BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

May 9, 2019 | www.btnresearch.com

Kraft Heinz (KHC) EQ Update- Detail from 8-Ks

We currently have a 2+ (Weak) rating on KHC from our review of the 9/18 quarter. We will postpone updating the rating given the continued delay in the filing of the 10-K and now the first quarter 10-Q.

It is tempting to look at KHC's forward PE of under 12 and its 4.9% yield (adjusted for the recent cut) and conclude that when all the noise surrounding the SEC investigation and the massive write-off dies down that the stock will prove to be cheap. However, investors should not forget that the write-down stems from a deteriorating outlook for the company's business. Organic sales growth in the US in 4Q18 was only 1.1% as pricing and increased promotional activity are taking their toll on growth and margins. The company has a decades-long history of acquiring brands, booking huge goodwill and intangibles balances, and then taking massive write-offs. We are skeptical that the latest fiasco will be the last. Now, the newly-appointed CEO's time will be taken up dealing with the fallout of all the bad news rather than dealing with the company's growth problems. Debt exceeds sales, payables have been stretched to 90 days, and the receivables securitization program has been wound down. Therefore, we believe KHC is far from out of the woods.

Our 3/1/19 overview of goodwill highlighted that KHC's 12/18 quarterly results included a massive write-off to goodwill and intangibles as well as the disclosure of an October 2018 SEC subpoena. The company has been delayed in releasing both its 10-K filing for 2018 as well as its 10-Q filing for the first quarter. We pieced together the following timeline since the beginning of the year from a series of 8-K filings.

- On 2/21/2019, KHC announced in its earnings press release for the 12/18 quarter that it was taking a $15.6 billion write-down to goodwill and intangibles. In addition, it disclosed that it received a subpoena from the SEC in October of 2018 pertaining to its accounting policies, procedures and internal controls related to its procurement function including agreements, side agreements and changes or modification to its agreements with vendors.

- The company also announced in its 4Q results that it had launched an internal investigation into its procurement processes as well as recording a $25 million increase to 4Q cost of sales as "an out of period correction" as the company determined the amounts were "immaterial" to the fourth quarter of 2018 and its previously reported 2018 and 2017 interim and year to date periods.

- On 2/28/2019, the company filed an 8-K declaring that it would not make its deadline for filing its 10-K for the 2018 fiscal year. In addition, it disclosed more details pertaining to the goodwill and intangibles write-downs mostly as a result of declines in sales and margin forecasts. Key write-downs included in the $7.1 billion reduction in goodwill included an almost 40% reduction in goodwill associated with the key US Refrigerated Foods segment and a 50% reduction in the Canada Retail Segment. The $8.3 billion write-down to intangibles included a 26% reduction in the carrying value of the *Kraft* brand name and a 50% reduction in the *Oscar Mayer* brand name. We have long criticized the company's ongoing cycle of high-priced acquisitions followed by charges and write-offs. Keep in mind that even after the write-off, the company has almost $70 billion in goodwill and intangibles remaining on its balance sheet.

- On 3/15/2019, KHC filed an 8-K disclosing that it had received notice that the late filing of its 10-K put it out of compliance with Nasdaq listing rules. The company has 60 days to submit a plan to regain compliance with Nasdaq and could be granted another 180 days from the original due date if the plan is approved. With the internal investigation largely complete, we would expect the 180 days to be adequate time to complete the 10-K.

- Similarly, on 3/22/2019, KHC filed an 8-K revealing that JPMorganChase had granted it a waiver for the deadline to file its 10-K under the company's senior revolving credit agreement. The deadline was extended to 5/14/2019 which is fast approaching. KHC had no outstanding borrowings under the agreement as of 12/2018, so even if KHC missed the deadline it would not appear to have an immediate impact on near-term liquidity. However, this poses a headline risk and demonstrates the complications that the situation with the SEC brings with it.

- On 5/6/2019, KHC filed an 8-K disclosing that the company will be restating its annual financial statements for 2016 and 2017 as well as the quarterly financial statements for 2017 and through September of 2018. This will result in the company missing the deadline for filing its first quarter 10-Q. Its internal investigation into

its procurement area is now substantially complete. KHC revealed that "several" employees in the procurement area (none were in senior management) were engaged in misconduct which resulted in misstatements from the incorrect timing of recognition of cost and rebate components related to complex supplier contracts and arrangements. The restatements will involve increases to previously-reported cost of sales to reflect the recognition of supplier rebates over time rather than up front. In addition, KHC identified that certain of the arrangements in the contracts were improperly classified as embedded capital leases. The correction of these errors did not impact 2017 net income and resulted in a decrease to 2018 net loss of $2 million. However, 2017 adjusted EBITDA will be reduced by $2 million and 2018 EBITDA reduced by $33 million.

- In addition, the company revealed in the 5/6/2019 8-K that it made errors in the calculation of impairment losses it reported in the 2/28/2019 8-K. While the net correction resulted in only a $13 million increase in the total impairment, the offsetting amounts were huge. Errors in the allocation of forecasted cash flows resulted in an increase in the impairment loss associated with intangibles assets of $278 million, while errors related to goodwill reduced the impairment by $173 million. Also, the corrections related to the supplier rebate misstatements reduced the goodwill impairment by another $92 million. All combined, these adjustments led to the $13 million increase in impairments. We find it remarkable that such large positive mistakes essentially offset a large negative. It is worth considering that the estimation of the value of goodwill involves considerable management judgment and is sensitive to the estimation of future growth rates and the selection of hurdles rates. It was disclosed in the 5/6/2019 8-K that the SEC issued another subpoena requesting not only more information on the procurement area but also information on the impairment charge. We would not be shocked to see future adjustments to the impairment charges.

- Management has stated multiple times that the misstatements were "immaterial" to any of the periods in question. However, the total amount of required adjustments related to the timing of recognition of rebates and expenses on supplier contracts totaled $208 million. The 3Q17 adjustment totaled 60 bps of sales and the 4Q18 adjustment totaled almost 40 bps of sales. If analysts at the time had been told that gross margins were actually lower by 40-60 bps, we believe they would have considered the impact to be material.

- The company will also be reporting two or more material weaknesses in its internal control over financial reporting in its 10-K. We pointed out in our 9/27/2018 earnings quality review that KHC has already identified material weaknesses in internal control in the 9/17 quarter related to the improper classification of cash flows from receivables securitizations as operating cash flows which led to restatements of the 3/17and 6/17 financials to the tune of several hundred million dollars.

- As noted above, the latest 8-K also revealed that the company received another subpoena from the SEC on 3/1/2019 which is associated with its impairment of goodwill and intangibles and also requests documents related to the procurement area. Our main concern here is further headline risk and the potential fallout of delays in future filings.

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.

Disclosure

BTN Research is a research publication structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. Information included in this report is derived from many sources believed to be reliable (including SEC filings and other public records), but no representation is made that it is accurate or complete, or that errors, if discovered, will be corrected.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.