BTN Research

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PepsiCo. (PEP) EQ Update-6/19 Qtr.

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 are lowering our earnings quality rating to 3- (Minor Concern) from 3- (Minor Concern)

PEP beats the consensus estimates by 3 cps in the quarter with a slight beat on the top line. An increase in receivables and payables plus the decline in the allowances prompts us to reduce our earnings quality rating. We would also note again that the company recently launched another restructuring program which always reduces our overall view of the quality of reported earnings.

- We mentioned PEP in our recent piece on the distortions of non-GAAP FX adjustments to organic revenue growth for companies with operations in Latin America. FX-adjusted results can be skewed at companies with operations in countries experiencing high inflation due to big pricing boosts from that geographic segment due to high inflation benefitting results while the offsetting negative FX impact is adjusted out of the organic results. PEP was not receiving as large a benefit from inflationary conditions in Latin America as some companies we looked at as its total company organic revenue growth figures of just over 5% in the 3/19 quarter only fell to a little more than 4.5% after we adjusted out the impact of Latin America. In the 6/19 quarter, the Latin American segment actually posted decent volume growth of 4%, up from 0% in the 3/19 quarter. Pricing was still strong at positive 6%, yet the negative currency impact persisted at negative 7%. Total company organic FX-adjusted revenue growth was approximately 4.5% and we estimate that falls to the high 3% range with Latin America adjusted out.

- Accounts receivable days jumped by 2.9 over the year-ago quarter. The company offered no explanation of the increase in its 10-Q and it was not mentioned in the

conference call beyond noting that working capital was a drain on cash flow growth for the six months ended 6/19. The 12/18 SodaStream acquisition could have driven some of this increase, the but the year-over-year increase in DSOs in the 3/19 quarter was only 1.8 days. Likewise, the 12/18 quarter, which included all the SodaStream assets but virtually none of the cost of sales, increased by only 0.6 days. Therefore, we are skeptical that SodaStream had a meaningful impact on the DSO growth. While this could have been a timing issue, we note that PEP's DSOs have been very stable and the almost 3-day increase appears out-of-line, increasing the chance that sales were pulled forward into the 6/19 quarter at the expense of the next.

- Accounts receivable allowances fell as a percentage of gross receivables to 1.3% compared to 1.6% a year ago and 1.5% in the previous quarter. We have noted in past reviews that allowances were in the 1.8%-1.9% range in 2017 and to return the allowance to that level would require about 3 cps in charges.

- Also, on the working capital front, inventory DSIs rose year-over-year by 5.3 days after rising 3.2 and 2.3 days in the 3/19 and 12/18 quarters, respectively. Of the 5.3-day increase, 3 days of the increase came from finished goods and 1.8 days came from work in process. As with receivables, the inventory increase could have been partly driven by the SodaStream acquisition, but again, the increase in DSIs was only 3.2 and 2.3 days in the 3/19 and 12/18 quarters, respectively. This increases the chance that the inventory buildup was unintended and may be signaling discounting pressure or reduced production ahead.

Explanation of EQ Rating Scale

Rating	Description
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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