BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

November 1, 2018 | www.btnresearch.com

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

Mondelez International (MDLZ) EQ Review Update-9/18 Quarter

Current EQ Rating*	Previous EQ Rating
2-	2-

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

We maintain our *EQ Review* rating on Mondelez International (MDLZ) at 2- (Weak)

MDLZ reported adjusted EPS of $0.62 which was 2 cps ahead of expectations. However, the company missed on revenue. All the concerning trends we have noted before continued into the 9/18 quarter:

- While accounts receivable DSOs adjusted for outstanding sold receivables remains under control, MDLZ continues to expand its use of factoring to boost cash flow. This helped reduce the cash drain from receivables by $300 million in the quarter.

- Accounts payable days continue to skyrocket, climbing almost 9 days in the 9/18 quarter and adding about $180 million to cash flow growth in the period. As with receivables factoring, this level of cash flow boost cannot continue indefinitely and will be a significant drain on future cash flow growth if it reverses.

- Inventory DSI jumped by more than 3 days over the year-ago quarter. Last year's DSI figure may have been slightly depressed from the malware incident, but the current quarter still looks 2-3 days high compared to the 9/16 quarter. Finished goods as a percentage of total inventory also increased by 120 bps. The company turns its inventory relatively quickly and the fact that its cost inflation is being partially offset by lower cocoa prices reduces our concern that higher costs are being delayed from hitting the income statement. However, a 2-3 days increase in DSI focused in finished goods could indicate an unexpected buildup and warrants minor concern.

- MDLZ announced it is continuing the seemingly endless Kraft/MDLZ string of restructuring charges by extending the current plan through 2022 and adding another $1.3 billion in charges and $700 million capital spending.

Continued Expansion of Factoring

The following table shows the calculation of accounts receivable days (DSO) adjusted for receivables that were sold off but still outstanding under the company's factoring program:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Sales	$6,288	$6,112	$6,765	$6,966
Trade Receivables	$2,732	$2,416	$3,113	$2,691
Factored Receivables	$769	$719	$866	$843
Adjusted Receivables	$3,501	$3,135	$3,979	$3,534
Adjusted Receivable DSOs	50.8	46.8	53.7	46.3
Factored Receivable DSOs	11.2	10.7	11.7	11.0

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Sales	$6,530	$5,986	$6,414	$6,770
Trade Receivables	$2,981	$2,395	$3,035	$2,611
Factored Receivables	$650	$594	$630	$644
Adjusted Receivables	$3,631	$2,989	$3,665	$3,255
Adjusted Receivable DSOs	50.7	45.6	52.1	43.9
Factored Receivable DSOs	9.1	9.1	9.0	8.7

Adjusted receivable DSOs with were roughly flat with the year-ago period. However, outstanding factored receivables jumped by more than 18% year-over-year, driving factored receivable DSOs up to 11.2 from 9.1. This serves to boost cash flow growth in the current period as the receivables are monetized more quickly. We can see the benefit from the fact that receivables consumed $230 million in cash in the 3-month period ended 9/18 while they consumed $540 million in the comparable year-ago period. As we have noted in the past, there is nothing inherently wrong with receivables factoring other than the cost incurred to sell them including discounts. However, the question is how long the company can continue to expand the sale of receivables to boost cash flow growth.

Payables Continue to Balloon

MDLZ also continued to stretch payment terms on suppliers as days payable (DSP) rose by almost 9 days over the year-ago quarter:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
COGS	$3,874	$3,572	$3,916	$4,295
Accounts payable	$5,374	$5,248	$5,727	$5,705
COGS YOY growth	-2.7%	-2.7%	0.5%	2.7%
Accounts payable YOY growth	4.6%	4.7%	16.9%	7.3%
Accounts payable DSPs	126.6	134.1	133.4	121.2

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
COGS	$3,981	$3,672	$3,896	$4,181
Accounts payable	$5,139	$5,012	$4,897	$5,318
COGS YOY growth	1.9%	-3.0%	-0.6%	-7.7%
Accounts payable YOY growth	5.2%	9.9%	2.5%	8.8%
Accounts payable DSPs	117.8	124.5	114.7	116.1

As with receivables, there was a huge boost to cash flow growth in the quarter from increasing the time to pay suppliers. The increase in payables added $182 million to cash flow growth in the period compared to just $4 million in last year's third quarter. We pointed out in a previous review that the company would have a difficult time making its full-year forecast to generate $2.8 billion in free cash flow without continuing to aggressively expand its receivables factoring and payables extensions. While the company has managed to continue to do this, the question remains how much longer can cash flow growth receive this type of tailwind and at what point does it reverse.

Inventory DSIs Up

MDLZ's inventory also showed a noticeable spike in the quarter. As shown in the table below, inventory days (DSI) showed 3.2-day increase over the year-ago quarter:

	09/30/2018	6/30/2018	03/31/2018	12/31/2017
COGS	$3,874	$3,572	$3,916	$4,295
Inventory	$2,842	$2,683	$2,620	$2,557
COGS YOY growth	-2.7%	-2.7%	0.5%	2.7%
Inventory YOY growth	2.2%	-1.0%	0.7%	3.6%
Inventory DSIs	66.9	68.5	61.1	54.3

	09/30/2017	06/30/2017	03/31/2017	12/31/2016
COGS	$3,981	$3,672	$3,896	$4,181
Inventory	$2,781	$2,710	$2,603	$2,469
COGS YOY growth	1.9%	-3.0%	-0.6%	-7.7%
Inventory YOY growth	0.2%	-0.1%	-5.6%	-5.4%
Inventory DSIs	63.7	67.3	61.0	53.9

	09/30/2016	06/30/2016	03/31/2016	12/31/2015
COGS	$3,908	$3,786	$3,920	$4,529
Inventory	$2,776	$2,713	$2,756	$2,609
Inventory DSIs	64.8	65.4	64.2	52.6

Last year's 6/17 quarter was impacted by a malware attacked which resulted in a significant delay in orders, some of which were realized in the 9/17 quarter. The above DSI calculations are based on quarter-end inventory levels, so it is possible that the 9/17 quarter DSI figure was depressed by higher cost of sales during the quarter from "catch-up" sales while the quarter-end inventory balance was back to a normal level. However, even when we compare to the 9/16 DSI level of 64.8, the 66.9 figure at the end of the 9/18 quarter is two days higher.

Adding some to the concern is the fact that finished goods as a percentage of total revenue rose by 120 basis points, a marked acceleration over the previous two quarters:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Raw Materials % of inventory	25.0%	26.0%	26.9%	26.5%
Finished Goods % of inventory	75.0%	74.0%	73.1%	73.5%

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Raw Materials % of inventory	26.2%	26.6%	27.5%	27.9%
Finished Goods % of inventory	73.8%	73.4%	72.5%	72.1%

MDLZ utilizes the average cost inventory method which approximates FIFO. Therefore, current sales are matched against older inventory costs. While the company is experiencing some cost inflation, it is also benefitting from a decline in cocoa prices. In addition, inventories are turned in 60 days, so we are not overly concerned that profits are artificially benefitting from delaying the recognition of higher costs. Still, a sudden 2-3 day increase in

DSI, while not overly alarming, could be an indication of an unexpected buildup in inventory that could potentially result in higher than expected discounting.

More Restructuring on the Way

One of our biggest issues with the Kraft/MDLZ story is the never-ending streak of major restructuring charges the company and its predecessor have taken over many years. Therefore, it was not surprising to us that the company announced that it is extending the existing "Simplify to Grow" program. The company already planned to record charges of $5.4 billion and $2.3 billion in capex under the existing plan which began in 2014. However, the extension adds another $1.3 billion in charges, $700 million in incremental capital expenditures and another three years in time-frame (now through 2022.) Some of these charges are recorded as restructuring charges while those that do not meet the accounting requirements for disclosure as restructuring costs are recorded as "implementation costs." Both types are added back to adjusted non-GAAP results used to evaluate the company. This type of ongoing, ever-expanding restructuring program raises serious questions about the quality of these charge-adjusted earnings given the very real possibility that operating expenses such as management time and other ongoing expenses are being included in the charges and ignored.

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 recent 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.