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Sysco (SYY) EQ Review Update- 6/18 Quarter

Current EQ Rating*	Previous EQ Rating
2+	NA

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

We initiate coverage of Sysco (SYY) with a 2+ (Weak)

SYY reported adjusted EPS of $0.94 per share in the 6/18 quarter, a penny ahead of the consensus. However, our review of the company's recent 10-K filings turned up several one-time benefits to recent results that will be disappearing in future quarters. While no one item is overly concerning, the volume of unusual benefits and the fact that virtually all will be expiring going forward prompts our 2+ (Weak) rating.

In addition, we note that we recognize that the company is enjoying a macro tailwind from the stronger economy resulting in people eating out more frequently. We would remind clients that the EQ Review Rating is a reflection of the quality of reported results and does not take into account other factors such as valuation or positive macro trends.

- SYY reversed previous bad debt allowances back into earnings in the 6/18 quarter as provision expense was actually a $10.9 million benefit in the period compared to a $1.4 million expense a year ago. We estimate this added about 1.6 cents per share to EPS in the period and more than accounted for the penny beat in the quarter.

- The company changed how it accounts for stock options in the 9/17 quarter which resulted in benefits to reported earnings of almost 1.5-3.0 cents per share over the last four quarters. That benefit will be gone in future quarters.

- Adjusted EPS has benefitted by over 2 cents per share in each of the last four quarters due to accelerated depreciation expense recorded in the year-ago periods which was not taken out of adjusted earnings per share amounts.

- Self-insurance expense fell by $62 million or about 8.5 cents per share for the fiscal year ended 6/18 due to changes in estimates for reserves. This accounted for over 12% of the reported growth in adjusted EPS for the year.

Provision Expense Benefitted from Reversal of Reserves

The following table shows the company's allowance for bad debts as a percentage of gross receivables as well as the provision expense for the last eight quarters:

	6/30/2018	3/31/2018	12/30/2017	9/30/2017
Gross Receivables	$4,099.5	$4,293.4	$4,006.2	$4,374.9
Bad Debt Allowance	$25.8	$65.6	$52.6	$41.2
Allowance %	0.6%	1.5%	1.3%	0.9%
Provision Expense	**-$10.9**	$12.2	$11.2	$9.0

	7/01/2017	4/01/2017	12/31/2016	10/01/2016
Gross Receivables	$4,043.5	$4,338.6	$4,012.1	$4,232.7
Bad Debt Allowance	$31.1	$56.5	$48.6	$41.2
Allowance %	0.8%	1.3%	1.2%	1.0%
Provision Expense	$1.4	$11.3	$4.4	$3.5

SYY's bad debt allowance rose for the three quarters ending 3/18. However, instead of reporting a provision expense in the 6/18 quarter, SYY recorded a net *benefit* of $10.9 million, effectively reversing a portion of the allowance into earnings. The $12.3 million year-over-year swing in expense added about 1.6 cents per share to EPS in the quarter, more than accounting for the reported 1 cps positive earnings surprise. As mentioned previously, we appreciate that people are eating out again and the company's customers are doing well and able to pay their bills on time. Regardless, the size of the reversal and benefit to the 6/18 quarter is unusual and obviously cannot continue to benefit results to the degree it did in the most recent quarter.

Options Accounting Change Tailwind Ending

SYY adopted FASB ASU 2016-09 (relating to the accounting of share-based payments) in the 9/17 quarter. Below is the company's description of the impact of the adoption from its most recent 10-K:

> *"Further, the company adopted the provisions that have changed its accounting for excess tax benefits or detriments.* ***Excess tax benefits or detriments were previously included within additional paid-in capital in the consolidated balance sheet and were a part of the diluted share calculation. On a prospective basis, excess tax benefits or detriments are included within income tax expense in the consolidated results of operations and are no longer a part of the diluted share calculation. Prior periods have not been adjusted.*** *In fiscal 2018, the company recognized excess tax benefits of $52.1 million from stock option exercises and restricted stock unit vestings that occurred during the period."*

In short, excess tax benefits related to options awards are now reported as a reduction of tax expense, whereas they were previously recorded directly to paid-in capital. **The company specifically quantified this benefit as 3 cents per share in each of the 9/17, 12/17 and 3 /18 quarter 10-Qs. For the fourth quarter, we estimate the benefit fell to about 1.5 cents per share. With the accounting change now anniversaried, this material benefit will be gone in upcoming quarters.**

Depreciation Expense Benefit Will Be Gone Going Forward

SYY has been reporting significantly lower depreciation and amortization expense on a year-over-year basis for the last several quarters. This has been due to accelerated depreciation relating to the shortening of estimated useful lives for an enterprise resource planning (ERP) software system which the company decided to discontinue in 2016. The system was fully depreciated in the 6/2017 quarter. SYY has been adding a portion of this accelerated depreciation back to profits in its adjusted EPS numbers to provide better comparisons. However, all of the accelerated depreciation has not been added back in historical periods, which has been a material boost to EPS growth in the last four quarters, as seen in the following table:

	6/30/2018	3/31/2018	12/30/2017	9/30/2017	7/01/2017	4/01/2017
Depreciation and Amortization	$201.8	$193.4	$190.7	$179.7	$234.7	$218.3
Net PPE	$4,521.7	$4,392.2	$4,366.3	$4,388.3	$4,377.3	$4,271.7
Intangibles	$979.8	$1,056.1	$1,056.3	$1,052.7	$1,037.5	$1,085.9
Accelerated Dep. From ERP					$45.9	$45.9
Accelerated Dep. In "Certain Items"					$28.0	$27.7
Impact on Adjusted Operating Income					$17.9	$18.2
EPS Impact	$0.024	$0.025	$0.025	$0.024		

The accelerated depreciation will now be gone from comparisons going forward which will take away a more than 2 cents per share tailwind to growth.

Self-Insurance Expense Down for the Year

SYY maintains a self-insurance program to cover portions of its workers' compensation, general and vehicle, and property insurance costs. The following table shows the development of its insurance liability account for the last three fiscal years:

	6/30/2018	6/30/2017	6/30/2016
Beginning Balance	$245.8	$199.1	$193.3
Charged to Costs and Expenses	$461.9	$523.7	$418.9
Payments	-$436.7	-$476.9	-$413.2
Ending Balance	$271.0	$245.8	$199.1

While SYY does not disclose quarterly detail on the account, we can see above that for the fiscal year ended 6/18, expenses related to the plan fell by $61.8 million or approximately 8.5 cents per share. This accounts for about 12% of the reported increase in adjusted EPS for the year. Management references this in the discussion of operating expenses in its 10-K and attributes it to a "reduction in our estimates for our reserves for our self-insurance program." We consider this a material, non-operating benefit which is not likely to repeat going forward.

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 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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