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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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# Kraft Heinz (KHC) EQ Update

| 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 lowering our earnings quality rating on KHC to 2- (Weak) from 2+ (Weak).**

KHC released its 10-K for 2018 on 6/7/2019. We had previously discussed the events leading to the delay of the 10-K, the proposed restatements in our 5/9/2019 review of the company as well as the huge write down to goodwill and intangibles. The reduction in our rating relates to new concerns regarding artificial benefits to organic sales growth from FX adjustments in from Venezuela and Argentina, a rise in other current assets, as well as a jump in accounts payable which consumed cash.

We will be doing more work on the company when the 10-Q is released, but for now, we note the following observations from the 10-K:

- The final restatements resulted in a $35 million reduction in adjusted EBITDA for the nine months ended 9/18 and $106 million and $79 million reductions for full-year 2017 and 2016, respectively. As expected, the focus of the restatements was on the improper deferral of supplier rebates as well as the misclassification of certain supplier arrangements as embedded capital leases. Other immaterial items were identified which we take to be part of the process of "cleaning house." The company has identified a material weakness of internal control in the areas of supplier arrangements and goodwill and intangible valuation and it still faces SEC subpoenas, not to mention several shareholder lawsuits. We remind investors that less than two years ago, KHC had to restate two 10-Qs in 2017 over a material improper

classification of cash flows which also resulted in the identification of a material weakness in internal control.

- The first waiver granted by the lender behind its senior revolving credit agreement to file its 10-K by 6/28/2019 has been satisfied. The company plans to release its 10-Q for the first quarter of 2019 on or before 7/31/2019 which will satisfy the second waiver. It will also satisfy the Nasdaq requirement to file the 10-Q by 9/30 to avoid being delisted.

- KHC disclosed that the delay of the 10-K filing makes it currently ineligible to utilize form S-3 to for one year. This would make it more difficult, costly, and increase the length of time for the company to do a public offering, raise capital or make acquisitions. It also prohibits the company from using form S-8 to issue stock to employees who have since received notice of a blackout period where they cannot acquire additional beneficial ownership in KHC.

- In the area of new concerns, we note that organic sales growth at the company's "Rest of World" segment is artificially benefitting from inflationary price increases in Latin America. While the unusually large price increases from the inflation in Latin America are benefitting organic growth, the large negative impact from the depreciation of the Venezuelan bolivar is adjusted out. We believe the almost 8% segment organic growth should be closer to the 2.5% volume growth reported by the segment. This is material to the company as the Rest of World segment organic growth accounted for the bulk of total company organic growth for 2018.

- Other current assets almost doubled from the year-ago level. While detail into the account is not available, we can verify that increases in the value of derivative assets accounted for well under half the increase. Such an unexplained jump in other assets is a red flag as it may indicate that current operating expenses have effectively been capitalized to delay recognition on the income statement. While we are skeptical that the company would be playing games with its numbers in light of the current scrutiny of its financials, such a sudden increase does deserve some notice.

- Accounts payable fell by approximately 5 days of cost of sales which the company attributed to the timing of payments. We have previously cited that the company's cash flow was benefitting from stretching payables to suppliers.

- We note that the exclusion of equity awards from the share count added about 2 cps to adjusted EPS for the year. The awards were excluded as they became anti-dilutive due to the net loss attributable to common shareholders. We view this as non-operational in nature.

## FX Adjustments Boosting Reported Organic Growth

We recently discussed in detail in our 6/13/2019 report how we are seeing major multinational companies benefitting from non-GAAP currency-related adjustments at Latin American operations. Segments operating in countries with hyperinflationary economies show misleadingly strong organic growth rates when organic growth figures include the benefit of abnormally high price increases resulting from the inflation while the negative impacts of the currency deterioration are excluded. KHC saw this work in its favor in 2018 as its "Rest of World" segment posted the following sales growth breakdown:

| 2018 Growth Rate for "Rest of World" | |
|---|---|
| Net Sales | 5.6% |
| Currency Impact | -7.6% |
| Acquisitions | 5.3% |
| Organic Net Sales | 7.9% |
| | |
| Price | 5.4% |
| Volume/Mix | 2.5% |

We see that the negative currency impact of 7.6% is adjusted out of the organic sales growth figure. The company attributed 5.1% of that amount to deterioration of the Venezuelan bolivar. However, the impact of rising prices which the company admits was due to "highly inflationary environments in Certain markets within Latin America" drove most of the reported organic growth. We propose that a more accurate growth rate for the segment would be closer to 2% as most of the price impact is as non-operational in nature as the currency drain. This is definitely a material issue, as the organic growth from the "Rest of World" segment accounted for the bulk of the total company organic sales growth for the year.

## Other Current Assets Jump

Prior to the restatement, KHC combined its prepaid expense account with its other current assets account. Now, it breaks out the two accounts separately as shown below. Note that these amounts are all post-restatement figures:

| | 12/29/2018 | 9/29/2018 | 6/30/2018 | 3/31/2018 |
|---|---|---|---|---|
| Prepaid Expenses | $400 | $389 | $388 | $367 |
| Other Current Assets | $1,221 | $352 | $431 | $426 |

| | 12/30/2017 | 9/30/2017 | 7/01/2017 | 4/01/2017 |
|---|---|---|---|---|
| Prepaid Expenses | $345 | $368 | $359 | $349 |
| Other Current Assets | $655 | $527 | $547 | $611 |

The other current assets account almost doubled from a year ago. The only detail we have seen regarding the makeup of the account is that the company records the fair value of derivative assets in that account. We note that it jumped by $165 million from the year-ago period which does not even account for half of the observed increase. The concern with a jump in other current assets is that it can be an indication the company capitalized current period operating costs thus delaying their recognition on the income statement until a later date. Quite frankly, given all the scrutiny of the company's accounting policies, we are very skeptical that the company would choose now to play games with its numbers, so we suspect there is a more benign explanation for the increase. Regardless, such a sudden jump should always be questioned, and we will follow up after the release of the first quarter 10.Q

# 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

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