Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

October 31, 2019 | www.btnresearch.com

Mondelez International (MDLZ) 3Q'19 Update
Downgrade to SELL

We are lowering our Rating on MDLZ to a SELL after 3Q19 results and a target price of $40. We see an expensive stock at 21x forward EPS, trading for 16-18x EBITDA (depending on whether an investor includes or subtracts the equity investments in coffee) that has many signs pointing to weaker growth. For example, the company is cheering that is has reported 4.2% organic growth (before FX) in 3Q19 and YTD, yet just "raised" its forecast for the year to 3.5%. It just reported 10% EPS growth last quarter adjusted for one-time items and FX and 11% YTD and now is expecting 5%-7% growth for the year.

The company appears overly dependent on pricing yet wants to grow by entering more club and discount stores in the US. Overall, we are seeing several areas that are decelerating and becoming headwinds that will hinder past modes of growth. With debt at 3.4x EBITDA the balance sheet is not amazing and as we noted in our March 1, 2019 issue – MDLZ has been restructuring continuously since the year 2000. Readers may want to return to that report to see some of the history as MDLZ continues to report more one-time items for what is now called the Simplify to Grow Program. We do not discuss their one-time items in this report, it looks like all the other programs MDLZ has been a part of over two decades.

- FX is a constant drag on EPS growth and is becoming a larger problem again. Yet, the company insists on adding it back. Just including FX in the mix cuts YTD EPS growth from 11.2% to 3.9%.

- Revenue with FX vs. Constant Currency has shown a widening spread in recent quarters. We see the FX issue hurting MDLZ in all regions of the world except North America. The strong dollar is also hurting its biggest goal – taking pricing.

- A huge issue that we have with the Constant Currency reporting is hyperinflation in Argentina is making Latin America look like MDLZ's strongest and fastest-growing market. That doesn't pass the smell test and looking deeper, the difference between

the reported negative revenue growth and adjusted constant currency growth is stark.

- Latin America at only 12% of total sales but is also adding a full percentage point to world-wide pricing change.

- Operating income growth adjusted for one-time items and pre-FX has already slowed from 20% in 2016 and 9% in 2017 to 6% and 4% in 2018 and 2019. Take out just the FX adjustment and operating income growth is now negative. This is a company that is expected to boost growth.

- The Coffee Equity Investments are providing a sizeable amount of reported (not adjusted) EPS – about 11%. They have had years of decent growth too before posting negative growth in 2019. This looks like another headwind and a large percentage of these earnings are non-cash.

- MDLZ has been driving EPS growth with share repurchases. The problem is with the stock price increasing – more options are being exercised and diluting the shares. At the same time, the spending on repurchases doesn't buy as many shares.

- We question if $2 billion+ in annual repurchases is still doable. The company's $1.6 billion dividend consumes 60% of free cash flow now, it's already cut capital spending, and the cash pulled from working capital in 2018 has now stalled and reversed in some areas.

- We also question if retiring stock with a pretax cost of capital at 2.8% makes sense vs. retiring debt or investing more in the company. Without repurchases, EPS growth falls about 2%-3% in this area too.

MDLZ Is Adding Back FX to EPS Even Though It is a Common Expense

In the last 5-6 years, FX has been as much as a 33-cent drag on EPS in 2015. It was 14-cents in 2014. It was fairly benign in 2016-18, but has accelerated considerably in 2019:

	9 mths 19	9 mths 18	2018	2017	2016
Adj EPS pre-FX	$1.99	$1.79	$2.46	$2.14	$1.84
Growth	11.2%		15.0%	16.3%	25.5%
FX impact	-$0.13		-$0.03	$0.01	-$0.06
Growth after FX	3.9%		13.6%	16.8%	21.6%

It is still not back to global crisis levels, but MDLZ is claiming its growth is 11.2% and really it is 3.9% after adding back all the other one-time charges. Also, look at the difference in operating income growth rates with and without FX impacts:

	9 mths 19	9 mths 18	2018	2017	2016
Op Income pre-FX	$3,348	$3,211	$4,578	$4,116	$3,773
Growth	4.3%		6.2%	9.1%	19.8%
FX impact	$185		$257	$3	$171
Growth after FX	-1.5%		4.9%	9.2%	14.7%

The basic business without one-time charges hasn't grown at 10% in years now. It is reporting negative growth with FX impacts being taken into account. We also do not think FX should be added back because this isn't only the US Dollar vs the Yen or Euro. About 40% of the business is to places like Russia, Ukraine, Turkey, Argentina… Places with some bigger problems that may well continue reporting sizeable FX losses.

We consider this a real expense and it quickly cuts the reported growth rate of the business in half or to negative levels.

Argentina and Latin America Reporting is Unrealistic without FX

The company reports organic growth as being the combination of price increases and volume growth. It is touting its ability to take pricing as a sign of strong demand and growth for snacks. However, in Latin America, MDLZ is dealing with Argentina in hyperinflation. It is getting huge price increases. Suddenly, here is Latin America as the strongest market MDLZ serves.

Pricing Gains	3Q19	YTD 19
Latin America	8.9%	10.0%
A/ME/A	1.7%	1.5%
Europe	0.3%	0.2%
N. America	1.9%	2.5%
Reported Growth	2.1%	2.3%
Take out L.A.	1.2%	1.2%

So, if you strip Latin America out of the mix with the hyperinflation – the pricing power gets cut in half. What makes that more amazing is Latin America is only 12% of sales at MDLZ.

The other absurdity to this is while pricing is telling investors this is a strong growth market – the volume figures are showing that it stinks, and the FX hit below the actual growth line shows the organic growth becomes negative rapidly after FX. Latin America lost 14.7% of its sales to FX alone.

Vol/FX	3Q19 V	YTD19 V	3Q19 FX	YTD19 FX
Latin America	-4.6%	-2.1%	-9.2%	-14.7%
A/ME/A	3.6%	3.9%	-3.8%	-5.1%
Europe	4.7%	3.6%	-4.3%	-6.4%
N. America	0.6%	-0.7%	1.4%	0.9%
Reported Growth	2.1%	1.9%	-3.1%	-5.3%

We addressed this issue in-depth in our June 13, 2019 issue. The FX issue we see here is the spread is widening between reported revenue and revenue adjusted to constant currency. The swing is 3-5 percentage points:

	3Q19	YTD 19	2018	2017
Sales Growth	1.1%	-1.1%	0.2%	-0.1%
CC Sales Growth	4.2%	4.2%	2.4%	0.9%

We also think it is important to notice that the strong dollar and competition is denying MDLZ much pricing power in Europe where it is dealing with some more developed countries. Also, the FX hits are not coming from just Latin America. FX is almost completely offsetting the positive volume gains in Asia/Middle East/Africa and Europe.

Coffee JVs Were Providing EPS Growth at MDLZ – That has turned Negative in 2019

We have talked about it in past reports, but MDLZ deconsolidated its coffee business in 2015 and became an equity holder in Jacob Douwe Egberts. In March of 2016, MDLZ exchanged part of its interest in JDE to Keurig Green Mountain as the latter was acquired. This set the value of MDLZ's stake in Keurig Green Mountain at $2 billion consisting of $1.6 billion in equity and $0.4 billion in a loan receivable. In July 2018 Keurig merged with Dr. Pepper Snapple and MDLZ recorded a $778 million gain on the transaction. The Keurig stake is worth about $5.4 billion these days.

We think it is important for investors to recognize that even adding back all the restructuring charges and impairment charges to MDLZ's operating income figures before all the tax law changes – there isn't much growth here and the growth rate is falling:

	9 mths 19	9 mths 18	2018	2017	2016
Adj Op. Income	3163.0	3211.0	4321.0	4119.0	$3,973
y/y Growth	-1.5%		4.9%	9.2%	14.7%

What else has been helping drive EPS growth of 10%+? It's the coffee equity earnings! Most of these are non-cash:

	9 mths 19	9 mths 18	2018	2017	2016
Equity Gains	-$2	$757	$778	$40	$43
Equity Income	$337	$399	$548	$344	$262
Cash Received	$217	$151	$180	$152	$75
% EQ income in cash	64%	38%	33%	44%	29%

When looking at reported EPS – not the adjusted figures – the size of this income is substantial. We will ignore the large gain from merging with Dr. Pepper Snapple and just focus on the Equity income amounts:

	9 mths 19	9 mths 18	2018	2017	2016
Equity Income/Share	$0.23	$0.27	$0.37	$0.22	$0.17
Reported EPS	$2.15	$1.72	$2.28	$1.85	$1.04
% of Reported EPS	11%	16%	16%	12%	16%

MDLZ pulls out part of this income when they compute adjusted EPS. However, we think it is important to recognize this has been a very volatile part of earnings that is now decreasing – it has added 5-15 cents at times and now is a 4 cent drag. At the same time, the KDP is not the only part of the equity investments, but it has been paying a $0.60 annual dividend. That is roughly $116 million in cash flow for MDLZ and is already included in the cash flow.

EPS Growth Is Getting a Boost from Stock Repurchases

Repurchases on EPS	9 mths 19	9 mths 18	9 mths 17	2018	2017	2016
Share Count	1459	1491	1537	1486	1531	1573
Adj. EPS with FX hit	$1.86	$1.79	$1.58	$2.43	$2.14	$1.84
EPS Growth	3.9%	13.3%	10.6%	13.6%	16.3%	21.6%
EPS from Repo	$0.04	$0.05	$0.04	$0.07	$0.05	$0.08
EPS Growth w/o Repo	1.7%	10.1%	7.7%	10.3%	13.6%	16.3%

EPS growth is plummeting in 2019 and yet is still be helped considering the share count is falling to help drive results further. Even the share count tailwind is shrinking at only 2.2% of EPS growth in 2019 so far vs. years of being over 3%.

We have a long history of both praising and criticizing stock repurchases. It really comes down to three points for us:

- Is the stock cheap? Low P/E vs. growth rate, low Price/EBITDA, High Dividend Yield?
- Is the share count falling – or are tons of shares being issued to management at the same time and muting the impact?
- Does the cost of capital and opportunity cost make sense? – Is the company borrowing at 4% to buy back pre-tax 7% dividend cost of capital? Are there other avenues of 15%-20% ROI that money is better spent on the business?

In our view, MDLZ is not a cheap stock. The dividend yield is only 2.2% and the pre-tax yield is 2.8%. The P/E ratio is essentially 20 with low-single-digit growth at best, at 17.8x EBITDA (or 16.4x assuming the sale of the coffee investments) – the case cannot be made that buying all the stock makes sense as the ROI would be in the 5%s on EBITDA.

Is MDLZ simply trying to prevent dilution of management stock options? Are they issuing shares almost as rapidly as they are buying them back? We think the answer to that is yes, especially issuing shares at a discount and buying them back at a premium:

	9 mths 19	2018	2017	2016
Shares Bought	24.0	47.3	50.6	62.0
Price Paid	$47.21	$42.18	$43.51	$41.97
Shares Issued	13.7	10.1	10.4	10.3
Issue Price	$27.46	$25.16	$26.17	$24.09

This concerning because even though the share count is dropping, the company is buying back less stock now as the stock price rises for the first time in years. Also, they are dealing with greater dilution with the higher stock price too. It used to be that to prevent dilution – it had to buy back 10 million shares for a net $17-$18. Or $170-$180 million. This year, the cost may be closer to $320 million.

The cost of capital issue causes us to think the share repurchases also make little sense. At the end of 2018, MDLZ said their weighted cost of borrowing was 2.3% largely because of their use of commercial paper. The biggest part of their bond borrowing was happening at 3.4% and that borrowing was increasing. So, they are borrowing at 3.4%, to retire equity with a pretax cost of capital of 2.8%. Not that the pension shortfall is alarming at just over $1 billion, but MDLZ could be earning 4.8% on pension funding vs. the 2.8% to retire the stock. Listening to management, they see great opportunities for new products, new markets, new distribution systems – the returns there are likely much higher than 2.8% also.

We also Question if MDLZ Can Afford Past Rates of Repurchases

On the surface, free cash flow does not cover the dividend and the repurchases:

	9 mths 19	9 mths 18	2018	2017	2016
CFO	$1,882	$1,885	$3,948	$2,593	$2,838
Cap-EX	$686	$810	$1,095	$1,014	$1,224
FCF	$1,196	$1,075	$2,853	$1,579	$1,614
Acquisitions	$284	$0	$528	$0	$246
Dividends	$1,131	$980	$1,359	$1,198	$1,094
Repurchase	$1,143	$1,650	$2,020	$2,174	$2,601
Dividends % FCF	95%	91%	48%	76%	68%
Repuchase % FCF	96%	153%	71%	138%	161%

The dividends and repurchases routinely add up to more than 100% of FCF. At the same time, the company makes some modest acquisitions to add to growth prospects too. They have already cut capital spending as well. **The current dividend rate is over $1.6 billion per year.**

It gets worse than that. We noted in 2018 that MDLZ was helping cash flow by pulling cash out of working capital. It was factoring receivables, stretching payables and limiting inventory growth. This produced $386 million in cash flow in 2016 and $128 million in 2018. We thought it looked stretched already and in 2019, this source of cash flow has reversed. (We will note that seasonality normally makes working capital increase in 3Q and some of that is reversed into cash flow in 4Q). But, thus far in 2019, working capital has been a $1.3 billion drag on cash flow vs. $1.1 billion in 9-months of 2018:

	3Q19	2Q19	1Q19	4Q18
DSO Trade A/R + Factored	47.2	43.5	50.1	41.5
DSO Factored A/R	10.7	10.7	11.3	11.0
DSI Inventory	65.2	69.4	60.6	56.0
DSP A/P	126.5	134.9	128.7	125.2

	3Q18	2Q18	1Q18	4Q17
DSO Trade A/R + Factored	50.8	46.8	53.7	46.3
DSO Factored A/R	11.2	10.7	11.7	11.0
DSI Inventory	66.9	68.5	61.1	54.3
DSP A/P	126.6	134.1	133.4	120.7

	3Q17	2Q17	1Q17	4Q16
DSO Trade A/R + Factored	50.7	45.6	52.1	43.9
DSO Factored A/R	9.1	9.1	9.0	8.7
DSI Inventory	63.7	67.3	61.0	53.9
DSP A/P	117.8	124.5	114.7	116.1

The size of factored receivables has stalled at this point and is not providing cash. Total trade receivables DSO's are still dropping about 3 days and helping cash flow. Inventory has been rising slightly and payables are now flat. **The net-net of working capital makes us believe this is not going to be a source of cash flow going forward. We think the company has confirmed this with guidance for $2.8 billion in free cash flow for 2019. That is basically flat with 2018.** However, 2018 gained pulled in $128 million from working capital. To make $2.8 billion in 2019, MDLZ is cutting capital spending by $100 million.

MDLZ has helped plug the funding shortfall with asset sales and divestitures, which total $1.8 billion from 2016-3Q19. They spent $1.1 billion on smaller acquisitions so they netted about $700 million over the nearly 4-years. The problem here is the cash from asset sales is getting smaller – it normally is about $100 million per year. Divestitures hurt growth too.

We pointed out in earlier reports that MDLZ was gaining earnings and cash flow by cutting advertising and posting basically flat R&D:

	2018	2017	2016
Advertising	$1,173	$1,248	$1,396
R&D	$362	$366	$376
Sales	$25,938	$25,896	$25,923

The company's last earnings call talked about investing more in those areas going forward. If that is true, it should become a drag on cash flow rather than a tailwind.

So, let's summarize this – Base FCF is $2.8 billion. Earnings are growing at less than 2%, working capital may be a drag on FCF especially seeing the factoring stall between $700-$800 million, Advertising should be a drag, and if capital spending stops falling – it will be a drag. Out of that flat to lower FCF figure, MDLZ is paying over $1.6 billion in dividends (almost 60% payout ratio), and it has to buy at least $300 million in stock to prevent dilution. However, investors are conditioned to expect over $2 billion in annual repurchases, so $1.7 billion in incremental purchases, but the company only has $850 million in cash flow left. That leaves two options- buy much less stock and hurt EPS growth or borrow the money.

Debt is currently $18 billion and 3.4x trailing EBITDA. Debt has already been steadily advancing too. It was $15.3 billion at the end of 2016.

Explanation of EQ Rating Scale

Rating	Description
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 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

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.