BEHIND THE NUMBERS
Quality of Earnings Analysis

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Sysco Corporation (SYY)
Earnings Quality Update- 12/21 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 SYY at 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 posted non-GAAP EPS of 57 cps in the 12/21 quarter which was 13 cps behind the consensus targets. However, revenue topped expectations by over $400 million. The company's top line is receiving a huge tailwind from food price inflation. Revenue was up 41% over the 12/20 quarter driven by 22.5% case volume growth in the Broadline business coupled with almost 15% inflation. Revenue was up 10.5% over the pre-Covid 12/19 quarter which implies volumes have still not reached levels seen before the pandemic. We believe it is reasonable to expect continued strong revenue performance as the industry likely moves on from Omicron over the next few months.

What was weak?

- Non-GAAP results continue to benefit from lower provision for bad debt as a percentage of revenue even after adjustment for credits related to pre-pandemic receivables. We estimate this added about 2 cps to 12/21 quarter EPS. Comparisons will become difficult

in the 3/22 quarter at which point this will turn into a meaningful headwind to non-GAAP profit growth.

- SYY seems to always have a restructuring going on. The current Recipe for Growth plan is the latest. The company incurred transformation charges of $23.4 million in the 12/21 quarter. Of this amount, $12 million was assigned to “restructuring, severance, and facility closure charges and $12 million to “various transformation initiative costs, primarily consisting of changes to business technology strategy.” The problem we have with these charges is they have occurred every quarter for years. At what point is at least a portion of these amounts considered a cost of doing business?

- SYY adds back the amortization of acquired intangibles to non-GAAP results. With the August acquisition of Greco and Sons, amortization of intangible assets is now $27 million with the add back amounting to more than 5% of adjusted operating income. In addition, $492 million of the $761 million purchase price was allocated to goodwill which will never be amortized. While not as bad as some tech and medical companies, we still think adding this distorts the adjusted profit picture as it ignores the cost of the acquisition.

What improved?

- SYY did not present its second level of non-GAAP results in its earnings presentations which included items such as “snap back” costs to hire new associates and “interest on Covid-related debt” which we criticized in our last review. However, management did blame the higher-than-expected costs in the quarter on the snap-back expenses and quantified them at $73 million versus $57 million in the 9/21 quarter and $36 million in the 6/21 quarter. On its slide presentation, the company indicated these costs include “recruiting, hiring marketing, sign-on, retention, training, vaccination incentives/promotion and contract labor.” These costs are expected to decline over the next two quarters. Our concern with these charges continues to be the potential for costs that should be viewed as ongoing to be lumped in and ignored.

Results Continue to Benefit from Lower Adjusted Provision Expense

We have documented before that SYY added back the unusually high provision expense related to building up allowance for bad debts on receivables initiated ***before*** the pandemic. When the company experienced better than expected collections on these receivables, it began recording credits to provision expense which it also removed from non-GAAP results. However, these

adjustments do not reflect activity on receivables generated ***during*** the pandemic. The following table shows our calculation of the implied provision expense used in non-GAAP results by adjusting GAAP provision expense for the non-GAAP adjustments:

	1/1/2022	10/2/2021	7/3/2021	3/27/2021
GAAP Provision (Credit) for Losses on Receivables	-$0.589	$2.097	-$15.070	-$43.428
Provision (Credit) for Bad Debt Expense Removed from Non-GAAP	-$6.438	-$7.061	-$22.441	-$33.473
Provision (Credit) for Bad Debt Expense Used in Non-GAAP Earnings	$5.849	$9.158	$7.371	-$9.955
Percentage of Revenue	0.04%	0.06%	0.05%	-0.08%
EPS Impact of Change in Provision %	$0.021	$0.031	$0.046	$0.044

	12/26/2020	9/26/2020	6/27/2020	3/28/2020
GAAP Provision (Credit) for Losses on Receivables	-$16.452	-$77.790	$190.389	$175.351
Provision (Credit) for Bad Debt Expense Removed from Non-GAAP	-$30.271	-$98.629	$169.903	$153.499
Provision (Credit) for Bad Debt Expense Used in Non-GAAP Earnings	$13.819	$20.839	$20.486	$21.852
Percentage of Revenue	0.12%	0.18%	0.23%	0.16%
EPS Impact of Change in Provision %	$0.002	-$0.010	-$0.015	-$0.010

We can see that the implied non-GAAP provision expense fell from 0.12% of revenue in the 12/20 quarter to 0.04% in the 12/21 quarter which we estimate added about 2 cps to earnings in the period.

We can also see in the following table that the allowance for bad debt as a percentage of gross receivables was 2.95% in the latest quarter which is down from the elevated year-ago levels but still not down to the pre-pandemic range.

	1/1/2022	10/2/2021	7/3/2021	3/27/2021
Allowance Beginning Balance	$126.759	$117.659	$211.607	$254.347
Allowance for Doubtful Accounts	$128.189	$126.759	$117.659	$211.607
Allowance for Doubtful Accounts % of Gross Receivables	2.95%	2.86%	3.02%	6.17%

	12/26/2020	9/26/2020	6/27/2020	3/28/2020
Allowance Beginning Balance	$265.597	$334.810	$246.076	$71.612
Allowance for Doubtful Accounts	$254.347	$265.597	$334.810	$246.076
Allowance for Doubtful Accounts % of Gross Receivables	8.18%	7.88%	10.37%	6.31%

	12/28/2019	9/28/2019	6/29/2019	3/30/2019
Allowance Beginning Balance	$49.443	$28.176	$59.643	$44.418
Allowance for Doubtful Accounts	$71.612	$49.443	$28.176	$59.643
Allowance for Doubtful Accounts % of Gross Receivables	1.61%	1.11%	0.67%	1.36%

We could see provision expense continuing to benefit next quarter if the company can roll back reserves as Omicron wanes. However, the first table shows clearly that the 3/22 quarter will compare to a 3/21 quarter which experienced a $9.995 million ***credit*** for bad debts even after the non-GAAP adjustments. As a result, we see the 2-4 cps EPS tailwind experienced in the last few quarters reversing to a 2-4 cps headwind over the next few quarters.

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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