

PepsiCo (PEP) EQ Update- 6/18 Quarter

Current EQ Rating*	Previous EQ Rating
4-	NA

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

We initiate coverage of PepsiCo (PEP) with an EQ Rating of 4+ (Acceptable).

In our 7/12/18 review of PEP's 6/18 quarter, we noted that the company regularly fails to exclude gains from the refranchising of bottling operations from its adjusted income figures. In the 6/18 quarter, this resulted in an apparent 10 cps earnings beat, but all but a penny of the upside came from such gains. The company prominently quantifies and discloses these items, but it would be preferable for it to exclude them from adjusted profits altogether.

We also note that accounts payable and accrued liabilities days of sales jumped by 5 days in the quarter. Given that the company does not break out payables from other items such as accrued marketing, it is difficult to determine what drove the increase.

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 as 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 score 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.

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