BEHIND THE NUMBERS
QUALITY EQUITY INCOME SOLUTIONS

BTN Thursday Thoughts

Jeff Middleswart
Bill Whiteside, CFA
btnresearch.com

April 26, 2018

Contents

Welltower (WELL) Chases Another Mess-Round 2 p. 1

Quarterly Reviews on:

Twitter (TWTR) p. 7

Kimberly Clark (KMB) p. 9

Coca-Cola (KO) p.16

If you're not confused, you're not paying attention.
-Tom Peters

Welltower (WELL) Chases Another Mess-Round 2

We wanted to get some initial thoughts out following Welltower's (WELL) latest merger/acquisition deal. Welltower, based in Toledo, Ohio, is setting up an 80/20 JV with ProMedica based in Toledo, Ohio whereby ProMedica will acquire HCR ManorCare which is based in Toledo, Ohio and is in bankruptcy. We're not sure the city of Toledo has seen this much activity since Klinger used to describe it on MASH. As part of this deal, Welltower will acquire the real estate assets of HCR ManorCare by purchasing its landlord, Quality Care Properties, for $20.75 per share in cash. That is essentially $2.0 billion in cash and $1.8 billion in debt. Quality Care Properties would violate its debt covenants if it fails certain financial tests or receives a Going Concern Warning from its auditors. It essentially believes that it can avoid this if HCR ManorCare restructures.

Much like Genesis that was one of Welltower's largest tenants, HCR ManorCare was squeezed on revenues and margins by more revenues coming from Medicare/Medicaid which were under pressure, patients staying shorter times in post-surgery centers, and rising wages for Skilled Nursing Care. This has been a problem for many years. In fact, these assets were spun-out of HCP – which is one of Welltower's competitors - in October 2016.

As part of the bankruptcy plan for HCR ManorCare, it was going to be acquired by Quality Care Properties and the leases restructured – that would mean restructured down, by the way, not up. Now HCR will go to ProMedica and the real estate to Welltower under a master lease for 70% post-acute surgery centers and 30% assisted living. The 8% cash yield has a 1.375% escalator in year 1 and 2.75% in years 2-15. ProMedica is expected to invest $400 million in upgrades for the property over 5 years.

Let's quickly look back on what HCP thought of this property:

> *HCRMC, a provider of a range of healthcare services, primarily in post-acute care, skilled nursing care and assisted living, is our largest tenant, representing 23% of our gross assets and revenues as of and for the year ended December 31, 2015.* ***In April 2011, we completed a $6 billion acquisition of substantially all the real estate assets of, and an equity interest in, HCRMC.***
>
> ***In the first quarter 2015, we recorded an impairment charge of $478 million*** *related to the real estate portfolio master leased to HCRMC, based on the present value of the future lease payments under the amendment to the master lease with HCRMC that became effective April 1, 2015.* ***As a result of HCRMC's fourth quarter 2015 performance deterioration and related decline in fixed charge coverage, we subsequently placed the real estate portfolio master leased to HCRMC on "Watch List" status effective at year-end 2015, and changed our accounting treatment to recognize rental income on a cash basis beginning January 1, 2016. Furthermore, HCRMC's preliminary 2016 forecast indicates only limited improvement in its fixed charge coverage and free cash flow after capital expenditures in 2016****. Accordingly, we assessed the value of this real estate portfolio, including obtaining an independent valuation appraisal of our post-acute/skilled nursing and senior housing facilities.* ***As a result, we reduced the carrying value of this real estate portfolio to $5.2 billion, approximating its estimated market value, which resulted in an impairment charge of $817 million recorded in the fourth quarter of 2015.***
>
> ***In the fourth quarter of 2014 and the third quarter of 2015, we recorded impairment charges of $36 million and $27 million, respectively, for our equity ownership interest in HCRMC.*** *These impairment charges resulted primarily from our review of their 2015 preliminary base financial forecast, operating results and other financial information provided by HCRMC, as well as market and industry data that, among other factors, showed a declining trend in admissions from hospitals and continuing*

trends in mix and length of stay driven by Medicare Advantage and other Managed Care plans. ***As a result of HCRMC's fourth quarter 2015 performance deterioration, we recorded an additional impairment charge of $19 million for our equity ownership in HCRMC, reducing its carrying value to zero."***

So, HCP bought these assets for $6 billion in 2011. In October 2016, the assets were sold to Quality Care Properties (QCP):

"In connection with the consummation of the Spin-Off, QCP and its subsidiaries transferred $1.69 billion in cash and 94 million shares of QCP common stock to HCP and certain of its other subsidiaries, and HCP and its applicable subsidiaries transferred the assets comprising the QCP portfolio to QCP and its subsidiaries. HCP then distributed substantially all of the outstanding shares of QCP common stock to its stockholders, based on the distribution ratio of one share of QCP common stock for every five shares of HCP common stock held by HCP stockholders as of the October 24, 2016 record date for the distribution. The Company recorded the distribution of the assets and liabilities of QCP from its consolidated balance sheet on a historical cost basis as a dividend from stockholders' equity of $3.5 billion, and no gain or loss was recognized. The Company primarily used the $1.69 billion proceeds of the cash distribution it received from QCP upon consummation of the Spin-Off to pay down certain of the Company's existing debt obligations."

HCR ManorCare filed bankruptcy in March 2018 and <u>is threatening to earn Quality Care a Going Concern Warning.</u>

"In November 2016, we provided to HCR III reductions of contractual rent due *under the Master Lease as follows: a $5 million reduction for the month of November 2016, a $15 million reduction for the month of December 2016 and a $10 million reduction for the month of January 2017. HCR III paid in full the reduced rent due for the months of November 2016, December 2016 and January 2017 and the contractual rent due for the months of February 2017 and March 2017.*

On April 5, 2017, the Company entered into a forbearance agreement *(the "First Agreement") with HCR III and HCRMC (together, "HCR ManorCare"). Among other things, the First Agreement required HCR ManorCare to make* ***cash rent payments of $32 million for each of April, May and June of 2017, with a deferral of payment of the additional $7.5 million per month*** *otherwise due until the earlier of (i) July 5, 2017 and (ii) an early termination of the First Agreement, with all deferred amounts becoming immediately due and payable upon an early termination. The First*

Agreement also required HCR ManorCare to deliver its 2016 audited financial statements and auditor consent to QCP not later than April 10, 2017, which were received on April 10, 2017 and included a "going concern" exception for HCR ManorCare in the auditor opinion.

During the term of the First Agreement, QCP also agreed to provide HCR ManorCare with a temporary secured extension of credit of up to $7 million per month *during each of April, May and June of 2017 (up to $21 million in the aggregate), which would be due and payable in full not later than December 31, 2017, subject to acceleration upon certain events.*

HCR ManorCare made the reduced cash rent payments of $32 million for each of April and May of 2017. HCR ManorCare borrowed $7 million for April 2017 under the temporary secured credit agreement. *On June 2, 2017, QCP received $15 million from HCR ManorCare, constituting $8 million of rent and repayment of the $7 million secured loan extended pursuant to the First Agreement, rather than the full $32 million in rent required to be paid for June 2017 under the terms of the First Agreement. HCR ManorCare was then required to pay approximately $39.5 million in monthly rent under the Master Lease. On July 7, 2017, QCP received approximately $8.2 million from HCR ManorCare. On July 7, 2017, QCP delivered a notice of default under the Master Lease relating to nonpayment of rent due and other matters. The notice of default demanded payment of all current and past due rent, totaling approximately $79.6 million, by the end of the day on July 14, 2017. Such amount was not paid, and therefore, an event of default exists under the Master Lease, causing an additional approximately $265 million of Tranche B DRO to become immediately due and payable and permitting the QCP lessors to terminate the Master Lease, appoint receivers or exercise other remedies with respect to any and all leased properties. On August 3, 2017, QCP received approximately $23.0 million in rent from HCR ManorCare."*

So, they have restructured the rent and reduced it, allowed HCR ManorCare to borrow money from Quality Care to pay the rent to Quality Care, and then receive partial payments and eventually a default.

In the current bankruptcy plan – here is what Quality Care agreed to in modifying the lease further:

"Upon completion of the HCRMC Transactions, QCP will enter into an amendment to the Master Lease (the "Master Lease Amendment"). The Master Lease Amendment

> *will provide that, among other things, until the seventh anniversary of the closing date,* ***HCR III will be permitted to defer paying any portion of the monthly minimum rent due to QCP to the extent that HCR III does not have cash and cash equivalents available to make such payment in a calendar month after HCR III retains amounts reasonably required, taking into account projected receipts, to satisfy HCR III's monthly cash needs and liabilities reasonably anticipated to be paid in cash within 90 days of the first business day of such calendar month.*** *This new deferred rent obligation will be due and payable upon the earlier of the seventh anniversary of the effective date of the Prepackaged Plan or the occurrence of certain other specified events. Upon completion of the HCRMC Transactions, the Tranche B DRO will be eliminated and any accrued but unpaid rent under the Master Lease released pursuant to the Master Lease Amendment. Within seven days of completion, HCRMC's guaranty of the Master Lease will be terminated, released and discharged."*

Coming OUT of bankruptcy, the parties involved still think HCR ManorCare will have cash flow problems caused by the margin squeeze of rising wages and revenue payments from the government. They were building in room for HCR to skip paying 100% of rent for 7-years after bankruptcy!

We need to read much more on this transaction and had planned on Welltower being an update for next week until they pushed up their earnings to announce this deal. But, our initial take is we don't like this deal for several reasons:

1. It increases the exposure Welltower has to one of the toughest parts of the market. One that Welltower has already experienced problems with.
2. Wage increases, shorter patient stays, as well as being paid by the government are all part of this market.
3. Government changes do not necessarily help. We are aware of a BDC (Business Development Company – OHA Investments) that lent money to a homecare medical service called OCI. OCI relied on State of Texas reimbursement and it was cut two years ago making OCI unable to pay its loan except in stock.
4. We have not looked yet, but given the financial troubles HCR ManorCare and Quality Care Properties have had, has maintenance been done on these properties in recent years? That may explain the proposed $400 million in upgrades ProMedica has planned.
5. The rent increases that are being baked in – Welltower had this same deal with Genesis that is has been trying to get away from via asset sales and modifications to leases.

Speaking of Genesis, Welltower extended them a larger loan in March 2018 with an additional $40 million and no amortization of principal until maturity. Also, Welltower cut the rent on the Genesis master lease again in February 2018:

> *"On February 21, 2018, we entered into a definitive agreement with Welltower to amend the Welltower Master Lease (the Welltower Master Lease Amendment). The Welltower Master Lease Amendment reduces our annual base rent payment by $35 million effective retroactively as of January 1, 2018, reduces the annual rent escalator from approximately 2.9% to 2.5% on April 1, 2018 and further reduces the annual rent escalator to 2.0% beginning January 1, 2019. In addition, the Welltower Master Lease Amendment extends the initial term of the master lease by five years to January 31, 2037 and extends the renewal term of the master lease by five years to December 31, 2048. The Welltower Master Lease Amendment also provides a potential upward rent reset, conditioned upon achievement of certain upside operating metrics, effective January 1, 2023. If triggered, the incremental rent from the rent reset is capped at $35 million."*

On that new loan just mentioned of $40 million, Genesis can pay 5% in cash interest and 5% more paid in-kind (PIK). They also restructured the first part of that loan so that 5% is paid in cash and 9% PIK. And, Welltower modified the bridge loan so that the 10.25% cash interest will now be 7% cash and 5% PIK. In addition, as part of a new omnibus agreement in March, Welltower will agree to write off $50 million of outstanding debt and take $50 million in Genesis stock, if Genesis can raise new capital to pay down its Welltower debts.

When we saw this HCR ManorCare JV put together from an HCP spin-off, it looked very similar to when Sunrise was in trouble and Welltower bought it to protect its rent payments. Then, Welltower sold Sunrise to its other customer Revera. Revera sold its troubled assets to Genesis and Welltower tried to exit that scene. Both deals have very similar events including Going Concern Warnings.

We're going to update this whole situation more over the next several days. There's more to look at than we can complete in one morning.

Twitter (TWR)- 3/18 Quarter

The company reported strong results that handily beat guidance for the first quarter with Adjusted EBITDA of $244 million vs. guidance of $185-$205 million. One of the biggest drivers of this outperformance was continued slow expense growth–which Twitter specifically called out to expect as a drag for 2018. From the 4Q17 earnings news:

> CEO Jack Dorsey – "We're investing to make 2018 a year of growth and expect our expenses to more closely align with revenue after a year of significant margin improvement."
>
> CFO Ned Segal – "If you look at expense growth, there may be opportunities to rationalize costs, but we're really focused on investing to grow in 2018. We'll invest in the product, both in our information quality efforts and in driving audience and engagement. And we'll also invest in sales to make sure that we've got the right folks on the ground talking to advertisers about all the great things happening on Twitter right now. So it's those investments that ought to cause expenses to more closely align with revenue and would be the reasons that margins ought to look a lot more like 2017, then expanding from here after a year of significant margin improvement."

4Q is traditionally stronger than 1Q. In beating forecasts, Twitter pointed out that seasonality played a role, as it did not add people as rapidly as planned. The company pointed out that its guidance for $100-$110 million in stock compensation expense came in much lower at $73 million.

We expected after 2017, when R&D was cut by over $170 million, to see a little bit more growth in 1Q18 as the company was moving back to spending mode. However, costs overall were essentially unchanged. Before stock compensation, R&D rose only $5 million, sales and marketing by only $1 million and $10 million in cuts to G&A offset those. The company indicated that investors should not expect this type of expense reduction to continue and DID NOT raise guidance for the year:

> "However, we face increasingly difficult comparables in the second half of 2018 as we approach the anniversary of the broad-based recovery that began in the second half of 2017. **As a result, we continue to believe that our sequential growth rates for total revenue for the remainder of 2018 will resemble the sequential growth rates for total revenue in 2016.**

> SBC expense in the quarter was $73 million, a decrease of 37% year-over- year and below our guidance range of $100 million to $110 million, primarily due to the timing of employee stock grant issuances. There is no long-term change to our trajectory or full year guidance with respect to SBC. We grew headcount sequentially again in Q1 and ended the quarter with more than 3,400 employees. **We expect to grow headcount 10-15% year-over-year in 2018, as we continue to invest in our priorities**, including improving the overall health of the platform, ongoing audience and engagement growth, improving ad products, and investments in sales."

So, if Twitter still sees revenue growth and expense growth to be roughly equal in 2018, there is some considerable reversion coming when expenses should be expected to rise faster than sales during this year. The comps are tougher which would lend credence to that also. We would expect expense growth to crimp EBITDA and thus cash flow.

We remain more concerned with sustainable cash flow performance. We noted a few weeks ago that Twitter might be already using fully depreciated equipment after slashing capital spending in both 2016 and 2017 and raising the estimated life of assets. Even with that life change, depreciation was still exceeding capital spending for a company that is supposed to be growing and investing.

Capital spending guidance of $375-$450 million in 2018 would be a turnaround in that area, and Twitter did spend $109 million in 1Q18. However, that comes after several quarters of the lowest levels seen since 2014. In 2017, quarterly spending was $77 million in Q1 and Q2 before falling to $64 million and $63 million to finish the year. We believe capital spending will need to ramp up more than forecast. It is interesting to note that accrued property and equipment purchases that jumped $40 million in 4Q17, fell $3 million in 1Q18.

Depreciation was $97 million in 1Q18 vs. the $109 million in spending. However, adding to the idea that the equipment at Twitter is older – they called out that part of their cost savings in 1Q18 was due to a $23 million y/y reduction in depreciation due to assets that are now fully-depreciated. We would not be surprised if Twitter needs to raise spending here and that would also crimp cash flow.

It is worth noting that despite the large increase in margin due to expenses rising less than forecast, Twitter's overall cash flow still relies on paying wages in stock and either not making acquisitions at all or paying for them with stock also:

$ in millions	1Q18	1Q17	4Q17
Cash from Ops	$243	$198	$203
Less Stock Comp	$73	$102	$117
Less CapX	$93	$40	$40
Less Cap Lease CapX	$16	$23	$37
Free Cash Flow	$60	$33	$9
Past Cap Lease Debt Paid	$24	$22	$27

Cutting costs and slashing capital spending drove free cash flow. Yet, if the costs bounce back as the company is forecasting and the capital spending is rising again, would this company really have much free cash flow if it cannot use stock as a wage? And, it still has to make the debt payments on past lease purchases.

Kimberly-Clark (KMB)-3/18 Quarter

Kimberly Clark (KMB) reported adjusted EPS of $1.71 in the 3/18 quarter, in-line with consensus estimates. Revenue rose by 5%, ahead of estimates aided by a 3% currency tailwind, yielding one of the strongest organic revenue performance in the last several quarters, albeit against easy comps.

Summary Points:

- While volume growth accelerated to 3% in the quarter, pricing had to fall by 1% to drive it. However, management initiated price increases and sheet/diaper count reductions in the quarter which will begin to be felt in the second quarter. Failure to stick or obvious volume weakness in the next couple of quarters will likely be punished by the market.

- Overall volume was aided by a 9% increase in Tissue driven by a very strong flu season, increased promotional spending and the timing of promotions versus last year.

- Adjusted gross margin fell 310 bps as pricing and rising raw materials prices (namely pulp) took their toll. Management increased its estimated impact from raw materials inflation to $400-$550 million in 2018, up $100-$150 million from its original estimate made just three months ago.

- Advertising spending continues to fall, even as private label makes inroads. Rising advertising/promotional spending would seem necessary in this environment, particularly as management tries to push through price increases.

- Inventory days of sales fell sharply in the quarter, with all of the decline centered in its LIFO inventories. This indicates either a LIFO liquidation in its North American inventories, or a possible shift to more inventories being accounted for under FIFO which would be an artificial benefit to margins.

Pricing Remains Pressured

KMB is still very much caught up in the struggle faced by its consumer products peers. Positive volume growth has only come with pricing concessions. The following table shows the breakdown of sales by segment for the last eight quarters:

CONSOLIDATED	3/18	12/17	9/17	6/17	3/17	12/16	9/16	6/16
Volume	3%	0%	1%	0%	1%	2%	0%	4%
Price	-1%	-2%	-1%	-1%	-1%	0%	0%	0%
Mix/Other	0%	1%	0%	0%	0%	-1%	-1%	-1%
Acquisition	0%	0%	0%	0%	0%	0%	0%	0%
FX	3%	1%	1%	0%	1%	-1%	-2%	-4%
Total	5%	1%	1%	-1%	0%	0%	-3%	-1%
Organic	2%	-1%	0%	-1%	-1%	1%	-1%	3%
PERSONAL CARE (49%)								
Volume	1%	2%	-1%	0%	2%	3%	3%	6%
Price	-2%	-3%	-1%	-1%	-2%	0%	-1%	-1%
Mix/Other	1%	1%	0%	1%	0%	-1%	-1%	0%
Acquisition	1%	1%	0%	0%	0%	0%	0%	0%
FX	2%	1%		0%	2%	-1%	-3%	-6%
Total	3%	2%	-1%	0%	2%	1%	-2%	-1%
Organic	*0%*	*0%*	*-2%*	*-1%*	*0%*	*2%*	*1%*	*5%*
TISSUE (34%)								
Volume	7%	-1%	4%	-1%	-2%	0%	-2%	3%
Price	0%	-1%	-1%	-1%	-1%	0%	0%	0%
Mix/Other	-2%	0%	0%	0%	0%	0%	0%	-1%
Acquisition	0%	0%	0%	0%	0%	0%	0%	0%
FX	3%	2%	1%	0%	0%	-1%	-2%	-2%
Total	9%	-1%	3%	-2%	-3%	-1%	-4%	0%
Organic	*5%*	*-2%*	*2%*	*-2%*	*-3%*	*0%*	*-2%*	*2%*
KC PROFESSIONAL (18%)								
Volume	2%	1%	2%	1%	0%	1%	-2%	-1%
Price	0%	0%	-1%	-1%	-1%	0%	1%	1%
Mix/Other	0%	0%	0%	0%	1%	0%	0%	0%
Acquisition	0%	0%	0%	0%	0%	0%	-2%	0%
FX	3%	2%	1%	0%	1%	-1%	0%	-2%
Total	5%	3%	3%	0%	1%	0%	-3%	-2%
Organic	2%	1%	2%	1%	0%	1%	-1%	0%

We highlight several points from the above table:

- As noted above, volume growth did accelerate, but it took a fifth straight quarter of pricing cuts to achieve this. Pricing has not been positive in the last eight quarters.

- The bulk of the volume increase came from the Tissue segment which benefitted from an unusually severe flu season and easy comparisons as well as the timing of promotional activity versus last year. The -2% impact from mix/other was a result of this promotional spending.

- Volume growth of 1% in Personal Care was much less impressive and required a 2% cut in prices to achieve. Pricing has been particularly difficult in this segment with declines in seven of the last eight quarters.

Gross Margins Were Crushed from Cost Inflation

In addition to negative pricing, KMB's margins were negatively impacted by rising pulp prices, which are a main component in both tissues and diapers. Adjusted gross margin fell by 310 bps in the quarter. In addition, management increased its estimated impact from raw materials inflation to $400-$550 million in 2018, up $100-$150 million from its original estimate made just three months ago. While admitting pulp prices have increased significant beyond its expectations, it is anticipating they will begin to moderate in the second half of the year.

The company seems more optimistic about the pricing environment than PG and has initiated price increases during the first quarter it expects to benefit second quarter results. In addition, it has begun to reduce the number of sheets in certain tissue products as well as reduce diaper counts as a stealth price increase. KMB management seemed more optimistic about the ability to push through price increases than PG management did during its call. It will be interesting to watch how volume growth responds to these price actions in the next couple of quarters.

Advertising Declining

Over the last few years, KMB has been cutting its advertising spending, as seen below:

	2017	2016	2015
Sales	$18,259	$18,202	$18,591
Advertising	$648	$665	$710
% of Sales	3.5%	3.7%	3.8%

Advertising and research is an area the company has mentioned as benefitting from its ongoing FORCE cost reduction efforts. While advertising is not disclosed on a quarterly basis, adjusted marketing, research and general expense fell by 140 basis points in the quarter, indicating the trend continued into the period. Management stated the following about advertising in the call:

"And then your first part of your question was around our lower SG&A expenses. ***And I think it was particularly around advertising.*** *And what I'd say there is that, we've done a deep dive on our advertising expenditures in all of our major markets. And what we found is that we had an opportunity to reduce the amount that we're spending on non-working advertising activities and redeploy some of those funds to working advertising.*

And so that's an area that we are focused on. And then as we talked about earlier, ***there's a shift between doing mass advertising and doing more specific targeted activities, some of which, such as digital couponing end-up outside of the advertising lines.*** *So, when I look at our overall investment, I think we're in a good place, even though you see the advertising line on the P&L a little lighter than it was last year."*

Management further indicated that the full year advertising would be down another 10 bps for 2018. We understand focusing on the most effective advertising and promotional channels. However, given the increasingly competitive market environment, we view the choice to reduce advertising while simultaneously trying to minimize advertising spend is a risky proposition.

This is particularly true when competing with private label competitors who appear to continue to be making inroads into the market both domestically and overseas. For example, management noted that Chinese private label brands took share at the expense of all the international name brand competitors in that market during the first quarter. Whether the spending comes in the form of promotional discounts or traditional advertising dollars, we believe spending to remind consumers why they are paying more for the KMB brands will have to maintain a secular upward trend going forward.

Inventory Declining- Signs of LIFO Liquidation

KMB's inventory days of sales (DSI) were down considerably in the 3/18 quarter as seen in the following table:

	3/31/2018	12/31/2017	9/30/2017	6/30/2017	3/31/2017	12/31/2016
COGS	$3,407	$2,984	$2,981	$2,910	$2,831	$2,866
Inventory	$1,778	$1,790	$1,748	$1,738	$1,728	$1,679
COGS YOY growth	20.3%	4.1%	1.9%	-0.5%	-0.2%	-1.6%
Inventory YOY growth	2.9%	6.6%	0.7%	-3.8%	-9.1%	-12.0%
COGS Seq growth	14.2%	0.1%	2.4%	2.8%	-1.2%	-2.0%
Inventory Seq growth	-0.7%	2.4%	0.6%	0.6%	2.9%	-3.3%
Inventory DSIs	***47.6***	***54.7***	***53.5***	***54.5***	***55.7***	***53.5***

KMB's 10-K states the following about its inventory accounting:

> *"Most U.S. inventories are valued at the lower of cost, using the Last-In, First-Out ("LIFO") method, or market. The balance of the U.S. inventories and inventories of consolidated operations outside the U.S. are valued at the lower of cost or net realizable value using either the First-In, First-Out ("FIFO") or weighted-average cost methods. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation."*

The company also discloses the breakout between its FIFO/Average Cost and LIFO inventories in the footnotes to its financial statements.

	3/31/2018	12/31/2017	9/30/2017	6/30/2017
LIFO	$422	$442	$417	$474
	23.7%	*24.7%*	*23.9%*	*27.3%*
FIFO/Avg Cost	$1,356	$1,348	$1,331	$1,264
	76.3%	*75.3%*	*76.1%*	*72.7%*
Inventory	$1,778	$1,790	$1,748	$1,738

	3/31/2017	12/31/2016	9/30/2016	6/30/2016
LIFO	$485	$474	$478	$505
	28.1%	28.2%	27.5%	27.9%
FIFO/Avg Cost	$1,243	$1,205	$1,258	$1,302
	71.9%	*71.8%*	*72.5%*	*72.1%*
Inventory	$1,728	$1,679	$1,736	$1,807

Note that in the last three quarters, there has been a sharp drop off in LIFO inventories while FIFO/Average Cost have continued to increase both on an absolute and percentage of sales basis. We realize that not all, just most, of the company's North American inventories are accounted for under the last-in, first-out (LIFO) method. However, we believe it is close enough in order to match North American revenue to LIFO inventories to arrive at an estimated LIFO and FIFO/Average Cost DSIs:

	3/31/2018	12/31/2017	9/30/2017	6/30/2017
LIFO (North America) DSO	16.1	17.6	15.7	18.3
FIFO/Avg Cost (Outside NA) DSO	51.1	52.0	52.8	50.8

	3/31/2017	12/31/2016	9/30/2016	6/30/2016
LIFO (North America) DSO	19.0	18.4	18.1	19.1
FIFO/Avg Cost (Outside NA) DSO	50.1	48.3	50.8	52.8

*Note that the company does not disclose gross margin by geography, so the above DSIs are calculated using sales, not COGS. This accounts for the discrepancy in total DSI between this table and table 1.

The trends in the decline in LIFO inventory levels in table 2 and the LIFO DSI in table 3 show that the LIFO decline is unrelated to any difference in sales trends between the two geographies. Keep in mind that the LIFO method matches the most recent (and higher cost) inventory with current sales, meaning the cost inflation is experienced more quickly on the income statement. A company using the LIFO method can artificially boost gross margins in a time of rising costs by delaying the production of newer inventory and eating into the

lower cost layers in a process known as a "LIFO liquidation." Eventually the company must replace this inventory with higher cost goods at which point the benefit reverses. Note that the company turns its North American inventory very quickly, so this benefit would be short-lived and require a rapidly rising cost environment to benefit results to a significant degree. However, our concern is the company may be gradually moving more of its North American inventory to the FIFO method to delay the recognition of the higher costs. Either way, the shift in FIFO to LIFO balances is noteworthy and should be monitored. In addition, the overall decline in inventory levels at the very least does not indicate management is gearing up to meet an expected increase in demand.

Coca-Cola (KO)- 3/18 Quarter

Coca-Cola (KO) reported non-GAAP EPS of $0.47 per share, a penny ahead of consensus estimates while revenue came in over 3.5% ahead of Street targets.

- KO's pricing in the quarter remained strong after adjustment for some one-time impacts. However, PEP appears to be tired of losing share and is responding with more aggressive advertising. Also, PEP's comments in its call this morning make us wonder if KO is spending more on advertising and promotions than its advertising line item might indicate.

- The company took another $390 million impairment charge related to its CCR North America bottling assets reflecting management's estimates of what it will receive upon refranchising.

- The new UK sugar tax is just one more move by governments to strangle soft drink consumption.

Pricing/Mix Hit by Accounting Change and Higher Shipping- but PEP Is Coming

The following table shows the composition of organic revenue growth for the last seven quarters and for each of the company's geographic segments:

CONSOLIDATED	3/31/2018	12/31/2017	9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Concentrate Sales	4%	1%	1%	0%	-3%	0%	1%
Price/Mix	1%	4%	3%	3%	3%	6%	1%
Organic	5%	6%	4%	3%	0%	6%	3%
EUROPE, MIDDLE EAST, AFRICA							
Concentrate Sales	9%	2%	4%	3%	-2%	5%	-1%
Price/Mix	-1%	6%	1%	3%	2%	0%	3%
Organic	8%	8%	5%	6%	1%	5%	2%
LATIN AMERICA							
Concentrate Sales	0%	2%	-4%	-3%	-6%	-5%	0%
Price/Mix	6%	11%	10%	5%	6%	15%	11%
Organic	6%	13%	6%	2%	0%	10%	11%
NORTH AMERICA							
Concentrate Sales	2%	2%	1%	1%	-3%	4%	1%
Price/Mix	-1%	2%	2%	4%	3%	5%	2%
Organic	1%	3%	2%	5%	0%	8%	3%
ASIA PACIFIC							
Concentrate Sales	5%	4%	2%	0%	0%	-2%	9%
Price/Mix	-2%	-2%	1%	-1%	0%	9%	-8%
Organic	3%	1%	3%	-1%	0%	7%	0%

Unlike some other consumer package goods companies, KO has been relatively successful at increasing prices without seeing its concentrate unit growth decline. At first glance, the fall to a positive 1% contribution from price/mix in the 3/18 quarter and the 1% decline in North American pricing makes it appear as if the company is easing back on increasing prices. However, this decline is a result of some one-time items. KO recently changed how it accounts for certain costs, primarily shipping. Prior to its January 2018 adoption of Accounting Standards Codification 606 (ASC 606), the company subtracted shipping costs again revenue in its income statement. Beginning in 2018, KO now reports shipping costs in cost of goods sold. Historical results have not been restated for the change. While this has no impact on reported gross and operating profit amounts, it will result in an artificial increase to revenue and cost of sales, which will in turn reduce reported gross and operating margins.

KO adjusted for the accounting change in its organic and price/mix figures. However, both a rapid increase in shipping costs in North America (20% increase in freight costs), product launches and the timing of the Easter holiday drug down the reported contribution from

price/mix. Adjusted for these items, North American pricing was positive "low single-digits" which is comparable with recent quarters. Management was adamant in the call that it had not changed its pricing strategy.

However, in its conference call this morning, **Pepsi (PEP) once again noted that had lost North American beverage market share as it has the last several quarters. However, PEP management sounded as if it was tired of losing share. Consider the following quotes from the call:**

> *"The overwhelming driver is that, despite moderately increasing our media on trademark Pepsi over the past three years, our share of voice has fallen dramatically relative to our key competitor, who has substantially stepped up their media spending on colas over the past two years.* ***To address this, we have allocated increased media to trademark Pepsi. And we've tightened and elevated our brand communication, dealing with the launch of our new Pepsi Generations campaign.***
>
> *…Whenever we have a competitive situation where somebody is going through a financial transaction with beverages, clearly, that creates room for reinvestment, which starts to perturb the competitive balance.* ***And that's what we are seeing in the last three quarters, because of stepped up investment resulting from business model changes.*** *The question is, should we allow this to pass or should we step up and invest along with our competitor and that's a big question we ask ourselves.*
>
> *…**And so we'll go toe-to-toe and increase our spending in colas**, in particular, but we're going to remain very responsible on pricing.*
>
> *…The only place where we're outspent in the marketplace is in colas.* ***And we were surprised by the extent of which media spending was taken out in colas by competition.****"*

KO's reported advertising expense was essentially flat in its 2017 10-K. However, the company also provides promotional and marketing support to its bottlers. This amounted to $6.2 billion in 2017, down from $6.6 billion in 2016. While the increased marketing spending may not show up in the obvious places, it could very well be lost in all the charges and costs associated with refranchising its bottlers. This is perhaps what PEP management meant by seeing "stepped up investment [advertising by competitors] resulting from business model changes." As is the case which the bulk of KO's recent financial statements, it is very difficult to get a feel for how real costs are trending given the huge disturbances caused by the bottler refranchising.

KO has made very pronounced efforts in supporting its Coke brand, including the recent updating of the Diet Coke products which helped drive sales in the quarter. In addition, it has stuck to a disciplined pricing strategy. However, PEP's comments indicate KO has taken significant increases in marketing spending to allow the pricing to stick which will become more evident as the major refranchising laps. Regardless, PEP appears to be upping its game and it will be interesting to see how the volume and pricing holds up in the next couple of quarters.

More Charges

During the quarter, KO recorded another $390 million charge to impair the assets of CCR (Coca-Cola Refreshments). CCR is primarily made up of its North American bottling assets which KO acquired from Coca-Cola Enterprises. The impairment reflected "management's view of the proceeds that are expected to be received for the remaining bottling territories upon their refranchising." This issue went totally unaddressed as the market continues to view capital spend on acquiring/spinning off/reacquiring the bottlers as being irrelevant.

In addition, the company recorded a $95 million charge related to its ongoing productivity and reinvestment initiatives as well as $45 million in charges related to the cost to refranchise its bottlers which include internal costs for employees working on the refranchising efforts. Like the impairments, these amounts are simply lumped into the non-GAAP adjustments and forgotten.

UK Sugar Tax

Management discussed in the conference call that it was raised prices in the UK and South Africa to adjust for recently enacted sugar excise taxes implemented in those countries. The purpose of these and similar taxes being enacted around the world is to discourage the intake of sugary drinks. In the case of the UK, the tax is tiered by sugar content, which has prompted the company to reduce portion size and sugar content in certain products in order to avoid the tax. Even if the company is able to avoid much of the tax by such maneuvers, it still takes time and money to respond and risks frustrating consumers in a market full of alternatives. While we do not see this sugar tax as a major disruptive factor, it is just more evidence of the push by governments to eliminate soft drinks.

Disclosure

BTN Research is a research publication structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. Information included in this report is derived from many sources believed to be reliable (including SEC filings and other public records), but no representation is made that it is accurate or complete, or that errors, if discovered, will be corrected.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.