BEHIND THE NUMBERS
Quality of Earnings Analysis
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PepsiCo, Inc. (PEP)
Earnings Quality Update- 3/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are lowering our earnings quality rating to 3- (Minor Concern) from the previous 3+ (Minor Concern)

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

Summary

PEP reported non-GAAP EPS of $1.21 in the 3/21 quarter which topped consensus estimates by 9 cps. We identified about 7 cps in unusual items so the beat remains intact. However, we are lowering our rating primarily due to the rising debt level and low dividend coverage.

What was weaker?

- The biggest unusual item in the quarter was 6 cps from an unrealized gain on a publicly-traded investment. This was recorded as a reduction to SG&A and was not adjusted out of non-GAAP results. The company even included the benefit in its definition of “core operating profit” which it cited as growing at 7%- but this falls to 2% when the $108 million pretax gain is removed. PEP also disclosed that the company has since sold the investment and will book a $30 million after-tax loss in the next quarter. We will be watching to see if the loss is adjusted out of results.

- Lower COVID-related expenses (not adjusted out of non-GAAP results) added 4 percentage points to core operating profit growth. After adjusting for that and the unrealized gain on securities, core operating profit growth fell to -2%. Management cited the negative impact of higher commodity costs of 5% and higher operating costs from supply chain issues and weather-related problems.

- Pension expense fell by 1.1 cps largely driven by the plan to freeze the company's US pension plan in 2025. This is expected to benefit 2021 by about 4 cps. This was telegraphed by the company and should have been included in analysts' models. We don't believe this be considered an unexpected part of the earnings beat.

- The tax rate came in about 30 bps lower than the 21% rate forecast for the full year due to a decrease in the tax reserve from the expiration of the statute of limitations in certain jurisdictions. This added about a penny per share.

- PEP changed the disclosure relating to its 2019 Multi-Year restructuring plan in its 3/21 quarter 10-Q. While the estimate for total cost of $2.5 billion and the cash component of $1.6 billion remained the same, the percentage of total costs expected to come from severance fell from 70% in the 9/20 Q to 65% in the 3/21 Q while the "other" component jumped to 20% from the previously estimated 15%. If the company identified that it would lay off fewer people or it would cost less to do so, why did the total cost of the plan not come down? By shifting this to the open-ended "other" category which includes the cost of implementation of the plan, it seems to us to increase the likelihood that these costs could include items such as management time that should be considered operational.

What to watch

- The company indicated in the 10-Q that favorable settlements of promotional spending accruals versus the year-ago quarter added 5 percentage points to operating profit growth. This is presumably accounted for in the impact of net pricing. Management stated in the call that it is seeing a more rational pricing and promotional environment among players in the market. Pricing has played a key role in organic growth in the last three quarters for all the company's major segments. Commodity inflation and easy comps could keep this alive for the next couple of quarters, but longer-term, consumer staples companies have a difficult time raising prices without negatively impacting volumes.

- PEP disclosed in its 12/20 10-K the existence of a voluntary supply chain finance program whereby suppliers can work with third-party institutions to receive cash payments on their

receivables due from PEP. This program has apparently been in existence for a while as amounts outstanding with third parties was disclosed as being $1.2 billion at 12/20 and $1.1 billion at 12/19. The company also states that it does not expect the program to materially impact liquidity. We are not overly concerned with the program but reiterate our ongoing complaints about PEP's practice of only disclosing trade payables on an annual basis.

- We remain concerned about the fact that the dividend consumes over 80% of the company's free cash flow and the buyback regularly consumes more than the remainder. This fact, coupled with acquisitions has led to the gradual increase in net debt to 2.8x EBITDA.

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 Concern)- 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 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 upcoming quarters. 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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