BEHIND THE NUMBERS
Quality of Earnings Analysis
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Mondelez International, Inc. (MDLZ)
Earnings Quality Update- 12/21 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 at 2- (Weak) and our Top Sell rating.

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

Summary

MDLZ’s 4Q21 adjusted EPS of 71-cents missed forecasts by 2-cents. After holding tax-rate guidance flat in 3Q, when the rate declined, it fell 440bp in 4Q, adding 3.5-cents to EPS. MDLZ also picked up 1 cent from cutting inventory and receivable reserves. We believe investors should be most concerned that MDLZ guided to higher gross margins and gross profit dollars for 4Q, yet saw margins fall 200bp and dollars only rise 0.7% by adding back FX – otherwise dollars were down too. Guidance for 2022 calls for 4%+ growth in gross profit dollars, but that is expected to be back-loaded for the year.

- **Inventory levels are a concern.** MDLZ uses average-cost accounting for inventory so with cost inflation, any new product it buys at higher costs should boost cost of goods and pressure gross margin. It looks to us that MDLZ has tried to wait out inflation hoping cost pressures would decline**. Inventory levels in dollars are up only 2% y/y on 3% volume growth. That is likely worse given that the inventory in dollars is rising faster than units given inflation.** We think MDLZ could be forced to buy more inventory in 1Q and 2Q of 2022 than it did in 3Q and 4Q of 2021 and that will pressure gross margin even more.

	4Q21	3Q21	2Q21	1Q21
Inventory	$2,708	$2,922	$2,925	$2,635
COGS	$4,825	$4,358	$4,011	$4,272
DSIs	51.3	61.2	66.5	56.3
	4Q20	**3Q20**	**2Q20**	**1Q20**
Inventory	$2,647	$2,840	$2,710	$2,441
COGS	$4,426	$3,873	$3,580	$4,256
DSIs	54.6	66.9	69.1	52.3
	4Q19	**3Q19**	**2Q19**	**1Q19**
Inventory	$2,546	$2,742	$2,731	$2,620
COGS	$4,154	$3,839	$3,593	$3,945
DSIs	55.9	65.2	69.4	60.6

MDLZ already missed on gross margin in 4Q21, costing it 8-cents in EPS despite letting inventories decline. Raw materials dropped from $822 million in 3Q to $770 million in 4Q-more than 6%. Again, costs are rising so units are likely down double-digits. MDLZ admitted on the earnings call that its inventory levels are too low, that they expect supply chain issues to remain and make it difficult to rebuild, and to expect more pressure on sales volumes.

- MDLZ is also saying that it has raised prices again for January and it expects higher pricing to offset commodity inflation as 2022 moves into summer and beyond. We think it is important to note that not only does MDLZ need to buy more inventory at higher prices than it could have paid in late 2021, it has already taken more pricing than the commodity inflation justified for the first three quarters of 2021:

	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20
Price gains on Op. Inc	$190	$207	$130	$151	$127	$129	$120	$118
Higher costs on Op. Inc	$225	$179	$20	$49	$120	$63	$102	$107
Net	-$35	$28	$110	$102	$7	$66	$18	$11

We’re not going to set off alarms over $7 and $11 million differences, but MDLZ took much higher price increases than the costs warranted in 1Q21 and 2Q21. It then let its inventories run down in 4Q21. It may be difficult for MDLZ to take as much pricing as it wants as it buys inventories at higher costs.

- **Organic growth remains very overstated in our view. The connotation is that top-line growth will leverage fixed costs and MDLZ has been cutting costs for decades through restructuring plans. This is simply not happening:**

	4Q21	3Q21	2Q21	1Q21	2021	2020	2019	2018
Org Rev Growth	5.4%	5.5%	6.2%	3.8%	5.2%	3.7%	4.1%	2.4%
Op. Inc Growth w/o FX	0.0%	4.5%	7.2%	12.8%	5.8%	4.6%	4.4%	6.2%
Op. Inc Growth w/ FX	-1.1%	6.1%	14.3%	16.8%	8.5%	3.2%	-0.9%	4.9%

When we first looked at MDLZ we noted that it often reported 3% organic growth, but looking back over 5 years or so, instead of having revenue that was 16% higher after 5 years, revenue was essentially flat over that time. FX is simply a big part of doing business for MDLZ. Other than 2021 when FX helped drive operating income growth in 1Q and 2Q – FX has been a drag on operating income too. The company's ability to have organic revenue growth create margin leverage really comes down to whether MDLZ has help or pain from FX. Normally it's pain. For 4Q21, it appears the FX tailwind ended. Also, note that the MDLZ guidance is for one of its normal years in 2022 – expect organic growth of just over 3% and FX headwind will chew up 2.5% of that.

- **Looking further, much of the organic growth in 2021 and 4Q21 came from taking pricing in Latin America where hyperinflation normally offsets all of it with FX hits.** Because the organic growth excludes FX, this is an easy way to make it appear that MDLZ is growing faster than it really is. **For 4Q21, MDLZ reported 5.4% organic growth. Stripping out Latin America which is only 9% of sales and where MDLZ boosted prices by 15.1% - organic growth drops to 4.1% for the rest of the company**. For all of 2021, organic growth of 5.2% falls to 3.7% without Latin America. We have pointed this out for some time, but it appears MDLZ had a windfall in 2021 because it took hefty price hikes and enjoyed very modest FX hits in Latin America after a disastrous 2020. It appears to be normalizing again with one more easy comp to go for 1Q22.

Latin Am	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20
Pricing	15.1%	15.1%	14.9%	10.1%	6.4%	8.2%	7.5%	8.9%
Volume	4.6%	10.8%	18.8%	-2.9%	-5.2%	-5.1%	-18.8%	-1.9%
Org. Growth	19.7%	25.9%	33.7%	7.2%	1.2%	3.1%	-11.3%	7.0%
FX Hit	-7.3%	-2.8%	-2.8%	-15.1%	-16.6%	-20.2%	-19.4%	-16.3%

We view the pricing and results in this region as an anomaly that should be ignored for several reasons and not a reflection of MDLZ's ability to take massive price increases:

- This region had negative volume growth with Covid and lockdowns, which gave MDLZ very easy comps in 2021.

- The FX hits were also larger than normal in 2020 amid world turmoil. We do not consider the minor 2.8% hits of 2Q21 and 3Q21 normal at all.

- Ignoring the FX hits in looking at organic growth is ignoring that hyperinflation is the reason for the pricing growth that makes Latin America the strongest region MDLZ has. Historically, organic growth becomes negative in Latin America net of FX, yet at only 9% of sales, the hyperinflation here is materially adding to MDLZ's total growth figure.

- Can MDLZ continue to repurchase shares? It added 2-cents to EPS in 4Q21 and 6-cents for all of 2021 due to a lower share count. That was funded largely by selling down its investment in Keurig Dr. Pepper. Net debt to EBITDA is 2.6x already (we used EBITDA of $6.15 billion of GAAP EBIT and added back $212 million in asset impairment charges and $172 million in equity investment distributions.) MDLZ simply doesn't throw off enough cash flow from operations to fund its capital spending, dividends, make minor acquisitions, and still buy back meaningful amounts of stock. There are still some asset sale possibilities, but that tends to be one-time in nature.

	2021	**2020**
Cash From Opers	$4,141	$3,964
Cap Exp.	$965	$863
Small Acq.	$833	$1,136
Free Cash Flow	$2,343	$1,965
Dividends	$1,826	$1,678
Repurchases	$2,110	$1,390
Shortfall	-$1,593	-$1,103
Asset Sales	$1,539	$2,489

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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