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Mondelez International, Inc. (MDLZ) Earnings Quality Update 12/20 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 MDLZ of 2- (Weak).

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

Summary

MDLZ's 4Q20 adjusted EPS of 67-cents beat forecasts by 1-cent. We would note that a lower tax rate and rounding added 0.9-cents to EPS, which is already accounts for the beat. More significantly, MDLZ claimed to lower Covid costs but boosted marketing. However, SG&A fell 120bp due to sales leverage. We are skeptical of this drop being sustainable as sales growth was weaker in 4Q at 3.2% organic vs. 4.4% in 3Q when SG&A only leveraged by 50bp. 3Q sales were helped by restocking retailer shelves that should have required less marketing. Also, MDLZ has noted that gum and candy are the weaker categories and those have higher margins – down 18% in both 3Q and 4Q. Gross margin did not leverage in 4Q down 80bp vs. up 20bp in 3Q. Every 10bp of this SG&A improvement is worth 0.4-cents. Thus, the drop in SG&A could have added more than 2-cents to 4Q. Guidance also looks weak as Covid-driven demand ends and appears tied to taking pricing, having gum recover, not losing sales as it culls SKUs, and posting a 3% growth rate against its toughest comp. Guidance points to a tough first half for 2021 and then MDLZ hopes to exceed guidance in 2H to make forecasts. The CFO even noted that gum's recovery may be slow, *"Our overall growth rate is negatively impacted by* ***Gum & Candy and continues to be challenged by reduced on-the-go consumption and mobility restrictions****. While we did not see material improvements in Q4 versus Q3,* ***we do expect***

gradual category improvement through 2021, but we are prudent in terms of those expectations."

What is strong?

- Working capital appears to be back at normal levels. We will need to see how many receivables are sold to evaluate DSOs. However, DSIs for inventory appear to have emerged from Covid in line with the past as have DSPs:

	4Q20	3Q20	2Q20	1Q20	4Q19	4Q18
DSPs	128.0	127.5	139.3	119.1	128.6	125.2
DSIs	54.6	64.7	69.1	52.3	55.9	56.0

  4Q picked up about 1/3 of its cash from operations from releasing $520 million in working capital. Thus, we do not expect much working capital tailwind for 2021. That means earnings will need to produce the expected $3 billion in free cash flow forecast for 2021. Essentially flat with 2020. There was some discussion on the earnings call that to hit the free cash flow guidance would require some working capital tailwind. We would not count on that happening, but we still think MDLZ is likely close enough without it.

- The $3 billion figure for free cash flow is expected to pay for $2 billion share repurchases up from $1.4 billion in 2020. This is expected to help EPS growth reach high single-digit growth on 3% organic sales gains. In 2020, repurchases were worth 1.2% of EPS growth. MDLZ has the liquidity on hand to likely reach its $2 billion target even if free cash flow isn't quite enough to do the job. In fact, with the dividend at $1.7 billion, MDLZ was likely already planning to use cash on hand for repurchases in 2021. Cash is at $3.6 billion now vs. $1.3 billion after 4Q19.

What is weak?

- As expected, taking pricing in excess of commodity inflation came to an end in 4Q. Gross margin fell 80bp vs. up 20bp in 3Q. In 1Q20 and 2Q20, we think retailers were a bit more forgiving in this area and MDLZ was not that aggressive. Our view is that these costs can be passed through, and it can be lumpy, but excess pricing tends to even out. We do not have the figures for 4Q yet, but here is what we saw:

Op Income	4Q20	3Q20	2Q20	1Q20
Price Hikes	n/a	$129	$120	$119
Cost Inflation	n/a	-$63	-$102	-$108
Net Boost	n/a	$66	$18	$11
y/y Gross Margin chg.	-80bp	20bp	-90bp	-20bp
y/y Op. Income chg.	40bp	70bp	-80bp	-20bp

On the call, MDLZ noted 4Q saw a lag between pricing and inflation and that it expects inflation in 2021 to exceed that of 2020 due to higher grain, cocoa, and transportation costs. That may offset any pricing MDLZ does push through. As noted in the introduction, we are skeptical that SG&A saw a 120bp improvement in 4Q vs. 50bp in 3Q on lower sales growth due to weaker pricing gains and lower volume gains than 3Q – plus gross margin deleveraged considerably in 4Q. This level of SG&A improvement doesn't appear sustainable as marketing spending is rising.

- **Guidance is calling for 2021's revenue organic growth of 3% to be achieved with half coming from higher pricing. In prior years, when MDLZ has taken pricing in the 1.5% range, it posts negative volume growth.** We think retailers will focus more on price vs. cost inflation with Covid driven demand and restocking completed. **MDLZ also has one of the toughest volume comps ever at 3.6% for 2021. Even MDLZ said on the call that it will not match market share gains in 2021.** MDLZ is pointing to gum and candy as a tailwind and we will concede that should improve off a -18% growth rate. However, they are driven by travel demand, which should remain sluggish in 2021, are only 10% of sales, and the CFO noted that Latin America is the area most impacted by lower sales in that area. Latin America has been one of the most overstated areas for growth in recent years because its pricing has exceeded gains in all other regions in organic growth. However, the pricing growth has been completely eliminated by the FX hits due to hyperinflation. North America at 30% of sales just posted a 6.3% volume gain in 2020, and most other years, North America volume is negative:

Price Volume Growth	2020	2019	2018	2017
MDLZ Price	1,9	2.2	1.3	1.5
MDLZ Vol	1.8	1.9	1.1	-0.6
N.Am Price	2.3	2.3	1.1	-0.6
N.Am Vol	6.3	-0.1	-0.5	-1.8
Lat. Am Price	7.7	9.9	6.2	7.7
Lat. Am FX	-18.1	-13.5	-13.8	1.6
Lat. Am Vol	-7.5	-2.1	-2.6	-4.2

Another key to tracking North America sales trends is watching biscuit sales which are the bulk of sales for that region. MDLZ noted in 2Q that biscuit sales were up 11% and

24% in North America driven heavily by people staying at home. As restrictions started to ease, 3Q saw biscuits rise 12% in 3Q but 17% in North America. For 4Q, biscuits were up less than 7% and North American organic growth was down to 4.5%.

- **Investors should also remember that revenues are reported net of sales incentives and other trade promotions for retailers.** This is in addition to more traditional advertising that is part of SG&A. By MDLZ's own admission, it spent less money on advertising and promotion during Covid in 2020 at a time when sales growth was very high at 3.7% for 2020 and 3.2% for 4Q20. According to the CEO on the 4Q call, *"We faced costs relating to lockdowns, supply chain disruptions, adaptations to our ways of working as well as the need for increased PPE. But **we were able to offset the majority of these costs through savings across areas like overheads, trade expense and nonworking media**."* That sales growth may have had an extra tailwind with lower deductions for some of these trade incentives. As MDLZ plans to ramp up marketing more in 2021, this could become a headwind to the 3% sales growth forecast.

What to watch

- Marketing costs are expected to rise. We have been predicting this ever since Covid gave MDLZ and its other food companies a perfect storm of growing sales and falling advertising. **The company noted it increased advertising by 17% in the 2H of 2020 and sees that trend continuing in 2021. We noted that accrued marketing expense was up about $100 million from 3Q to 4Q. MDLZ believes it can offset rising marketing with falling Covid costs. That may be a problem in 1Q21 as Covid costs did not fully hit yet in 1Q20 and MDLZ had the panic buying driving a 12.2% in North American volume.** Also, keep in mind, advertising is a $1.2 billion expense for MDLZ in past years and it spends more on store promotions that are accounted for as a reduction in sales. In 2Q20, the height of Covid – MDLZ estimated it spent $100 million on that for 2Q and total Covid spending was $250 million for the year. It's tough to see the trade-off of a dollar for dollar exchange, as a bigger number grows vs. a smaller number declines. MDLZ is also only forecasting that Covid costs fall to one-third of 2020 levels – or about $160-$170 million and that may be more pronounced in 2Q and 3Q – not 1Q. If they are already growing marketing back at a 17% rate – that may well exceed the Covid cuts. And the CFO noted that the 3% organic growth forecast relies on continued growth in marketing.

- More headwinds for early 2021 in addition to the tough comps and perhaps having higher Covid costs in 1Q21 than 1Q20 – MDLZ said it expects poor results from emerging markets in non-BRIC countries in the first half of 2021. It called this out as a headwind it needs to overcome to reach the 3% sales growth figure. Much of guidance appears to call for a back-loaded year to reach forecasts.

- Guidance is calling for a tax rate of low-mid 20s for 2021. That may be a bit higher than the 22.4% MDLZ had for 2020. Guidance for high-single-digit growth in EPS is likely about 18-20 cents. A 100bp change in the tax rate is worth about 3-cents. Also, the repurchase may be worth 3-4 cents.

- In 2020, organic growth was 3.7% about 50-50 pricing/volume and gross margin fell by 40bp. That combination still allowed MDLZ to realize about 10-cents in incremental EPS. Now for 2021, organic growth is expected to be 3% with about 50-50 pricing/volume, but MDLZ expects higher commodity inflation. This source of EPS growth may be under more pressure in 2021 especially in the 1Q. And, volume gains are very tough for 1H. MDLZ said it believes it took pricing in excess of what it needs to offset FX losses in Latin America at the end of 2020 which will help 2021 gross margin. We're not seeing that. 4Q Latin American pricing was up only 6.4% vs. the FX hit of 16.6%. That compares to 3Q pricing up 8.2% and FX hurting 20.2%.

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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