Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

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PepsiCo (PEP) EQ Update-12/18 Quarter

Current EQ Rating*	Previous EQ Rating
3-	4-

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

We are lowering our earnings quality rating on PEP to 3- (Minor Concern) from 4- (Acceptable) largely based on the new round of restructuring charges the company announced with fourth quarter earnings.

- PEP just announced a brand-new restructuring program which will result in $2.5 billion in new charges through 2023. It has not even finished its 2014 plan which itself was expanded in scope in the last five years and we found it interesting that the company labeled $138 million of expenses in the 12/18 quarter under the scope of the 2019 plan even though it was not announced until 2/15/2019. We are always skeptical of restructuring plans that seem to never end as it is quite possible for expenses that should be charged against ongoing operations to be lumped into the charges and overstate the adjusted non-GAAP numbers on which most analysts rely.

- The allowance for bad debts fell sharply in the 12/18 quarter. The allowance as a percentage of sales was 40 bps below the year-ago level and we estimate it would take approximately 1.6 cps in charges to restore the reserve to that level. While the company does not disclose provision expense by quarter, the sudden drop in the allowance balance during the 12/18 quarter may indicate the bulk of the benefit from lower expense occurred in that quarter. This potential benefit becomes more relevant given PEP only matched fourth-quarter EPS estimates.

New Round of Restructuring Charges

PEP announced on 2/15/2019 in conjunction with its fourth-quarter results that it is undertaking a new round of restructurings called the 2019 Multi-Year Productivity Plan. According to management, the plan will *"leverage new technology and business models to further simplify, harmonize and automate processes; re-engineer our go-to-market and information systems, including deploying the right automation for each market; simplify our organization and optimize our manufacturing and supply chain footprint."*

Total pre-tax charges are expected to run $2.5 billion through 2023. Approximately 70% are expected to be related to severance and other employee-related costs, 15% for asset impairments from plant closures and 15% associated with implementation. We note that the company already labeled $138 million of expenses in the fourth quarter as falling under the heading of the not-then-announced 2019 plan.

We noted in our earlier reviews of PEP that it has been taking restructuring charges for years. It is still taking charges under its 2014 plan and we were waiting to see if that plan would be extended further. The announcement of the new plan greatly reduces PEP's earnings quality in our minds. As we have pointed out many times in the past, never-ending charges call into question the reliability of charge-adjusted non-GAAP numbers as it is relatively easy to lump expenses which should be matched against ongoing operations into the charge, thus overstating the "adjusted" results. For example, companies often make assumptions about how much executive time is spent on the restructuring and deem that percentage of their pay as "one-time". This makes the 15% of the charge which is labeled as "implementation" particularly worthy of scrutiny. We also would propose that "leveraging new technologies" and "harmonizing processes" are a regular part of doing business, not to mention the fact that the company has already spent billions under the 2014 plan performing which had similar goals.

Allowance for Bad Debts Declining

PEP's allowance for bad debts has gradually fallen as a percentage of gross receivables for the last several quarters, but the allowance balance took a noticeable dive in the 12/18 quarter.

	12/29/2018	9/8/2018	06/16/2018	03/24/2018
Accounts Receivable	$7,142	$7,975	$7,841	$7,171
Allowance	$101	$120	$124	$141
Allowance % of Gross Receivables	1.4%	1.5%	1.6%	1.9%

	12/30/2017	09/09/2017	06/17/2017	03/25/2017
Accounts Receivable	$7,024	$7,923	$7,543	$6,848
Allowance	$129	$146	$137	$139
Allowance % of Gross Receivables	1.8%	1.8%	1.8%	2.0%

The company does not disclose provision expense by quarter, but we have the following data from the 10-K regarding the year-over-year development in the reserve:

	12/2018	12/2017
Trade Receivables	$6,079	$5,956
Other Receivables	$1,164	$1,197
Beginning Allowance	$129	$134
Charged to Expenses	$16	$26
Deductions	-$33	-$35
Other	-$11	$4
Ending Allowance	$101	$129

We can see from the above disclosure that bad debt expense for the year was down by $10 million ($16 million-$26 million). In addition, deductions (primarily write-offs) in 2018 were double the amounts expensed which was one of the factors reducing the reserve percentage. Unfortunately, we cannot tell the quarterly timing of the expense. The $11 million "other" reduction in the reserve relates primarily to currency movements. As with expense, we are not certain of the quarterly timing of that item, but we would not expect that to have a meaningful impact on the reserve percentage as the underlying receivables associated with the reserve should have come down by a like amount in the FX translation.

We know for sure that the reserve percentage materially declined during the year and can estimate that it would take an approximate $29 million (1.6 cps) charge to restore the reserve to the year-ago level. In addition, the $20 million drop in the reserve between the 12/18 and the 9/18 quarters could indicate that the bulk of the benefit of the reduced expenses was experienced in the 12/18 period. The importance of this is magnified by the fact that the company's earnings were exactly in-line in the 12/18 quarter.

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. 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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