BEHIND THE NUMBERS
Quality of Earnings Analysis
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Mondelez (MDLZ) Earnings Quality Update

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are maintaining earnings quality coverage of MDLZ with a 2- (Weak) rating.

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

Summary

MDLZ beat forecasts by 8-cents in 1Q21 and had a 1-cent headwind from a slightly higher tax rate. Taking more pricing than cost inflation added $102 million to operating earnings in 1Q and provided 6-cents in EPS. We doubt that level of excess pricing gain can continue and that was the largest bump in many quarters. It's worth noting that despite that much excess pricing, MDLZ posted a flat gross margin. We believe the company also benefited from flat accruals on marketing sequentially and while Easter was in 2Q, it occurred on April 4 and thus some revenues were likely pulled into 1Q21.

What is strong?

- MDLZ has seen more initial stocking demand into new stores in China and India. This is giving the company some more market share. Going forward, sales should at least hold at those levels. And, MDLZ has a very easy comp in that area for 2Q.

	1Q21	4Q20	3Q20	2Q20	1Q20
Asia/ME/Africa Vol	7.9%	-0.8%	1.8%	-4.6%	0.9%

What is weak?

- Real evidence that COVID demand was short-lived and is rapidly returning to normal is in the biscuit category. Biscuits are the bulk of North American sales. As noted in prior updates, MDLZ had 11% biscuit growth worldwide and 24% in North America in 2Q20. By 4Q20, Biscuits were up less than 7% and rose by only 3.4% in 1Q21. North American growth has resumed its history of weak volume gains that move inversely with attempts to boost price. The company will argue it had a tough comp in 1Q, which is true, but the comps are not going to be easy for some time. For 1Q21, North American volume growth was -2.8%. For much of 2019 and earlier, volume growth at this unit was negative anytime MDLZ sought to take pricing greater than 1%.

- Organic Growth of 3.8% in 1Q is overstated by 90bp in our view due solely to inflation in Latin America. This unit is now less than 10% of total company sales and posting negative volume changes. Yet, its 10.1% price hike was the difference between MDLZ reporting 3.8% growth instead of 2.9%. More importantly, the negative FX hit for Latin America was -15.1% so the unit actually posted huge negative growth overall and this situation has been happening for years so it's not a COVID issue.

- Trade promotions and incentives are reported as reductions to sales. Marketing accruals were flat sequentially and have stalled the last two quarters. Management is touting higher marketing but also making comments about being more focused on where it spends and seeking higher ROI. We think promotions are not growing and that is allowing net sales to increase and also help EPS.

- Gross margin is flat despite pricing gains exceeding cost inflation by $102 million in 1Q21. In the past, MDLZ has had a difficult time taking large amounts of excess price without it costing it volume. The $102 million was 6-cents in EPS and was the largest bump in many quarters. What if inflation takes some of that back? What if gross margin actually declines? 20bp of gross margin is about 1-cent in quarterly EPS.

What to watch

- Working capital appears in line with pre-COVID levels, except for payables. Normally 1Q is one of the lower figures for the year and 2Q is the highest.

MDLZ working capital	1Q21	4Q20	3Q20	2Q20	1Q20	1Q19
Days Payable	136.1	126.0	127.5	139.3	119.1	128.7
Days Inventory	56.3	54.6	64.7	69.1	52.3	60.6
Days Receivables	33.5	28.7	34.1	30.6	35.8	38.8
Days Receivables Sold	11.4	9.5	10.7	10.6	11.4	11.3

What is concerning about this is MDLZ's cash flow guidance may get some pressure from working capital. For 1Q21, MDLZ generated -$443 million from working capital for operating cash flow. That is better than 1Q20 when receivables spiked with the start of COVID and MDLZ posted a -$740 million headwind for cash flow. But 1Q19 was -$743 million too. For the latest quarter, MDLZ had a bigger help from payables rising. Normally, that occurs in 2Q so some of that may have been pulled forward. It is worth watching to see if cash flow is more subdued y/y for 2Q21.

Supporting Detail

Latin American Price Increases Are Adding about 100bp to Organic Growth

Sales growth is skewed by Latin American price increases. MDLZ reported 3.8% organic growth based on 2.3% price increases and 1.5% volume growth. Latin America reported a 10.1% price hike and the market is poor as volume growth was -2.9%. Because of massive inflation in the region, MLDZ is taking a sizeable hit on FX of -15.1% that wipes out all of the Latin American organic growth.

By all accounts, Latin America is probably the weakest market in the world. That is not just 2021, it's been that way for some time. Here are some recent results from that region:

Latin American Growth	% Total Sales	Vol	Price	Org. Growth	FX	Real Growth
1Q21	9.2%	-2.9%	10.1%	7.2%	-15.1%	-7.9%
2020	9.3%	-7.5%	7.7%	0.2%	-18.1%	-17.9%
2019	11.7%	-2.1%	9.9%	7.8%	-13.5%	-5.7%
2018	12.3%	-2.6%	6.2%	3.6%	-13.8%	-10.2%

As a percentage of total MDLZ sales, Latin America is getting smaller and smaller. It has been reporting negative volume – even during COVID, the volume decay tripled. The hefty price hikes are giving the illusion of strong organic growth, but the FX hit more than wipes out the price hikes. What is problematic is MDLZ's total organic growth is being overly skewed higher by this distressed situation:

MDLZ Org. Growth	Vol	Price	Org. Growth	w/o L.A Price
1Q21	1.5%	2.3%	3.8%	2.9%
2020	1.8%	1.9%	3.7%	2.9%
2019	1.9%	2.2%	4.1%	2.9%
2018	1.1%	1.3%	2.4%	2.2%

If we only strip out the price increase from Latin America (less than 10% of total sales) which is misleading because of the negative FX problem – it erases basically 100bp off MDLZ's organic growth rate.

Trade Promotions and Incentives Reduce Revenue – Those Items Are Another Headwind

Trade promotions and sales incentives are another headwind for sales growth. These are recorded net of sales. Thus, with COVID when there was no need to run in-store promotions, incentives, or coupons at normal levels, sales did not have as large of a drag from these programs. That alone lifted sales in 2020 quarters and likely still into 2021. We are going to isolate price to show some of the impact of lower trade promotions cutting revenue:

Price Gains AMEA	1Q	4Q	3Q	2Q
2020/1Q21	2.9%	3.8%	2.4%	1.5%
2019/1Q20	1.3%	2.6%	1.7%	1.9%
2018/1Q19	1.1%	1.1%	1.5%	2.7%
Price Gains Europe				
2020/1Q21	0.9%	-0.6%	-0.2%	-0.8%
2019/1Q20	0.4%	-0.5%	0.3%	0.3%
2018/1Q19	0.0%	-1.1%	0.5%	-0.7%
Prices Gains Nor. Am				
2020/1Q21	0.5%	2.1%	2.1%	3.6%
2019/1Q20	1.2%	1.9%	1.9%	3.5%
2018/1Q19	2.0%	2.9%	1.2%	0.6%

MDLZ claims it is starting to boost trade promotions again along with other forms of advertising. It sounds like more of the new spending is going toward e-commerce and the company has talked about boosting ROI for other forms of marketing which we interpret as selectively spending. We still think going forward, there will be more pressure on pricing as trade promotions increase. When we look at accrued marketing, it has risen y/y. However, it is no longer rising sequentially.

Accrued Marketing $	**1Q**	**4Q**	**3Q**	**2Q**
2020/1Q21	$2,136	$2,130	$2,028	$1,804
2019/1Q20	$1,848	$1,836	$1,745	$1,638
Accrued Mrk % Sales				
2020/1Q21	29.5%	29.2%	30.4%	30.5%
2019/1Q20	27.6%	26.6%	27.5%	27.0%

It appears to us that MDLZ may not be seeing this ratio rise going forward and may actually decline a bit more. The dollar amount saw the largest jump from 2Q20 to 3Q20. Since then, the recovery in advertising and trade promotion appears more muted.

How Long Can MDLZ Take Pricing in Excess of Inflation? Gross Margin Is Already Pressured

We also have seen MDLZ taking pricing in excess of commodity inflation and this continued in 1Q21. Our view is customers watch the inflation data also and are also stocking private-label goods at lower prices. This is something that should even out over time. What is a red flag is MDLZ is NOT getting gross margin gains from this:

Price/Cost change	**1Q21**	**4Q20**	**3Q20**	**2Q20**	**1Q20**
Price Hikes	$151	$127	$129	$120	$119
Cost Inflation	-$49	-$121	-$63	-$102	-$108
Net boost	$102	$6	$66	$18	$11
y/y Gross Margin chg.	0 bp	-80 bp	20 bp	-90 bp	-20 bp
y/y Oper Margin chg	140 bp	40 bp	70 bp	-80 bp	-20 bp

There are three other points to consider here. In 2Q and 3Q in particular, retailers were low on product and needed to refill shelves. That type of demand may have been less price-conscious and allowed MDLZ to boost prices faster than warranted. We doubt that situation repeats itself.

Next, during this same time, MDLZ culled 25% of its SKUs in 2Q and 3Q. We think SKUs come and go all the time, but 25% was a large number during 2020. Normally, SKUs being eliminated are marked down to clear the shelf space for new product. We believe COVID allowed that product to be sold at full price. In fact, much of it may have disappeared before MDLZ formally discontinued them.

Third to consider is the timing of Easter and Chinese New Year. Easter was technically in the 2Q this year, but it was April 4th. Much of the consumer buying for Easter likely happened in 1Q which helped sales growth and the Chinese New Year was disrupted in 1Q20 but had far fewer issues in 2021. So, we think there were some additional sales in 1Q21 that should have leveraged gross margins.

Thus, with all those extra sources of demand and taking pricing in excess of cost inflation – MDLZ is not seeing its gross margin rise. What happens as sales level off further? What happens as trade promotions return to normal and become headwinds on sales? MDLZ is making up for that with SG&A cuts. COVID costs are falling at this point, but that eventually runs out. Also, we noticed the largest SG&A contributions came in the last two quarters when marketing accruals were flattening out.

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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