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BTN Thursday Thoughts

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LyondellBasell – The Consumer Company to Buy

We have been writing quite a bit about consumer products companies and their lack of growth, high valuations, and endless series of restructurings. The question becomes, is there anything to buy in this sector? YES there is! LYB – LyondellBasell the chemical company. We talked about this in our January 25th issue.

57% of LYB sales are polyethylene (P/E) and polypropylene (P/P) plastics. These are largely going to end-markets like automobile parts, consumer packaging, electronics, and building materials. Another 24% of sales are in intermediate chemicals, which are fuel additives and things like Styrofoam and packing supplies. LYB may have broader reach than a Proctor & Gamble or Colgate-Palmolive as it is a supplier to consumer disposables like shampoo, dish soap, and toothpaste. It also supplies to food packaging, consumer electronics, and car parts.

As we noted in the January 25th issue, the chemical industry research house IHS shows a link between more P/E and P/P usage as the middle class increases. North America uses over 60 pounds per person, Asia is 20-30 pounds now and India is in the teens.

We'll talk about acquisitions more in a moment, but LYB discussed in its earnings call a JV with SUEZ in France for a company to recycle plastics with growth potential specifically aimed at consumer products firms:

> Bob Patel – the CEO, *"With respect to our acquisition and the joint venture of with SUEZ in this QCP venture, that's really anticipating a broader move towards brand owners like Procter & Gamble and IKEA and Unilever looking for more recycled content in their products. And as you think, circularity is going to be a very, very important feature of going forward."*

Our belief is US chemical companies have a significant cost advantage in a capacity constrained market that is growing. That should make them far less cyclical than in prior decades and they are serving consumer product markets. We are going to focus on LYB here, but the theme is the same with DowDuPont, Westlake Chemical or Eastman Chemical. These chemical stocks are cheaper, have faster growth and most pay attractive and rising yields compared to the consumer stocks.

LYB Valuation and Dividends

Price/Earnings (TTM)	7.8x	Current Yield:	3.80%
Price/EBITDA (TTM)	6.5x	Debt/EBITDA:	0.9x

	2017	2016	2015	2014	2013
Dividend	$3.55	$3.33	$3.04	$2.70	$2.00
Growth	7%	10%	13%	35%	38%
Dividend% EPS	29%	36%	32%	34%	30%
Dividend % FCF	39%	41%	32%	31%	34%

The cost edge comes from cheap US shale gas and high oil prices. Chemical plants burn lots of natural gas in their operations and gas in the US is still under $3 and the rest of the world is paying about $7-$10. Moreover, the feedstock for most chemical plants comes from oil. In the US, the plants are using feedstocks derived from NGLs (Natural Gas Liquids) such as ethane and propane. Oil prices are essentially in the high $60s to $70s, which means more drilling and more natural gas and NGLs are produced as byproducts. That keeps the price of the latter two down. Essentially, when oil prices exceed natural gas prices by more than 8x, it's a heyday for US chemical plants using NGLs. The current ratio is above 20x. Oil would need to go below $25 for this ratio to lose its power. The pipeline sector continues to build new gas and NGL lines as well, so more supply is making it to market and keeping pressure on prices.

LYB recently raised the dividend 11% to $1 per quarter. The company also has periods when it will invest in expansion and thus boost capital spending for a couple years. This boosts the payout ratios, but it normally falls back as the new capacity comes online. We think this is important too, as it demonstrates that LYB can not only cover a rising dividend, but also self-finance the maintenance and growth of the company.

Most recently, the company announced a multi-year program to spend as much as $5 billion in expansion capital spending and acquisitions – we will talk about this below. We are impressed with the discipline shown by LYB. For years, they have been asked about acquisitions on the conference calls and they have long pointed out that focusing first on fixing bottlenecks at its own plants is a higher ROI, then expansion of existing plants could also generate a high ROI, and finally, they know their own company best and when it is selling for under 10x EPS and 7x EBITDA – repurchasing LYB stock made as much sense as trying to buy another company. More importantly, when LYB repurchases stock – the share count actually declines by the amount they purchased. They are not issuing new shares to management faster than they can buy back shares on the market merely trying offset part of the dilution:

$ in mm	2017	2016	2015	2014	2013
Cash from Ops	$5,206	$5,606	$5,842	$6,048	$4,835
Capital Spend	$1,547	$2,243	$1,440	$1,499	$1,561
Free Cash Flow	$3,659	$3,363	$4,402	$4,549	$3,274
Dividend	$1,415	$1,395	$1,410	$1,403	$1,123
Repurchases	$866	$2,938	$4,656	$5,788	$1,949
Number of Shares	394.5	404.0	440.1	487.0	548.8

Even though the dividend growth per share has been significant, the actual amount paid in dividends has been fairly flat because LYB has repurchased so many shares. The company is asking for approval to repurchase another 10% of the stock.

Earnings quality for LYB is very clean. The only recurring issue is they are buying and selling products linked to various petroleum prices and those values have to be marked to the Lower of Cost or Market (LCM) on a regular basis. Inventory turns fast enough that the actual cash flow incorporates much of the changes in pricing in a given year. But, LYB does not have much control over oil spiking at the end of a quarter or the value of propylene falling 10% against ethylene when the prior quarter, propylene was selling at a premium. So, mark-to-market items are regular occurrences. In 2014, 2015, and 2016, LYB saw charges of this nature of $760 million, $548 million, and $29 million. Moreover, there are

years like 2016 where some quarters show a benefit and other quarters show a charge. But, as shown in the table above, the non-cash charge is added back and the actual operations incorporate the changes in selling prices without being as pronounced in reality as the LCM charge.

The new tax law resulted in an $819 million benefit to earnings in 4Q17. This added $2.05 to EPS for the year and is obviously a one-time event. The new lower tax rate was evident in 1Q18 at 19.8% versus 28.1%. That added 33-cents to EPS. That is the new law so that should be sustainable. LYB did have some one-time charges in 1Q17 related to refinancing debt that amounted to about 20-cents and did not recur. "Apples-to-apples", EPS growth was $2.79 in 1Q18, up from $2.20 in 1Q17. Operating income was up 23%.

Expansion plans are coming to fruition for LYB too. The company announced last year that it was looking to put about $3-$5 billion into new ways to expand along the Gulf Coast. That has now taken the form of 1) an acquisition of A. Schulman for $2.25 billion, 2) forming a European joint venture with SUEZ to buy 50% of Quality Circular Polymers, 3) Expanding capacity at its La Porte complex with more high-density PE, and 4) Building a new PO/TBA (Propylene Oxide and Tertiary Butyl Alcohol) plant.

We like all of these deals for four basic reasons:

1. They are serving growing markets and the acquisitions are not based solely on cost-cutting
2. They are adding capacity within the company's expertise – this is vertical expansion
3. LYB is over $40 billion in market cap – none of these deals are so big that they risk much downside
4. LYB is sticking to what has already worked for them – expansion at existing plants is often cheaper to build, debottlenecking and improving purchasing on acquisitions is something LYB has already been doing for years.

A. Schulman will essentially double LYB's presence in Polypropylene Compounding. LYB currently sells 90% of its Polypropylene Compounding output to the auto industry. A. Schulman has a more diversified customer base with 25% in consumer packaging and 17% in electronics, so this gets LYB more exposure to more consumer markets. All the end markets A. Schulman serves are growing at 6%-7%. The price is not crazy at 11x trailing EBITDA, which assumes zero synergies. LYB's forecast is it can achieve $150 million in

synergies over 2 years, which would make the price 6.3x EBITDA. That actually is not a terribly aggressive target. LYB's EBITDA margins are 11.3% versus 8.1% for A. Schulman. Picking up 300bp in that area is $75 million, or half the goal. Schulman is operating many more facilities with over 3x the number of employees to generate roughly the same sales so there should be room to cut costs. There will be larger economies of scale for purchasing and logistics for Schulman too. Even if it only hits $75 million in synergies, the price is 8x EBITDA with inherent growth occurring already.

The SUEZ JV for Quality Circular Polymers is a European Plastics company that LYB bought 50% from a group of private equity owners last November. SUEZ will supply the company with high-grade used plastic to recycle and LYB will market the recycled product to customers. As noted above, many existing LYB customers want to incorporate recycled plastic into packaging as a marketing tool. The actual costs for this deal are not yet known. We again see this as an area where LYB is essentially monetizing existing relationships further.

Expanding the La Porte site will double the volume of High Density P/E produced there to 2 billion pounds per year. Currently, LYB makes about 7 billion pounds, so 16% growth in capacity is coming. This expansion is cheaper than building a greenfield plant and will be operational in 2019. It is being funded out of normal maintenance and growth capital spending. It is also planning to build a $2.5 billion plant at its current Channelview site to be opened in 2021. It will make propylene oxide used as a building block for other plastics and pasteurization. It will also make Tertiary Butyl Alcohol, which is used to boost octane in gasoline and many other solvents. Both of these areas are seeing great supply of feedstocks delivered via new pipelines and LYB already has operating plants there.

We are not going to get too bogged down in the quarterly conference calls that always seem to begin on a great big picture story of cheap feedstocks, rising demand, and high cost producers in Asia setting the prices, and then the last 20 minutes turns into "well the spread was 18 cents better than competitors this quarter and may only be 17 cents in the future so should we all just go kill ourselves?" The prices of these products will move around and there will be some fluctuations in results based on comparing quarters with a 1-cent higher cost edge to quarters with a 1-cent lower cost edge. We are going to instead focus on LYB as having three big things going for it:

1. The stock is very cheap and even a dividend rising at 11% has lots of cushion. Multiple expansion may also be able to drive additional capital return.

2. There is real growth here of more than 6% from emerging markets with a strong focus on consumer products.

3. Buying a US chemical company is buying the cheapest producer. Higher oil prices enhance that cost edge as does the billions being spent on pipelines to bring more cheap feedstocks to the US chemical industry. Unless oil collapses into the $20s, this cost edge is very pronounced.

Welltower (WELL) Update

We hoped to have some more color on WELL's recent deal and what is going on in the industry. Unfortunately, WELL has not released its 10-Q yet and neither has QCP (who it is buying). Its competitor, HCP, reported earnings this morning but did not file its 10-Q yet, and its customer – Brookdale (BKD) has not announced results yet, and neither has Genesis Healthcare (GEN). So, this will be a quick update on the industry as a whole, and we are not seeing much reason to be excited compared to the company's forecasts of never-ending rent increases and people rushing into facilities with an aging population.

First, we listened to the call QCP (Quality Care Properties) had about Welltower acquiring it. It confirmed several of the negatives we believed were true:

1. They were looking at a sustained long-term negative trajectory for its primary tenant HCR Manorcare that began in 2012 and has accelerated even more during 2017. They do not see this ending anytime soon.

2. They blamed this on the continued headwinds of people spending less time in the facilities, the rising wage pressure for skilled nurses, and the wave of new capacity opening making both sides of that equation worse.

3. The assets Welltower is acquiring are older and have not seen much investment in recent years.

4. QCP only received about $57 million in rent from HCR Manorcare in 1Q18. Annualized that is about $228 million. Against that, QCP has $140 million in interest expense that will likely rise as about 60% of its $1.76 billion in debt is floating rate, and it has about $20-$25 million in overhead cash costs and had debt maturities to pay.

5. Selling assets piecemeal to pay down debt would not solve the rent problem on the remaining properties.

Second, Genesis is selling all its Skilled Nursing Facilities in Texas. Another Genesis landlord, Sabra Healthcare, is trying to sell 46 of its 54 Genesis properties this year. It intends to restructure leases as necessary to make the sales work. We again expect Genesis rents to be going down even though Sabra is like Welltower and touts that is has rent escalators on the properties.

Colgate-Palmolive (CL) - 3/18 Quarter

Colgate (CL) reported EPS of $0.74 in the 3/18 quarter which barely beat consensus estimates. Revenues were a slight miss. We have the following observations on the quarter:

- Management cut its 2018 outlook for organic sales growth from "mid-to-low single-digits" to "low single-digits". The previous guidance had been affirmed as late as February 23rd, implying a rapid deterioration in conditions in emerging markets.

- Organic growth picked up in North America, but meaningful growth remains elusive in markets outside the US.

- Adjusted gross margin fell by 40 bps in the quarter and management lowered its 2018 forecast to 50 bps of improvement from 50-75 bps due to higher-than-expected raw materials inflation. However, that forecast is relying on some raw materials, including oil, to trend below current levels in the second half of the year. This seems very optimistic.

- Advertising rose rapidly in 2017 and management guided for advertising as a percentage of sales to continue to increase in 2018. However, advertising actually fell as a percentage of sales in the quarter by 20 bps, helping to shield operating margin from higher raw materials costs. This also implies a catch up in advertising spending in the remainder of the year as management stuck by its forecast for an increase as a percentage of sales for the full year. Increased spending seems almost a requirement to help the expected price increases to stick.

- Inventories DSIs increased by 2.4 days over last year and 3.9 days over the 12/17 quarter after trending in a tight range in the last several quarters. This is consistent with lower-than-expected sales and raises some concern of discounting to move excess inventories.

Sales Trended Below Management Expectations During the Quarter

At the beginning of the year, management seemed upbeat about 2018 being a better year than 2017. From the 4Q 17 conference call:

On sales:

> *"We expect organic sales to be up low to mid-single digits with improvement in our growth rate versus the second half of 2017. We are encouraged by our volume growth over the second half of 2017, and we plan for a combination of pricing and volume growth for 2018."*

The company was still expecting improving growth trends in 2018 as late as the February 23rd Consumer Analyst Group of New York Conference (CAGNY). However, late in the quarter, conditions deteriorated specifically in the emerging markets which led the company to lower its guidance for 2018 organic revenue growth to low single-digits.

> *"…we did from CAGNY [February 23] see changes. Actually, the developed markets played out pretty much the way we would have expected. It was really in the emerging market, and it was this pricing activity which stepped up as the quarter unfolded, and we had to take a position in terms of would we respond or would we not respond. That took pricing out of the category, which led to the slowdown in the value growth rate of the category. So yes, it did unfold after CAGNY, to our disappointment."*

Pricing and volume data by segment are shown below:

	3/31/2018	12/31/2017	9/30/2017	6/30/2017
North America				
Unit Volume	5.5%	4.5%	3.0%	-2.0%
Pricing	-0.5%	-3.5%	-4.0%	-1.5%
Organic Growth	5.0%	1.0%	-1.0%	-3.5%
Latin America				
Unit Volume	0.0%	4.0%	3.0%	2.5%
Pricing	0.5%	-1.5%	2.5%	4.5%
Organic Growth	0.5%	2.5%	5.5%	7.0%
Europe				
Unit Volume	4.0%	6.0%	3.0%	-1.0%
Pricing	-2.5%	-2.0%	-2.0%	0.5%
Organic Growth	1.5%	4.0%	1.0%	-0.5%
Asia Pacific				
Unit Volume	0.5%	1.0%	0.0%	-2.0%
Pricing	-0.5%	1.5%	0.0%	-1.5%
Organic Growth	0.0%	2.5%	0.0%	-3.5%
Africa/Eurasia				
Unit Volume	-3.5%	-0.5%	-4.5%	-7.5%
Pricing	2.5%	0.0%	2.5%	4.5%
Organic Growth	-1.0%	-0.5%	-2.0%	-3.0%
Hill's Pet Nutrition				
Unit Volume	0.5%	0.0%	1.0%	-1.5%
Pricing	1.0%	0.5%	0.0%	2.0%
Organic Growth	1.5%	0.5%	1.0%	0.5%

Organic growth picked up in North America, but meaningful growth remained elusive in Latin America, Europe, Asia and Africa/Eurasia. Management specifically cited aggressive pricing in Latin America that it declined to participate in which led to a significant drop off in volume growth.

We know that many of the branded consumer products companies are experiencing difficulties with consumers in the emerging markets being much less brand loyal and more open to private label products. In addition, markets such as China are seeing rapid growth

in the online channel which is also less brand-sensitive. We plan to explore these areas more, but investors are beginning to question why growth rates in emerging markets are converging with and even falling below developed country growth rates and whether this is a permanent situation.

Gross Margin Was a Disappointment Too

Gross margin adjusted for restructuring charges fell by 40 bps in the quarter as cost savings from the funding-the-growth initiatives of 130 bps were more than offset by 190 bps in higher raw materials and packaging costs. Management had previously guided for 50-75 bps in gross margin gains in 2018, yet this was tempered to 50 bps during the call. The company blamed this on higher than expected raw materials costs. It hopes to pass along price increases during the year to offset some of this, but recent history has shown that demand for branded consumer products has been very price elastic, so it remains to be seen how well any meaningful price increase will stick.

Also, the company's current gross margin forecasts are calling for some raw materials, including oil, to trend lower in the second half of the year from their current levels. This seems to be a very optimistic assumption and we have not heard many people expecting cost inflation to ease, let alone reverse over the remainder of the year.

Lower Than Expected Advertising Makes Up for Gross Margin Shortfall

We pointed out in our initial review of CL two weeks ago that the company had rapidly increased its advertising spending in 2017 to help drive sales and had announced more of the same in 2018. From the 4Q17 conference call:

> "**We expect another year of increased advertising spending in 2018, both on an absolute basis and as a percentage of net sales**. We still see significant opportunity to spend behind our core brands, support new product launches and drive consumption in emerging markets."

However, while advertising expense increased by 4% in the quarter, it actually fell by 20 bps as a percentage of sales. To put this in perspective, operating margin adjusted for restructuring charges fell by 20 bps in the quarter, so the decline would have looked significantly worse without the boost from the lower advertising percentage. Management

contended on the call that "we never said that spending was going to be up on a ratio basis starting January1." However, the decline was certainly unexpected and implies that there will be a catch up in advertising spending in the remained of the year.

We also note that advertising spending declined as a percentage of sales in all markets except Europe, where it actually increased by 60 bps. So, the 4% increase in volumes in Europe took an increase in advertising and a 2.5% decline in prices to generate.

Inventory Jumped During the Quarter

CL's inventory increased by 7.5% over the 12/31 quarter compared to a 1.9% sequential increase in cost of sales. This led to a 2.4-day increase versus the year ago quarter and an almost 4-day increase over the 12/17 quarter. We note that although the company bought Physicians Care Alliance in January, its inventory balance was only 7 million which would not have had a material impact on the numbers. The following table shows DSIs for the last six quarters:

	3/31/2018	12/31/2017	9/30/2017	6/30/2017	3/31/2017	12/31/2016
COGS	$1,594	$1,564	$1,591	$1,526	$1,493	$1,474
Inventory	$1,312	$1,221	$1,205	$1,199	$1,189	$1,171
COGS YOY growth	6.8%	6.1%	3.1%	-1.0%	-1.4%	-8.2%
Inventory YOY growth	10.3%	4.3%	1.0%	-2.7%	-3.6%	-0.8%
COGS Seq growth	1.9%	-1.7%	4.3%	2.2%	1.3%	-4.5%
Inventory Seq growth	7.5%	1.3%	0.5%	0.8%	1.5%	-1.8%
Inventory DSIs	***75.1***	***71.2***	***69.1***	***71.7***	***72.7***	***72.5***

While not a gargantuan increase, CLs DSIs have been trending in a tight range in the last several quarters, making the increase seem more unusual. This would also be consistent with sales falling short of management expectations. The concern is if the company will have to resort to discounting to move the excess inventory balances in future quarters which would put pressure on margins that are already strained.

PepsiCo (PEP)-3/18 Quarter Review

- Snack foods and international beverages performed well in the quarter. However, North American beverages continues to struggle. As we mentioned in last week's review of KO's 3/18 quarter, PEP management is blaming this poor performance on unusually aggressive ad spending by KO. PEP has begun its own increase in advertising to counter.

- While the company is already putting increased advertising dollars to work in the market, they are not yet being reflected on the income statement due the timing of expense recognition. Management has admitted this and the large jump in prepaid expenses in the quarter is likely confirmation. The benefit to operating margins was likely significant and will reverse in upcoming quarters as this spending is finally recognized on the income statement.

- Rising raw materials costs are expected to continue to force gross margin compression in 2018.

- PEP plans to invest its savings from restructuring into the business which will offset any benefits from cost reductions. We do not view this as a bad thing conceptually, but it will limit profit and cash flow growth in the foreseeable future.

- Management stood by its forecast for $6 billion in free cash flow for 2018, essentially flat from last year. We again remind investors that management will not expand the dividend payout ratio further and the 15% increase in the recent dividend should be viewed as a one-time increase.

- As PEP management seems committed to keeping its North American beverage business, it is weighing its options of how to handle its bottling operations. We find some of management's comments and apparent reluctance to refranchise interesting in relation to KO.

Decent Strength Except North American Beverage

Most of PEP's segments performed well in terms of volume and pricing power. The following table shows pricing and volume trends by segment for the last six quarters:

	3/31/2018	12/31/2017	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Total						
Volume	1.0%	0.0%	-1.0%	0.0%	0.0%	2.0%
Pricing	2.0%	2.0%	3.0%	3.0%	2.0%	2.0%
Organic Growth	2.0%	2.0%	2.0%	3.0%	2.0%	4.0%
Frito-Lay North America (29% of sales)						
Volume	1.0%	3.0%	1.0%	1.0%	-1.0%	2.0%
Pricing	2.0%	2.0%	2.0%	3.0%	3.0%	2.0%
Organic Growth	3.0%	5.0%	3.0%	3.5%	2.0%	3.0%
Quaker Foods North America (5% of sales)						
Volume	0.0%	0.5%	1.0%	0.0%	-1.0%	1.0%
Pricing	-0.5%	-1.0%	0.0%	-1.0%	-2.0%	-1.0%
Organic Growth	0.0%	0.0%	1.0%	-1.0%	-3.5%	0.0%
North American Beverages (35% of sales)						
Volume	-3.0%	-3.0%	-6.0%	0.0%	0.0%	1.0%
Pricing	1.0%	0.0%	1.0%	1.0%	1.5%	1.0%
Organic Growth	-2.0%	-3.0%	-5.0%	1.0%	1.0%	2.0%
Latin America (10% of sales)						
Volume	2.0%	-4.0%	-2.0%	-1.0%	0.5%	2.0%
Pricing	7.0%	7.0%	7.0%	8.0%	6.0%	6.0%
Organic Growth	9.0%	3.0%	5.0%	8.0%	6.0%	9.0%
Europe Sub-Saharan Africa (13% of sales)						
Volume	5.0%	5.0%	4.0%	2.5%	0.0%	1.0%
Pricing	1.0%	1.0%	2.0%	3.0%	3.5%	4.0%
Organic Growth	6.0%	6.0%	6.0%	6.0%	4.0%	5.0%
Asia , Middle East & North Africa (8% of sales)						
Volume	5.0%	0.0%	1.0%	-3.0%	2.0%	5.0%
Pricing	1.0%	6.0%	7.0%	5.0%	0.0%	0.0%
Organic Growth	6.0%	6.0%	9.0%	2.0%	2.0%	5.0%

While total company volume growth has not been stellar, PEP has been able to realize a consistent pricing growth that most branded consumer companies have not. This has largely

been due to the strength of its salty snacks products, as well as international beverages (which are not broken out in the geographic results.)

However, North American Beverages has struggled for several quarters, which the company has blamed on unusually aggressive spending by competitor KO as it undergoes its major bottler refranchising in North America.

> *"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…*
>
> *And let me talk a little bit about this, and I am reflecting back in the last 15 years of looking at North American Beverages, in particular. 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."*

Management is insistent it will not resort to sacrificing pricing to regain share, but rather will increase its own spending on advertising to counter. We believe this is a logical way to approach the situation, even though as management admitted, there could be some delay before the advertising takes effect.

However, as we examine in the next section, even though the company has increased its ad spend, the increase has yet to be fully reflected in the income statement.

The Advertising Increase Is Not Being Felt on the Income Statement - Yet

Despite the company alluding to its increase in advertising spending, it's discussion on segment operating results references declines in advertising expense in most of its segments including North American Beverages. This is due to the fact that PEP, like most companies, capitalizes its advertising spending which is then recognized in the income statement over the course of the year as certain milestones such as sales or volume targets are realized. This can result in a mis-match between cash advertising spend and advertising expense recognized on the income statement. Management openly addressed this in the call:

"A couple things on that, number one, we kind of have to separate the accounting from the actual spending in the marketplace. From an accounting perspective, as, of course you know, A&M gets spread out on a curve. As the volume was a little bit softer in the first quarter relative to our expectations for the year, less of the spend would have been booked in the first quarter. And so you're seeing a timing difference in what appears in the books. ***In terms of media spend in the marketplace, we were actually up strong double digits and strong double digits across the big brands. So I wouldn't over-focus on what the A&M showed up in the financial books. That's a product of GAAP convention. In terms of actual advertising in the marketplace behind the big brands, it was up significantly."***

Much of PEP's capitalized advertising spending is booked in "prepaid expenses and other current assets" on the balance sheet. This account is shown on a days-of-sales basis below:

	3/31/2017	12/31/2017	9/30/2017	6/30/2017
Prepaid Expenses and Other Current Assets	$1,931.00	$1,546.00	$745.00	$933.00
Prepaid expense days	13.9	7.2	4.2	5.4

	3/31/2017	12/31/2016	9/30/2016	6/30/2016
Prepaid Expenses and Other Current Assets	$1,031.00	$908.00	$1,454.00	$1,517.00
Prepaid expense days	7.8	4.2	8.3	9.0

	3/31/2016	12/31/2015	9/30/2015	6/30/2015
Prepaid Expenses and Other Current Assets	$1,896.00	$1,865.00	$1,345.00	$1,733.00
Prepaid expense days	14.6	9.2	7.5	9.9

While this account contains other items, we suspect much of the increase seen in the account is a result of the delay in booking advertising expense.

We applaud management's openness about the issue, but it nonetheless was a temporary, material benefit to earnings. PEP does not disclose advertising expense on a quarterly basis. However, we do know that in 2017, advertising and marketing spending recorded in SG&A amounted to about 6.5% of sales. If we assume that advertising was 6% of sales in the 3/17 quarter, and that amount increased by 10% year-over-year, it would have amounted to an approximate additional spend of $70 million, or about 50 bps on a percentage of sales basis. This just gives a rough idea of how much the quarter's operating margin could have benefitted from the delay in the recognition of advertising expense. This benefit should now reverse itself over the next couple of quarters which will be an additional drain on margins.

Margins Will Remain Under Pressure

PEP's gross margin adjusted for restructuring charges fell by 30 bps in the quarter due to higher raw materials costs. This is expected to continue in the balance of 2018. Meanwhile, management indicated it will reinvest its cost savings back into the business, so margin expansion is unlikely. This makes the added pressure of the catch up in advertising expense even more of a concern.

Refranchising Discussion

Management appears committed to its namesake segment, a move we would agree with given how it complements its snack food business. However, the company is carefully examining how to manage its bottling operations going forward. As we noted in our recent review on KO, PEP's arch nemesis has bounced its bottlers back and forth between company-owned status and independent franchises for years with the market cheering every move. While results may benefit in the short-term from refranchising by protecting KO's financials from the pricing and raw materials exposure of the distribution business, the problems experienced by the bottlers longer-term invariably lead to large, equity-consuming investments. The market is currently in love with KO's refranchising, but we found the following discussion by PEP management on the call very insightful:

> Analyst:
>
> *"And I'm just wondering, because if you're in the marketplace and you look at a refranchised Coke territory versus a Pepsi territory, you can see a very stark difference in terms of pre and post a refranchising for Coke. And so I'm just wondering. How can you compete in that type of situation where you have these independent franchisees just spending a lot more of their own capital in improving execution at retail versus a company-owned bottling operation? So I just was hoping you can give me some context around that as we think about some of the options you might have in the future."*

Indra K. Nooyi – PEP CEO

"You're right, Nik. You know what? And this is just our observation, because we've studied all these in great detail. ***In the first couple of years of refranchising, when the parent company gives you a bit of a break, you're spending the parent company's money. After the first 18 months, it's your money that you have to spend. And right now, those independent bottlers are operating on very, very low margins. So, the real challenge is going to be after the first 18 months after refranchising, are they going to be spending their own money off of lower margins already to do what they've been doing in the first 18 months post-refranchising where they got some breaks from the parent company.***

I don't know. The jury is out. All that I tell you is, ***the evidence in a couple of cases where we've seen the first 12 months pass after refranchising, we are already seeing execution drop off significantly.*** *Again, I'm not passing any judgment, I'm just giving you an observation. Believe me, what we are doing is studying their model in great detail. And if we believe their model makes sense, and* ***if we believe that it's a model that can be executed without having to buy back the bottlers again in a few years down the road****, the advantage is we can follow it easily. We are in studying mode at this point, along with all other options."*

While PEP may very well end up refranchising its bottlers too, we believe the observations above are spot on.

In addition, they are consistent with the belief that PEP's North America Beverage segment can experience a bounce in the next few quarters as the benefits of the refranchising-related advertising and promotional spending on Coke products begins to cool off.

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