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BTN Research
November 15, 2018 | www.btnresearch.com

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Sysco (SYY) EQ Review Update-9/18 Quarter

Current EQ Rating*	Previous EQ Rating
3+	2+

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

We are raising our rating on Sysco (SYY) to 3+ (Minor Concern) from 2+ (Weak).

SYY reported EPS of $0.91 which missed consensus estimates by a penny. This is the first such miss since 2015. We suspect that some of the shortfall relative to analysts' targets could have been due to expiring non-operating tailwinds which we warned of in our 6/18 review. Given the expiration of these tailwinds, we are raising our rating to a 3+ (Minor Concern) although we remain watchful of the company's bad debt allowances. More specifically:

- We had previously warned in the 6/18 quarter that the artificial benefits from a change in stock option accounting, the exclusion of certain portions of accelerated depreciation from adjusted results, and a decline in self-insurance expense were expiring going forward. We suspect that this could have been a factor in the company missing analysts' EPS targets in the 9/18 quarter.

- Our 6/18 review also highlighted that provision for bad debt expense was a credit of $11 million in that quarter versus a $1 million expense in the year-ago quarter. Bad debt expense reversed in the 9/18 quarter and was higher than the year-ago period. Nevertheless, the allowance for bad debts as a percentage of gross receivables remains at a historically low level, leaving open the risk of higher provision expense in upcoming quarters. It worth noting that management cited two large local customers going out of business as a reason for the increase in provision expense.

Our Warning of Certain Expiring Tailwinds Has Now Passed

We pointed out to clients in our review of the 6/18 quarter that several earnings tailwinds were expiring going forward. These included:

- A 9/17 quarter change in accounting for stock options which was adding 1.5-3.0 cps per quarter to EPS growth.

- A portion of accelerated depreciation in year-ago quarters that was not being removed from adjusted EPS figures was adding about 2 cps per quarter.

- A decline in self-insurance expense of 8.5 cps for fiscal 2018 disclosed in the 6/18 10-K.

Management cited higher costs, customer mix, and Hurricane Florence as factors in the higher-than-expected expenses. We can't help but wonder if the expiration of the above benefits were a factor in the company missing earnings targets for the first time since 2015. The expiration of these benefits is the largest reason for our *EQ Review* rating upgrade to a 3+ (Minor Concern) from 2+ (Weak).

Bad Debt Allowances Remain Low

We noted in our review of the 6/18 quarter that the company's allowance for bad debt percentage was more than cut in half after the company apparently reversed $10.9 million of the reserve back into earnings. The following table shows that while provision expense normalized in the 9/18 quarter, the allowance percentage remains at very low levels:

	9/29/2018	6/30/2018	3/31/2018	12/30/2017
Gross Receivables	$4,268.8	$4,099.5	$4,293.4	$4,006.2
Bad Debt Allowance	$26.4	$25.8	$65.6	$52.6
Allowance %	0.6%	0.6%	1.5%	1.3%
Provision Expense	$10.5	-$10.9	$12.2	$11.2

	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Gross Receivables	$4,374.9	$4,043.5	$4,338.6	$4,012.1
Bad Debt Allowance	$41.2	$31.1	$56.5	$48.6
Allowance %	0.9%	0.8%	1.3%	1.2%
Provision Expense	$9.0	$1.4	$11.3	$4.4

While we never saw the company mention the benefit of lower bad debt expense to the 6/18 quarter, it was quick to point out that higher bad debt expense was a drag on the 9/18 quarter. Higher bad debt expense was cited in the 10-Q filing as a source of higher costs:

> *"Our operating expenses increased during the first quarter of fiscal 2019, driven by supply chain costs in both transportation and the warehouse, increased fuel costs and* ***increased bad debt expense in our U.S. Operations****."*

It was also mentioned in the 9/18 quarterly conference call as well:

> *"The increase in expense as previously discussed was largely driven by supply chain costs in both warehouse and transportation and increased fuel costs, as well as* ***increased bad debt expense in our US operations related to larger recoveries in the prior year and a couple large local customers going out of business."***

Likewise, management mentioned higher bad debt expense in the 10-Q filing for the 3/18 quarter:

> *"Our operating expense growth is primarily attributable to increased supply chain costs in both warehouse and transportation, our ongoing investment in our selling organization, specifically marketing associates, in an effort to accelerate our local sales, and* ***increased bad debt expense as a result of year-over-year comparisons to a strong prior year period."***

It is true that the company's bad debt expense jumped to a significantly higher level in the 3/17 quarter which it has so far maintained. However, based on the provision for bad debt

expense shown in the table above, bad debt expense was only $1.0-$1.5 million higher year-over-year in the 9/18 and 3/18 quarters.

More importantly, the allowance for bad debt as a percentage of gross receivables remains at historically low levels. It is worth noting that management's conference call commentary we quoted above cited two large local customers going out of business as factors behind the increase in bad debt expense in the quarter. We believe the low allowance level leaves open the possibility of higher bad debt expense to shore up the reserve in future quarters.

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 recent 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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