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Mondelez Intl. (MDLZ)- Initiate with NEUTRAL

We are initiating Mondelez (MDLZ) with a NEUTRAL rating. We have been following the company as an EQ report since last June with a low 2- rating based on the company stretching payables and factoring receivables to boost cash flow. In addition, the company has been restructuring continuously and has generated the bulk of earnings growth from boosting prices. Other areas show signs of being stretched too and may be unable to produce the same level of EPS growth as in the past.

There are two key reasons why we are not making this a SELL recommendation at this time. First, while the operating model does not generate enough cash flow to support the company's cash needs, it hasn't run out of sources of liquidity yet. It still has $1.1 billion in cash on hand, availability on its revolver/commercial paper, and a 13.8% stake in Keurig Dr. Pepper worth $5.4 billion. Second, forecasts expect almost nothing in the way of growth. The company is guiding to 2%-3% organic growth but will face a 3% headwind from FX. EPS is expected to grow 3%-5% but face a 3% headwind from FX too. At over 18x EPS (or 17x subtracting the KDP stake), we can see some negative catalysts forming, but the timing does not appear to be imminent yet.

- **The long-term plan laid out for shareholders of 3% sales growth fueling faster EPS growth and then dividends growing faster than EPS has a hole. The cash need to fund the dividend and share repurchases is $3.9 billion and rising vs. the company's goal of generating $3 billion in free cash flow.**

- **Recent cash flow looks healthy but has been stretched by reducing receivables and extending payables. That resulted in nearly $500 million of cash flow in 2018.** Also, inventory has not grown as much as the impact of higher costs until 2018, that source of cash flow may be turning.

- **Advertising and R&D also have helped earnings and cash flow and the company plans to increase both. That could become another nearly $200 million headwind on cash flow**. Also, the coffee investment is likely to produce less cash flow than in recent years.

- **MDLZ still faces cash payments for restructuring and pension funding that will reduce cash flow.** The capital spending level has been elevated during the 7th round of restricting and should come down, to help free cash flow. It may not drop enough to offset the loss of the recent tailwinds in costs and working capital.

- **MDLZ as part of Kraft started with 20% operating margins back in the 2000-2002 time frame. After making numerous acquisitions, spin-offs, and seven major restructurings designed to lower costs and boost profits at a cost in the multiple billions, margins fell considerably and only sit now at 16%-17%.**

- **The constant recurring restructuring has us asking questions.** How was the first one so cheap, and the seventh one so expensive – was the still so much fat to uncover by then? How many on-going costs were lumped into restructuring and removed from adjusted figures? If lower margin units were culled and higher margin units added – shouldn't margins be much higher than when all this started?

- **Price hikes appear to be MDLZ's key to growth and margins. The company faces a headwind from FX nearly every year which makes its products more expensive in many cases and it has lost volume in 4 of the last 5 years.** Yet, its forecasts and recent results rely heavily on boosting prices. Pricing is rising faster than input costs. Pricing has been over 100% of income growth in most of the recent years. This may be the largest potential issue.

- **MDLZ is plugging its cash funding shortfall to shareholders with debt. Net debt is up almost $4 billion since 2015.** With pricing driving earnings, the debt figure looks manageable. Also, MDLZ still has $1.1 billion in cash and a large investment it could monetize. However, if pricing gains slow or reverse this could become an issue. MDLZ also has some sizeable maturities over the next 3 years.

Basic Cash Flow Story and Goals for MDLZ

During the last year, the company has laid out its long-term picture several times for investors. It is looking to produce 3%+ organic revenue growth per year which translates into high single-digit EPS growth annually. It expects to grow its dividend faster than EPS and generate $3 billion in free cash flow.

On the surface, some of this does not appear outrageous because the company has been achieving some of these targets. Dividend growth has long been above 10% annually and a hefty share repurchase program has aided EPS growth:

	2018	2017	2016	2015
Dividend/shr	$0.96	$0.82	$0.72	$0.64
Dividend growth	17.1%	13.9%	12.5%	10.3%
Shares	1,486	1,531	1,573	1,637
EPS growth from Repo	3.2%	2.9%	4.1%	4.4%

The first problem arises as these two cash needs are running above $3 billion per year:

	2018	2017	2016	2015
Dividends	$1,359	$1,198	$1,094	$1,008
Repurchases	$2,020	$2,174	$2,601	$3,622
Total	$3,379	$3,372	$3,695	$4,630

The dividend is likely expected to come in at $1.08-$1.10 this year, which would make it close to $1.6 billion, assuming MDLZ repurchases another net 40 million shares. To purchase a net 40 million shares, MDLZ has to offset dilution from options and buy 50 million shares. The stock price has been $42-$43 in past years but now trades at $47. The cost of buying a similar number of shares would be over $2.3 billion. The cash need to continue meeting these forecasts is $3.9 billion and rising vs. MDLZ's goal of generating $3 billion in free cash flow to pay for it.

Free cash flow has also not been running at $3 billion:

	2018	2017	2016	2015
Cash from Ops	$3,948	$2,593	$2,838	$3,728
Cap. Ex.	$1,095	$1,014	$1,224	$1,514
FCF	$2,853	$1,579	$1,614	$2,214
Acq/Divest	-$527	$604	$57	$5,258

We will examine this further in this review as some of the recent numbers appear unlikely to last. Moreover, with the exception of selling its coffee unit in 2015, the net of acquisitions and divestitures has not been enough to help the $3 billion free cash flow situation either. **Guidance for 2019 is for $2.8 billion of free cash flow due to tax issues.**

Nor has 3% organic revenue growth been happening:

	2018	2017	2016	2015
Price Growth	1.3%	1.5%	1.6%	3.9%
Vol. Growth	1.1%	-0.6%	-0.3%	-2.5%
Organic	2.4%	0.9%	1.3%	1.4%
FX	-1.4%	0.3%	-4.6%	-12.0%

Plus FX, while not viewed as part of organic revenue changes, has routinely been a drag on growth.

Working Capital and Advertising Stretched to Help Cash Flow Already

When the company posted $3.9 billion in cash from operations in 2018, we think investors believe a sustainable free cash flow of $3 billion is doable. However, a key reason we started following MDLZ was it was reporting some sizeable changes in working capital. (We will not cover all this in as much detail as the EQ reports from August 2, 2018 and February 14, 2019 – please review those reports for more information.)

In summary, the company has been factoring receivables for about $800 million. That is cash that was pulled forward. Factored receivables had been about $600 million in most quarters and running about 8-9 days of total receivables. In recent quarters, this has bumped up to $700-$800 million and 11 days of total receivables. That appears to have topped out at that level based on recent trends.

In addition, total days of receivables (those on the balance sheet and factored) really had not changed much in recent years moving +/- one day looking at the figures. Suddenly, in 4Q18, the factored receivables stayed flat at 11 days while the amount on the balance sheet dropped 5 days. In 2018, MDLZ pulled in $257 million of cash from operations by shrinking its receivables. We do not think that can be repeated again.

Second, MDLZ has been stretching payables. They were high to begin with but in the last two years have moved from 114 days to as high as 134 days. MDLZ finished December at 125 days up nearly 5 days from the year before. In 2018, MDLZ pulled in another $236 million in cash from stretching payables. We're skeptical how much further this can go as well.

Those two items are nearly $500 million of 2018's free cash flow. At the same time, inventories have not been nearly the drag on cash flow, that one would expect. MDLZ lists the impact of rising input prices on earnings and it also is looking to boost sales:

	2018	2017	2016	2015	2014
y/y Inventory chg.	-$204	-$18	$62	-$49	-$188
Impact of higher costs	-$42	-$181	-$126	-$186	-$384

The company has improved its focus on working capital management, and we will give it some credit here. However, it appears that inventory started to reflect the years of higher costs in 2018 and become a bigger drag on cash flow at the same time we question the sustainability of pulling more cash from receivables and payables. Working capital has been a key source for operating cash flow for years:

	2018	2017	2016	2015	2014
Inventory	-$204	-$18	$62	-$49	-$188
Receivables	$257	-$24	$31	$44	$184
Payables	$236	$5	$409	$659	$387
Total W/C	$289	-$37	$502	$654	$383
CFO reported	$3,948	$2,593	$2,838	$3,728	$3,562

The company deconsolidated its coffee unit in 2015, which lowered sales and lowered gross spending on advertising and R&D. However, since then, it has continued to pick up earnings and cash flow from cutting these areas further as a percentage of sales.

	2018	2017	2016
Advertising	$1,173	$1,248	$1,396
R&D	$362	$366	$376
Sales	$25,938	$25,896	$25,923
Adv % Sales	4.5%	4.8%	5.4%
R&D % Sales	1.4%	1.4%	1.5%

MDLZ is now saying it will focus on boosting spending in both areas to support the 3% organic revenue growth target. From 2016 levels, MDLZ pulled $237 million in costs from this area. Net of taxes, this represented about $180 million in earnings and cash flow in 2018. And while we're mentioning coffee – MDLZ is now a stockholder in Keurig Dr. Pepper. While it recognized $180 million in distributions from coffee in 2018 as part of that transaction and a dividend; going forward, the dividend is 15-cents per quarter or $115 million to MDLZ. That's a $65 million headwind.

Adding this up, working capital could become a drag on cash flow in the near future and become a $200 million negative against last year's $289 million positive. Simply returning to 2016 levels of investment in adverting in R&D is probably another $180 million drag on cash flow and the coffee another $65 million.

Restructuring Liabilities remain, Pension Funding, and Capital Spending Too

Again, looking at the big picture – we can understand how MDLZ is coming up with its forecast of producing $3 billion of free cash flow per year. Operating earnings in 2018 adjusted for all one-time items like restructuring, tax law changes, and hedges were $4.3 billion. The company is forecasting $450 million for interest expense this year and let's give them a 24% tax rate – that nets out to $2.94 billion in income. Add in $115 million of coffee dividends and $820 for depreciation and amortization and presto – that's $3.9 billion in cash from operations.

The company has been spending $1.0-$1.2 billion in capital investments and sees that falling to about $900 million or slightly below. That's free cash flow of $3.0 billion. The drop in capital spending would move it more in line with depreciation and amortization and we do not consider that an aggressive move.

The first problem is MDLZ needs $3.9 billion and growing to maintain its other goals of EPS growing faster than sales and dividends growing faster than EPS, which require share repurchases. That already exceeds the cash flow by $900 million under perfect conditions.

The second problem is MDLZ has been augmenting cash flow with lower working capital, which may be about to reverse and become a drag on cash flow. Plus, higher advertising and R&D should hurt that $4.3 billion in operating income too and become a drag on free cash flow.

The third problem is there are more cash payments to deal with. We will explore the history of restructuring at MDLZ later in this report, but there have been on-going restructurings here before it spun-off Kraft Foods and every year since. Under the current plan, there remains $373 million in accrued liabilities to settle – basically all related to wages/severance. That's likely to be cash payments as will future announced restructurings.

The pension plan is fully funded in the US and underfunded by about $1.1 billion overseas. Some of this was helped by a jump in discount rates. The US plan went from 3.7% to 4.4% which is more than rates really moved here. The overseas plans had the discount rate jump from 2.20% to 2.45%, which comes against the backdrop of European rates remaining extremely low. Interesting the discount rate to calculate expense rather than liability declined in both areas 51bp and 11bp respectively.

Pension expense has been $148 million in 2018 and $172 in 2017. Contributions have been exceeding the expense figure at $362 million and $505 million. The net impact is pensions have been a consumer of cash flow in the amount of $200-$300 million per year. This figure probably comes down going forward a bit more, but it likely still going to consume cash.

None of these items by itself is a dire situation. But, if several start working against the company on a regular basis, suddenly it adds up to a problem. Especially when they are starting with a 30% shortfall to maintain the shareholder plans for dividend and repurchases.

Restructuring Is A Way of Life at Mondelez

Mondelez as part of Kraft acquired Nabisco in late 2000 and spun out of Philip Morris in 2001. The company announced an integration plan that would cost $200-$300 million. The goal was to eliminate duplicate expenses, streamline operations and save $600 million annually by 2004. By 2002, this program was increased to $379 million.

In 2004, the company rolled out a 3-year restructuring program designed to leverage its global scale, reduce the cost structure, and optimize capacity utilization. The cost was forecast at $1.2 billion and savings were projected to be $400 million by 2006.

In 2006, the 3-year plan was expanded to a 6-year plan that would cost $2.5 billion with savings of $700 million annually by 2009. In 2007, the savings forecast was boosted to $1.2 billion annually by 2009.

Let's just review these plans. The first plan should have boosted margins by about 200bp by 2004 ($600mm of savings over 29.5b in revenues). The second plan should have boosted margins by 330bp ($1.2 billion of savings over $36.1b in revenues). The company intended to focus some of these savings into new programs that would mitigate some of that margin gain. However, despite continually buying and selling other businesses and one would assume that was also designed to sell less similar businesses where costs were tougher to cut and buy more similar businesses where margins could easily grow- profitability still slid. For example, Post Cereal was spun off in 2007 while the company bought the biscuit business of Danone. Our view is that deals would be made with the goal of helping margin more.

Old Kraft	2009	2008	2007	2006	2005	2004	2003	2002	2001
Sales	$40,386	$42,401	$36,134	$34,356	$34,113	$32,168	$31,010	$29,723	$29,234
Adj. Op Profit	$5,528	$4,946	$4,545	$5,113	$5,318	$5,312	$5,924	$6,441	$6,108
Op. Margin	13.7%	11.7%	12.6%	14.9%	15.6%	16.5%	19.1%	21.7%	20.9%

We added back the restructuring, implementation, write-off changes to operating profit. Because of spin-offs, the revenue figures and income figures for continuing operations change in some years when looking backwards. We kept the reported number for the year listed. The company was definitely complaining of headwinds from rising input costs during these years and we remember the price of wheat, corn, oil etc. all rising from 2004-08.

Margins should have had a 500bp tailwind over this period and margins collapsed 700-1000bp.

In 2010, Kraft bought Cadbury and sold its frozen pizza business. At the time, Cadbury was already running its own restructuring plan, which Kraft kept going. In addition, the company announced a $1.5 billion integration plan that was expected to save $750 million annualized by 2013. In 2011, that savings forecast was boosted to $800 million. Some other cost savings plans were also adopted that cost $318 million in 2009 and $170 million in 2010.

By 2012, it was time for another large restructuring and Kraft announced a $1.1 billion plan over 3 years. Later in the year, that was boosted to $1.5 billion and the spin-off of Kraft Foods was announced that formed Kraft Foods and Mondelez International. We know commodity prices were more subdued, which should have helped recover some of that headwind from 2004-2008. Instead, with three more rounds of integration, cost savings ideas, and beginning another major restructuring – margins did not recover:

	2013	2012	2011	2010
Sales	$35,299	$35,015	$54,365	$49,207
Adj. Op Profit	$3,460	$4,235	$6,657	$6,493
Op. Margin	9.8%	12.1%	12.2%	13.2%

Again, we added back "one-time charges." It is widely known that the Cadbury acquisition was disappointing for Kraft and then the spin-off happened in late 2012. So, we grant that there is some turmoil going on during these four years. But, management authorized another $3+ billion in restructuring during this time all designed to boost margin.

Finally, Mondelez is on its own to start 2013. It finishes the 2012-2014 $1.5 billion restructuring. It immediately follows that up with a $3.5 billion restructuring for 2014-2018.

The company also sold its coffee business that had been 11% of sales and deconsolidated the results in 2015. By looking at the results of the equity method investments – the operating margin is essentially 8%. Removing a lower-margin business should help results and it finally did:

MDLZ	2018	2017	2016	2015	2014
Sales	$25,938	$25,896	$25,923	$29,636	$34,244
Adj. Op Profit	$4,376	$4,116	$3,773	$4,352	$3,906
Op. Margin	16.9%	15.9%	14.6%	14.7%	11.4%

We will discuss later that we believe much of the margin gain is coming from price hikes and would not take much regression there to shrink margins again. But we do think investors should consider three points:

First, the easiest time to find low-hanging fruit and complete fat to cut should be the earliest rounds of restructuring. Notice how the first plan that involved essentially the Mondelez/Kraft company acquiring Nabisco was the smallest restructuring plan of the whole set. Not only that, the smallest plan $200-$300 million had the largest multiple of savings – targeting $600 million of improved cost structure. Yet, subsequent plans came in at $1.2 billion, $2.5 billion, $1.5 billion, $1.5 billion, and finally $3.5 billion for stand-alone Mondelez.

Second, how many on-going costs were put into the restructuring charges that were added back to income as "one-time" in nature? Do you think management had travel and salary allocated to these multi-billions in costs? How about tech people who wrote new software or staff that spent weeks with investment bankers? If they tried new production at other facilities to explore consolidation, did those normal operating costs go into restructuring? We shall see going forward after the largest restructuring ever for Mondelez has ended.

Third, removing the lower margin coffee operation should have helped and it appears that it did. Also, in the later years, Mondelez became much more professional in grouping charges that it viewed as "one-time" to make it easy for analysts. Until the last 3 years, this was strictly listed as restructuring related. Of late, it has included mark-to market hedging costs, malware problems, etc. Those weren't added back in the early years, which may have overly flattered more recent margins. On top of that, they've spent nearly two decades cutting costs and spinning off low-margin units, yet margins are lower now than when they started.

That all sort of knocks down the recent management boasts:

> *"During the last 5 years, we have gone through a significant restructuring and a cost focused approach, which has created a solid foundation for investment. These strengths of our company are amplified through our unique group of people who have*

an incredible capability to really make a difference when they put their minds to it. Witness to that has been our margin improvement over the last 5 years."

Pricing Is Key to MDLZ Recent Results

In recent years, pricing gains have been positive and more than offset volume issues and FX headwinds:

Revenues	2018	2017	2016	2015	2014
Price	1.3%	1.5%	1.6%	3.9%	5.1%
Volume/Mix	1.1%	-0.6%	-0.3%	-2.5%	-2.6%
FX	-1.4%	0.3%	-4.6%	-12.0%	-5.2%
Net	1.0%	1.2%	-3.3%	-10.6%	-2.7%

We do think the first thing to notice is the FX drag that occurs in many years and MDLZ is forecasting it again for 2019. The forecast for 3% organic growth to recur annually is based on only price and volume. But, each year, the organic growth comes against the prior year's actual sales that were impacted by FX. That really reduces the compounding impact. If sales actually rise 3% per year – then they would be 16% higher after 5-years. That would boost earnings and cash flow more easily too. But, if the 3% growth is really a 1% number on average and one negative year of 2%, then five years later sales are essentially flat. That is what is happening here in our view. Look at the sales figure for the last three years when organic growth has been positive and the coffee business has already been deconsolidated:

	2018	2017	2016
Sales	$25,938	$25,896	$25,923

The other thing to keep in mind is the FX impact is only showing translation issues after a sale is made. It does not show the sale that is lost because a foreign product was cheaper. If it is very common for MDLZ to have headwinds from FX – it should make taking pricing more difficult. We have seen this issue come up in numerous consumer goods companies: soap, soft drinks, beer, dairy. Raising prices and then effectively having them raised again by FX is difficult to do continuously. If all competitors are facing higher raw materials, then boosting price is not as negative of an issue because all products are likely seeing the same effect.

The other point to remember is price increases are a bigger driver of earnings growth because there are fewer incremental costs associated with them. No extra manufacturing occurs, no extra inventory supplies are purchased, no other physical thing has to be transported. Thus, when looking at revenue changes, pricing can look more benign. Look at the components of MDLZ income growth:

	2018	2017	2016	2015	2014
Adj. Op Income	$4,321	$4,119	$3,953	$3,490	$3,658
Income Growth	$257	$346	$463	-$65	$198
Pricing	$332	$370	$415	$1,146	$1,582
Input costs	-$42	-$181	-$126	-$186	-$384
Volume	$43	-$160	-$9	-$248	-$971

In 2016 and 2014 we used the reported figures for those 10-Ks, in subsequent years they were adjusted by the company to reflect changes in the portfolio such as the coffee being deconsolidated and eventually sold.

We are showing the above table because it looks clear to us that MDLZ has been driving margin and operating income via higher prices. The input costs have been a headwind, but nothing close to the amount of pricing the company is taking. Pricing has routinely been more than 100% of the total income gain. The fact that volume growth has been negative in most years is also a sign that customers can find local substitutes. And for all the work in restructuring, MDLZ is touting the popularity of Oreos and Triscuit crackers for sales growth. Those brands go back generations. Kudos for MDLZ for still keeping them popular but how many people haven't seen an Oreo at this point?

Remember MDLZ's long term picture – 3% organic sales growth with earnings growing faster than sales and free cash flow above $3 billion. The FX over time does become a drag on that plan as we stated above – 3% organic growth every year against a flat prior year does not create a compounding sales figure. Without price hikes – revenue growth is hurt more and earnings do not leverage to the same degree. The last three years, pricing gains have only been 1.3%-1.6% and it still is driving all of earnings growth.

The company is forecasting another year of FX headwind. How long can MDLZ boost prices for weaker currency markets and still make sales? Pricing is definitely showing signs that it is losing some power by becoming a smaller increase for four years in a row.

Mondelez Is Filling the Holes with Borrowing

We know MDLZ is running a deficit on cash flow. We also know it is pulling cash from working capital. Yet it is still borrowing more money. Net debt is up almost $4 billion since 2015.

	2018	2017	2016	2015
S-T Debt	$3,192	$3,517	$2,531	$236
L-T Debt	$15,180	$14,135	$14,668	$15,162
Less Cash	$1,100	$761	$1,741	$1,870
Net Debt	$17,272	$16,891	$15,458	$13,528
Adj cash flow	$5,132	$4,935	$4,536	$4,449
Debt/cash flow	3.4	3.4	3.4	3.0

Our adjusted cash flow is operating earnings without one-time items as reported by MDLZ plus depreciation and amortization. That has been heavily influenced by taking more pricing than the input prices have been rising as we already discussed. If pricing is not as strong going forward, here is another area where rising debt could suddenly look worse because adjusted cash flow would turn flat or down.

Debt is one of those catalysts that few people care until overnight – they all do. To us, MDLZ has liquidity right now. The cash balance has been high as a result of pulling money from working capital and stands at $1.1 billion. MDLZ also has the $5.4 billion stake in KDP. They could seek ways to monetize that either selling shares or borrowing against them. It has capital lines and commercial paper available too. It has been utilizing them to pay debt and reissue new bonds in an orderly manner. The maturity schedule remains fairly high too:

2019	$ 2,648
2020	$1,544
2021	$3,334
2022	$726
2023	$1,822

None of that is an immediate trigger, but the debt that is maturing in 2019 -2021 involves more cash than MDLZ has on hand. If the company needs to borrow annually at the same time issue debt every year, this could become a problem – but not one we see hurting right now.

What we think is clear is MDLZ needs a way to raise more external cash annually to reach its goals. Otherwise, it needs to lower the share repurchase plan in a large way and take its lumps. That is probably the next shoe to drop in our view. It would preserve the dividend – which they could still easily cover but would start to slow dividend growth and EPS growth if the share count is no longer falling.

Disclosure

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