Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

January 31, 2020 | www.btnresearch.com

MDLZ 4Q19 Update
Maintain SELL

We are maintaining our SELL recommendation on MDLZ after the company's adjusted EPS came in at 61 cents beating forecasts by 1-cent, but we think that was aided by booking oversized price hikes from Latin America and then not accounting for the oversized FX loss in the $0.61. **Every point of price increase from Latin America is worth 0.4 cents in EPS for the quarter and they raised prices by 9.4% and lost 10.0% in FX. With that unit posting inflated sales and falling margins, we can easily see the results as a miss. Ignoring Europe's FX hit also helped lift organic growth and that was 1-cent for the quarter.** The company also beat revenue forecasts by $80 million with $70 million coming from the same price increase. Guidance at 3% organic growth for revenue looks weak coming off a 4.1% year and quarter too. Getting more product into club stores and discounters has helped drive volumes in 2019. We think that initial stocking will lap in 2020 and volume may return to the historically flat levels the company posts.

We need to update the Accounts Receivable figures for DSOs when we have the 10-K and can see the level of factoring MDLZ is using. The inventory figures looked good from the press release figures. **Accounts payable days were up 3 days y/y and now 12 days since 4Q16. That may not be able to produce as much cash flow in 2020.**

We have also talked about how the share repurchases are losing steam. **Guidance is to purchase $2 billion in stock this year from free cash flow of $3 billion. That will only produce about 2% EPS growth. MDLZ will also have a dividend in the $1.6-$1.7b range, so debt will increase again.**

- **Putting Latin America in the standard organic growth definition that excludes FX is skewing the results in our view. To deal with hyperinflation in Argentina, MDLZ is continuing to take huge price hikes which are being considered organic growth. The problem is the FX charge after organic growth continually exceeds the entire price hike.**

- **Even MDLZ is starting to admit that Argentina's outlying numbers are skewing the results. In the last three quarters, it has shown Latin America organic growth with and without Argentina on the slides in its presentation. In 4Q19, organic growth for Latin America was 7.6% but was only 1.7% without Argentina. 3Q19 was a reported 4.3% vs. a more realistic -1.5%.**

- **Latin America at 12% of sales is moving MDLZ's total growth rate. The unit is continually reporting growth at over 2x total MDLZ and had a 50-80bp impact on the total company's growth rate last year.**

- **Worse than that, while investors are cheering this source of sales growth – the unit itself is routinely posting declining volume, declining margins, and y/y operating income growth rates of -30%.**

- **While investors may cheer a growth rate that is still above 3.5% without Latin America – the rest of the world is not getting anything close to that level of price hikes. In fact, without adding back the FX hits for Europe and AMEA – MDLZ's growth is actually under 1%.** The stronger dollar acts as its own price increase to help local competitors against MDLZ. MDLZ has already said it has reversed the past margin gains it achieved by cutting marketing costs – in order to compete better overseas.

- **Keurig Dr. Pepper investment may have more risks than MDLZ investors realize – the company has a debt to equity ratio of 4.8x and is financing itself with commercial paper, a decent amount of short-maturity debt, and stretching payables by helping suppliers factor its obligations. Any issues with its debt rating may unwind some of that very quickly.**

- **Keurig Dr. Pepper is also showing flat sales growth and may have already booked much of the synergies from the combing the businesses 18-months ago.** It is not boosting its dividend and produced 30-cents of MDLZ's $2.47 in EPS last year. Plus, only 17-cents arrived in cash.

- **Is MDLZ giving itself an easy hurdle with guidance of 3% organic growth or has initial stocking in new channels given a short-lived boost to volume?** The company has a long history of posting flat or negative volume growth. Suddenly it sees a jump in 2019 to 1.9% that built through the year. We know it was adding more distribution to discount stores and club stores. Given that pricing normally exceeds volume growth and the company's forecast is 3% vs. the 4% it just posted, we wonder if the volume results are sustainable.

Latin America's Sinking Ship Still Drives MDLZ Growth

Mondelez continues to tout its growth rate before FX. We have pointed out that hyperinflation in Argentina is driving pricing increases for MDLZ and other companies. In fact, it makes the Latin American region look like the strongest place on earth. We think this really causes investors to overstate growth when viewing the adjusted constant-currency results. In the last 8-quarters, Latin America has never had volume growth for MDLZ even against easy comps:

Latin America	4Q19	4Q18	3Q19	3Q18
Price chg.	9.4%	7.2%	8.9%	5.2%
Vol. chg.	-1.8%	-3.3%	-4.6%	-0.6%
Organic growth	**7.6%**	**3.9%**	**4.3%**	**4.6%**
FX Impact	-10.0%	-19.1%	-9.2%	-19.4%
Real growth	-2.4%	-15.2%	-4.9%	-14.8%
Total MDLZ growth	**4.1%**	**2.5%**	**4.2%**	**1.2%**

Latin America	2Q19	2Q18	1Q19	1Q18
Price chg.	11.5%	6.1%	9.9%	6.2%
Vol. chg.	-0.6%	-2.3%	-1.5%	-4.0%
Organic growth	**10.9%**	**3.8%**	**8.4%**	**2.2%**
FX Impact	-15.7%	-12.5%	-18.6%	-4.3%
Real growth	-4.8%	-8.7%	-10.2%	-2.1%
Total MDLZ growth	**4.6%**	**3.5%**	**3.7%**	**2.4%**

Notice that MDLZ has seen organic growth from Latin America accelerate in every quarter in 2019 except 3Q, when it was basically flat. However, the volume has been negative in every period and the real growth net of FX has been negative in every period. The reason, MDLZ is getting pricing is because the FX losses are so terrible. Yet, the higher pricing only offset the FX loss in 1Q18.

Also, notice that Latin American growth exceeds MDLZ's total organic growth in every quarter except 1Q18. Viewed in complete terms, Latin America is not a healthy market and is only 12% of the sales. However, it has a huge swing factor when comparing GAAP results vs. the constant currency figures MDLZ wants to tout:

GAAP Sales	2019	2018	Growth
Total Sales	$25,868	$25,938	-0.3%
Sales w/o L.A.	$22,850	$22,736	0.5%

Under GAAP, Latin America reduced the growth rate of MDLZ by 0.8%. It only posted 0.5% even adjusting for that.

Non GAAP Sales	2019	2018	Growth
Total Sales	$26,879	$25,812	4.1%
Sales w/o L.A.	$23,427	$22,610	3.6%

With the Non-GAAP results, Latin America inflated results by 0.5%. For people cheering the 3.6%, it is worth noting that FX being ignored for Europe added 2.0% to sales and in AMEA it added 0.7% in 2019. Thus, we're talking about a company doing 0.9% sales growth – of that, they have a 1.3% swing from Latin America depending on adjusting for the huge inflation in price with or without the even larger FX loss.

The company has started to call out Argentina's impact on organic growth in the last three quarters and it really highlights this problem with the reported growth figures. Here is what Latin American growth looks like as it drives MDLZ core growth and what it looks like without Argentina in the mix:

	4Q19	3Q19	2Q19
Org LA growth	7.6%	4.3%	10.9%
Org LA without Arg.	1.9%	-1.5%	4.2%

More importantly, Latin America's profits and margins are also declining – so how much is this FX driven growth really worth?

LA Op Income	4Q19	3Q19	2Q19	1Q19	2019
2019 LA Adj Op Inc.	$136	$122	$104	$133	$495
2019 LA Adj Op Inc. w/ FX	$111	$99	$87	$115	$412
2018 LA Adj Op Inc.	$101	$140	$119	$165	$525
Reported Op Inc Growth	34.7%	-12.9%	-12.6%	-19.4%	-5.7%
Op Inc. Growth w/ FX	9.9%	-29.3%	-26.9%	-30.3%	-21.5%

Latin America has a lower profit margin than the rest of MDLZ and in 2017 the division had $553 million in adjusted operating profit, in 2019 it was $412 million – down 25% on explosive sales growth.

While We are Looking at FX – Is Europe or AMEA Really Growing? And How About Those Forecasts?

We mentioned above that pulling Latin America out of the mix – cuts MDLZ's organic growth rate from 4.1% to 3.6%. That still gives them credit for adding back FX and Europe's reported growth is heavily tied to that adjustment. Adjusting for FX for Europe would cut the 3.6% growth to 1.6% and adjusting for AMEA after that cuts the 1.6% to 0.9%.

The first thing we would say is that these markets are acting more like what a strong dollar normally does. A strong dollar tends to make US exports less competitive on price and in order to grow volumes – pricing tends to be much weaker. In periods when the foreign currency rallies, pricing gets stronger and/or volume growth tends to be higher. MDLZ is getting little pricing of late and what they do get is more than offset by FX losses:

Europe	4Q19	3Q19	2Q19	1Q19	2019
Pricing	-0.5%	0.3%	0.3%	0.0%	0.0%
Volume	3.8%	4.7%	3.6%	2.7%	3.7%
Organic Growth	3.3%	5.0%	3.9%	2.7%	3.7%
FX	-1.7%	-4.3%	-6.3%	-8.4%	-5.2%
Real Growth	1.6%	0.7%	-2.4%	-5.7%	-1.5%

AMEA	4Q19	3Q19	2Q19	1Q19	2019
Pricing	2.6%	1.7%	1.9%	1.1%	1.7%
Volume	2.3%	3.6%	2.8%	5.0%	3.6%
Organic Growth	4.9%	5.3%	4.7%	6.1%	5.3%
FX	-2.9%	-3.8%	-5.3%	-6.0%	-4.6%
Real Growth	2.0%	1.5%	-0.6%	-0.1%	0.7%

In both cases, these situations are improving as the FX losses are decreasing and helping actual growth turn positive. It is interesting to us that MDLZ continues to post weak guidance on revenues:

- 4Q18 – 2019 guidance was 2-3% organic growth
- 1Q19 – MDLZ had 3.7% growth – guidance was 2-3% organic growth
- 2Q19 – MDLZ had 4.6% growth – guidance was raised to 3% organic growth
- 3Q19 – MDLZ had 4.2% growth – guidance was raised to 3.5% organic growth
- 4Q19 – MDLZ hits 4.1% growth – 2020 guidance at 3%+ organic growth

That was the first question out of the gate on the call and management noted that some categories were running about 2.8% growth rather than 4.0% earlier in 2019, it is watching China, and has more work to do in Brazil.

Coffee JVs May See Slowing Growth and Balance Sheet Issues

We noted after 3Q results that merging the various coffee JVs into Keurig Dr. Pepper resulted in a $778 million gain for MDLZ in 2018. The company's cash flow rose as the new venture started paying a $0.15 quarterly dividend. That dividend has not grown and MDLZ benefited on cash flow from having received four quarters of dividend in 2019. The equity income on MDLZ declined in 2019:

Equity Income	2019	2018
Equity Gains	-$2	$778
Equity Income	$442	$548
Cash Received	$250	$180
Adj. EPS	$2.47	$2.42
EPS from JV	$0.30	$0.37
Cash EPS	$0.17	$0.12

The dividend isn't growing at this point. There was even a tax-sharing agreement between the two companies that ended in September 2019 and had Keurig paying $16 million to MDLZ. We believe the cash EPS from this deal will at best be flat going forward.

On top of that, this was a merger involving several companies in 2018. There was some sizeable integration and cost-cutting that happened quickly. That gave Keurig some operating income growth through September 2019. On a proforma basis – the growth was 9.4% on operating income. The company adjusted for integration costs to reach that figure.

It is not clear if the inventory step-up in 2018 was backed out. That is only mentioned in talking about 3Q results not 9-month figures, but it was a $131 million headwind for 3Q18 vs. 3Q19. It helped gross margin in 3Q19 by 480bp. If it was not part of the 9-month adjusted results – then the proforma growth may only be 2.4%. The discussion indicates Keurig benefited from synergies but faced headwinds on higher input costs. There also is no real revenue growth:

Keurig DrP	9 mths 19	9 mths 18	3Q19	3Q18
Pro forma Rev.	$8,186	$8,211	$2,870	$2,856
Pro forma Op. Inc.	$2,077	$1,898	$754	$698

The pro forma operating income gain slowed to 8.0% from 9.4% for the full nine months.

Also, investors should focus on where Keurig's cash flow is coming from – accounts payable. The company sets up deals with suppliers to factor its payables. They had $1.9 billion of payables factored on 9/30/19 up from $1.4 billion on 12/31/18. Total payables rose to $3.0 billion from $2.3 billion. Sales are flat!!

For the nine months ended 9/30/19 – cash flow stats are helped significantly from boosting payables to 218 days.

Keurig DrP	9 mths 19
Cash Ops	$1,803
Cash from A/P	$561
CapX	$208
FCF Adj	$1,034
Dividend	$633

Also keep in mind that Keurig Dr. Pepper has $74 million in cash and owes $15.0 billion, which doesn't include the $1.9 billion in payables being factored. The 15.0 billion in debt against an adjusted EBITDA of $3.1 billion is a Debt/EBITDA ratio of 4.8x. Of that $15.0 billion, $1.4 billion is commercial paper and along with the $1.9 billion in payables – likely hinge on the company's credit rating to roll it over. They also have $2.25 billion in debt maturities in 2021.

The Increase in Volume May Be Due to Initial Stocking

One of the other reasons we question the growth and restructuring success at MDLZ is it never seems to produce much in the way of results. For example, in 2014 – it announced another restructuring program for $3.5 billion to grow the business and boost adjusted operating margins to 17%-18% by 2018.

The result was MDLZ hit 16.7% in 2018 and announced a continuation of the restructuring through 2022. In 2019, the adjusted margin was 16.5%. We were pointing out during those years, MDLZ cut $223 million out of the advertising budget, which added 86bp to margin and it held R&D basically flat. We will need to see the 10-K, but MDLZ noted that it boosted marketing by about $150 million in 2019 and expects to boost it another $150 million in 2020. Given guidance of 3% organic revenue growth and high single-digit EPS growth that will include about 2% growth from share repurchases, it does not sound like they are counting on much operating margin growth in 2020.

Plus, the company is finally seeing some volume growth:

	2019	2018	2017	2016	2015
Volume Growth	1.9%	1.0%	-0.6%	-0.3%	-3.1%

	4Q19	3Q19	2Q19	1Q19
Volume Growth	2.2%	2.1%	1.6%	1.7%

Looking at 2018, that is likely bouncing off three negative years. In 2019, the company talked glowingly about entering many more stores in particular club stores and discount retailers. We think that helped stock more inventory and boost sales. The focus is to repeat that in 2020. So again, why cut the forecast? Normally, more of the organic growth comes from pricing and the company is running over 2% in volume at the end of 2019 – how can the forecast be for 3%?

If that recent volume growth came from initial stocking, that level of growth may not repeat, and guidance makes more sense.

Disclosure

BTN Research is a research publication structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. Information included in this report is derived from many sources believed to be reliable (including SEC filings and other public records), but no representation is made that it is accurate or complete, or that errors, if discovered, will be corrected.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.