BEHIND THE NUMBERS
Quality of Earnings Analysis

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Sysco Corporation (SYY)
Earnings Quality Update- 9/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are maintaining our earnings quality rating of 3- (Minor Concern) and our Top Sell rating.

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

Summary

SYY reported non-GAAP EPS of $0.83 in the 9/21 quarter, missing estimates by 4 cps but beating the top line hurdle by over $600 million. Demand is bouncing back from the depths of Covid but while management contended that profitability exceeded its expectations, it was not enough for the company to raise guidance for the full fiscal year ended 6/22.

- We have discussed in past reviews how SYY has been adding back the reversals of accounts receivables allowances to non-GAAP results. However, it has only been adding back those reversals related to receivables created prior to the pandemic and is not taking into consideration adjustments made to receivables that were generated after Covid hit. GAAP provision expense adjusted for the add-back of pre-pandemic allowances indicates that non-GAAP results received a 3 cps boost from lower provision expense.

- SYY's non-GAAP results include regular add-backs of restructuring and transformation project costs as well as acquisition-related costs that include the amortization of acquired intangibles. This quarter saw the introduction of an additional disclosure which adds even more adjustments on top of non-GAAP results. These adjustments include costs to hire back employees to replace those let go during the pandemic which management deems

"incremental" as well as costs attributed to its very open-ended Recipe for Growth initiative. They also include interest on the debt the company attributed to Covid. Determining what goes into these costs seems very subjective and management anticipates that the 12/21 quarter amounts will at least equal the most recent quarter's total. While the market is still utilizing the previous non-GAAP measure to set targets, investors should be watching for migration of these adjustments into official non-GAAP results or any expansion of the existing restructuring and transformational costs.

Lower Provision Expense Added 3 cps to Non-GAAP Earnings

We have discussed in past reviews how SYY has been adding back the reversals of accounts receivables allowances to non-GAAP results. However, it has only been adding back those reversals related to receivables created prior to the pandemic and is not taking into consideration adjustments made to receivables that were generated after Covid hit.

The following table shows the GAAP (credit)/provision for bad debts and adjusts that amounts using the non-GAAP adjustment given in the company's disclosures to arrive at the implied provision expense used to calculate non-GAAP earnings:

	10/2/2021	7/3/2021	3/27/2021	12/26/2020
GAAP Provision (Credit) for Losses on Receivables	$2.097	-$15.070	-$43.428	-$16.452
Provision (Credit) for Bad Debt Expense Removed from Non-GAAP	-$7.061	-$22.441	-$33.473	-$30.271
Provision (Credit) for Bad Debt Expense Used in Non-GAAP Earnings	$9.158	$7.371	-$9.955	$13.819
Percentage of Revenue	0.06%	0.05%	-0.08%	0.12%
EPS Impact of Change in Provision %	$0.031	$0.046	$0.044	$0.002

	9/26/2020	6/27/2020	3/28/2020	12/28/2019
GAAP Provision (Credit) for Losses on Receivables	-$77.790	$190.389	$175.351	$19.706
Provision (Credit) for Bad Debt Expense Removed from Non-GAAP	-$98.629	$169.903	$153.499	$0.000
Provision (Credit) for Bad Debt Expense Used in Non-GAAP Earnings	$20.839	$20.486	$21.852	$19.706
Percentage of Revenue	0.18%	0.23%	0.16%	0.13%
EPS Impact of Change in Provision %	-$0.010	-$0.015	-$0.010	-$0.003

We see that in the most recent quarter, the company incurred $2.1 million in GAAP provision expense. However, this amount included a $7.1 million credit from writing back allowances established on pre-pandemic receivables. When we adjust that out, we see that non-GAAP earnings reflect a $9.2 million provision expense in the latest quarter compared to a similarly adjusted figure of $20.8 million in the year-ago quarter. If the expense had remained comparable on a percentage of revenue basis, it would have taken 3 cps off earnings growth in the period.

Adjustments to Non-GAAP Earnings?

We have discussed in the past how SYY's non-GAAP results include regular add-backs of restructuring and transformation project costs as well as acquisition-related costs that include the amortization of acquired intangibles. SYY refers to these costs as "Certain Items" in its press releases and SEC filings. The latest quarter slides included SYY's regular presentation of non-GAAP results adjusted for these Certain Items, but also an additional presentation showing results adjusted for Certain Items plus "Short-Term Transitory Expenses Associated with Business Recovery (Snap Back)" costs, Recipe for Growth Investments, and Interest on COVID-related Debt." The disclosure is re-created below:

	10/2/2021
Net Earnings (GAAP)	$378.013
Per Share	$0.73
Impact of Restructuring and Transformational Project Costs	$24.511
Impact of Acquisition Related Costs	$35.926
Impact of Bad Debt Reserve Adjustment	-$7.061
Tax Impact of Restructuring and Transformational Costs	-$6.186
Tax Impact of Acquisition-Related Costs	-$9.066
Tax Impact of Bad Debt Reserve Adjustments	$1.782
Impact of Adjustments to Uncertain Tax Positions	$12.000
Net Earnings Adjusted for Certain Items (Non-GAAP)	$429.919
Per Share	$0.83
Impact of Short-Term Transitory Expenses Associated with Business Recovery (Snap Back)	$57.025
Impact of Investment for Recipe for Growth Initiatives	$24.360
Tax Impact of Short-Term Transitory Expenses Associated with Business Recovery (Snap Back)	-$14.392
Tax Impact of Recipe for Growth Initiatives	-$6.148
Net Earnings Adjusted for Certain Items, Business Recovery and Recipe for Growth Investments	$490.764
Per Share	$0.95
Impact of Interest on COVID-19 Related Debt	$50.852
Tax Impact of Interest on COVID-19 Related Debt	-$12.833
Net Earnings Adjusted for Certain Items, Business Recovery and Recipe for Growth Investments and Impact of Interest on COVID-19 Related Debt	$528.783
Per Share	$1.03

We will take a brief look at each component.

Snap Back Costs

In the 3/20 quarter, management noted that it had reduced its employee count by 33% through furlough and permanent reduction in response to the pandemic. The company later announced that it expected to hire back 6,000 associates in the second half of the fiscal year ended 6/21. It later announced in the fourth quarter conference call that it had met those goals but it now would require more hiring to ensure it could adequately meet demand. The company began referring to these "Snap Back" costs which are mostly associated with hiring in the 6/21 quarter conference call:

> *"During the fourth quarter, we estimate that we spent more than $36 million against the snap-back including incremental investments against recruiting, training, retention and maintenance."*

Elsewhere in the 6/21 quarter call management offered more color on the composition of Snap Back expenses:

> *"In contrast, for the snapback expenses, we are very careful in monitoring that which we believe to be one-time or short-term, or transitory in nature. And it goes to, are we paying recruiting firms more money? Are we doing more recruiting marketing than we were doing before? Are we doing incremental training because of the velocity of new associates we have incoming into our buildings? Are we paying retention, etc.? And that's what -- that's what you will find within those -- within that disclosure."*

In the 9/21 quarter, the company designated $57.025 million as Snap Back costs and added them back to its already adjusted non-GAAP earnings in its earnings presentation. Our observation is that there seems to be a high degree of subjectivity that goes into deciding what to include as "incremental" costs and what should be viewed as a normal part of doing business.

Recipe for Growth

SYY announced its Recipe for Growth strategy in its annual meeting in May of 2021. Management hopes to spur growth to 1.5 times the industry rate by FY 2024 with the plan involving the enhancement of digital capabilities and marketing solutions offered to customers along with optimizing its supply chain and increasing team-based selling. Recipe for Growth is very broadly defined, yet the company designated $24.36 million of spending in the 9/21 quarter as Recipe for Growth spending and added it back to its already adjusted non-GAAP results.

Interest Expense

SYY designated $50.85 million in interest expense as being related to "COVID-19-related debt" and added it back to its already adjusted non-GAAP results.

Management stated in the conference call that it is "assuming continued heavy snapback and transformation investments in Q2 at levels at least equal to the investments in Q1" so we expected these new disclosures to continue to receive attention. The market is still utilizing the Net Earnings Adjusted for Certain Items (Non-GAAP) figure to set forecasts although investors should be watching for any migration of Recipe for Growth adjustments into Non-GAAP results or any increase in the existing Transformational Cost adjustments line.

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 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 Concern)- 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 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 upcoming quarters. 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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