BEHIND THE NUMBERS
QUALITY EQUITY INCOME SOLUTIONS

BTN Earnings Quality Review

February 15, 2018

Bill Whiteside, CFA
btnresearch.com

PepsiCo (PEP)

PepsiCo (PEP) reported EPS in the 12/17 quarter that was essentially in-line with consensus estimates. However, like most branded consumer products companies, PEP continues to struggle with competition, a strengthening retail customer, rising raw materials costs and a rapidly changing retail landscape. While PEP reported that it is increasing its dividend by 15%, the 46th straight annual increase, dividend growth in the future will be more difficult to come by as cash flow simply is not posting meaningful sustainable growth.

Operating cash flow has not grown meaningfully in years

PEP is considered a "dividend aristocrat" given its long history of dividend growth. In the last five years, the company's annual dividend growth rate has topped 8%. However, as the following table shows, this has been entirely driven by an increasing free cash flow payout ratio:

	12/31/2017	12/31/2016	12/31/2015	12/31/2014	12/31/2013
T12 Operating Cash Flow	$9,994	$10,673	$10,580	$10,506	$9,688
T12 Capex	$2,969	$3,040	$2,758	$2,859	$2,795
T12 Free Cash Flow	$7,025	$7,633	$7,822	$7,647	$6,893
T12 Dividends	$4,472	$4,227	$4,040	$3,730	$3,434
T12 Net Stock Repurchases	$1,688	$2,672	$4,368	$4,153	$1,768
T12 Div % of T12 FCF	**63.7%**	**55.4%**	**51.6%**	**48.8%**	**49.8%**

Cash flow from operations declined in 2017, which the company attributed to higher cash tax payments and negative working capital impacts from higher payments to suppliers and customers, partially offset by lower pension and retiree health benefit contributions. This is not expected to improve much in 2018. Management forecast operating cash flow of $9 billion for next year, which does include a $1.4 billion one-time pension payment. Even adjusting for the pension payment, operating cash flow of $10.4 billion is still below levels reported from 2014-2016.

Capital spending is also expected to jump to $3.6 billion in 2018 as the company is accelerating some of its capital plans. This implies free cash flow of $5.4 million next year. Even a pension charge-adjusted free cash flow number of $6.8 billion is well below trend.

Nevertheless, the company is boosting its return to shareholders this year given the increased flexibility to move cash around the world courtesy of tax reform. It plans to return $7 billion to shareholders in 2018 with $5 billion in dividend and $2 billion in buybacks. However, the 15% increase in the dividend should not be expected to continue. When asked about dividend growth trajectory in the conference call, the CFO responded:

> "In terms of our projections going forward on dividend and share repurchase, **with this 15% announcement, you've seen the payout ratio go up a little bit. I think that's likely where we're to maintain. This is not a signal of a longer-term increase in the payout ratio over time.** So we talk about dividends once a year, every year. I'm not going to talk about specifically what'll happen going forward. But I think what you see is just a modest uptick in the payout ratio. Beyond that, we'll see what happens as we get beyond 2018 regarding where the cash goes and what we do with it."

While management still has room to grow the dividend by expanding the free cash flow payout, at almost 65% and rising, the room is running out. Some room may be freed up after the accelerated capital plan in 2018 passes but in general, dividend growth is soon going to be limited to the growth in free cash flow, which the table above shows has been essentially nonexistent in recent years.

Also, despite management's claim that cash flow was hurt by higher payments to vendors, accounts payable has actually been on the rise. The following table shows accounts payable days of sales for the last four years:

	12/31/2017	12/31/2016	12/31/2015	12/31/2014
Sales	$63,525	$62,799	$63,056	$66,683
Accounts payable	$6,727	$6,158	$5,546	$5,127
Sales YOY growth	1.2%	-0.4%	-5.4%	0.4%
Accounts payable YOY growth	9.2%	11.0%	8.2%	10.7%
Accounts payable DSPs	**38.7**	**35.8**	**32.1**	**28.1**

Like most consumer products companies we look at, PEP is putting the pressure on its suppliers to boost cash flows. Accounts payable balances have outpaced sales growth for the last several years by a sizeable margin. Mondelez (MDLZ) and Kraft-Heinz (KHC) had fourth quarter days-payable numbers of 75 and 55, respectively, implying PEP may have more room to lean here. Still, this should be monitored going forward as it is an important source of cash flow growth.

Inventories jumped in the 12/17 quarter

Continuing on the subject of working capital, PEP's inventories jumped by almost two days over the year-ago period:

	12/31/2017	9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016
COGS	$9,077	$7,366	$7,056	$5,286	$8,944	$7,284
Inventory	$2,947	$3,251	$3,612	$3,282	$2,723	$3,120
COGS YOY growth	1.5%	1.1%	3.3%	2.6%	5.4%	-2.8%
Inventory YOY growth	8.2%	4.2%	3.6%	2.0%	0.1%	-0.1%
COGS Seq growth	23.2%	4.4%	33.5%	-40.9%	22.8%	6.6%
Inventory Seq growth	-9.4%	-10.0%	10.1%	20.5%	-12.7%	-10.5%
Inventory DSIs	***29.6***	***40.3***	***46.7***	***56.7***	***27.8***	***39.1***

While a two-day increase is not especially large, it is out-of-trend for a company which typically does not show much fluctuation in its inventory days. Obviously, the company's inventories have a very limited shelf-life and would have to be discounted and moved quickly. With PEP's gross margin already under pressure, it hardly needs anything else putting pressure on prices.

Recurring one-time charges

Like most other consumer products companies, PEP seems to be in a perpetual state of restructuring. While its charges are not as large as Kraft-Heinz, P&G and Mondelez, it nonetheless does take regular charges that it adds back to its "core earnings" for investors.

	12/31/2017	12/31/2016	12/31/2015	12/31/2014	12/31/2013
Restructuring charges and write-offs	$295	$160	$169	$357	$53
EBITDA	$13,158	$12,761	$12,480	$12,938	$12,724
% of Adjusted EBITDA	**2.2%**	**1.3%**	**1.4%**	**2.8%**	**0.4%**

Note that the above amounts are for restructuring activities only and do not include other unusual amounts such as pension charges and write-downs of its Tingyi investments and impairment of its Venezuelan assets.

The company recently expanded its 2014 Productivity Plan through 2019 and is projecting charges of $254 million and $17 million in 2018 and 2019, respectively. Given the pattern, we fully expect a new plan or a further expansion to be announced in the next few quarters. As we already noted, PEP's charges are not as large as some of its peers, but any ongoing restructuring plan call into question the quality of the charge adjusted earnings amounts. We will be concerned if the next plan is larger is larger in scope.

One-time gain in the "core"

PEP took some heat in the 12/17 conference call for not excluding from its "core" profit figures its one-time gains from the refranchising of bottling operations in Jordan in the fourth quarter and the gain from its sale of its minority stake in Britvic in the second quarter. These added about 15 cents to EPS for the year. Management' defense was that these benefits were essentially more than offset by a 53rd week of sales in the previous year, incremental investments, and the impact of the hurricane. While this may be true, the amount of a one-time gain is very specific and is traditionally excluded from such adjusted earnings figures. We believe it would have been more appropriate to exclude the gains from the core profit amount and simply disclosed the amounts of the other items as an aside.

Disclosure

BTN Research is a research publication structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. Information included in this report is derived from many sources believed to be reliable (including SEC filings and other public records), but no representation is made that it is accurate or complete, or that errors, if discovered, will be corrected.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.