BEHIND THE NUMBERS

EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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April 29, 2019

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PepsiCo (PEP) EQ Update -3/19 Quarter

Current EQ Rating*	Previous EQ Rating
3+	3-

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

We increase our earnings quality rating to a 3+ (Minor Concern) from a 3- (Minor Concern).

Our largest overall concern with PEP was the previous quarter's announcement of the 2019 restructuring plan which will result in $2.5 billion in new charges through 2023. The company is just now wrapping up its 2014 restructuring plan. We are always skeptical of serial restructurings and their negative impact on the quality of adjusted earnings.

Aside from the restructuring issue, we had only minor concerns with earnings quality in the 3/19 quarter.

- Allowance for doubtful accounts as a percentage of gross receivables recovered slightly in the 3/19 quarter:

	3/23/2019	12/29/2018	9/8/2018	6/16/2018	3/24/2018	12/30/2017
Accounts Receivable	$7,604	$7,142	$7,975	$7,841	$7,171	$7,024
Allowance for Bad Debts	$113	$101	$120	$124	$141	$129
% of Gross Receivables	1.5%	1.4%	1.5%	1.6%	1.9%	1.8%

Despite the sequential rebound in the allowance, the percentage of gross receivables remains at a low level compared to recent experience. For perspective, it would take about a 2 cps charge to boost the reserve percentage back to year-ago levels. This is not a major concern but could be a mild headwind to future quarterly profit growth if provision expense increases to rebuild the reserve.

- PEP’s 10-Q indicates that the company recognized tax benefits of 2 cps related to the TCJ Act. However, the company also noted that it increased the reserves for uncertain tax positions in foreign jurisdictions in addition to other negative timing impacts of the TCJ which would have more than offset the benefit.

- On a non-accounting note, we observe that while the market was excited by PEP’s 5% organic revenue growth, this was mostly driven by price increases as volume was only a positive 1%. Despite increasing investment in marketing and advertising, PBNA (35% of revenue) actually saw 2% volume declines and Quaker Foods (5% of revenue) experienced a 1% erosion in volumes.

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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