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AT&T (T) – What Has Changed Since Time Warner Deal Was Announced

AT&T is reporting the merger with Time Warner officially started June 15, 2018. It should be something discussed on the 2Q18 earnings call and more of the accounting mechanics should be available in that 10-Q. AT&T is scheduled to report earnings on July 24. We wanted to preview those results by reviewing what has changed and concerns for this deal that took nearly two-years to close.

The market has hated the deal due to more shares being issued and considerable debt taken on to buy Time Warner both potentially pressuring AT&T's dividend. Those concerns are still out there as are questions of synergies and how well does this combination work.

We will still highlight two basic problems in the long-term for AT&T: 1) Return on Investment is falling due to issuing capital for DirecTV and now Time Warner and heavy capital spending does not appear to be declining anytime soon and 2) in recent years that heavy capital spending has not produced much growth in cash flow.

There are some positives happening with the basic AT&T business that attracted our attention. At less than 7x EBITDA and a yield over 6%, the stock looks cheap. The actual

cash flow at AT&T has improved considerably – without Time Warner. The ability to digest Time Warner and reduce debt while keeping the high dividend is actually stronger now in our view than when this merger was announced.

AT&T does not look like a utility – Years of capital spending over $20 billion annually has resulted in basically flat operating income. This has become a very expensive maintenance reinvestment story.

Cash flow is improving from lower pension funding and rising rates may make this source of cash flow sustainable for a few years.

Cash flow will improve materially from the lower tax rate at both AT&T and Time Warner. Faster depreciation has not been factored into earnings forecasts. We see that as another area of tax reform that could cut non-cash earnings but boost overall cash flow with the tax shield. The ASC-606 rule on amortizing commissions over time is boosting non-cash earnings too.

Retirement of Copper lines is accelerating. The FCC wants faster fiber and broadband rolled out more quickly and is viewing the maintenance of legacy copper lines as an impediment in that area. New rules have been adopted and AT&T should be able to reduce operating expenses and capital spending related to copper and boost cash flow.

Without Time Warner we think the market would be giving AT&T stock a strong look given material increases in cash flow, better dividend coverage, its 5-G roll out with the FirstNet contract. ROI would be increasing.

Time Warner has happened and is weighing on the stock. Time Warner appears to be performing better than forecast in 2016 at the time of the deal and it does produce enough cash flow to cover the interest expense and dividend on the debt and shares issued to complete the deal. The forecast of paying down a significant amount of debt in the first year is one area where we still have concern, as it should require some asset sales.

Time Warner looks like a call option at this point. AT&T has boosted its synergy forecasts from $1 billion to $2.5 billion since the deal was announced in 2016. Even without synergies or asset sales, the goal of paying debt down to 2.1-2.2x EBITDA in four years looks realistic. If synergies on the revenue side emerge, that would be a positive.

We Don't Consider AT&T to be a Utility

Years ago, we were bearish on many of the cable companies overall due to cord-cutting. They generally responded that no one quits broadband and they can raise pricing there to offset losses in other areas. What they left out is they would continue to see competition force them to invest in ever-faster technology, data storage, etc. Often, prices were flat-to-down with the new investment simply maintaining cash flow levels. We have seen this with AT&T. First the wireless network needed to be built, then the next generation network had to be built, then to improve service and lower costs, fiber was run between cell towers, then video and broadband was added to the fiber, then 3G rolled out, 4G rolled out, now fiber needs to be run from towers to homes, more content is needed, 5G is rolling out…

We simply do not view this as a utility any more. The amount of spending going on here has been substantial. While people are correct to have concerns about large acquisitions (and we'll talk about Time Warner below), AT&T only has DirecTV as a sizeable acquisition in recent years. And yet, results were very flat after adjusting for some asset impairments and pension accrual charges or income:

	2017	2016	2015	2014	2013	2012	2011	2010
Capital EX	$21.60	$22.40	$20.00	$21.40	$21.20	$19.70	$20.30	$20.30
Net Acquisitions	-$1.20	$2.30	$30.70	-$5.00	$2.20	$0.00	$1.30	$1.10
Net Spending	$22.80	$24.70	$50.70	$16.40	$23.40	$19.70	$21.60	$21.40
Adj. Op. Income	$23.90	$25.70	$22.70	$22.20	$23.20	$23.00	$22.60	$19.50

So, +/- $2 million, AT&T has been making $22 million in operating income per year for years. It is spending $20 million per year to maintain that along with a $30 million acquisition of DirecTV in 2015. And it's not as though the company hasn't been adding customers and showing some growth:

# customers	2017	2016	2015	2014	2013	2012	2011	2010
Wireless	156.7	146.8	137.3	120.6	110.4	107	103.2	95.5
Access Lines	11.8	14	16.7	19.9	24.6	29.3	34.1	39.2
Broadband	15.7	15.6	15.8	16	16.4	16.4	16.4	16.3
Video	38.9	38	37.9	5.9	5.5	4.5	3.8	n/a

Wireless growth has exceeded landline losses. Some of the early broadband numbers included the first video customers, so arguably broadband has been flat and video grew almost completely from the DirecTV purchase. On the positive side, AT&T has been such a cash machine; it has covered its dividend despite hefty recurring capital spending. The coverage was tighter than many prefer, but it didn't wreck the balance sheet:

	2017	2016	2015	2014	2013	2012	2011	2010
Cash Ops	$39.2	$39.3	$35.9	$31.3	$34.8	$39.2	$34.7	$35.0
Free Cash Flow	$16.4	$14.6	-$14.8	$14.9	$11.4	$19.5	$13.1	$13.6
Dividend	$12.0	$11.8	$10.2	$9.6	$9.7	$10.2	$10.2	$9.9
Dividend %	73%	81%	64% *	64%	85%	52%	78%	73%
Repurchases	$0.5	$0.5	$0.3	$1.6	$13.0	$12.8	$0.0	$0.0
Equity	$142.0	$124.0	$124.0	$90.0	$92.0	$93.0	$106.0	$112.0
Net Debt	$114.0	$118.0	$121.0	$73.0	$71.0	$65.0	$62.0	$65.0
ROI	9.3%	10.6%	9.3%	13.6%	14.2%	14.6%	13.5%	11.0%

**We adjusted the Free Cash Flow to omit the $31 billion DirecTV purchase in calculating the dividend coverage for 2015.*

So, coming into the Time Warner deal, AT&T has made only one other sizeable deal that arguably reduced ROI given that operating income rose about $4 million in the entertainment unit from 2015 to 2016, but has been declining since then. Plus, capital rose as debt and equity increased. The dividend cushion had been about $2-$3 billion for years. It remained at that level since the DirecTV deal as well.

We will look more fully at the Time Warner deal, but we do think investors should focus on a few areas where AT&T should see some improving cash flow going forward. Each should be a positive for dividend coverage and more rapid debt retirement. These have already happened and will benefit 2018 and 2019 as Time Warner is being digested.

The Pension and Retirement Funding Should Produce Higher Cash Flow in the Short-Term

Like nearly all companies with pension and other benefit programs, AT&T has suffered from declining interest rates in recent years. This essentially drove up the obligations. In 2015, the discount rate was 4.6% in 2015, 4.4% in 2016, and 3.8% in 2017.

The 60bp drop in 2017 resulted in the Pension Benefit Obligation rising by $4.6 billion and the underfunded level was $13.8 billion. For the Post Retirement Benefits, the obligation rose by $1.6 billion and the underfunded level was $18.1 billion. Moreover, the cash flow levels above were impaired by cash payments made under ERISA rules:

	2017	2016	2015
Pension Cash Funding	$566	$910	$735
Benefit Cash Funding	$500	$0	$0

In 2018 with interest rates increasing, the discount rates are up 30bp to 4.1%. That should reduce the underfunding levels by roughly $2.3 billion and $0.8 billion. More importantly, AT&T noted in its 2017 10-K, "We expect only minimal ERISA contribution requirements to our pension plans for 2018."

We believe, the discount rates will probably rise again for 2019 and cut the PBO further and mitigate funding needs again. A $600-$700 cut in annual cash funding needs may be a reasonable assumption for the next 2-3 years. After that, rates would need to rise 250-300bp overall and other issues such as weaker returns or reassessments of accruals would need to not occur.

Tax Law Changed to Improve Earnings and Cash Flow

AT&T guidance for 2018 earnings includes $0.45 per share from the lower tax rate, which they estimate will effectively be 23% in 2018. This flows easy enough thinking that taxes have normally been about $7 billion per year of late. Taking 12%-14% lower tax rate reduces that to $4.2-$4.6 billion or $2.4-$2.8 billion lower. At 6.14 billion shares that is 39-46 cents per share. The company already collected a $1.1 billion tax refund in cash flow in 1Q18.
There are two other issues to consider. The first is equipment depreciation can be accelerated now. The company has not fully discussed this and is still evaluating parts of this. Just thinking in rough terms, AT&T had $313 billion in plant & equipment and $188 billion of accumulated depreciation at the end of 2017. $125 billion has been net PP&E for a couple years and we know depreciation is about $20 billion per year against capital spending of $20-$22 billion. So, under the old law, this was largely a wash.

AT&T is expected to boost capital spending with some of the cash flow gains from tax reform. To the extent the new law allows depreciation to rise $1-$2 billion per year – it could reduce taxes by another $200-$400 million. That is another 3-6 cents on the 6.14 billion shares.

We do not think this revolutionizes the balance sheet accounts but could boost the size of the tax shield provided by depreciation a small amount. $1 billion in higher depreciation would be 16-cent non-cash reduction in EPS, offset by 3-cents in tax savings.

While higher depreciation would reduce earnings, it remains a non-cash charge. AT&T will also pick up earnings by amortizing commissions over the life of a contract with ASC-606. This is likely to have minimal impact on cash flow. However, amortizing some costs over 1-3 years will reduce expenses in the first two years. AT&T estimated it should add 10-15 cents in 2018. Eventually, all contracts will move from upfront expensing to an amortization model and earnings should essentially be the same as before. The transition will be complete when all contracts are on the amortization model. It appears to us that these two changes could essentially offset each other.

We believe AT&T's main business before Time Warner should see about $2.0-$3.0 billion in higher cash flow as a result of tax and accounting rule changes.

Faster Retirement of Copper

As is widely known, the number of people still using land line copper phones has been falling for years as wireless has gained business. We listed this above, but will do it again here to see the change at AT&T in recent years:

# customers	2017	2016	2015	2014	2013	2012	2011	2010
Wireless	156.7	146.8	137.3	120.6	110.4	107	103.2	95.5
Access Lines	11.8	14	16.7	19.9	24.6	29.3	34.1	39.2

The problem is not that one is growing as the other decays. It is that AT&T has to maintain two different phone systems. The Wireless phones are using cell-towers and fiber between the towers. The fiber can also be used to carry video and broadband. It has a longer life, a higher capacity, it doesn't use electricity, it is cheaper to maintain, and it is attracting a higher number of users via several forms of communication thus the ROI from using fiber is going up.

The copper phone line system is just the opposite. It is losing customers, it cannot carry fast Internet speeds or HD video. It essentially carries voice calls for phones attached to the wall, which fewer people are willing to pay for these days. Storms and other events that

knock out copper lines and poles require repair every year and because there are fewer customers every year, the ROI is going down.

We think people are aware that fiber and broadband continues to be rolled out and that is generally accepted as a positive for better service, data speeds and better video quality. So, we won't belabor that point and focus on the economics. AT&T and other telecom people are spending $45-$50 per copper line home annually to maintain that system.

Late in 2017, the FCC reduced the delays and time needed for telecom companies to eliminate more old copper networks. This is called the Accelerating Wireline Broadband Deployment by Removing Barriers to Infrastructure Investment plan. It recognizes that telecom infrastructure is expensive – as AT&T's $20+ billion in capital spending per year demonstrates. It also recognizes that the future is in rolling out fiber and giving customers faster broadband access. As Ajit Pai of the FCC noted,

> *"Having to maintain two networks – one legacy, one modern – diverts resources away from new deployments. By definition, every dollar spent maintaining fading copper networks cannot be spent on fiber. And the dollars are substantial; one estimate found companies could save $45-$50 in operating expenses per home each year by not having to maintain old copper facilities. Nationwide, that translates into billions of dollars annually that could be devoted to next-generation networks. But that digital opportunity is denied when the FCC's rules force carriers to maintain the networks of yesteryear."*

As a result, the FCC passed new regulations allowing copper networks to be retired more quickly, with less notice, to take advantage of storm damage and not replace copper at all, etc. The companies have developed work-around systems for people to have a traditional land-line phone set up that works over the internet as substitutes as well.

This should mean that AT&T capital spending goes more fully into new technology that results in higher cash flow. It should mean a reduction in capital spending and operating expenses related to copper. It also already led to a write-down of copper assets in the 4Q17 after these rules took effect. As noted in AT&T's 10-K:

> *"In November 2017, the FCC updated and streamlined certain rules governing pole attachments, copper retirement, and service discontinuances. These changes should facilitate our ability to replace legacy facilities and services with advanced broadband infrastructure and services."*

"During the fourth quarter of 2017, we determined that certain copper assets will not be necessary to support future network activity due to fiber deployment plans in particular markets. We recorded a noncash pretax charge of $2,883 to abandon these assets."

"Internet Protocol (IP) Technology -- IP is generally used to describe the transmission of data, which can include voice (called voice over IP or VoIP), using a software-based technology rather than a traditional wire and physical switch-based telephone network. This technology can provide voice and data services at a lower cost because this technology uses bandwidth more efficiently than a legacy copper wire network. Using this technology also presents growth opportunities, especially in providing data and video services to both fixed locations and mobile devices. To take advantage of both these growth and cost-savings opportunities, we are rapidly converting our network to a software-based network and managing the migration of wireline customers in our current 21-state ILEC service area to services using IP, and expect to continue this transition through at least 2020."

This direction was already established before this recent change to regulation. However, we think if it speeds up, there should be a positive impact on capital spending for copper and lower operating expenses related to copper that improves each year for several years to come. This is difficult to quantify, and we are just going to say that it will be a benefit to cash flow for AT&T.

Adding Up the Positive Changes in Cash Flow

AT&T has included pensions and tax reform in its forecasts as well as activating more fiber areas and seeing lower churn. It is expecting to boost capital spending to $25 billion in 2018, but $2 billion of that will be reimbursed by the government as it builds out the FirstNet infrastructure that will link the various policy and fire emergency units across the country and will form the first part of the AT&T 5G roll-out. So, capital spending is expected to rise to a net $23 billion in 2018. Free cash flow is expected to be close to $21 billion.

Even if AT&T is being a bit aggressive, investors should still be expecting much better results from the AT&T business in 2018-19. The dividend was roughly $12 billion and even at $20 billion of free cash flow, the payout ratio improves to 60%. And, cash left over for other activities jumps to $8-9 billion from $3-$5 billion in recent years.

Time Warner Numbers

The final numbers for Time Warner was a net payment of $42.5 billion in cash, assuming about $24 billion in Time Warner debt, and issuing 1.437 billion shares of AT&T stock. As a result, the AT&T dividend is now 7.58 billion shares at $2 per share or $15.2 billion.

The total debt at AT&T is now $180.4 billion, which is 2.9x EBITDA. They expect to be at 2.5x after one year and at historical levels (about 2.1-2.2x) within 4 years. That would mean paying down debt by about $40 billion with $25 billion in the first year. (This may be $30 billion over four years and $20 billion in the first year if some of the proposed synergies and growth materialize) AT&T has talked about possibly doing an IPO with the Latin American part of DirecTV to raise funds. Time Warner will also benefit from tax reform for about $500 million per year.

Time Warner results appear to be running on forecast laid out by management in the November 2016 S-4 document. In it, they forecast adjusted free cash flow for 2017 at $4.6 billion for Time Warner. A standard free cash flow calculation on actual 2017 results has $4.4 billion. However, Time Warner was using Operating Income before depreciation and one-time events less capital spending. That would mean they left out interest expense and adjusted tax expense for that. Given that there were some minor one-time charges that are about half the $200 million difference and interest expense was $1.0 billion in 2017 and would have penalized the standard definition of free cash flow which starts with net income not operating income as the first part of cash flow; we believe Time Warner results are stronger than planned. The same could be said for 2016 numbers, forecast at $4.8 billion without interest expense of $1.2 billion. Free cash flow defined as cash from operations less capital spending was $4.3 billion so the $1.2 billion more than accounts for the difference.

AT&T paid about 12.5x EBITDA for Time Warner. It was forecasting 9% cash flow growth going forward. It does out-earn its cost of capital. It had $1.0 billion of interest expense on existing debt, the incremental $42.5 billion would be almost $2.0 billion more, and the incremental dividend on 1.437 billion shares adjusting for taxes is another $3.6 billion. This means $6.6 billion cost of capital total compared to EBITDA of $9 billion and growing. Capital spending has been minor at about $0.5 billion.

View of Time Warner

The deal on the surface does not boost ROI; it basically stays at 9%. They issued $112 billion in new debt and stock and add that to AT&T capital of $256 billion to get to $368 billion. AT&T was doing $23.5 billion in operating income and add that to Time Warner's $8.2 billion and ROI is 8.6%.

It is interesting that at the time of the deal, AT&T was forecasting only $1 billion in cost synergies and no revenue synergies. At closing, they are forecasting $1.5 billion in cost savings and $1.0 billion in revenue. The cost savings were about 330bp and now they are about 470bp. Over three years, that range may be doable, but we have some reservation about that as these are different companies and the normal easy synergies on costs are less likely to be available – like consolidating production plants or delivery systems when two food companies merge. Revenue should be the main focus of this because they want to offer the Time Warner content to the AT&T mobile platform. Even adding the full $2.5 billion of synergies – the ROI improves to only 9.3%. While Time Warner has been growing, it remains a much smaller part of AT&T overall.

Quite frankly, the bigger improvements to AT&T are not coming from the Time Warner deal – they are coming from pension funding going down, tax reform, and copper retirement allowing them to speed up broadband and fiber rollout. This deal would look much tighter on maintaining the dividend and debt pay-down if those unrelated events had not occurred.

However, if we look at the deal based on current guidance:

Free Cash Flow from AT&T Operations	$21.0 billion
Free Cash Flow from TW Operations	$5.0 billion
Less TW interest expense net of tax	$3.0 billion
Cash for Dividend	$23.0 billion
Dividend	$15.2 billion
Left for debt pay-down	$7.8 billion

AT&T's dividend coverage actually improves to 0.66x and if the goal is to retire about $30-$40 billion of debt in four years, $8 billion per year covers much of that. The only goal that sounds a bit lofty is paying down $20-$25 billion in debt in the first year. That will require asset sales. Already, AT&T sold some data centers to Brookfield under essentially a

sale/leaseback for $1.1 billion. It's going to take more than that. An IPO for the Latin America DirecTV operations have been forecast to bring in $4-$8 billion on estimates we have seen. Again, that isn't enough.

Our conclusion is the AT&T dividend looks safe in the near future. The cash flow has improved and Time Warner is net cash flow positive. Debt repayment will likely be a bigger focus for several years rather dividend growth. We look at this situation as sustainable with many potential wild cards that could actually be positives to cash flow.

Do cost synergies materialize?
Will Time Warner content drive more AT&T revenue?
Will Time Warner content convert more people to DirecTV Now?
Do copper savings accelerate?

If the answer to any of this is yes – the dividend gets more cushion, debt repayment may accelerate, and the dividend may grow faster. If Time Warner does not add many positives, AT&T's cushion on cash flow looks strong enough to support the current situation and the stock is really not very expensive at under 7x EBITDA and a 6.3% yield. Overall, we'd prefer they NOT make another major deal.

So, we would view Time Warner as a call option at this point. It was expensive to buy, but that's done now. We will be curious to see in the earnings and the next 10-Q some more specificity on potential synergies and asset sales. We will also look more closely at how Time Warner's acquired assets were allocated and if there is potential for more of a tax shield to help cash flow further.

EQ Review of J.M. Smucker (SJM)

J.M. Smucker (SJM) has not been immune to the troubles faced by packaged food companies. Over 30% of the company's sales come from coffee, but growth from selling *Dunkin Donuts* brand Keurig cups is being offset by floundering sales of its *Folgers* instant brand. Its second largest segment, Pet Food, faces increasing competition, while its more familiar consumer food brands are under pressure from consumers switching to more fresh products. With 92% of sales in the US and 6% in Canada, SJM has essentially no diversification and no exposure to faster growing, less developed markets. The company continues to attempt to diversify into higher growth areas as evidenced by its announcement this week it is selling its baking business which includes the iconic *Pillsbury* brand.

Despite these challenges, SJM's reported earnings appear to be some of the highest quality in the food industry. Our observations include:

- SJM has some of the most efficient working capital management in the industry. Accounts receivable days-of-sales are low and declining while inventories days-of-sales are low and stable.

- Accounts payable in the 3/18 quarter increased by over 4 days versus the year-ago period. However, we note that the increase was more muted than some of its peers and its absolute level of payables relative to cost of sales is the lowest in the group.

- Capital spending has been on the rise to support the buildout of new factory capacity and is projected to increase another $40 million in FY 2019. This will continue to be a drain on free cash flow but should start to reverse in FY 2020.

- SJM has postponed its buyback and did not purchase any shares in the fiscal year ended 4/18. Management plans to reduce leverage after the Ainsworth acquisition back to 3 times EBITDA over the next couple of years which will likely prioritize debt reduction over the buyback. Lower share count boosted EPS by 1% in the quarter, a benefit which will be gone moving forward.

- SJM has taken multiple goodwill and intangible write-offs in the last few years related to its Pet Food segment which accounts for 30% of total goodwill and over 20% of total shareholders' equity. However, impairment testing revealed that the carrying value of goodwill only exceeds fair value by less than 1% and just a 50 bps drop in

long-term growth assumptions drop fair value below carrying value, meaning more write offs are possible.

Receivables and Inventory Are Under Control

SJM's accounts receivable days of sales (DSOs) fell to 19.8 in the 4/18 quarter, down from 22.4 in the 4/17 quarter, continuing several quarters of such declines. We would also note that the company's DSOs in the low 20s are some of the lowest in the industry. Likewise, inventory days (DSI) declined slightly to 71.5 from 72.7 in the year-ago period.

From this perspective, the company has little room to improve its cash flow growth by tightening up receivables collection. However, while we don't advocate the practice, it seems the company could be in a position to drive some sales growth by extending better payment terms with customers if it needed to.

Accounts Payable Up

The following table shows accounts payables on a days-of-cost-of-sales basis for the last eight quarters:

	4/30/2018	1/31/2018	10/31/2017	7/31/2017
COGS	$1,091	$1,175	$1,169	$1,087
Accounts payable	$512	$471	$507	$478
Accounts payable DSPs	42.8	36.6	39.6	40.1

	4/30/2017	1/31/2017	10/31/2016	7/31/2016
COGS	$1,137	$1,156	$1,171	$1,093
Accounts payable	$477	$429	$436	$452
Accounts payable DSPs	38.3	33.8	34.0	37.7

The 4.5-day year-over-year increase in days payable continues a trend of rising payables which is boosting cash flow. The trend of rising payables is something we are seeing in many industries and it is particularly pronounced in the packaged food industry. However, we must note that the company's levels of payables relative to COGS is one of the lowest in the group and the increase, while significant, is still relatively modest when compared to some

if its peers including Mondelez (MDLZ) and Kellogg (K). This could be an indication that the company still has room to boost cash flow growth by lengthening payments terms. As with extending receivables terms, we do not condone the practice as a healthy solution, but simply observe that SJM appears to not have stretched as far as some of its peers meaning it has more "dry powder" at its disposal.

Capex Is Rising and Share Buyback Is Stalled

SJM has forecast free cash flow in fiscal 2019 of $850 million, an approximate $50 million decline from FY 2018. The below table shows a breakdown of cash flow for the last eight trailing-12 periods:

	4/30/2018	**1/31/2018**	**10/31/2017**	**7/31/2017**
T12 Operating Cash Flow	$1,218	$1,168	$1,118	$1,124
T12 Capex	$322	$266	$238	$212
T12 Free Cash Flow	$896	$902	$880	$913
T12 Dividends	$350	$349	$348	$346
Dividend % of FCF	39%	39%	40%	38%
T12 Stock Repurchases	$7	$426	$426	$426
Cash After Buyback	$539	$128	$107	$140

	4/30/2017	**1/31/2017**	**10/31/2016**	**7/31/2016**
T12 Operating Cash Flow	$1,059	$1,131	$1,254	$1,393
T12 Capex	$192	$177	$168	$199
T12 Free Cash Flow	$867	$954	$1,086	$1,194
T12 Dividends	$339	$332	$325	$318
Dividend % of FCF	39%	35%	30%	27%
T12 Stock Repurchases	$438	$452	$453	$452
Cash After Buyback	$90	$169	$308	$424

Capex has been on the rise for the last several quarters, driven partly by the buildout of new factory capacity. Management is currently expecting capex of $360 million in FY 2019.

The increased pace of capital spending and one-time integration costs has led management to put the share buyback on hold. The company did not repurchase shares in the fiscal year ended 4/18. The lower share count added about 1% to EPS growth in the most recent quarter which is a benefit that will be gone in the next quarter absent the buyback. Once the accelerated capital spend is complete in FY 2019, free cash flow should normalize, freeing up more cash for capital allocation. Net debt as of the end of the 4/18 quarter was

approximately 2.8 times EBITDA. The company added another $1.9 billion to its quarter-end debt load of $4.8 billion for the May acquisition of Ainsworth which will bring its total to $6.7 billion. We estimate Ainsley generates about $140 million annually in EBITDA, implying a post-acquisition debt-to-EBITDA of about 3.7. Management has stated it would like to pay down debt to 3 times EBTIDA over the next couple of years, implying debt reduction of around $1.2 billion. The $375 million in proceeds from the sale of the baking business will help, but the company will obviously have to divert most of its post-dividend free cash flow to paying off debt to reach that goal. Therefore, we would not expect a meaningful return to the buyback anytime soon.

Pet Food Goodwill Impairments and Possibly More on the Way

During fiscal 2018, SJM took a $145 million goodwill impairment charge to write down the value of goodwill related its Pet Food division. In addition, the company recorded another $31.9 million in charges to reduce the carrying value of certain indefinite lived-intangibles, also related to the Pet Food segment. The Pet Food goodwill and intangibles balances mostly stem from the company's 2015 acquisition of Big Heart. The company also disclosed in its 10-K that the estimated fair value of the goodwill of its Pet Foods segment (30% of total goodwill) exceeded its carrying value by only 1%, and that a 50 bps decrease in the long-term growth assumptions or the cost of capital would result in a fair value below carrying value. Therefore, future goodwill impairment charges seem very possible.

PepsiCo (PEP) EQ Update

We note the following observations regarding PEP's 6/18 quarterly earnings. We saw no material erosion in the company's earnings quality during the quarter.

- PEP recorded a $144 million ($0.09 per share) gain from the refranchising of its Thai bottling operations during the quarter. However, following its recent practice, PEP did not exclude the gain from its adjusted "core earnings" figure. PEP reported $1.61 in core EPS, $0.10 ahead of the Zack's consensus estimate. Almost all the upside came from the non-operational gain.

- The company does not disclose accounts payable on a quarterly basis, but rather lumps it in with other accrued expense items such as accrued marketing, accrued dividend payable and accrued marketplace spending in the "accounts payable and other current liabilities" account. On a days-of-cost-of-sales basis, this account jumped by almost 5 days over the year-ago quarter which may be an indication that PEP is continuing to stretch payables on its suppliers.

- PEP took another $32 million in restructuring charges in the quarter related to its 2014 plan. As of the end of the second quarter, the company expects the plan to be wrapped up by the end of the year.

Disclosure

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