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BEHIND THE NUMBERS
Quality of Earnings Analysis

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The Coca-Cola Company (KO)
Earnings Quality Update- 3/21 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 of 3- (Minor Concern).

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

Summary

KO beat estimates by 5-cents in 1Q21. This was an improvement over 1Q20 as COVID issues began then. What is not quantified is KO definitely benefited from delaying marketing spending gains to normal levels. This also likely played a role in higher operating margins too. Of course, more restructuring charges were taken in the quarter also, which was 3-cents added back to the adjusted EPS of $0.55.

- Marketing is an expensive cost for KO. In 2019, it spent $4.25 billion on advertising and $4.4 billion on promotional expenses for bottlers, resellers, and customers. In 2020, it was down to $2.78 billion and $4.1 billion, respectively. That is a savings of $1.77 billion or 32-cents in annual earnings. KO does not break out these costs on a quarterly basis but said several times on the conference call that some markets have not fully returned to normal marketing levels and “We continue to reintroduce marketing spend in a targeted way.” This is likely a large part of the EPS beat in our view.

- Lower marketing spending for promotional items nets against revenue so if KO spends less in that area, revenue would be higher. KO beat handily on revenue forecasts by $370 million so they likely still beat even adjusting for the lower level of promotional spending. Advertising runs through SG&A and impacts operating margin. If you want to see this process in action, look at the margin items:

KO's Adj. Rev/Margin	1Q21	1Q20	1Q19
Revenue	$9,019	$8,573	$8,698
Gross Margin	60.6%	61.6%	60.8%
SG&A Percentage	29.6%	30.9%	32.6%
Oper. Margin	31.0%	30.7%	28.2%
Operating Income	$2,794	$2,634	$2,456

If 1Q19 was normal, then revenue was reduced by higher promotional spending, but 1Q21 is 4% higher than 2019 and 5% higher than 2020. That should indicate that lower promotional spending had a meaningful benefit to revenue figures.

Also, that higher revenue figure should have leveraged cost of goods sold and gross margin should likely have risen. That's a red flag to us that gross margin is actually down in 1Q21 vs. the last two years and indicates some inflationary pressure at a minimum. Plus KO is touting its operating margin gain, but all of it came from lower SG&A where advertising expense would be and we know that is lower. 2021 will be a weird year – everyone concedes that. But we think the margin gains and revenue growth at KO may look short-lived as marketing and promotion continue to normalize.

- As we noted in the original EQ report – KO is constantly restructuring to the tune of about $500 million per year. Right on schedule, 1Q21 saw KO record $165 million of these charges again, which it promptly added back to adjusted EPS. This was 3-cents of the non-GAAP 55-cents. Our concern remains that the margin gains KO has posted for all this restructuring are minor and often less than the annual charges themselves. This is still worth following.

- There was no update on the potential $12 billion tax liability at KO. KO continues to wait on the outcome of a similar transaction pricing case involving 3M before the court will formally rule on the remaining issues for KO. That could lead to a large cash outflow if KO has to post $4.6 billion to appeal.

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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