BEHIND THE NUMBERS
Quality of Earnings Analysis
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Sysco Corporation (SYY)
Earnings Quality Update- 6/21 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 keeping it on our Top Sell list.

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

Summary

After our review of the company's 10-K for the fiscal year ended 6/21, we are maintaining our earnings quality rating of 3- (Minor Concern). SYY's non-GAAP EPS of $0.71 in the 6/21 quarter topped estimates by 11 cps. However, we estimate that almost 5 cps of growth came from a decline in provision for bad debt expense as a percentage of sales even after adjustment for unusual reductions in pre-pandemic receivables allowances. A lower tax rate added another 2 cps. In addition, we believe the company's ongoing restructuring and acquisition-related charges continue to erode the quality of non-GAAP results. Despite the company's assessment that the industry recovery has been much quicker than expected and a rosy outlook for its ability to continue to grow its market share, it raised its guidance for fiscal 2022 by only 10 cps or 3% which seems cautious.

What Is Weak?

- During the first two quarters of the pandemic, SYY took unusually large provisions for bad debt to build up allowances on receivables generated prior to the onset of the pandemic as a result of the stress of lockdowns on its customers. SYY added these amounts back to its non-GAAP results in the 3/20 and 6/20 quarters. As conditions improved and visibility into the ability of its customers to pay these receivables increased, the company began to reverse some of these reserves leading to net credits for bad debt expense in the last several quarters. SYY removed these credits related to pre-pandemic receivables from its non-GAAP results. However, as we pointed out in our review of the 3/21 quarter, the company did not remove $10 million of credits related to receivables generated ***after*** the onset of the pandemic. In the 6/21 quarter, provision for bad debt after adjustments for changes in pre-pandemic allowances fell to 0.05% of sales from 0.23% in the year-ago period which we estimate added over 4.5 cps to earnings in the period.

- The allowance for bad debts as a percentage of gross receivables fell to 3 percent at the end of the 6/21 quarter from over 10% a year ago. This is still above the pre-pandemic range of around 1%, so the company could still see some benefit from adjustments to existing reserves. However, we believe the 4-5 cps tailwind experienced in the last two quarters from bringing down bad debt reserves will fade going forward.

- SYY's non-GAAP tax rate fell to 20.2% from 22.8% in the year-ago period adding 2.3 cps to earnings growth in the period. The company guided towards a 24% effective rate for the full year at the beginning of fiscal 2021 so we believe the 20.2% rate was below what most analysts' models were expecting.

What to Watch

- SYY was extremely upbeat on the call, stating that it had not seen a negative impact from the Delta variant as of the end of the June quarter. However, we note that competitor US Foods Holdings was a little more cautious on its call stating: "Most of July was also in line with May and June, but we did see in the last two weeks, a tick down of about 100 basis points. But it's too early to say whether that small change is due to the impact of the Delta variant." The possibility of disappointing dining traffic, especially if there is a surge in Delta cases in the North as the weather cools remains a significant overhang for the stock.

- SYY experienced product cost inflation of 9.6% in the quarter centered in categories like poultry, beef, paper, and consumables. Most of the company's contracts contain pass-through provisions so while gross margin may be pressured, absolute gross profit dollars growth could be relatively unscathed. However, we are more concerned about the negative impact of potential sourcing problems as the supply chain remains under considerable stress.

- SYY has hired over 6,000 new employees but implied that it would need to hire more. Management indicated that the extra costs it is incurring to attract employees have been in the form of hiring bonuses so the higher than normal costs will not be permanent. Still, difficulty finding talent of incurring higher than expected costs to bring it in remains a significant short-term risk factor.

Adjusted Provision for Bad Debt Added Over 4 cps

During the pandemic, SYY had to shore up its allowance for doubtful accounts receivable reflecting the stress faced by its customers. This forced the provision for bad debts to climb well above historical norms and SYY chose to add these amounts back to its non-GAAP earnings. However, when industry conditions improved, it resulted in the company taking credits to reverse these previously-reserved allowances. Visibility into the ability of customers to ultimately pay has improved as well as the company has taken steps such as negotiating payment terms and discontinuing interest payments for some receivables.

The company removed the resulting credits from its non-GAAP results. The following table shows the provisions (credits) used in calculating GAAP earnings, the non-GAAP adjustments, and the implied adjusted provision(credit) expense as a percentage of sales for the last twelve quarters.

	7/3/2021	3/27/2021	12/26/2020	9/26/2020
GAAP Provision (Credit) for Losses on Receivables	-$15.070	-$43.428	-$16.452	-$77.790
Provision (Credit) for Bad Debt Removed from Non-GAAP	-$22.441	-$33.473	-$30.271	-$98.629
Implied Provision (Credit) Used in Non-GAAP Earnings	$7.371	-$9.955	$13.819	$20.839
Percentage of Revenue	0.05%	-0.08%	0.12%	0.18%
EPS Impact of Change in Provision %	$0.046	$0.044	$0.002	-$0.010

	6/27/2020	3/28/2020	12/28/2019	9/28/2019
GAAP Provision (Credit) for Losses on Receivables	$190.389	$175.351	$19.706	$18.712
Provision (Credit) for Bad Debt Removed from Non-GAAP	$169.903	$153.499	$0.000	$0.000
Implied Provision (Credit) Used in Non-GAAP Earnings	$20.486	$21.852	$19.706	$18.712
Percentage of Revenue	0.23%	0.16%	0.13%	0.12%
EPS Impact of Change in Provision %	-$0.015	-$0.010	-$0.003	-$0.012

	6/29/2019	3/30/2019	12/29/2018	9/29/2018
GAAP Provision (Credit) for Losses on Receivables	$19.155	$16.144	$17.183	$10.464
Provision (Credit) for Bad Debt Removed from Non-GAAP	$0.000	$0.000	$0.000	$0.000
Implied Provision (Credit) Used in Non-GAAP Earnings	$19.155	$16.144	$17.183	$10.464
Percentage of Revenue	0.12%	0.11%	0.12%	0.07%
EPS Impact of Change in Provision %	-$0.029	-$0.025	-$0.026	-$0.016

We see that the 3/20 and 6/20 quarters saw unusually high GAAP provision expense with the company adding the bulk of those amounts back to non-GAAP results. Beginning in the 9/20 quarter, SYY began to reverse some of these reserves back into earnings which resulted in net credits to GAAP earnings. SYY has been adding back reversals of reserves taken on "pre-pandemic" trade receivables to non-GAAP results. The above table shows the implied adjusted provision (credit) used in non-GAAP earnings.

We can see that the adjusted provision expense in the 6/21 quarter fell to 0.05% of sales compared to 0.23% in the year-ago quarter. We estimate that the reduction in provision expense percentage added over 4.5 cps to earnings growth versus the year-ago quarter. While the provision percentage was unusually high in the 6/20 quarter at 0.23%, the 7/21 quarters percentage of 0.05% was unusually low. If the percentage settles back to a more normal pre-pandemic level in the 0.10%-0.12%, this sizeable boost to earnings will fade.

We also want to back up and point out that the adjusted provision amount was a credit only in the 3/21 quarter. We explained in our review of that quarter was due to the company not adjusting out a $10 million reversal of allowances provided on receivables generated ***after*** the initial wave of the pandemic. We highlighted that as a material non-operating benefit to non-GAAP results and we wonder if a similar adjustment to "post-pandemic" receivables allowances could have been the source of the unusually low adjusted provision percentage in the 7/21 quarter. There is evidence of this in the following table which shows the progression in the allowance for doubtful accounts and the allowance as a percentage of gross receivables. Note that we estimate the "write off and other" impact as an implied plug number.

	7/3/2021	3/27/2021	12/26/2020	9/26/2020
Allowance Beginning Balance	$211.607	$254.347	$265.597	$334.810
Provision for Losses on Receivables	-$15.070	-$43.428	-$16.452	-$77.790
Write Offs/Other (PLUG)	-$78.878	$0.688	$5.202	$8.577
Allowance for Doubtful Accounts	$117.659	$211.607	$254.347	$265.597
Allowance % of Gross Receivables	3.02%	6.17%	8.18%	7.88%

	6/27/2020	3/28/2020	12/28/2019	9/28/2019
Allowance Beginning Balance	$246.076	$71.612	$49.443	$28.176
Provision for Losses on Receivables	$190.389	$175.351	$19.706	$18.712
Write Offs/Other (PLUG)	-$101.655	-$0.887	$2.463	$2.555
Allowance for Doubtful Accounts	$334.810	$246.076	$71.612	$49.443
Allowance % of Gross Receivables	10.37%	6.31%	1.61%	1.11%

	6/29/2019	3/30/2019	12/29/2018	9/29/2018
Allowance Beginning Balance	$59.643	$44.418	$26.373	$25.768
Provision for Losses on Receivables	$19.155	$16.144	$17.183	$10.464
Write Offs/Other (PLUG)	-$50.622	-$0.919	$0.862	-$9.859
Allowance for Doubtful Accounts	$28.176	$59.643	$44.418	$26.373
Allowance % of Gross Receivables	0.67%	1.36%	1.06%	0.62%

SYY typically makes significant adjustments to its allowances in the June fourth quarter at the end of every fiscal year through the "write-off and other adjustments" line. We can see that the allowance as a percentage of gross receivables peaked during the pandemic in the 6/20 quarter and steadily fell to 3.02% in the 6/21 period. This is still substantially above the pandemic range of under 1%. Depending on how the Covid variant situation plays out, we could see the allowance percentage declining further over the next few quarters. Still, we don't expect the dramatic decline in provision expense as a percentage of revenue seen in the last couple of quarters can continue.

The company noted the uncertainty in the allowance situation in the 10-K:

> *"As of July 3, 2021, our pre-pandemic receivable balance outstanding is no longer significant and a majority of the amount outstanding is reserved within our allowance for doubtful accounts. The COVID-19 pandemic is more widespread and longer in duration than historical disasters that have impacted our business, and it is possible that actual uncollectible amounts will differ and additional charges may be required; however, if*

collections continue to improve, it is also possible that additional reductions in our bad debt reserve could occur."

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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