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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Sysco (SYY) EQ Update- 9/20 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 maintain our earnings quality rating of 3- (Minor Concern)

SYY reported adjusted EPS of $0.34 which was 7 cps ahead of consensus estimates. The company has fought through COVID's impact on its customers by expanding to new areas of distribution such as supermarkets and helping its customer base work through their problems. Its market-dominating size has been a plus in this regard. We have criticized SYY's quarterly results several times over the years due to multiple unusual items amounting to a few cents here and there that seemed to allow the company to barely meet or slightly beat earnings estimates. The dramatic decline in EPS during the COVID quarters has more than overshadowed the relevance of those types of items. As conditions begin to normalize, they will begin to stand out more. We will revisit some of our longer-term concerns with the company in this update.

What deteriorated?

- SYY has been in perpetual restructuring mode since the 2016 acquisition of Brakes. Restructuring and transformational charges have grown larger almost every year,

amounting to $371 million in the year ended 6/20. Such amounts are added back to non-GAAP earnings and essentially dismissed by analysts focusing only on the non-GAAP numbers. Some of the recent charges appear to relate to the company's acceleration to improve its technological capabilities, but we question if all these amounts should be considered non-operational. Also, some charges are attributed to ongoing integration issues in the company's French and UK operations. Regardless of the location of the spending, the bulk of the charges are described as severance charges, facility closures, integration charges, and changes in technology, most of which should result in cash expenditures. Such a large amount of cash charges being dismissed over so many years in our view reduces the quality of the non-GAAP earnings.
(Concern level: MEDIUM)

- The company also adds back the amortization of intangibles associated with the Brakes acquisition to non-GAAP earnings. To the company's credit, it does not add back amortization from its smaller acquisitions done over the years. Just the amortization of Brakes typically amounts to 2-3% of non-GAAP operating income. Also, the company took $203 million in goodwill impairments in the June quarter with $109 million of that attributed to the France group which was picked up in the Brakes deal. So, from the perspective of non-GAAP earnings, the cost of amortization for the Brakes deal, the sizeable restructuring and integration charges associated with it, and the write-down of the goodwill all never cost shareholders a penny.
(Concern level: MEDIUM)

- A lower than expected tax rate added about a penny to EPS.
(Concern level: LOW)

What improved?

- SYY identified $170 million and $154 million in incremental provision for bad debt expense related to COVID in the 6/20 and 3/20 quarters, respectively which it added back to non-GAAP results. In the 9/20 quarter, the company experienced significant improvement in the collection of receivables which resulted in a positive adjustment to bad debt provision of $99 million. To the company's credit, the benefit was adjusted out of its non-GAAP results for the 9/20 quarter.

What to watch

- Management stated in the conference call that it does not anticipate making any share repurchases for the remainder of FY 2021. Previously, the lower share count was boosting EPS growth by approximately 1.5%-2% per quarter and this tailwind will begin to wane going forward.

Restructuring Charges Continue

(Concern level: MEDIUM)

SYY has been in perpetual restructuring mode for years in the wake of its 2016 acquisition of Cucina Lux Investments, the holding company of the Brakes Group. Brakes is a European foodservice business distributing products to restaurants and pubs in primarily the UK, France, Ireland, and Sweden. The following table shows restructuring and transformational charges which the company added back to non-GAAP operating profit for the last five fiscal years:

FY Ended June:	2020	2019	2018	2017	2016
Non-GAAP Operating Income	$1,711.995	$2,733.282	$2,533.416	$2,351.831	$2,009.248
Restructuring & Transformational Charges	$371.088	$325.300	$109.524	$161.011	$123.134

Before 2016, the company recorded nominal severance and facility closure charges. However, the Brakes acquisition has posed several challenges, resulting in a steady increase in the expenses incurred. Consider the following description of the 2020 charges in the 6/20 10-K:

> *"[Operating expenses included] our ongoing restructuring and integration work in our European operations and facility consolidations in our Canadian operations.* ***Our business in France continued to experience operational challenges arising from our integration efforts. Restructuring and business transformation charges also negatively affected our U.K. operations as we continue our efforts related to modernizing the business and growing our customer base."***

In addition, the company has undergone various "transformation programs" with the latest focused on regionalization, accelerating the adoption of Sysco Shop digital ordering, and equipping the salesforce with new tools. Management identified $350 million in expenses that will be eliminated from the cost structure in FY 2021. However, some of these

amounts, particularly the ones involving investment in technology upgrades, sound as if they are simply operational investments in the business and should not be viewed as non-operational in nature.

Also, the fact remains that analysts are being asked to add an ever-increasing stream of "one-time" charges back to earnings and the bulk of these charges appear to be cash. Consider the description in the 10-K of the 2020 and 2019 restructuring and transformational charges:

> *"Fiscal 2020 includes $265 million related to restructuring, severance and facility closure charges, of which $99 million relates to severance charges. Fiscal 2020 also includes $106 million related to various transformation initiative costs, primarily consisting of changes to our business technology strategy. Fiscal 2019 includes $174 million related to severance, restructuring and facility closure charges in Europe and Canada and at Corporate, of which $61 million relates to our France restructuring (i.e. our integration of Brake France and Davigel into Sysco France), and $151 million related to various transformation initiatives costs, of which $18 million relates to accelerated depreciation with regard to software that was replaced."*

The majority of the charges are described as severance charges, facility closures, integration charges, and changes in technology. Only $18 million was called out as accelerated depreciation which would be a non-cash charge. Such a large amount of cash charges over so many years in our view reduces the quality of the non-GAAP earnings numbers.

Adding Back Acquisition Costs- Namely Amortization

(Concern level: MEDIUM)

In addition to adding back restructuring and integration charges related to acquisitions, SYY also adds back "acquisition-related costs" which is essentially the amortization of the intangibles picked up in the Brakes deal. To the company's credit, it does not add back amortization from intangibles picked up in other smaller deals it has done over the years. The following table shows acquisition-related costs added back for the last five fiscal years ended June:

FY Ended	2020	2019	2018	2017	2016
Non-GAAP Operating Income	$1,711.995	$2,733.282	$2,533.416	$2,351.831	$2,009.248
Acquisition-Related Costs	$64.793	$77.832	$108.136	$102.049	$35.614

While we applaud not adding back costs from smaller acquisitions, we nonetheless disagree with the principle of ignoring the cost of the acquisition. Also, we note that the company incurred $203 million in goodwill impairments in fiscal 2020 with $109 million of that related to the France Group which was picked up in the Brakes deal. Of course, the impairment charge was also added back to the non-GAAP results. So, from the perspective of non-GAAP earnings, the cost of amortization for the Brakes deal, the sizeable restructuring and integration charges associated with it, and the write-down of the goodwill all never cost shareholders a penny.

Lower Tax Rate Added a Penny

(Concern level: LOW)

The adjusted effective tax rate was 19.7% in the 9/20 quarter versus 22.2% in the year-ago quarter. Management noted that it was below normal due to “favorable impacts of equity compensation and other factors.” This added only about a penny per share to EPS in a quarter where the company beat by 7 cps which warrants a low concern level.

The Previous Boost to Allowances Reversed- But SYY Adjusted the Benefit Out

SYY was understandably experiencing collection issues with its receivables at the onset of COVID as its restaurant customers were struggling to generate cash flow. This resulted in the company identifying $170 million and $154 million in incremental provision for bad debt expense in the 6/20 and 3/20 quarters, respectively. SYY added these amounts back to its non-GAAP results. In the 9/20 quarter, the company experienced significant improvement in the collection of receivables which resulted in an adjustment to bad debt provision of $99 million. To the company’s credit, the benefit was adjusted out of its non-GAAP results for the 9/20 quarter.

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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