BEHIND THE NUMBERS

EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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PepsiCo (PEP) EQ Update- 3Q '19

Current EQ Rating*	Previous EQ Rating
3-	3-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

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

We maintain our earnings quality rating of 3- (Minor Concern)

Our main concern with PEP remains its recent extension of restructuring charges with the 2019 Multi-Year Productivity Plan. This was introduced soon after the wrap-up of the 2014 Multi-Year Productivity Plan. PEP incurred $98 million in charges and paid $95 million in cash restructuring costs in the 9/19 quarter, up from $35 million in the year-ago quarter with cash costs of $53 million. The company adds these charges back to its non-GAAP earnings numbers which calls into question the quality of the adjusted earnings.

In addition to this issue, several more minor red flag trends continued to pop up in the company's results:

- DSOs continued to rise, jumping by 2.2 days over the year-ago third quarter. As we have noted in recent reviews, we suspect the increase may be due to the SodaStream acquisition in the 12/18 quarter.

- Likewise, inventory DSIs continued to rise, climbing by more than 5 days versus the 9/18 quarter. As with DSOs, we suspect this is being driven by the SodaStream deal.

We will, therefore, be more concerned if the trend in both measures does not flatten in the 12/19 quarter when the SodaStream deal has lapped.

- Accounts receivable allowance as a percentage of gross receivables fell to 1.3% from 1.5% in the year-ago quarter. We have noted this trend in the last three quarters and observe that it would take an approximate 3 cps charge to return the allowance to 1.8-1.9% range of the 2017 time frame. This is not a huge concern but could represent a mild headwind should credit conditions worsen and the company is forced to increase in the reserve.

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.

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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