BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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# PepsiCo (PEP) EQ Update

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

PEP beats EPS expectations by 17 cps in the 9/20 quarter. We are raising our earnings quality rating to 3+ (Minor Concern) reflecting the improvement in receivables. However, overhangs remain that prevent us from raising the rating to a 4 (Acceptable) at this time.

Changes of note in the quarter:

### What got worse at PEP?

- A lower tax rate added 4 cps. While we doubt it was anticipated in many models, we are not concerned given the much larger earnings beat. Concern level- LOW
- Lower pension costs added about 1.7 cps to EPS growth in the 9/20 quarter. Concern level- LOW

### What got better at PEP?

- The growth in accounts receivable DSOs fell to just half a day from the 1.5 to 3.0-day pace of the last few quarters. This is only one quarter after several meaningful acquisitions and a period which is still likely seeing delayed collections as a result of COVID. This reduces our concern level and prompted us to upgrade the earnings quality rating.

**Overhangs that remain**

- Cash flow remains tight although the company has cut capex forecasts by $1 billion for the full year. The dividend and buyback will still exceed free cash flow.  Concern level- MEDIUM
- PEP has made several sizeable acquisitions so far this year and net debt to EBITDA has risen to 2.7. Concern level- MEDIUM
- Non-GAAP earnings add back the company's ongoing restructuring charges. These charges have averaged about 3% of non-GAAP net income per quarter for the last 6 quarters. Concern level- MEDIUM

**Other Items**

- PEP identified approximately $150 million in costs in the quarter related to COVID in the form of employee protection and compensation costs, inventory write-downs, an increase to bad debt provision and other costs. PEP expects some of these costs may be recurring, but we would expect these to begin dropping off over the next few quarters.

## Lower Tax Rate Added 4 cps

*(Concern level: LOW)*

PEP's adjusted tax rate fell to 18.9% from 20.8% in the year-ago quarter. This added about 4 cps to EPS growth. The company's guidance is for a full-year core effective tax rate of 21%, so we doubt many analysts' models were expecting the lower rate. We are not overly concerned as the company would have still beaten earnings by a wide margin without the unexpected boost.

## Lower Pension Expense Added 1.7 cps

*(Concern level: LOW)*

Lower pension costs added about 1.7 cps to EPS growth in the 9/20 quarter. Expense benefitted from recognized gains on fixed income in plan assets, increased plan contributions, and a decline in settlement costs which was partially offset by a decrease in discount rates. While we would consider this a low-quality source of income growth, as with the tax rate above, we are not overly concerned given the much higher earnings beat in the period.

## The Trend of Rising DSOs Improved

In past reviews, we noted that PEP's DSOs had been rising 1.5 to 3 days for the last few quarters. However, as the following table shows, the YOY increase fell to just 0.5 days in the 9/20 quarter.

| | 9/05/2020 | 6/13/2020 | 3/21/2020 | 12/28/2019 |
|---|---|---|---|---|
| Sales | $18,091 | $15,945 | $13,881 | $20,640 |
| Accounts Receivable | $9,295 | $8,780 | $8,477 | $7,822 |
| DSOs | 43.2 | 46.3 | 51.3 | 42.4 |

| | 9/07/2019 | 6/15/2019 | 3/23/2019 | 12/29/2018 |
|---|---|---|---|---|
| Sales | $17,188 | $16,449 | $12,884 | $19,524 |
| Accounts Receivables | $8,735 | $8,502 | $7,604 | $7,142 |
| DSOs | 42.7 | 43.4 | 49.6 | 41.0 |

Given the large acquisitions in the 6/20 quarter and the likelihood that the company is still seeing delayed collections pertaining to COVID, we are not concerned by the mild increase.

## Ongoing Concerns

- Cash flow remains tight. The company reduced its full-year outlook for capex to $4 billion from the previous $5 billion and kept its full-year free cash flow outlook for $6 billion. Cash return to shareholders in the form of dividends and buybacks was

left at $7.5 billion. The dividend was raised by 7% in June. The buyback is adding about 1.2% to EPS growth which itself is running the mid single-digits.
*Concern level- MEDIUM*

- PEP made several acquisitions in the 6/20 quarter totaling over $8 billion. This followed the $3.3 billion SodaStream deal at the end of 2018. In that timeframe, the buyback and acquisition spending have driven net debt to EBTIDA from 1.6 to 2.7. To its credit, PEP has split the amount of the purchase price over tangible assets acquired roughly half between goodwill and acquired intangibles and it is not adding the amortization of acquired intangibles back to non-GAAP results. Nevertheless, an acquisition habit that drives up debt is always a concern.
*Concern level- MEDIUM*

- Non-GAAP earnings add back the company's ongoing restructuring charges. These charges have averaged about 3% of non-GAAP net income per quarter for the last 6 quarters. This is not alarmingly large, but it lowers the perceived quality of adjusted earnings and we will consider it more of a concern if the 2019 plan is expanded or new plans announced.
*Concern level- LOW*

# 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.

# Disclosure

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