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Mondelez International (MDLZ) 3Q'20 Update
Cancel SELL, Raise EQ Rating to 2+ (Weak)

We are canceling our SELL rating and reiterate our earnings quality rating of 2- (Weak)

MDLZ's adjusted EPS was flat y/y at $0.63 and beat forecasts by 1-cent. The earnings quality looks better than in the past. MDLZ is boosting marketing again, which we expected as a headwind. SG&A was up $22 million which was 1-cent in lower EPS. SG&A included COVID, Marketing, and Promotional costs. Cuts in that area helped MDLZ beat in 2Q forecasts. There were 8-cents in FX hedging gains, but MDLZ adjusted those out. It picked up about 1% of its reported topline growth from restocking the pipeline that won't repeat. Using the adjusted margin and tax rate – the 1% stocking revenue produced about 0.6-cents in EPS. We also applaud that MDLZ is reducing its holdings in Keurig Dr Pepper, which is we believe uses several short-lived levers in to drive its results and define its balance sheet.

What improved?

- Inventory growth less likely to be a headwind for cash flow in 4Q as it was in 3Q.
- Guidance for 2020 looks more than reasonable with a sales growth below the rate of the firsts 9-months and only 5% EPS growth. It may be tough to miss.
- Selling some of Keurig Dr Pepper raised cash that effectively covered the Give & Go acquisition.
- We consider the accounting at KDP to be weak and MDLZ pulling cash out here is good source of cash.

What deteriorated?

- We estimate that MDLZ earned 2-cents in EPS by taking much more pricing than cost inflation justified. We question if the client base will accept this.

- MDLZ is expecting higher cost inflation for 4Q and may not be able to pass it through.
- We consider marketing a positive investment – but MDLZ benefited from cuts in this area during 2Q and it has now begun to be spent again and should be an EPS headwind.
- The growth rate slowed and had 1% of sales from channel stocking. Comps get tougher and the COVID bump is losing steam.

What to watch

- Cash flow remains tight to cover the dividend and repurchases.
- MDLZ has already stretched payables and factored receivables to raise cash.
- Gum business is hurt by lack of travel – it could be a growth area as it recovers.
- Latin America still helps organic growth, but the FX continues to make that source of growth very low-quality in our view.

The Stretching of Working Capital in 2Q Reversed and Normalized

We noted last quarter that MDLZ picked up considerable cash flow from working capital. Plus, much of it came from stretching payables. With COVID, some of that is not surprising. As we expected, the situation reversed in 3Q and cash flow saw the effects of building working capital back:

	3Q20	2Q20	1Q20
Cash from Ops	$757	$1,274	$284
Cash from W/C	-$348	$624	-$740
Cash flow before W/C	$1,105	$650	$1,024

Also while working capital grew, the days outstanding returned to the normal stats:

	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19	4Q18
DSPs	127.5	139.3	119.1	128.6	126.5	134.9	128.7	125.2
DSIs	64.7	69.1	52.3	55.9	65.2	69.4	60.6	56.0
DSOs	34.1	30.6	35.8	29.2	35.8	32.8	38.8	30.5
DSOs Sold	10.7	10.6	11.4	10.0	10.7	10.7	11.3	11.0

There is some seasonality to working capital, but the 5-days growth in payables in 2Q was a red flag for us while at the same time receivables days were falling. We still have an issue with some sources of MDLZ cash flow. For example, when payables are already 120+ days, can you stretch them much further to unlock cash? Also, the company has already tapped receivables for cash by factoring some. Those are the types of cash-generating moves that can occur once.

We were more alarmed after 2Q that inventories were too low in dollar terms and MDLZ was noting that the inventory in the channel was too low also. The company guided to rising inventories in 3Q as a cash flow headwind. That happened- inventories on the balance sheet grew $130 million. Also, MDLZ noted that 1% of its sales in 3Q was restocking the trade channel. That's another $66 million. That restocking won't repeat either as sales growth, but the MDLZ is already cut 4Q guidance on sales to 3% after 3Q's 4.4% organic growth.

Also, MDLZ is pointing to inventories being in good shape now. On the earnings, when asked about further inventory growth, it was reported, "On inventory levels, there are obviously puts and takes. I would say, we got to a more normalized level at the end of Q3. Overall, I think we are in a decent situation."

Much of this has simply corrected already and guidance specifically acknowledges that the benefits will not repeat. Thus, the headwinds of working capital may not pose a major threat for MDLZ.

North American Volumes Are Losing Some COVID Bump

After 2Q20 results, we called out the North American volume gains of 7.4% that occurred with a longer period of lock-down than 1Q, Easter, and still some pantry stocking. The volume growth added $127.7 million to North American sales.

We did not think that would recur and 3Q20 saw volume growth fall to 4.2% or $76.6 million. Plus, we know that MDLZ benefited from stocking the channel for 1% of total sales. That may be about $18 million overstated in terms of sustainability.

Biscuits are about 80%-90% of North American sales. Adjusted for acquisitions, these rose 16.5% in 2Q and only 8.5% in 3Q. That's still impressive but is declining quickly. We should also note that North America actually has a positive comp to go against in 4Q at the same time it already restocked the channel. The growth here could slow further:

North Am.	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19	4Q18
Price	2.1%	3.6%	1.2%	1.9%	1.9%	3.5%	3.0%	2.9%
Mix	4.2%	7.4%	12.1%	1.2%	0.6%	-1.0%	-1.5%	-2.1%

We Still Worry MDLZ is Taking Too Much Pricing vs. Cost Inflation

Given that the large retailers often compete on price and are aware of what commodity prices are doing as well as MDLZ, we think they will take notice of MDLZ pushing price hikes that may not be warranted. At a minimum, MDLZ may find it tougher to take more pricing with those customers and there may be pressure to reverse some of the pricing already taken. When we look at the quarters for 2020, 3Q stands out:

Op. Income	3Q20	2Q20	1Q20
Price hikes	$129	$120	$119
Cost Inflation	-$63	-$102	-$108
Net boost	$66	$18	$11
Volume	$53	-$60	$125

- 1Q saw all the panic buying and volume soared. Yet MDLZ essentially pushed through pricing close to inflation levels.

- 2Q was still major COVID issues and low inventories in the channel. MDLZ still did not get much net pricing and volumes fell.

- 3Q had channel stocking help volumes, but it still took much larger amount of net pricing. **If the amount of pricing should have been closer to $20 million instead of $66 million, MDLZ picked up 2-cents in EPS in this area that may not repeat.**

MDLZ said the same thing on its conference call:

> *"Nevertheless, **we see some cost pressures, particularly in the U.S. since elevated demand**. And the need we have to improve on shelf availability is causing some extra logistics cost. We have been hearing also by competitors and others that there is a pressure we are feeling this as well. **As we buy a portion of our transportation on the spot market. And as I said, inflation is quite high.** In addition, **we are running out of some positive for exchanges in Latin America.** In other words, and I would say, **gross profit will be more muted in terms of growth in Q4 versus the 6% you have just seen in Q3."***

Latin American Pricing Continues to Skew Reported Organic Growth

We have talked about this quite a bit and even MDLZ is admitting it now and calling out Argentina's hyperinflation. Essentially, the largest source of pricing power continues to come from Latin America. It's losing volume even in COVID, so this is not a healthy market at all in our view. Yet, it continues to report good organic growth before FX. The problem is the FX losses continue to overwhelm the actual results.

3Q Sales	Price	Vol.	Organic	FX	Actual
Latin Am	8.2%	-5.1%	3.1%	-20.2%	-17.1%
Emerg Mrks	1.4%	3.9%	5.3%	-8.4%	-3.1%
All MDLZ	2.0%	2.4%	4.4%	-1.4%	3.0%

Selling Some of KDP Is a Positive in Our View

During 2020, and mostly in the 3Q – MDLZ cut its ownership in KDP from 13.6% to 11.2% and pulled $962 million in cash out of the investment. It also pulled $394 million from JDE taking that ownership down from 26.4% to 22.9%. We urge clients to read our reports on KDP. The company appears to have considerable debt issues given:

- It has extended accounts payables to about 250 days and used that cash to retire funded debt.

- Stretching payables has provided a high percentage of recent cash flow from operations too.

- The effective debt to EBITDA is closer to 4.5x and the bulk of the debt is only guaranteed by the Dr. Pepper assets which essentially makes it much higher again.

- KDP also reduced forecasts and has driven earnings by cutting marketing.

MDLZ adjusts the gains realized out of non-GAAP earnings – so that is conservative too. We also think pulling $1.36 billion in cash out of these deals helps the overall liquidity and helps cover the dividend and debt service. In 2020, this cash essentially funded the entire Give & Go acquisition of $1.14 billion in April.

The dividend coverage at MDLZ is still tight in our view, but if it can monetize more of these assets for cash it may not be as dire:

	9mths 20	9mths 19
Cash from Ops	$2,315	$1,882
Cap-Exp.	$630	$686
Free Cash Flow	$1,685	$1,196
Dividend	$1,227	$1,131
Dividend %	73%	95%
Stock Repo.	$720	$1,143

We still see MDLZ as a company that has tight coverage on the dividend and it certainly isn't covering stock repurchases from free cash flow. That is why MDLZ continues to borrow more money and has a Net Debt to EBITDA of 3.22x. With about $8 billion in market value from these two investments that can to sold to generate additional cash, the situation looks better.

We have talked about this tight coverage before. We do not believe MDLZ can afford a $1.6 billion dividend and $1.5-$2.0 billion in stock repurchases per year. In the past the stock purchases of $2 billion were helping EPS growth by 3%-4%. As the repurchase fell to $1.5

billion in 2019, EPS growth from this was only 1.9%. For 3Q20, the repurchase helped EPS growth by only 1.25%.

That is why guidance for 2020 only calls for 3% sales growth (down from 3.9%) for the first 9-months and EPS growth of 5%.

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 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.

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