BEHIND THE NUMBERS
Quality of Earnings Analysis

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Sysco Corporation (SYY)

Update on 3/22 results and 10-Q review

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 's non-GAAP EPS of 71 cps blew estimates away by 16 cps. The driving force behind the beat was a solid revenue figure which came in 6% above analysts' expectations. However, the company raised its guidance for the full year ended 7/22 from $3.00-$3.10 to $3.16-3.26. This is essentially the size of the earnings beat indicating the company is not expecting the improvement to continue into its fourth quarter.

We saw several concerns in the period:

- The revenue beat was solid with US Broadline growth of 43% featuring 20% volume growth and 16% inflation. Management indicated that conditions improved and viewed them as strong exiting the quarter. However, comments made by other companies that supply the restaurant industry such as Ecolab (ECL) and Lancaster Colony (LANC) seem more reserved in their outlooks.

- The company recorded a $29.6 million pretax charge to write down the value of Covid-related personal protection equipment inventory which is added back to non-GAAP results. While we have seen such charges at companies like Cintas (CTAS) and Patterson Dental (PDCO) several quarters ago, the timing of this charge seems strange given the fact its customers struggled with Omicron during much of the quarter. Our concern is that if the inventory is sold at a later date, it could result in artificially high profits given the reduced cost basis.

- As we expected, the company's adjusted provision for credit losses expense swung to a headwind in the 3/22 quarter after providing a boost to EPS growth for the last several quarters. With normalized comparisons and the possibility of slowing conditions requiring a rebuilding of reserves, we expect this will remain a material headwind for the next several quarters.

What Drove the Revenue Beat?

SYY's revenue beat appears solid. The 42.6% revenue growth in US Broadline was driven by 20% case volume growth and 16.7% inflation with the balance coming from a 4.5% boost from acquisitions and 2.4% from "other". Much of the growth was due to easy comparisons against a Covid-muted 2021 period. Compared to a pre-Covid 2019 period, sales grew by 15.3% which when taking into account the impact of inflation, implies a decline in volumes. Still, revenue was better than expected which the company seems to be attributing to market share gains.

However, we are very skeptical that revenue growth can continue to outperform. The company stated in the 10-Q regarding business trends in the quarter:

> *"Our third quarter began with disruptions from the Omicron variant of COVID-19, which negatively impacted consumer demand and our customers due to the reintroduction of significant restrictions on their businesses. These conditions persisted through February; however, we experienced a strong market rebound beginning in late February and during March, as the impact of this variant lessened and restrictions eased."*

However, this seems slightly at odds with comments we have read from other suppliers to the restaurant business. Consider the statement from Ecolab's (ECL) CEO in its conference call regarding its restaurant supply business:

> *"**if we look at restaurants, especially in the U.S...you clearly see a slowdown of demand, which is most probably related to inflationary pressure because of oil, because of COVID, because of mortgages, you name it.** But that's very early. So those are indications that are probably so important to follow."*

Also, Lancaster Colony (LANC) recently reported a 2% *decline* in volumes in the Foodservice side of its business in its 3/22 quarter. Management gave a seemingly less optimistic assessment of the restaurant business as well:

> *"Now, as we think about the impact on Foodservice, here's what my observation is. I don't think Omicron necessarily changed our consumer behavior. It impacted in Foodservice our operators' ability to staff and run their restaurants. So if you look at their volume and transaction trends during that period, you might see some of those same sort of trends because of their ability to staff the restaurants, not because people were necessarily pulling back on how they were eating.*
>
> ***Now, as we've looked at the most recent few weeks, even after the quarter is closed into April, what we're seeing generally across our consumer segments or our Foodservice segment, is that sales are continuing to grow, really driven by pricing.***

> ***But if you look at the transaction trends, the transaction trends are probably down, let's say low single-digits, in some cases mid-single digits.*** *Now, there are some winners that are doing a little better, some losers that are doing a little bit worse. But we're also comping a point in time where, if you remember last year right now this very same week, QSR [quick service restaurants] transactions were up about 50%, right? So we're comping it against a really elevated base in the same period. But as you looking at the model on Foodservice and you're estimating transactions, right now sales up, let's call it, mid-single digits somewhere around there, particularly in the QSR space,* ***transactions probably off low-single digits with some winners and losers in there****. But that gives you a rough idea of where we are."*

We realize that ECL and LANC are not direct comps to SYY. Still, their cautious outlook for the restaurant industry is worth considering. Inflation, $5+ gas prices, rising rates, stimulus checks gone, and talk of a recession may put a damper on consumers' appetites for dining out.

So what did drive SYY's revenue outperformance in the quarter? We have a few thoughts which we admit are speculation but we believe are worth taking into consideration:

- SYY has gained market share during the pandemic given its ability to offer some additional services. With restaurants having trouble with staffing during Omicron, this was likely even more attractive. However, we remain skeptical that the company can continue to make permanent inroads after conditions normalize given restaurants' preference to maintain a diversified supplier base.

- Restaurants can't stock up on perishable items like meats and dairy. However, they could stock up on more dry goods and pre-buy in an inflationary market to get ahead of expected price increases. This could have accelerated towards the end of the quarter as talk of inflation increased with the Russian invasion of Ukraine.

- As dining returned towards the end of the Delta wave last summer and fall, we experienced restaurants only bringing condiments to tables on request rather than keeping the table stocked at all times. We have seen less of this as the pandemic has worn on and we wonder if restaurants restocking on items like salt, pepper, and ketchup could have been a temporary boost to revenue that will fade.

Inventory Valuation Charge

SYY took a $29.6 million pretax charge in the 3/22 quarter to write down the value of Covid-related personal protection equipment in inventory due to the reduction in realizable value. We saw these kinds of charges for companies like Cintas (CTAS) and Patterson Dental (PDCO) a few quarters ago, but this is the first time SYY has taken such a charge. We find the timing of this charge unusual, especially when we know its customers were struggling with the Omicron outbreak through much of the quarter. Our concern with such charges is we do not know if the inventory was disposed of or if it will be sold at a later date and generate artificially large profits given the reduced cost basis.

Adjusted Provision for Bad Debts Turned to a Headwind

We have been highlighting how SYY's provision for bad debts after adjustment for pre-pandemic receivables was providing a 3-4 cps tailwind to EPS growth in the last few quarters which we predicted could reverse in the 3/22 quarter. This did come to pass, as shown in the following table:

	4/2/2022	1/1/2022	10/2/2021	7/3/2021
GAAP Provision (Credit) for Bad Debts	-$0.936	-$0.589	$2.097	-$15.070
Provision (Credit) for Bad Debts Removed from Non-GAAP	-$5.717	-$6.438	-$7.061	-$22.441
Provision (Credit) for Bad Debt Used in Non-GAAP Earnings	$4.781	$5.849	$9.158	$7.371
Percentage of Revenue	0.03%	0.04%	0.06%	0.05%
EPS Impact of Change in Provision %	-$0.029	$0.021	$0.031	$0.046

	3/27/2021	12/26/2020	9/26/2020	6/27/2020
GAAP Provision (Credit) for Bad Debts	-$43.428	-$16.452	-$77.790	$190.389
Provision (Credit) for Bad Debts Removed from Non-GAAP	-$33.473	-$30.271	-$98.629	$169.903
Provision (Credit) for Bad Debt Used in Non-GAAP Earnings	-$9.955	$13.819	$20.839	$20.486
Percentage of Revenue	-0.08%	0.12%	0.18%	0.23%
EPS Impact of Change in Provision %	$0.044	$0.002	-$0.010	-$0.015

The better than expected performance in the quarter more than covered for this headwind. However, we see that the company faces more normalized comparisons in the upcoming quarters. Also, the company's allowance for doubtful accounts as a percentage of gross receivables is down to 2.6%. While this is slightly above the pre-pandemic level, we could see tightening economic conditions preventing the company from lowering this further or even force a rebuilding of reserve requiring a further increase in provision expense. Therefore, we believe this area remains a potentially material headwind that should continue to be monitored.

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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