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Mondelez International (MDLZ) 2Q'20 Update
Maintain SELL

We maintain our SELL recommendation on MDLZ as the company may not maintain the COVID-related strength in sales or cash flow. The company's adjusted EPS beat forecasts by 7-cents. It picked up 5-cents from reversing an allowance against Chinese tax loss-carryforwards:

From the 10-Q:

> "O*ur second quarter effective tax rate was 12.1% reflecting a discrete net tax benefit of $72 million. The discrete net tax benefit primarily consisted of a $70 million net benefit from the release of a valuation allowance in China as we now expect to utilize prior-year carryforward tax benefits to offset future taxable income."*

The company did not quantify it, but reported it spent less on advertising and promotional expense in its international markets and for the company overall. It had pension expense decline by $28 million y/y or 1.5-cents in the quarter. If the lower advertising was more than a $9 million impact, the 7-cent beat is basically gone. Advertising is a $1.2 billion annual expense for MDLZ historically.

- **North American Volume was not as amazing as 1Q despite having a much longer period of the lockdown, an easy comp, and Easter.** Management noted that the pantry-stocking is essentially over but has seen continued sell-through of products.

North Am	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19	4Q18	3Q18	2Q18
Price	3.6%	1.2%	1.9%	1.9%	3.5%	2.0%	2.9%	1.2%	0.6%
Vol/Mix	7.4%	12.1%	1.2%	0.6%	-1.0%	-1.5%	-2.1%	-3.2%	5.1%

They are out of easy comps on volume at this point. And even with all the COVID tailwinds that lasted longer than two-weeks in 1Q20, volume growth declined by 470bp.

It is also worth noting that biscuit sales for the company were up 11% and in North America up 24% in 2Q. Biscuits are 80%-90% of North American sales. MDLZ noted several times on the call that biscuit sales are heavily tied to people staying at home. With restrictions easing more and schools restarting in many places, this could become a headwind.

- **Latin American Pricing continues to skew reported organic growth.** Because MDLZ reports its growth rate as the net change of only price + volume and ignores FX – it is still essentially denying the reason Latin America was able to take price hikes in the first place and Latin America is the largest part of pricing:

2Q20 Sales Growth	Price	Vol	Organic	FX	Actual
Latin Am	7.5%	-18.3%	-11.3%	-19.4%	-30.7%
Emerg. Mrks	2.7%	-7.8%	-5.1%	-9.7%	-14.8%
All MDLZ	2.0%	-1.3%	0.7%	-4.6%	-3.9%

The actual results are adjusted for acquisitions and divestitures. Latin America had the largest gain in pricing but lost more than twice of that total to negative FX impacts. The entire company reported growth from pricing of 2.0% which is $121.2 million. Latin America's 7.5% amounted to $55.3 million or nearly half the total increase. Latin America is the smallest unit at less than 9% of sales. Removing it from the mix cuts the full company's pricing gain from 2.0% to 1.2%. Plus, the growing losses at Latin America also point to how unrealistic the strong pricing figure before FX hits are in the reported organic growth. Latin America operating income fell from $70 million adjusted for a $2 million VAT settlement in 2019 to -$6 million in 2Q20. That further supports the notion that the strong pricing figure is not showing a healthy market with strong demand allowing price hikes.

- **Stretching working capital was a big source of cash flow for 2Q20.** Given some of the market disruptions around the world and one-quarter does not make a trend – we are going to say, this is something to watch in 3Q and 4Q.

MDLZ Wrk Cap	2Q20	1Q20	4Q19	3Q19
Days Payable	139.3	119.1	128.6	126.5
Days Inventory	69.1	52.3	55.9	65.2
Days Receivables	30.6	35.8	29.2	35.8
Days Receivables Sold	10.6	11.4	10.0	10.7

MDLZ Wrk Cap	2Q19	1Q19	4Q18	3Q18
Days Payable	134.9	128.7	125.2	126.6
Days Inventory	69.4	60.6	56.0	66.9
Days Receivables	32.8	38.8	30.5	33.7
Days Receivables Sold	10.7	11.3	11.0	11.2

Inventory dropping so much at the end of 1Q20 makes sense as COVID hit and started the panic buying. Also, remember that MDLZ's balance sheet receivables exclude receivables that it sells to help cash flow. That overall level has not moved much in the last two years. However, when looking at cash flow so far in 2020 vs. 2019 – 2Q had a huge boost from working capital:

MDLZ Cash Flow	2Q20	2Q19	1Q20	1Q19
Cash from Operations	$1,274	$581	$284	$465
Cash from Working Cap.	$624	-$355	-$740	-$743
Cash flow before W/C	$650	$936	$1,024	$1,208

The reason we are pointing to this is MDLZ is giving guidance to expect inventory levels to increase going forward and payables may not be able to increase at the same rate. This may cause a headwind for cash flow:

> *"As it relates to the trade, if anything, **I would say that the trade inventories at the moment are low because it has been difficult to keep up with demand**. We significantly have reduced our assortment of SKUs just to provide a good customer service. And so if anything, **I would say as our demand would slowdown a little bit, that will give us an opportunity to bring the trade stocks back in line with where they should be**. So from my perspective, I feel pretty strong, certainly about Q3 and Q4 in U.S., I don't really expect, it might slowdown a little bit, but we're still in high single-digit growth rates, to my opinion, which is much better than it was in the past."*

Three points to make here: The SKU reduction was pointed out as 25% of SKUs but only about 2% of sales. Also, the inventory growth is expected to come from filling the channel

– that would give MDLZ a one-time boost in sales. However, that type of growth can vanish very quickly because it isn't necessarily matched by sell-through to the consumer. Third, while gum was hurt by people staying at home and biscuit sales drove the recent results which MDLZ pointed out on the call several times are heavily tied to people staying home – gum is only about 7% of sales and biscuits are about half. As people get out of the house losing biscuit sales to gum is a drag. Also, does the trade want to carry COVID-level stocks if consumer sell-through slows? This could back up on MDLZ in the form of higher DSIs on its balance sheet and that could become an area for a sales disappointment if DSIs rise rather than being recorded as sales to the trade channel.

- **MDLZ is still taking more pricing based on raw material cost increases – but the spread is getting much smaller.** In our view, this is an area that has not been sustainable given how much buying power the retail channel has after consolidating into several very large customers. Wal-Mart, Kroger, Target, Safeway, Costco – those companies all follow the inflation numbers too. COVID had an impact on the volume figures, but look at some of the components for pricing vs. raw material costs on operating income:

Op Income	2Q20	2Q19	2Q18
Pricing	$120	$180	$84
Input Costs	-$102	-$116	-$18
Volume	-$60	$35	$43

In 2019, pricing exceeds input cost inflation by $236 million in operating income, and in 2018 it was $296 million. They are not getting the same level of increase in 2020. This may become a headwind as these differences tend to even out.

- **MDLZ continues to outspend its free cash flow.**

Cash Flow	1H20	1H19	2019	2018	2017
Cash from Ops	$1,558	$1,046	$3,965	$3,948	$2,593
Capital Exp.	$445	$465	$925	$1,095	$1,014
Free Cash Flow	$1,113	$581	$3,040	$2,853	$1,579
Acquisitions	$1,141	$0	$284	$528	$0
Dividends	$819	$756	$1,542	$1,359	$1,198
Repurchases	$720	$940	$1,480	$2,020	$2,174
Total spent	$2,680	$1,696	$3,306	$3,907	$3,372
Total % FCF	240.8%	291.9%	108.8%	136.9%	213.6%

Recent acquisitions lost money – Give & Go reported a -$8 million loss for 2Q20. Debt is now $18.1 billion up from $15.5 billion at the end of 2016. Adjusted Operating Income + Depreciation/Amortization is now $5.1 billion (or $5.3 billion for 2019 if you want to exclude COVID). So, debt/EBITDA is 3.4-3.6x. Their share repurchases are getting smaller while the share count is down 8.5% or 134 million shares since 2016. It should be down 12%, but MDLZ also issued 55 million shares to management during that same time.

The basic conclusions are MDLZ is touting that it expects FX to be less of a headwind in 2020 than they guided to after 1Q. The negative 4-5% hit to revenue is now expected to be 3% and the EPS hit of 10-cents is expected to be 5-cents. **It also thinks it will see COVID-related spending decline from $100+ million in 2Q which hurt EPS by 7-cents. Then, it will continue to hold on to the higher sales growth as the channel restocks.**

We disagree on several points:

- 100% of COVID costs may not disappear in the coming quarters and they already offset much of COVID expenses by reversing the tax allowance, which shouldn't repeat either.
- MDLZ has also said it will need to see marketing and advertising increase again. They spend $1.2 billion per year on that plus whatever they record as reductions to sales for rebates, incentives, and other trade promotion to help retailers. That is simply a larger number and a 5% move is more than $60 million.
- Recent growth was helped by a surge in biscuit sales that will be tough to maintain in our view. The dynamics that created that surge are waning now and 2Q did not hold 1Q's level of surge. Picking up gum again is unlikely to offset the much larger biscuit sales unit if that slows.
- Recent growth has been fueled by pricing exceeding raw material headwinds. That source of growth is shrinking and may become a drag especially if the sales growth

is going to be driven by stocking the channel and not as much from consumer sell-through.

We also want to point out that we have some serious issues with Keurig Dr. Pepper (KDP), which MDLZ owns a 13.1% stake worth about $5.6 billion. We believe that a sizeable part of KDP's recent cash flow has come from stretching payables to as long as over 250 days. Also, we disagree that KDP has been retiring debt as it has simply refinanced it into areas like payables, leases, and a structured payable. None of those items are viewed as financed debt. So, cash flow is overstated and the debt is being understated in our view. It may also face slowing sales as people return to work and drink less pod coffee and canned soda at home.

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.

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