BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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PepsiCo (PEP) EQ Update- 6/20 Qtr.

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

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

PEP beats consensus estimates by 7 cps in the 6/20 quarter. We did not see especially alarming signs with earnings quality in the quarter although the continuing rise in DSOs warrants watching. While restructuring spending is not as large as some consumer products companies we follow, the ongoing nature of those charges and adding them back to non-GAAP results lowers our perceived quality of the company's earnings. Our main concern revolves around the acquisition and investment binge which has left PEP with elevated debt levels and a tight cash flow position.

- Cash from operations after adjustment for the $1.5 billion voluntary pension contribution in 2018 has been flat for several years. Going into 2020, the company was expecting operating cash flow to increase, but COVID has dashed those hopes. Meanwhile, an aggressive internal investment program has boosted capital spending from the $3 billion range to $5 billion. Before COVID, the company was calling for the $5 billion level to hold for "several years." While we would not be surprised to see spending fall below that level in the short run, it should remain elevated for the

foreseeable future. The dividend also continues to rise and now consumes almost 100% of FCF as of the trailing 12-month period ended 6/20.

- PEP went on an acquisition binge in the 6/20 quarter spending over $5 billion on acquisitions. The buyback continues at its approximate $2.5 billion pace. This has resulted in debt to EBITDA jumping to 2.7x. The tight cash flow position will limit debt reduction for the foreseeable future.

- The company paid $1.2 billion to acquire South African-based Pioneer Foods, but also had to commit to another $400 million in investments into South Africa. Of that $100 million was recognized as an expense in the quarter although it was added back to non-GAAP results. The remaining $300 million relates to "capital expenditures and business-related costs" which will be recorded over the next three years. If these costs are run through capex, they will be capitalized and amortized. Almost all of the purchase price on all the acquisitions was booked as either goodwill or indefinite-lived intangibles, none of which is amortized meaning the cost of these deals will never be reflected in the income statement unless there is an impairment. We wonder if the remaining $300 million of the South Africa costs will be treated the same.

- We have noted in past reviews that accounts receivables DSOs have been rising for some time. In the 3/20 quarter, the company more than doubled its allowance for bad debts and increased it again in the 6/20 quarter. If we calculate DSOs on a gross receivables basis to adjust for this, we get a 2.4-day increase in the 3/20 quarter and a 3.5-day increase in the 6/20 quarter. While acquisitions were likely the cause of much of the 6/20 increase, they would not have impacted the 3/20 quarter. While receivables are not out of control at this point, the ongoing nature of the increase warrants watching in future quarters.

Cash Flow Now Barely Covers Dividend…

The following table shows cash flow statistics for PEP for the last four trailing 12-month periods ended in June:

	6/13/2020	6/15/2019	6/16/2018	6/17/2017
T12 Operating Cash Flow	$9,723	$9,716	$8,866	$9,807
T12 Capex	$4,253	$3,504	$3,036	$2,999
T12 Free Cash Flow	$5,470	$6,212	$5,830	$6,808
T12 Dividends	$5,346	$5,260	$4,602	$4,342
Dividend % of Free Cash	97.7%	84.7%	78.9%	63.8%
T12 FCF After Dividends	$124	$952	$1,228	$2,466
T12 Net Stock Repurchases	$2,411	$2,742	$2,042	$2,613
T12 Net Cash for Acquisitions	$5,942	$3,732	$209	$248
Cash Flow After Div, Repos, Acquis	-$8,229	-$5,522	-$1,023	-$395

In the 6/18 period, PEP's growth in cash from operations suffered a setback from a $1.5 billion voluntary pension contribution. Operating cash flow rebounded in the 6/19 period, about the time the company embarked on a massive investment program which resulted in a huge jump in capex. Management described some of these investments in the 12/19 quarter conference call:

> *"We invested in becoming Faster by increasing our global advertising and marketing spending by more than 12% for the full year, reflecting investment across snacks and beverages, and in both our large and established brands and our emerging brands;* ***expanding our market presence by increasing route capacity, adding merchandising racks and coolers and advancing the technologies that we deploy to drive greater and more precise execution; and investing in additional manufacturing capacity to remove bottlenecks and increase growth capacity for our products. This includes investments in new plants, new lines and added distribution infrastructure.***
>
> *Whilst we intend to continue to invest back into our business, we know that sustaining higher growth would require building stronger capabilities, ones which will be difficult to match by our competitors. During 2019, we enhanced our consumer and customer-facing capabilities, strengthened our organizational culture and transformed our cost management.* ***Specifically, we invested in data analytics and other information technology to build consumer intimacy and achieve precision at scale.*** *By capturing and analyzing more granular consumer-level data, we can understand the consumer in a more individualized way to both customize communication and executing in every store with precisely the right products placed*

in the right location and at the right price. We strengthened our omnichannel capabilities, particularly in e-commerce, but our retail sales were nearly $2 billion in 2019. ***To meet the growing need across channels for greater customization and faster innovation, we're investing in an end-to-end agile value chain that can deliver more precision and variety to enable us to win in the marketplace.***

…

To complement our Faster, Stronger and Better initiatives, we also made investments to fortify our portfolio for future growth. ***Specifically, we invested in our SodaStream business, which grew net revenue more than 20% last year in order to capture an incremental growth opportunity."***

During the conference call, management forecasted that capital spending would total $5 billion "and remain at or around these levels for the next few years." At the same time, it forecasted free cash flow of $6 billion for 2020, implying operating cash flow of about $11 billion. However, the impact of COVID on the company's results has dashed hopes of hitting that target as trailing 12 operating cash flow was still under $10 billion as of the 6/20 quarter. At the same time, the dividend continues to rise and now consumes almost 100% of free cash flow. We will discuss in the next section that cash spent on acquisitions has been rising dramatically.

…Yet Acquisition Spending Is Skyrocketing

As free cash flow after the dividend gets tighter, the company has not backed off its share buyback and has increased spending on acquisitions. Acquisition activity lulled after the 2018 purchase of SodaStream but resumed with a vengeance in 2020. Details on the recent acquisitions are discussed below:

Pioneer Foods

On 3/23/2020 PEP acquired Pioneer Foods for $1.2 billion. In addition to the purchase price, the company had to commit another $400 million in commitments to the South Africa Competition Commission. These will include benefits to employees, agricultural development, education, developing Pioneer Food's operations, and enterprise development

programs in South Africa. ***Of the $400 million in payments, $100 million was recognized in SG&A in the current quarter as they will be paid out over the next year. These costs were added back in the company's non-GAAP results. The remaining $300 million relates to capital expenditures and business-related costs which will be recorded over the next five years. If these costs are run through capex, they will be capitalized. Considering almost all the intangibles picked up in all these acquisitions was labeling as "indefinite-lived", none of it or the goodwill will ever be reflected on the income statement.***

Rockstar

On 2/24/2020 PEP acquired Rockstar, maker of the number three player in the energy drink category for $3.85 billion plus a possible contingent consideration of $850 million.

Be & Cheery

On 6/1/2020, PEP acquired Be & Cheery, a major snack food company in China for $700 million.

The cash spent on these deals plus the $2.4 billion buyback resulted in the company burning over $8 billion in cash in the trailing 12-month period ended 6/20, resulting in a net debt to EBITDA of 2.7. It is reasonable to expect operating cash flow to begin recovering when the impact of COVID wanes, but capital spending will remain high for some time leaving little room for debt reduction.

Receivables Continue to Trend Up- Especially After Reserve Adjustments

We have noted in past reviews that PEP's receivables have been trending up for some time. While not dramatic, pre-COVID DSOs are 2-3 days above where they were two years ago. However, we note that while sales declined in the 6/20 quarter, receivables still rose, driving up DSO by 2.8 days versus the year-ago quarter. However, the company more than doubled its allowance for bad debts in the 3/20 quarter and increased it again in the 6/20 quarter which materially reduced net receivables in those quarters. DSOs calculated on gross receivables showed an even larger 3.5-day jump in the 6/20 quarter and 2.4-day jump in the 3/20 quarter:

	6/13/2020	3/21/2020	12/28/2019	9/07/2019
Sales	$15,945	$13,881	$20,640	$17,188
Accounts Receivables	$8,780	$8,477	$7,822	$8,735
Accounts Receivables Days of Sales	46.3	51.3	42.4	42.7
YOY Increase	*2.8*	*1.7*	*1.5*	*2.1*
Allowance for Doubtful Accounts	$235	$228	$105	$114
Gross Receivables	$9,015	$8,705	$7,927	$8,849
Gross Receivable DSOs	47.5	52.7	43.0	43.2
YOY Increase	*3.5*	*2.4*	*1.5*	*2.0*

	6/15/2019	3/23/2019	12/29/2018	9/08/2018
Sales	$16,449	$12,884	$19,524	$16,485
Accounts Receivables	$8,502	$7,604	$7,142	$7,975
Accounts Receivables Days of Sales	43.4	49.6	41.0	40.6
Allowance for Doubtful Accounts	$113	$113	$101	$120
Gross Receivables	$8,615	$7,717	$7,243	$8,095
Gross Receivable DSOs	44.0	50.3	41.5	41.2

As we noted above, the company made several significant acquisitions in the 6/20 quarter which would have had a material impact on receivables growth. However, the fact that gross receivables DSOs jumped in the 3/20 quarter prior to the acquisitions is noteworthy and while we don't have the data necessary to determine the impact of the acquisitions on DSO, we are skeptical that they accounted for all of the DSO increase in the 6/20 quarter.

While receivables are not out of control, given the length of the rising trend it continues to warrant scrutiny in the future.

Explanation of EQ Rating Scale

Rating	Explanation
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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