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Sysco Corporation (SYY)
Earnings Quality Update- 3/21 Qtr.

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

We maintain our earnings quality rating of SYY at 3- (Minor Concern).

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

Summary

SYY's adjusted 3/21 quarter EPS of 22 cps was 2 cps ahead of the consensus. However, we identified over 7 cps in unusual benefits to the quarter without which the company would have reported a miss.

- Reported other income jumped to $12.7 million of income in the 3/21 quarter compared to $5.2 million of expense in the year-ago period. However, the 3/21 quarter figure included a $10.8 million loss from the sale of a business which is removed from the company's non-GAAP adjustments. This widens the beneficial swing in the non-GAAP other income line items to $29 million, or about 4 cps. We saw no discussion of the source of the swing in the 10-Q or in the conference call.

- SYY shored up its bad debt reserves at the beginning of the pandemic to account for its hard-hit full-service dining restaurant customers. Collections have improved and the company has been writing back some of these reserves as amounts are collected. SYY has adjusted some of these unusual amounts out of its non-GAAP figures by removing

both the impact of increased provision expense in the 3/20 and 6/20 quarters as well as removing the benefit of the writebacks in the 9/20, 12/20, and 3/21 quarters. In the 3/21 quarter, the company recognized $33.5 million of benefit from writing back reductions of reserves on pre-pandemic receivables which it adjusted out of its non-GAAP results. However, according to the 10-Q, SYY also reduced its reserves related to receivables generated after the onset of the pandemic by another $10 million. This amount was not removed from non-GAAP results and added over 1.5 cps to earnings in the period.

- The non-GAAP tax rate was 14.3% compared to 19.5% in the year-ago quarter which the company attributed to the impact of stock option exercises. The company has forecast a 24% tax rate for 2021 so we believe it is reasonable to view the entire 1.5 cps benefit in the tax rate swing as unexpected.

- SYY has been adding back restructuring and transformational costs to non-GAAP results ranging from $30 million to over $100 million on a pretax basis for many years. On pre-COVID earnings, these regularly amounted to 10% of adjusted pretax results. In our opinion, the regularity and material size of these charges significantly erode the quality of reported earnings.

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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