BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Mondelez International (MDLZ)

Our review of Mondelez International (MDLZ) turned up several items which make us believe the company may have a difficult time maintaining its double-digit dividend growth. Our specific concerns include:

- MDLZ's cash from operations showed remarkable improvement in the 3/18 quarter. However, much of the improvement was related to working capital improvements that will likely prove one-time in nature.

- Accounts payable DSPs rose to 133 days from 114 a year ago. The company has clearly leaned on its suppliers to stretch payment terms and we are skeptical this level of improvement can continue.

- MDLZ has increased the use of its receivables factoring program. Receivables adjusted for outstanding factored balances are under control, so we are not overly concerned about aggressive revenue recognition. However, the increased sale of receivables has been a large benefit to cash flow growth.

- Profits have benefitted from lower advertising and promotional activity. However, this will likely have to reverse in upcoming periods given the company's dependence on brand awareness and its attempts to push through higher prices to offset rising raw materials costs.

- MDLZ has taken huge restructuring charges over the years, possibly distorting adjusted reported profits. The current program is slated to terminate at the end of 2018 and we would view any extension of the program as a red flag.

- MDLZ has a large intangibles balance which is not amortized even though material amounts are written off every year. Almost $1 billion of the balance was estimated to be less than 10% greater than its fair value as of the last impairment test, making the likelihood of future write-offs seem high.

- Management is forecasting free cash flow of $2.8 billion in 2018, a huge improvement over 2017. However, much of the recent improvement has been due to working capital benefits we believe could reverse in the future. It appears cash outflows from restructuring will likely continue for another two years. Cash flow after dividend and buyback is already negative, which the company has partially funded by asset sales. Net debt-to-EBITDA is approximately 4 times. Absent a dramatic acceleration in sales growth, we do not see how the company will be able to maintain its share buyback (which is key to EPS growth) and grow its dividend at the current pace.

Working Capital Improvements May Be Short-Lived

MDLZ's saw its cash from operations jump considerably in the 3/18 quarter which it attributed "primarily to improved working capital trends, higher earnings and lower pension contributions in 2018 than in the first quarter of 2017." This knockout performance in the quarter led to a meaningful increase in cash from operations on a trailing 12 basis:

Table 1

	3/31/2018	12/31/2017	9/30/2017	6/30/2017
T12 Operating Cash Flow	$3,557	$2,593	$2,497	$2,763
T12 Capex	$992	$1,014	$1,036	$1,108
T12 Free Cash Flow	$2,565	$1,579	$1,461	$1,655
T12 Dividends	$1,236	$1,198	$1,162	$1,138
Dividend % of FCF	48%	76%	80%	69%
T12 Stock Repurchases	$2,240	$2,174	$2,660	$2,358
Cash After Buyback	-$911	-$1,793	-$2,361	-$1,841

	3/31/2017	12/31/2016	9/30/2016	6/30/2016
T12 Operating Cash Flow	$2,735	$2,838	$3,454	$3,494
T12 Capex	$1,195	$1,224	$1,245	$1,328
T12 Free Cash Flow	$1,540	$1,614	$2,209	$2,166
T12 Dividends	$1,117	$1,094	$1,073	$1,050
Dividend % of FCF	73%	68%	49%	48%
T12 Stock Repurchases	$1,875	$2,601	$2,346	$2,802
Cash After Buyback	-$1,452	-$2,081	-$1,210	-$1,686

Cash from operations benefitted from lower cash pension contributions of $144 million in the 3/18 quarter compared to $310 million in the year-ago period. For all of 2017, MDLZ

contributed $493 million to its pension plans and as of the end of the 3/18 quarter, it expects to contribute $340 million in all of 2018. This implies that it will spend $196 million in the remaining nine months of the year ($340-$144) compared to $183 million ($493-$310) in the year-ago nine-month period. So, the benefit of lower pension contributions in the first quarter will actually turn into a slight headwind for the remainder of the year.

However, working capital changes have been a key driver to cash flow growth in recent periods. MDLZ's supply chain and inventory management was significantly impacted by a malware attack on the company's computer systems in the second quarter of 2017. The resulting disruption led to the cancellation of orders during 2017 that were never recovered, and management has indicated that its supply chain is still not completely back on track. The company's inventory DSIs actually remained remarkably stable during the period while its account payable have skyrocketed as shown in the following table:

Table 2

	3/31/2018	**12/31/2017**	**9/30/2017**	**6/30/2017**
COGS	$3,916	$4,295	$3,978	$3,662
Accounts payable	$5,727	$5,705	$5,139	$5,012
Accounts payable DSPs	133.4	121.2	117.9	124.9

	3/31/2017	**12/31/2016**	**9/30/2016**	**6/30/2016**
COGS	$3,896	$4,181	$3,908	$3,786
Accounts payable	$4,897	$5,318	$4,884	$4,562
Accounts payable DSPs	114.7	116.1	114.0	110.0

Most of the working capital benefit was generated by accounts payable increasing to historically elevated levels. Compare MDLZ's DSP level to that of some of its closest peers:

Table 3

	1Q DSPs
MDLZ	**133**
Kraft Heinz (KHC)	95
General Mills (GIS)	87
Kellogg (K)	109
Conagra (CAG)	57

Almost all the food companies have seen their accounts payables rise disproportionately over the last several quarters while inventories have, for the most part, remained in line with cost of sales. While we are not prepared to comment on each company, we do know that

Kellogg has increased its utilization of payables tracking systems which facilitates its suppliers' abilities to sell payables to third-party financing institutions. The purpose behind these arrangements is for the company to be able to capture supplier discounts by allowing the suppliers to get their cash earlier, but it can pay the financial institutions back over a longer time frame. We do not know if MDLZ is utilizing such arrangements. It is also possible that disruption from the malware incident has led to some delay in paying suppliers. Regardless, it is clear that MDLZ has dramatically increased the amount of time it is holding onto its cash prior to paying for its raw materials and we expect to see this benefit to cash flow growth reverse in upcoming quarters.

Receivables Factoring Boosts Cash Flow

MDLZ utilizes receivables factoring arrangements whereby it sells certain receivables to third-party financial institutions. This must be adjusted for when analyzing trends in accounts receivable. The following table shows trends in reported trade receivables, factored receivables outstanding at the end of the periods, and other receivables balances on a days-of-sales basis for the last eight quarters:

Table 4

	3/31/2018	12/31/2017	9/30/2017	6/30/2017
Sales	$6,765	$6,966	$6,530	$5,986
Reported Trade Receivables	$3,113	$2,691	$2,981	$2,395
Factored Receivables	$866	$843	$650	$594
Adjusted Trade Receivables	$3,979	$3,534	$3,631	$2,989
Other Receivables	$841	$835	$932	$913
Total Adjusted Receivables	$4,820	$4,369	$4,563	$3,902
Reported Trade DSOs	42.0	35.3	41.7	36.5
Factored DSOs	11.7	11.0	9.1	9.1
Adjusted Trade DSOs	53.7	46.3	50.7	45.6
Total Adjusted Receivables DSO	65.0	57.2	63.8	59.5

	3/31/2017	12/31/2016	9/30/2016	6/30/2016
Sales	$6,414	$6,770	$6,396	$6,302
Reported Trade Receivables	$3,035	$2,611	$3,019	$2,796
Factored Receivables	$630	$644	$589	$494
Adjusted Trade Receivables	$3,665	$3,255	$3,608	$3,290
Other Receivables	$829	$859	$895	$1,123
Total Adjusted Receivables	$4,494	$4,114	$4,503	$4,413
Reported Trade DSOs	43.2	35.2	43.1	40.5
Factored DSOs	9.0	8.7	8.4	7.2
Adjusted Trade DSOs	52.1	43.9	51.5	47.6
Total Adjusted Receivables DSO	63.9	55.5	64.2	63.9

Reported trade receivables DSOs in the 3/18 quarter declined over a day compared to the 3/17 quarter. However, when we add in the factored receivables outstanding at the end of the quarters, adjusted trade DSOs increased by roughly 2 days in each of the last two quarters. This is not an alarming increase and we are not overly concerned by the jump. We also note that the company mentioned in the 12/17 quarter conference call that receivables balances were higher at the end of the year due to the timing of collections. The year-over-year increase in DSO in the 3/18 quarter narrowed compared to the 12/17 quarter, implying that the situation did improve some.

However, we do believe that the increased use of factoring does deserve attention. The outstanding factored receivables balance at the end of the 3/18 quarter jumped by $236 million (almost 40%) over the year-ago period. We note that MDLZ used to disclose in its 10-Qs the amount of receivables actually sold during the period, but now it only shows the

uncollected balances at the end of the period. Still, the disproportionate increase in outstanding factored balances indicates a significant benefit to cash flow in recent quarters. If MDLZ becomes unable or unwilling to continue expanding the use of its receivables factoring programs in upcoming quarters, it will become a headwind to cash flow growth.

Advertising on the Decline

As a consumer products company, MDLZ is highly dependent on brand loyalty from its customers. It is therefore concerning to see the company cutting advertising and promotional expense. The following table shows advertising expense as a percentage of sales for the last three years:

Table 5

	2017	2016	2015
Sales	$25,896	$25,923	$29,636
Advertising Expense	$1,248	$1,396	$1,542
Advertising % of Sales	4.8%	5.4%	5.2%

While MDLZ does not disclose advertising expense on a quarterly basis, it did identify lower advertising and promotional spending being a benefit to profit growth in the 3/18 quarter. This is another item that the company cannot continue to get away with for long, especially as it is trying to pass along price increases to cover rising raw materials and production costs.

We also note that accrued marketing costs actually jumped in the 3/18 quarter:

Table 6

	3/31/2018	12/31/2017	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Sales	$6,765	$6,966	$6,530	$5,986	$6,414	$6,770
Accrued Marketing	$1,847	$1,728	$1,651	$1,574	$1,679	$1,745
Accrued Marketing days of sales	24.9	22.6	23.1	24.0	23.9	23.5

Such an increase is usually associated with an increase in expenses. We are uncertain as to the cause of the discrepancy but wonder if the company actually increased advertising spending but lowered on-site promotional activity which is often booked as a reduction in

sales rather than an expense. Nevertheless, we will continue to monitor this trend in future quarters.

One-Time Charges

MDLZ began a restructuring program in 2014 that has been scheduled to finish at the end of 2018. The table below shows a summary of these charges for the last three years:

Table 7

	2017	2016	2015
Severance and related costs	$323	$402	$442
Asset write-downs	$212	$312	$269
Implementation Costs	$257	$372	$291

Behind the Numbers was always critical of Kraft's practice of making high-priced acquisitions, then later writing much of the purchase price off, selling off pieces of them, and taking huge "one-time" charges in the process. However, we realize that current MDLZ management is not Kraft's. We also realize that the company has undergone a major transformation over the last several years and restructuring charges are warranted in a major rebuilding. As such, we will reserve judgement on these charges to see if they actually end in 2018.

Non-Amortizable Intangible Asset Write-Offs

MDLZ has a sizeable goodwill and intangibles balance courtesy of the long string of acquisitions made when it was part of Kraft Foods. The following table shows the current net balances of goodwill and intangibles:

	3/31/2018
Goodwill	$21,301
Non-Amortizable Intangible Assets	$17,868
Net Amortizable intangible assets	$942
Goodwill & Intangibles	$40,111
Total Assets	$64,503

We would point out the large intangibles balance that is not amortized. According to the company, these balances "consist principally of brand names purchased through our acquisitions of Nabisco Holdings Corp., the Spanish and Portuguese operations of United Biscuits, the global LU biscuit business of Groupe Danone S.A. and Cadbury Limited. Considering we are not fans of the GAAP practice of not amortizing goodwill, we are definitely not excited about the logic of not amortizing intangible assets. This is especially true given that the company regularly writes off portions of this intangible balance every year, as seen in the following table documenting intangible write-offs for the last three years:

	2017	2016	2015
Intangible Asset Impairment Charges	$109	$137	$83

So, rather than amortize these amounts over time to arrive at a more realistic earnings number, these amounts are lumped into one-time charges which are glossed over in non-GAAP earnings adjustments despite their regular occurrence.

Additionally, the company disclosed in its 10-Q that:

> *"During our 2017 annual testing of non-amortizable intangible assets, we recorded $70 million of impairment charges in the third quarter of 2017 related to five trademarks recorded across all regions. During that annual review,* ***we identified thirteen brands, including the five impaired trademarks, with $980 million of aggregate book value as of March 31, 2018 that each had a fair value in excess of book value of 10% or less.*** *We believe our current plans for each of these brands will allow them to continue to not be impaired, but if the product line expectations are not met or specific valuation factors outside of our control, such as discount rates, change significantly, then a brand or brands could become impaired in the future."*

This means that almost $1 billion of these intangible assets could be closing in on being impaired, which indicates we have not seen the last of the regular write offs.

Growth Dependent on Lower Share Count

MDLZ's non-GAAP adjusted EPS rose to $0.62 in the 3/18 quarter, up from $0.52 a year ago. Of this $0.10 per share increase, $0.01 came from VAT settlements, $0.02 came from lower interest expense, while another $0.02 came simply from lower share count. We have

noted in previous work that much of MDLZ's growth comes from a lower share base, which we consider a low-quality source of growth given that the company's cash flow is negative after subtracting the dividend and the buyback (we refer you back to table 1).

MDLZ has supplemented some of this cash shortfall with asset and equipment disposals over the last few years. With net debt/EBITDA at about 4 times, the company is limited in its ability to continue to add to debt to help finance an aggressive buyback. However, the company has also increased the dividend by 16% in 2018 and promised to grow it at a faster pace than earnings going forward. With the cash payout relatively low, the company can continue to raise the dividend for a while, but it will not be able to maintain meaningful growth without generating a sustainable growth in cash flow that is not dependent on milking working capital.

Putting All the Pieces Together Makes the Cash Flow Forecast and Sustained Aggressive Dividend Growth Seem Very Optimistic

For the purpose of discussion, we reprint table 1 below which shows MDLZ's cash flow components on a trailing-12 basis for the last eight quarters:

	3/31/2018	12/31/2017	9/30/2017	6/30/2017
T12 Operating Cash Flow	$3,557	$2,593	$2,497	$2,763
T12 Capex	$992	$1,014	$1,036	$1,108
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Cash After Buyback	-$1,452	-$2,081	-$1,210	-$1,686

Management has forecast free cash flow for 2018 of $2.8 billion. Given that trailing-12 free cash flow as of the 3/18 quarter was almost $2.6 billion may make the $2.8 billion seem

plausible. However, remember that free cash flow was previously trending about $1.5 billion in the last few quarters and that a huge part of the first quarter growth was due to working capital improvements. Lower pension contributions will not benefit cash flow in the remainder of the year either. In addition, the company appears to have considerable cash restructuring payments left to go. The company's 3/18 10-Q filing states the following with regard to the status of the program:

> *"On August 31, 2016, our Board of Directors approved a $600 million reallocation between restructuring program cash costs and capital expenditures so that now the $5.7 billion program consists of approximately $4.1 billion of restructuring program costs ($3.1 billion cash costs and $1 billion non-cash costs) and up to $1.6 billion of capital expenditures. The primary objective of the 2014-2018 Restructuring Program is to reduce our operating cost structure in both our supply chain and overhead costs. The program is intended primarily to cover severance as well as asset disposals and other manufacturing-related one-time costs. Since inception, we have incurred total restructuring and related implementation charges of $3.4 billion related to the 2014-2018 Restructuring Program. We expect to incur the full $4.1 billion of program charges by year-end 2018"*

The following table shows a breakdown of the 2014-2018 restructuring program between charges and cash amounts spent so far using data provided in footnotes:

	Charges Incurred	Cash Rest Paid	Implementation Costs
1Q 2018	$52	$79	$62
2017	$535	$347	$257
2016	$714	$315	$372
2015	$711	$243	$291
2014	$274	$17	$107
	$2,286	$1,001	$1,089

Of the $4.1 billion in total charges expected from 2014-2018, the company has already incurred $3.38 billion, implying another $750 million will fall in the remaining 9 months of 2018. The company does not disclose how much of the implementation costs are paid in cash, but if we assume that it is 100%, then the company has only paid only $2.1 billion of the expected $3.1 billion in cash costs associated with the program, leaving $1 billion left to the paid. (We would also point out that it is likely that some of the implementation costs are for payments for ongoing operations that will likely to be incurred on a regular basis going forward.) If the cash charges are paid out over the next couple of years, the company could

easily spend $500-$600 million in cash in 2018 or roughly equal to what it spent in 2016-2017. Therefore, any tailwind from lower cash restructuring costs could be delayed until 2020. This means that meaningful growth in operating cash flow during the remainder of the year will depend on either a dramatic recovery in sales growth or for working capital improvements to continue at their recent pace. As we showed above, MDLZ saw a ten-day increase in days payable which would have added in excess of $400 million to operating cash flow. The increased use of receivables factoring likely added another $200 million. Capital spending has also come down from lower restructuring related capital spending charges. Management is forecasting capex of $1 billion in 2018 which is about $100 million lower than 2017. This seems reasonable if restructuring-related capital spending is down, although it remains to be seen if $1 billion in capex is sustainable in the long run.

Making the above adjustments to the 3/18 trailing-12 cash flow numbers, the current dividend is consuming in the mid-60% range of free cash flow, not the 50% seen in the table. Given that these working capital benefits are likely to actually reverse at some point in the future, we could see that number rise fairly quickly, making it even more difficult for the company to continue with its share buyback and double-digit dividend growth. As we pointed out above, a lower share count has been a key driver of EPS growth in addition to reducing the cash impact of the dividend.

Dr. Pepper Transaction

MDLZ owns a $2 billion interest in Keurig Green Mountain which is currently acquiring the Dr. Pepper Snapple Group. In January, the company announced it would exchange its ownership interest in Keurig for equity in the Keurig Dr. Pepper, assuming the transaction is completed. The company has estimated it will own approximately 13-14% of the combined Keurig Dr. Pepper combination. The transaction is expected to close July 9th.

Disclosure

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