our Annual Report on Form 10-K for the year ended December 29, 2018, we identified a material weakness in the risk assessment component of internal control as we did not appropriately design controls in response to the risk of misstatement due to changes in our business environment. This material weakness in risk assessment gave rise to the specific control deficiency described below, which we also determined to be a*

> *material weakness, and both material weaknesses have not been remediated as of December 28, 2019:*
>
> *Supplier Contracts and Related Arrangements: We did not design and maintain effective controls over the accounting for supplier contracts and related arrangements. Specifically, certain employees in our procurement organization engaged in misconduct and circumvented controls that included withholding information or directing others to withhold information related to supplier contracts that affected the accounting for certain supplier rebates, incentives, and pricing arrangements, in an attempt to influence the achievement of internal financial targets that became or were perceived to have become increasingly difficult to attain due to changes in our business environment. Additionally, in certain instances, we did not have a sufficient understanding or maintain sufficient documentation of the transaction to determine the appropriate accounting for certain cost and rebate elements and embedded leases. This material weakness resulted in misstatements that were corrected in the restatement included in our Annual Report on Form 10-K for the year ended December 29, 2018."*

We are not overly alarmed that the material weakness has not been classified as resolved yet. At this point, there is so much attention focused on the company's accounting that we are inclined to think management will be very focused on being "above reproach" and quick to report the discovery of any material misstatements.

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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