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Kraft Heinz (KHC) EQ Review

Current EQ Rating*	Previous EQ Rating
2+	NA

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

We initiate coverage of Kraft Heinz Corporation (KHC) with a rating of 2+ (Weak.)

We have several items of concern with KHC's recent results:

- KHC has maintained a receivables securitization program for several years. In the second quarter, it unwound the US portion of the program. After adjusting for the sold receivables, accounts receivable days sales have been rising by 1-2 days over the last few quarters. This is not overly concerning.

- However, in November of 2017, the company had to restate its 10-Qs for the 3/17 and 6/17 quarters for failing to properly account for cash flows from receivables securitizations under ASU 2016-15 which it had adopted in the 3/17 quarter. This also led to the company identifying a material weakness in internal control over financial reporting.

- Operating cash flow growth adjusted to include payments on previously securitized receivables currently classified as investing cash flows is stronger than what is implied by reported operating cash flow. However, the adjusted figure is being boosted by the accelerated collection of these retained interests in receivables. This should normalize after the next two quarters.

- Operating cash flow has received a significant boost from an increase in accounts payable for the last several quarters. However, the pace of the increase is slowing, and the company has indicated that terms with its suppliers are becoming less favorable.

- Even after adjusting for a one-time pension contribution, the dividend still consumes approximately 80% of free cash flow on a trailing 12-month basis. With net debt-to-EBITDA already approaching 4x, we see little room for dividend growth.

- The allowance for bad debts as a percentage of trade receivables fell to 1.2% from 3.0% a year ago. We estimate it would have taken an additional 1.2 cents per share in provision expenses to have kept the allowance flat with the previous quarter.

- KHC has taken over $2 billion in charges since 2015 related to the integration of Heinz along with maintaining several other restructuring programs simultaneously. While integration charges related to a deal the size of Heinz are understandable, we will be concerned if the charges continue to roll in. In addition, the quarter contained $265 million in impairment charges to goodwill and intangibles related to struggling reporting units and brands, and the company identified that several units have goodwill and intangible balances with fair values that are less than 10% of carrying value.

Receivables Securitization Unwind

Like many companies we have reviewed, KHC has been utilizing an accounts receivable securitization facility to accelerate cash collections from sales. Under the program, accounts receivable are transferred to a wholly-owned special purpose finance subsidiary which then securitizes and sells those receivables to third-party banks. KHC receives consideration in the form of cash and a retained beneficial interests in the outstanding receivables. In addition, the receivables are deconsolidated from KHC's balance sheet at the time of sale. The company describes its securitization program as follows in its most recent 10-Q filing:

> *"We utilize accounts receivable securitization and factoring programs (the "Programs") globally for our working capital needs and to provide efficient liquidity. We operate these Programs such that we generally utilize the majority of the available aggregate cash consideration limits. We account for transfers of receivables*

pursuant to the Programs as a sale and remove them from our condensed consolidated balance sheets. Under the Programs, we generally receive cash consideration up to a certain limit and record a non-cash exchange for sold receivables for the remainder of the purchase price. We maintain a "beneficial interest," or a right to collect cash, in the sold receivables. Cash receipts from the payments on sold receivables (which are cash receipts on the underlying trade receivables that have already been securitized in these Programs) are classified as investing activities and presented as cash receipts on sold receivables on our condensed consolidated statements of cash flows."

Therefore, to analyze trends in receivables, one must add the securitized receivables that have not been collected yet back to the trade receivables account on the balance sheet. The following table shows balances related to trade receivables and the associated securitized balances:

	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Trade Receivables	$1,950	$1,044	$921	$938
Reclassified as "Sold Receivables"	$37	$530	$353	$427
Receivables Exchanged for Cash	$162	$659	$673	$673
Adjusted Receivables	$2,149	$2,233	$1,947	$2,038
Sales	$6,686	$6,304	$6,957	$6,314
Adjusted DSOs	29.3	32.3	25.5	29.5

	7/1/2017	4/1/2017	12/31/2016	10/02/2016
Trade Receivables	$913	$886	$769	$855
Reclassified as "Sold Receivables"	$521	$588	$129	$208
Receivables Exchanged for Cash	$579	$612	$871	$694
Adjusted Receivables	$2,013	$2,086	$1,769	$1,757
Sales	$6,637	$6,324	$6,857	$6,267
Adjusted DSOs	27.7	30.1	23.5	25.6

"Trade receivables" amounts are the balances shown on the company's balance sheet representing receivables that have yet to be securitized. The "Sold Receivables" amounts are also disclosed as a separate line on the balance sheet and represent the retained interest in receivables that have been securitized and reclassified but remain on the balance sheet. "Receivables Exchanged for Cash" are securitized receivables for which the company received cash, but the sold receivables have yet to be collected from the customer. These amounts must all be added together to arrive at an adjusted accounts receivable balance which we use to calculate an adjusted account receivable days of sales (DSO). We can see from the table that DSOs have been rising around 1-2 days on a year-over-year basis for the last few quarters. This is not an alarming increase, and we observe that adjusted DSOs did

not skyrocket during the periods the company was utilizing its securitization facility, so the increased rate of securitization was not disguising a buildup in receivables from aggressive revenue recognition. However, reporting changes related to cash flow disclosures have significantly impacted the comparability of operating cash flow as discussed in the next section.

Cash Flow Impact of ASU 2016-15, Restatements, and Weakness in Internal Control

Reporting changes related to receivables securitizations have had a dramatic impact on reported operating cash flow over the last year. Historically, the company recorded cash received from receivables that have been securitized as operating cash flows. In the 3/17 quarter, KHC early-adopted ASU 2016-15 governing the classification of certain cash flows. The ASU requires that cash from the collection of payments on sold receivables be recorded as investing cash flows. **However, KHC failed to change its disclosures in the 3/17 quarter which ultimately led to the November 2017 filing of amended 10-Qs for the 6/17 and 3/17 quarters. This also resulted in the company identifying a material weakness in internal control over financial reporting. Consider the note from the amended 10-Q for the 6/17 quarter filed on 11/7/2017:**

> *"In August 2016, the Financial Accounting Standards Board ("FASB") issued ASU 2016-15 related to the classification of certain cash payments and cash receipts on the statement of cash flows.* ***ASU 2016-15 requires companies to classify cash receipts on sold receivables, or consideration received for beneficial interest obtained for transferring trade receivables in securitization transactions, within investing activities in the statement of cash flows. We early adopted ASU 2016-15 during the first quarter of 2017, and this classification should have been made within our statements of cash flows beginning with our Quarterly Report on Form 10-Q for the quarter ended April 1, 2017, including retrospective application. Our financial statements have been restated to correctly classify cash receipts from the payments on sold receivables (which are cash receipts on the underlying trade receivables that have already been securitized) to cash provided by investing activities (from cash provided by operating activities) within our condensed consolidated statements of cash flows.*** *We have restated certain notes to the condensed consolidated financial statements to reflect the impacts of this cash flow correction, including Note 1,*

> *Background and Basis of Presentation, Note 11, Financing Arrangements, and Note 16, Supplemental Financial Information.*
>
> *Correspondingly, this Form 10-Q/A amends and restates Item 2 of Part I, which includes our revised discussion of liquidity and capital resources to reflect the impact of the cash flow correction. Item 4 of Part I includes our revised assessment of the effectiveness of our disclosure controls and procedures.* ***This restatement resulted in the identification of a material weakness in internal control over financial reporting related to our adoption and disclosure of new accounting standards. In addition, pursuant to the rules of the Securities and Exchange Commission, Item 6 of Part II of the Original Form 10-Q has been amended to contain currently-dated certifications from our Chief Executive Officer and Chief Financial Officer, as required by Sections 302 and 906 of the Sarbanes-Oxley Act of 2002."***

Moving the cash collected on securitized receivables to investing cash flows resulted in a huge hit to reported operating cash flows. Like several other companies we have seen, not long after the implementation of the ASU, the company put plans in motion to terminate its securitization program. **However, cash flow is being significantly impacted by the unwinding of the securitization program. The company states in the liquidity section of its 6/18 10-Q:**

> *Net Cash Provided by/Used for Operating Activities:*
>
> *Net cash provided by operating activities was $229 million for the six months ended June 30, 2018 compared to net cash used for operating activities of $178 million for the six months ended July 1, 2017. This change was primarily driven by a federal tax refund received in the first quarter of 2018 and decreased cash payments for employee bonuses in 2018.* ***These increases in cash provided by operating activities were partially offset by unfavorable changes in trade receivables, as fewer were non-cash exchanged for sold receivables in connection with the wind-down of our U.S. securitization program in the second quarter of 2018.***
>
> *Net Cash Provided by/Used for Investing Activities:*
>
> *Net cash provided by investing activities was $579 million for the six months ended June 30, 2018 compared to $423 million for the six months ended July 1, 2017. This increase was primarily due to decreased capital expenditures, which was driven by*

the wind-up of Integration Program footprint costs, and ***higher cash collections on previously sold receivables in connection with the wind-down of our U.S. securitization program in the second quarter of 2018.*** *These increases in cash provided by investing activities were partially offset by the cash paid to acquire Cerebos on March 9, 2018. We expect 2018 capital expenditures to be approximately $850 million.*

We can see the magnitude of these impacts in the table below which adjusts reported operating cash flow for receivables-related amounts included in the investing section of the cash flow statement:

6 months ended:	6/30/2018	7/1/2017
Cash Flow Impact from Trade Receivables (operating section)	-$2,001	-$1,598
Cash Receipts on Sold Receivables (investing section)	$1,221	$1,069
Net Cash Flow Impact from Receivables	-$780	-$529
Reported Cash from Operations	$229	-$178
CFO Adjusted to Include Receipts on Sold Receivables	$1,450	$891

We see that the wind-down of the securitization program resulted in trade receivables being a much larger drain on cash flows from operations as the company is no longer selling them off. However, this was partially offset by a boost to investing cash flows from the retained interest on previously-securitized receivables being paid off. Note that the company also disclosed the following in its 10-Q filing for the 6/18 quarter regarding the wind-down:

"In June 2018, we issued approximately $3.0 billion aggregate principal amount of long-term debt. ***We used approximately $500 million of the proceeds from the New Notes in connection with the wind-down of our U.S. securitization program in the second quarter of 2018."***

We assume that part of these borrowed funds was used to pay off the retained interests.

In conclusion, after adjusting out all the noise, accounts receivable DSOs have been increasing some, but not to an alarming degree. Also, growth in cash flow from operations after adding back cash collected from previously securitized receivables is stronger than what has been indicated by reported operating cash flows in the last couple of quarters. However, adjusted cash flow growth is still misleading because of the paydown in retained interests. This should all normalize over the next couple of quarters as the company completes the wind-down of its US securitization program.

Accounts Payable Increasing

Like all the packaged food companies we have looked at, KHC's cash flow has benefited from extending payable terms with suppliers. The company began disclosing in its 10-K that it was utilizing structured payment terms to stretch its accounts payable with suppliers:

> *"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 consolidated balance sheets. We had approximately $188 million on our consolidated balance sheets at December 30, 2017 related to these arrangements. There were no amounts related to these arrangements on our consolidated balance sheets at December 31, 2016."*

The 12/17 10-K is the first place we have seen this disclosure and given that there were no amounts listed for 2016, we believe the structured payable arrangements were not material until towards the end of 2017.

Also, we take the above disclosure to mean that all of the quantified structured payable amounts are included in other current liabilities, so we will add those amounts to accounts payable when calculating days payable (DSP) which are shown in the following table:

	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Accounts payable	$4,326	$4,241	$4,449	$3,947
Structured Payables in Accrued Liabilities	$88	$141	$188	$0
Adjusted Payables	$4,414	$4,382	$4,637	$3,947
Cost of Sales	$4,321	$4,059	$4,200	$4,000
Days Payable	93.2	98.5	100.7	90.0

	7/01/2017	4/01/2017	12/31/2016	10/02/2016
Accounts payable	$3,888	$3,936	$3,996	$3,456
Structured Payables in Accrued Liabilities	$0	$0	$0	$0
Adjusted Payables	$3,888	$3,936	$3,996	$3,456
Cost of Sales	$4,204	$4,125	$4,398	$4,049
Days Payable	84.4	87.1	82.9	77.9

	7/03/2016	4/03/2016	1/03/2016	9/27/2015
Accounts payable	$2,960	$2,773	$2,844	$2,719
Structured Payables in Accrued Liabilities	$0	$0	$0	$0
Adjusted Payables	$2,960	$2,773	$2,844	$2,719
Cost of Sales	$4,262	$4,192	$4,720	$4,492
Days Payable	63.4	60.4	55.0	55.2

The increase in payables is still boosting days payable, but the year-over-year pace of expansion is slowing. Consider the company's commentary on full-year 2017 operating cash flow from its 2017 10-K filing:

> *"**The decrease in cash provided by operating activities** was primarily driven by the $1.2 billion pre-funding of our postretirement benefit plans in 2017, lower collections on receivables as more were non-cash exchanged for sold receivables, **favorable changes in accounts payable from vendor payment term renegotiations that were less pronounced than the prior year,** and increased cash payments of employee bonuses in 2017."*

Clearly, the company is running out of room to stretch its payables and we can't help but wonder if the appearance of the structured payable disclosure is an indication that the company was "pulling out all the stops" to delay payments. We would also be interested to know the details on what is different about the terms of the structured payable amounts that cause them to be disclosed as other current liabilities rather than traditional payables.

Just a "back of the envelope" calculation shows that if payables had risen in-line with cost of sales from the year-ago period that payables would have been about $400 million lower than what was reported. This amounts to the bulk of the growth in cash from operations for the 6-month period ended 6/18 even after including cash collected on securitized receivables

in operating cash flow. So, while the benefit of extending terms is waning, it is still a very significant boost to cash flow growth.

Dividend Cash Flow Coverage Looks Tight

The following table shows the trailing 12-month free cash flow and the cash dividend paid for the 6/18 and 6/17 periods adjusted to include cash collected on securitized receivables as operating cash flows:

Trailing-12 months ended:	6/30/2018	7/1/2017
Reported Cash from Operations	$934	$1,572
Cash Receipts on Sold Receivables	$2,438	$2,453
Adjusted Cash from Operations	$3,372	$4,025
Capex	$965	$1,423
Free Cash Flow	$2,407	$2,602
Dividend	$3,113	$3,684

Consider the statement from management in the 12/17 quarter conference call regarding the outlook for 2018.

> *"Below the line, we are still targeting adjusted EPS growth and strong cash generation in 2018. This should be aided by tax favorability, where we now expect an effective tax rate of approximately 21% for the full year in 2018. I will also note that based on successful recent refinancing activity, we now expect incremental interest expense in 2018 of roughly $80 million versus the $100 million we previously outlined.* ***And in terms of cash generation, we continue to expect a significant step-up in 2018 despite a near-term headwind to working capital from recent termination of our accounts receivable securitization and factoring program in the U.S."***

KHC made approximately $1.5 billion in one-time pension contributions during the 12/17 quarter. Just that drain dropping out of trailing 12-month operating cash flow in the 12/18 quarter will cause a significant step-up in reported growth in operating cash flow for full-year 2018. However, if we add the pension contribution back to the 6/18 trailing 12-month operating cash flow number, it brings adjusted free cash flow to about $3.9 billion which still leaves the dividend consuming about 80% of free cash flow. We also noted in the previous section that the rise in accounts payable has been a huge boost to operating cash

flow, but the pace of the increase is narrowing quickly. Capex is declining due to the wind-down of the restructuring and integration program and is expected to fall to about $850 million for the full year ended 2018. However, most of the decline is already reflected in the trailing 12-month numbers. Therefore, even when the unusual factors are behind the company, the dividend will still consume the bulk of free cash and with net debt-to-EBITDA approaching 4x, future dividend growth seems very limited.

Trade Receivable Allowances Declining

The following table shows the allowance for doubtful accounts which the company shows specifically as a reduction of trade receivables on the balance sheet. (It does not appear to be tied at all to retained interest in sold receivables left on the balance sheet.)

	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Trade Receivables	$1,950	$1,044	$921	$938
Allowance- Applied to Trade Receivables	$24	$24	$23	$29
Gross Receivables	$1,974	$1,068	$944	$967
Allowance % of Gross Receivables	1.2%	2.2%	2.4%	3.0%

	7/1/2017	4/1/2017	12/31/2016	10/02/2016
Trade Receivables	$913	$886	$769	$855
Allowance- Applied to Trade Receivables	$28	$30	$20	$28
Gross Receivables	$941	$916	$789	$883
Allowance % of Gross Receivables	3.0%	3.3%	2.5%	3.2%

As we discussed in a section above, trade receivables balances ballooned in the 6/18 quarter as the company unwound its receivables securitization program in that period. However, despite the near-90% sequential increase in trade receivables in the quarter, the allowance for bad debts remained flat and the was actually down from the year-ago period. KHC does not disclose the provision expense, but we calculate it would have taken almost $20 million (1.2 cents per share) in incremental provision expense to keep the allowance as a percentage of gross trade receivables flat with the 3/18 quarter.

Restructuring Program and Impairment Charges

KHC is winding down an integration program related to the Heinz deal that was begun in 2015. Through 6/18 the company incurred over $2.1 billion including $542 million of severance costs, $883 million of non-cash asset costs, $601 million in implementation costs

and $109 million of other exit costs. Despite the program being deemed "substantially complete" as of 12/17, there were $80 million in charges taken in the first six months of 2018 with $22 million of that falling in the second quarter. In addition to the integration program, the company has several smaller restructuring programs which are expected to result in the elimination of 1,400 positions. These programs resulted in charges of $135 million in the fourth quarter. All of the $157 million in second quarter charges were added back to adjusted EPS figures. Integration charges for a deal the size of the Heinz integration are understandable. The concern will be if more restructuring plans are announced in the future as ongoing charges cloud the quality of adjusted earnings as operating expenses could be getting lumped in with the "one-time" charges.

We also note that the company recorded $164 million in goodwill impairments in the quarter related to declining margins in its Australia and New Zealand reporting unit. In addition, the company disclosed that of its 20 reporting units, 4 has fair values that were less than 10% above carrying value. This could be an indication of future impairment charges should conditions worsen in those units. KHC also recorded $101 million in impairment charges related to indefinite-lived intangibles related to sales and margins declines for its *Quero* brand in Brazil and also identified its *ABC* and *Smart Ones* brands as having fair values that are less than 10% above carrying value.

Explanation of EQ Rating Scale

Rating	Explanation
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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