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BTN Thursday Thoughts

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"People should realize that I shot a Coke commercial back in 1986. So, you know, I've been around a long time. I carry my Screen Actors Guild card."

-Kato Kaelin

Earnings Quality Review

The Coca-Cola Company (KO)

Intro:

We are adding Coca-Cola (KO) to the list of large cap companies whose earnings we will regularly review for earnings quality issues. We have been following the KO saga since the 1990s and have issued multiple warnings over the years on both KO and its former bottling partner, Coca Cola Enterprises. This report serves mostly as a primer on the history of the company's relationships with its bottlers and how that has impacted the company's reported results.

Our concerns with KO are longer-term in nature. The company could very well enjoy some good quarters in the near-term as it finalizes the refranchising of its company-owned bottling assets. However, we believe the underlying problem of the lower return bottling operations has not been eliminated and will at some point come home to roost and cause investors to question KO's premium valuation.

Our Observations

- KO's recent refranchising of its North American bottling operations marks just the latest move to shuffle the lower-margin, higher-debt assets off its books. Over the last

30 years, the company has cycled through buying bottlers, spinning them off, and then buying them back to shore them up.

- Removing the bottling operations' low margins immediately makes KO's results look better. However, if history is any guide, the bottlers will require considerable support from KO to thrive. We do not see how the new bottler agreements based on bottler gross margin will alleviate this problem. Analysts' expectations for margins to exceed levels seen the last time Coca Cola Enterprises was off the books seem very optimistic.

- Regular restructuring costs and write-downs cloud results. Intangible bottling franchise assets were slashed to a fraction of their original value while on CCE's books and were cut again prior to being refranchised. Regular charges have included amounts such as costs related to internal Coke employees and IT costs that can lead to overstated adjusted results.

- Volumes still remain flat as a more health-conscious population moves away from soft drinks. KO's moves into water, juices and teas have helped, but these carry lower margins and have much less consumer loyalty than the flagship Coke brand. City governments from Philadelphia to Abu Dhabi have already sighted in on soft drinks and energy drinks with punitive taxes as these beverages become the "new tobacco."

Understanding the Relationship Between KO and Its Bottlers

From the inception of the company in 1886, KO has never sold Coke in a bottle. The company initially sold syrup to drug stores and soda fountains who mixed it with water and served it directly to their customers. The beginning of the modern distribution system dates back to 1899 when the company granted the rights to bottle and sell Coke to two Tennessee attorneys who, in turn, sold the rights to businesses that eventually set up over 400 different bottling plants nationwide. Over time, this network consolidated into a few larger bottlers. As retail customers consolidated and gained power, KO had to invest in its bottlers to keep them competitive. In the early 1980s, KO began to buy some of its larger US bottlers, including the Coca-Cola Bottling Company of New York, Associated Coca-Cola Bottling Company, and the bottling operations from Beatrice Foods. In 1986, it combined its owned North American bottlers and spun them off as a separate company called Coca-Cola Enterprises (CCE). CCE and other "anchor bottlers" around the world began to acquire smaller bottling operations to create a handful of large, independent bottlers.

Distortions Created by the Anchor Bottling Relationship

The original KO anchor bottler system was essentially made up of two very different business types- the very profitable KO and its low-margin, high-debt bottling system. Under the bottling agreements, KO was allowed to set the price of the syrup concentrate it sold to its bottlers and the bottlers set the price they charged the end customer for the final product. KO received praise (and high multiples) from the market for its legendary brand name, growth, and high profitability. Meanwhile, volatile raw materials and fuel costs, pushback on prices, and mounting debt loads experienced by the bottlers were kept off of KO's books. In addition, KO sold bottling operations and other assets to Coca Cola Enterprises and booked gains on those sales, calling into question whether the deals were done at arm's length. There was even talk in the late 1990s of the SEC considering forcing KO to consolidate its bottlers even though it owned well less than the 50% share requiring consolidation.

This highlights the major challenge for KO. If it leaves the bottling operations on its financial statements, it will report lower profits and returns and higher debt loads. If it reduces its interest below 50% and removes the bottlers from its reported operating results, it will show healthier returns, but it will still have to support the bottlers with ongoing marketing spending, price concessions and regular large investments to keep them competitive. Investors must always consider the KO/bottler system when the bottlers are separated, not just KO's stand-alone results.

The following table shows KO's gross profit and pre-charge operating income margin for the last 16 years:

	12/31/2017	12/31/2016	12/31/2015	12/31/2014	12/31/2013	12/31/2012	12/31/2011	12/31/2010
Sales	$35,410	$41,863	$44,294	$45,998	$46,854	$48,017	$46,542	$35,119
Gross Profit	$22,154	$25,398	$26,812	$28,109	$28,433	$28,964	$28,327	$22,426
Gross Margin	62.6%	60.7%	60.5%	61.1%	60.7%	60.3%	60.9%	63.9%
Operating. margin	27.3%	24.2%	23.4%	23.7%	23.7%	23.4%	23.4%	26.4%

	12/31/2009	12/31/2008	12/31/2007	12/31/2006	12/31/2005	12/31/2004	12/31/2003	12/31/2002
Sales	$30,990	$31,944	$28,857	$24,088	$23,104	$21,742	$21,044	$19,564
Gross Profit	$19,902	$20,570	$18,451	$15,924	$14,909	$14,068	$13,282	$12,459
Gross Margin	64.2%	64.4%	63.9%	66.1%	64.5%	64.7%	63.1%	63.7%
Operating margin	27.6%	27.5%	26.0%	27.0%	26.7%	28.4%	27.5%	27.9%

On 10/2/2010, KO acquired the North American bottling operations of Coca Cola Enterprises (CCE). The dramatic impact on margins can be seen between 2011 and 2010. In addition to having lower margins, CCE, like all the bottlers, is very exposed to the volatile prices of aluminum, plastic, and fuel. The following table shows results for CCE for the nine years leading up to KO's acquisition of its North American operations:

	2009	2008	2007	2006	2005	2004	2003	2002	2001
Sales	$21,645	$21,807	$20,936	$19,804	$18,743	$18,158	$17,330	$16,058	$14,999
Cost of Sales	$13,333	$13,763	$12,955	$12,067	$11,258	$10,771	$10,165	$9,458	$9,015
Gross Profit	$8,312	$8,044	$7,981	$7,737	$7,485	$7,387	$7,165	$6,600	$5,984
Selling, delivery and admin	$6,785	$6,718	$6,511	$6,310	$6,054	$5,951	$5,588	$5,236	$5,383
Operating income	$1,527	$1,326	$1,470	$1,427	$1,431	$1,436	$1,577	$1,364	$601
Gross margin	38.4%	36.9%	38.1%	39.1%	39.9%	40.7%	41.3%	41.1%	39.9%
Operating margin	7.1%	6.1%	7.0%	7.2%	7.6%	7.9%	9.1%	8.5%	4.0%
Franchise license impairment charges		$7,325		$2,922					

Slowing industry growth, fewer acquisition opportunities, rising material and fuel costs, and competitive pressures all led to a string of margin declines from 2003 to 2008. Ironically, CCE saw its margins improve in 2009 prior to the acquisition, but after adjustment for materials costs, gross margin would have still declined in that period as well.

It is also imperative to note the more than $10 billion in impairment charges taken by CCE during the period to write down the value of intangibles related to its franchise licenses. In 2006, CCE's regular impairment testing determined that the fair value of those intangibles had declined due to changes in "anticipated growth rates by geographic region, our long-term anticipated growth rate, the discount rate, and estimates of capital charges." Reasons

given for the 2008 write down included difficult macroeconomic conditions in the US, and current and forecasted cost increase for key cost of sales inputs. Franchise licenses were valued at $13.8 billion in 2005 and accounted for 55% of CCE's total assets and 245% of book value. The two write-offs represented an almost 75% reduction of that asset. While investors are quick to shrug off such charges, the move indicated that the right to distribute Coke in the US was suddenly worth 25% of what it was once thought to be.

Throughout this time, KO was also helping support CCE through cash payments, largely to cover marketing and promotional spending. KO's bottler agreements do not oblige it to pay for any marketing activities, but it is obviously in its best interest to do so. The following table shows KO's net payments to CCE:

Payments from KO to CCE	2009	2008	2007	2006	2005	2004	2003	2002	2001
Cash payments made to CCE	$742	$916	$939	$800	$769	$795	$862	$837	$606
Cash payments made to CCE customers	$174	$131	$123	$113	$136	$104	$214	$204	$282
Marketing reimbursements from CCE	-$330	-$316	-$299	-$279	-$245	-$246	-$221	-$264	-$252
Net payments to CCE	$586	$731	$763	$634	$660	$653	$855	$777	$636
Payments as % of KO Sales	1.9%	2.3%	2.6%	2.6%	2.9%	3.0%	4.1%	4.0%	3.6%

Despite cutting back on its support of CCE, payments made to the bottler ranged from 2-4% of KO's total sales. Keep in mind that this was just one bottler.

The Refranchising

According to KO management, the acquisition of CCE was the first step in a long-term plan to refranchise its North American bottlers. This quote is from an October 2017 press release:

> *"The Coca-Cola Company began working with its bottling partners a decade ago on plans to develop a model that evolves the system to serve the changing customer and consumer landscape with a focus on creating stronger system alignment."*

Beginning in 2013, KO began the "refranchising" of its bottling units by granting new comprehensive bottling agreements (CBAs) to existing independent Coca-Cola bottlers. At the same time, it sold the related bottling assets to these bottlers. In Europe, the company created Coca-Cola European Partners by merging its European bottling assets with CCE's remaining European bottling operations. It also returned company-owned bottling operations to independent bottlers in China and Africa.

New CBAs Don't Seem to Solve the Problem

The main reasons given for the refranchising is to allow the local bottlers to use their flexibility to better serve their respective markets. In addition, the new CBAs are being touted as better aligning the interests of the bottlers and KO to allow the two groups to "grow together".

As noted above, KO's past arrangements with its bottlers have given it complete discretion in setting the price of its concentrate that it charges its bottlers. It also supported the bottlers' marketing efforts as it saw fit. However, the CBAs being granted to the newly refranchised territories call for the company to make quarterly payments based on their gross profits in the refranchised territories. The company has also touted its "incidence-based pricing" offered to bottlers whose territories were not expanded by the refranchising. Consider the quote from the most recent 10-K:

> *"Also, in some markets, in an effort to allow our Company and our bottling partners to grow together through shared value, aligned incentives and the flexibility necessary to meet consumers' always changing needs and tastes, we worked with our bottling partners to develop and implement an incidence-based concentrate pricing model. Under this model, the concentrate price we charge is impacted by a number of factors, including, but not limited to, bottler pricing, the channels in which the finished products are sold and package mix."*

This is all well and good. **However, the problem we see is that analysts are expecting KO's gross margins to not only reach levels seen when CCE was not on its books, but to actually exceed them by 2019. If the new agreements truly do result in a more equal sharing of the lower margins and the volatility inherent in the bottling business, we simply don't see how this is reasonable to expect this level of profitability to be reached and maintained, particularly in an environment where retailers seem to gain more power every day.** As we will discuss in a later section, conditions in the beverage industry do not look to get any easier than they were in the early 2000s, which leads us to believe that these expectations will either prove to be overly-optimistic in the next couple of years, or the cycle of charges and write-offs resulting from deteriorating conditions at the bottlers will begin all over again.

Charges Cloud Results

The endless shuffling of assets at KO has resulted in a myriad of various types of charges on the company's income statement. As we noted above, CCE had to take massive write-offs to the value of its intangible franchise rights in the mid-2000s, so large charges and write-offs are not uncommon in the KO empire. The following table documents just some of the "one-time" items that have appeared in KO's results in the last few years:

	2017	2016	2015	2014	2013	2012	2011	2010
Impairment of CCR assets	$737							
Impmt. of intang & goodwill - US & Pac. bottler franchise rights		$153			$195			
Charges related to German bottling integration and CCE		$240	$292	$208	$188	$163	$119	$153
Productivity & Reinvestment Initiatives- includes integration of CCE	$650	$352	$691		$494	$270	$156	$190
Costs to refranchise bottlers (includes internal and IT costs)	$422	$297						

The $737 million impairment of CCR (Coca-Cola Refreshments) assets included a write down of $375 of goodwill and $310 million of PP&E. CCR is the company's owned bottling unit that consisted largely of the acquired CCE assets. As we noted above, CCE had already taken huge write-downs to its intangibles multiple times in the past. The 2017 charges were related to the refranchising of those assets and reflect management's estimate of fair value and the proceeds to be received in the refranchising.

KO also incurred regular charges over several years totaling well over $1 billion to cover the integration of its acquired German bottling operations as well as CCE prior to being refranchised. In addition, the company incurred almost $3 billion in productivity and reinvestment initiatives over the last several years that were labelled as "one-time" in nature. Also, in the last two years, KO incurred $719 million in costs to refranchise the bottlers. KO's 10-K states that:

> *"These costs include, among other items, **internal** and external costs for **individuals directly working on the refranchising efforts**, severance, pension settlement charges and **costs associated with the implementation of information technology systems** to facilitate consistent data standards and availability throughout our bottling systems."*

We look at costs such as KO employees working on the refranchising and costs to implement technology systems at the bottlers as being operational in nature. Adding them back to profits leads to artificially high adjusted earnings. Similar activity is certainly possible in the ongoing "productivity and reinvestment charges" noted above.

In short, the ongoing stream of large charges makes it difficult to get a handle on what real operational costs will be going forward. With the refranchising now winding down, it will be concerning if such unusual charges continue to pop up.

Also, on a more existential level, the huge write-downs to the value of franchise rights over the years should draw attention to the remaining intangible assets on KO's books. Warren Buffet's mentor, Ben Graham, was not a believer in placing a high value on intangible assets. Yet in the 1990s, Buffet heralded KO's highly-prized trade name as having a value as solid as any real asset. This may have been the case in the 1990s when everyone on the other side of the newly-fallen Berlin Wall wanted to start drinking Coke, and memories of the cherub-faced, Coke-drinking Santa were still fresh on everyone's mind. Now, however, millennials can't sing "I'd Like to Buy the World a Coke" and cities around the world are imposing hefty taxes on soft drinks, as we will discuss more below. The real value of the over $16 billion in goodwill and trademarks with indefinite lives on KO's balance sheet seems a little less certain to us.

Conditions in the Beverage Market

It is no secret that makers of soft drinks have struggled in the last few years as saturation and a more health-conscious population have resulted in declines in soft drink consumption. KO has responded by branching into bottled water, bottled teas, juices and energy drinks. While the company can certainly be successful in these areas, it is a much harder business than selling Coke 20 years ago. Margins on most of these products are significantly below those of soft drinks, and while there has been a huge increase in the consumption of bottled water over the years, there is much less brand loyalty than with soft drinks. What's more, the Coke trademark means next to nothing in these areas. There are no children on the other side of the world who dream of someday coming to America so they can drink a *Desani* water. All of this means increasing price pressure and having to spend more on advertising to maintain market share.

KO has certainly not given up on its core soft drink business. It has shrewdly tried to tap into the health-conscious wave by offering Coke branded products with no or lower sugar content. It has also introduced smaller can sizes to supposedly limit consumption. (We can't help but believe that the "this has half the calories, so I can have twice as much" logic kicks in when most consumers open their fridges.) These smaller cans can lead to lower sales, but higher margins. While such efforts may help in the short-run, we believe it may prove to be "putting a finger in the dike." The way consumer health activists have targeted soft drinks

and energy drinks resembles the way tobacco was targeted 30 years ago. New York has moved to limit serving sizes and Philadelphia has imposed restrictive taxes on sodas. Such government intrusions are not limited to the developed West. The following article documents how Abu Dhabi recently imposed 100% taxes on all tobacco products and energy drinks and a 50% tax on all carbonated beverages. The tobacco companies will testify as to how once governments realize they can raise tax revenues by assuming the role of champions of public health, things can snowball quickly. We therefore see a meaningful risk of negative headlines for the soft drink makers in the future.

Foreign Currency Risk

Investors should also consider the foreign currency risk faced by KO. As much as Coke is viewed as an American icon, almost 60% of its revenues came from outside of the US in 2017. The company deals with 73 functional currencies from around the world, and in many cases, decreases in the value of one are often offset by increase in another. Nevertheless, a pronounced, uniform strengthening of the US dollar can meaningfully stunt reported growth. For example, currency movements negatively impacted revenue growth by 1% in 2017. However, simultaneous declines in the Mexican peso, and South African rand and the Brazilian real led to a reduction in KO's sales growth of 3% in 2016.

Foreign currency can also be a serious problem for some of the company's bottling partners with operations in emerging economies. For example, Coca-Cola Amatil, KO's Australian bottling partner, has seen its growth stunted in the past by its Indonesian operations when the Indonesian rupiah declined against the Australian dollar. This represents a small, indirect risk to KO if it were to lead to a bottling partner having difficulties that necessitated KO's involvement.

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