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The Coca-Cola Company (KO)
Earnings Quality Update- 12/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are maintaining our earnings quality rating of KO at 3- (Minor Concern).

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

Summary

At first glance, KO beat forecasts for 4Q21 adjusted EPS by 2-cents. We are not impressed at all. KO took 10% more in pricing against 4Q20's -3%, and yet gross margin still declined 10 bps. KO guided to 4Q21 being 6 days shorter than 4Q20 and that it would spend more on marketing after $300 million in cuts during 4Q20. Even with that backdrop, adjusted operating margin fell to 22.1% vs. 27.3%. That drop in operating margin lowered operating profit by $261 million, or 4.9 cents in EPS. KO says the marketing on 6 days of lower sales may have cost 500 bp in the quarter, so that is the bulk of the margin drop.

How did KO recover from that much headwind? Its hedges on FX and commodity prices generated $37 million of other income in adjusted earnings vs. a loss of $108 million in 4Q20. That $145 million swing added 2.7 cents to adjusted EPS. Unrealized gains/losses on equity and trading debt securities cut adjusted earnings by $85 million in 4Q21, but that was much better than the $257 million hit in 4Q20. That $172 million positive swing added 3.2 cents to adjusted EPS. The company guided to a lower tax rate and it came in 90bp lower y/y and added 0.5-cents to adjusted EPS.

Guidance is for organic growth to slow to 7%-8% and 5%-6% non-GAAP EPS growth with a tax rate of 20% vs. 18.6% in 2021. Commodity cost pressures are expected to be mid-single digits net of the impacts of hedging. There is still the multi-billion dollar tax dispute outstanding over transaction splitting where initial rulings have sided with the IRS. KO could be required to post more than $4 billion in cash to appeal a final decision.

- Inventory is a red flag in our view. We think given commodity price increases, KO's inventory is down considerably in unit terms as it delayed replenishing it:

Inventory $	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20
Raw Materials	n/a	$1,914	$2,024	$2,097	$2,106	$2,069	$2,265	$2,282
Total Inventory	$3,414	$3,182	$3,281	$3,356	$3,266	$3,264	$3,501	$3,558
y/y Case Vol	9%	6%	18%	0%	-3%	-4%	-16%	-1%

It is likely raw materials grew from 3Q21 levels, but look at how much they were falling. $2.3 billion in raw materials during the Covid collapse in commodity prices should be much more unit inventory than $1.9 billion in 3Q21. The same should be true with total inventory for 4Q21. We know actual case volume was up 9% against a -3% comp. But inventory in dollar terms was up only 4.5% y/y and likely represents lower volume carried at inflated dollars.

- DSIs are showing the problem even better as the Cost of Good Sold figure is rising with inflation too. Normally DSIs are 85 days +/- 2 days. Coke is running 10 days below normal:

	12/31/21	10/1/21	7/2/21	4/2/21
Adj. COGS	$4,042	$3,908	$3,904	$3,556
Inventory	$3,414	$3,182	$3,281	$3,356
DSI	76.9	74.1	77.3	85.9

	12/31/20	9/25/20	6/26/20	3/27/20
Adj. COGS	$3,661	$3,508	$3,038	$3,291
Inventory	$3,266	$3,264	$3,501	$3,558
DSI	86.5	84.7	104.9	94.1

- Coke uses FIFO and Average Cost accounting for inventory. Both would help margins during inflation, especially FIFO. We think Coke has resisted replenishing inventory at higher prices in the hopes that some of the inflationary pressures would reverse. Also, avoiding higher-priced purchases would limit the pressure on gross margin from average cost accounting. Some sales leverage with stronger case volumes helped gross margins as did enormous price hikes in 2021. However, with 10% pricing gains in 4Q21 against a 0% in 4Q20, KO just saw gross margin tick down:

	12/31/21	10/1/21	7/2/21	4/2/21
Pricing	10%	6%	11%	1%
Case Volume	9%	6%	18%	0%
Gross Margin	57.3%	61.1%	61.4%	60.6%

	12/31/20	9/25/20	6/26/20	3/27/20
Pricing	-3%	-3%	-4%	0%
Case Volume	-3%	-4%	-16%	-1%
Gross Margin	57.4%	59.4%	57.7%	61.6%

Coke is reporting that gross margins were up 30bp in 4Q21 y/y due to lower-margin bottling operations being less of the total mix as was the case for much of 2021 when it helped 20bp in 3Q, an unspecified large amount in 2Q, and hurt by 10bp in 1Q21. We would not count that as a tailwind that should last forever and instead expect commodity inflation to hurt all segments. Also, Coke is calling out the BodyArmor acquisition in mid-4Q21 as the headwind that pushed gross margins down.

Coke didn't even mention commodity inflation in discussing gross margin in 2Q21's or 1Q21's 10-Q filings. Now it's calling for mid-single-digit commodity pressure for 2022. They have already taken pricing, they have already delayed buying higher-cost inventory, and unless Coke can continue to have bottling shrink as a percentage of the total – we think the cost pressure on margins is going to intensify going forward.

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 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 Concern)- 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 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 upcoming quarters. 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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