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Mondelez International (MDLZ) EQ Review Update-6/18 Quarter

Current EQ Rating*	Previous EQ Rating
2-	NA

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

We initiate coverage of Mondelez International (MDLZ) with an EQ Rating of 2+ (Weak).

Problems noted in the previous quarter have persisted. While the pace of increasing receivables factoring and extending payables moderated in the quarter, we remain concerned that there is a possibility of a disappointment in cash flow growth if these factors reverse in upcoming quarters.

Our concerns are as follows:

- While overall accounts receivable balances adjusted for factored receivables remain under control, the company continues to expand its use of its factoring program. While its pace of expansion has slowed, it remains elevated. We estimate the increased use of factoring has added about $100 million to recent cash flow growth.

- MDLZ continues to extend the time it is taking to pay suppliers as days payable (DSPs) rose almost 10 days over last year and 1 day from the previous quarter. While the pace of extension has slowed, we estimate extending payables has benefitted recent cash flow growth by around $200 million. We remain concerned cash flow growth could disappoint if this benefit dries up or even reverses going forward.

- The benefit of lower pension contributions will reverse in the back half of 2018 and cash restructuring costs could be higher as well.

Continued Increase in Receivables Factoring

We noted in our previous review of MDLZ that the company utilizes factoring arrangements whereby it sells receivables to third-party financial instructions in order to accelerate the receipt of cash. MDLZ has accelerated its use of its factoring programs in recent quarters. The following table shows reported receivables, factored receivables and other receivables on a days-of-sales basis for the last eight quarters:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Sales	$6,112	$6,765	$6,966	$6,530
Reported Trade Receivables	$2,416	$3,113	$2,691	$2,981
Factored Receivables	$719	$866	$843	$650
Adjusted Trade Receivables	$3,135	$3,979	$3,534	$3,631
Other Receivables	$818	$841	$835	$932
Total Adjusted Receivables	$3,953	$4,820	$4,369	$4,563
Reported Trade DSOs	36.1	42.0	35.3	41.7
Factored DSOs	**10.7**	11.7	11.0	9.1
Adjusted Trade DSOs	46.8	53.7	46.3	50.7
Total Adjusted Receivables DSO	59.0	65.0	57.2	63.8
Factored Rec.% of Adj. Trade Receivables	22.9%	21.8%	23.9%	17.9%

	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Sales	$5,986	$6,414	$6,770	$6,396
Reported Trade Receivables	$2,395	$3,035	$2,611	$3,019
Factored Receivables	$594	$630	$644	$589
Adjusted Trade Receivables	$2,989	$3,665	$3,255	$3,608
Other Receivables	$913	$829	$859	$895
Total Adjusted Receivables	$3,902	$4,494	$4,114	$4,503
Reported Trade DSOs	36.5	43.2	35.2	43.1
Factored DSOs	**9.1**	9.0	8.7	8.4
Adjusted Trade DSOs	45.6	52.1	43.9	51.5
Total Adjusted Receivables DSO	59.5	63.9	55.5	64.2
Factored Rec.% of Adj. Trade Receivables	19.9%	17.2%	19.8%	16.3%

From the standpoint of analyzing revenue recognition, the “adjusted trade receivables” line in the above table gives a measure of the company’s overall level of trade-related receivables.

While the 6/18 adjusted trade DSOs jumped by 1.3 days over the 6/17 quarter, we are not alarmed by this. However, the fact that factored receivables DSOs increased from 9.1 days to 10.7 days indicates that factoring activity remains high. Another way to analyze the level of factoring is to look at the percentage of factored receivables to total adjusted trade receivables. We can see above that factored receivables as a percentage of total trade receivables increased sequentially from 21.8% in the 3/18 quarter to 22.9% in the 6/18 quarter and was a full 300 bps above the year-ago level. While the year-over-year increase in the 6/18 quarter decelerated some from the previous two quarters, it is clear the company is still increasing its use of its factoring program, although it appears to have leveled off some in the most recent quarter.

The increased use of factoring is providing a significant benefit to reported cash flow growth. If the percentage of factored receivables had remained constant with the previous quarter, factored receivables would have been about $35 million lower and cash from operations would have been lower by a like amount. If we compare the level of factoring to last year and assume factored DSOs had remained constant, cash from operations would have been over $110 million lower. While this has been a very real benefit to cash flow growth, factoring has its limits and MDLZ cannot continue to expand the use of it indefinitely. Additionally, accelerating the receipt of cash must include a cost of financing, so the benefit does not come free. This cost will go up if interest rates rise.

DSPs continued to increase

As we noted in our initial review, MDLZ has been aggressively extending the time it takes to pay its suppliers. Accounts payables days of cost of sales (DSPs) are shown in the table below for the last eight quarters:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Accounts Payable	$5,248	$5,727	$5,705	$5,139
DSPs	134.1	133.4	121.2	117.9

	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Accounts Payable	$5,012	$4,897	$5,318	$4,884
DSPs	124.5	114.7	116.1	114.0

Payables have risen rapidly over the last several quarters. While payables declined sequentially in the 6/18 quarter, DSPs rose almost 10 days over the year-ago quarter and almost 1 day sequentially. The pace of extension does appear to have slowed in the 6/18 quarter. However, if we assume DSPs had remained at the year-ago level, it would have shaved over $200 million off of cash flow. Our concern is that this significant benefit to cash flow growth is now turning and could even become a headwind if suppliers pressure the company to revert to more historically normal payment patterns.

Cash Flow

MDLZ reported cash from operations of $1.182 million in the six months ended 6/18. That is up over $900 million from the $262 million in the year-ago period. However, we estimate over $100 million came from the increased use of factoring, closer to $200 million from the disproportionate increase in payables, and over $170 million from lower pension contributions. The company expects $136 million in pension contributions in the back half of the year, up from the $115 million made in the comparable 2017 period, so that tailwind reverses going forward. The timing of cash restructuring costs is difficult to estimate, but we still expect approximately $800 million in cash restructuring and implementation costs to be paid over the next several quarters. We also estimate that the company spent about $325 million in cash restructuring and implementation costs in the second half of 2017, so we do not see how lower restructuring-related cash spend will be less in the remaining six months of 2018. Given that the trailing 12-month free cash flow run rate is less than $2.5 billion as of the end of the 6/18 quarter, we still believe the company's target of $2.8 billion for all of 2018 seems like an aggressive forecast which depends on a continued extension of days payable and growth in receivables factoring.

Highly Inflationary Accounting Switch in Argentina

MDLZ disclosed in the 10-Q that the 3-year cumulative inflation rate in Argentina exceeded 100% which will trigger the use of highly inflationary accounting for its Argentinian subsidiary. Beginning on July 1, the company therefore moved to treating the US dollar as its functional currency for its Argentinian subsidiaries which account for only about 2% of revenue. We do not expect a material negative surprise from this development.

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 recent reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem as 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 score 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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