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BEHIND THE NUMBERS
Quality of Earnings Analysis

April 9, 2021

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YUM! Brands, Inc. (YUM)
Earnings Quality Review

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are initiating earnings quality coverage of YUM with a 4- (Acceptable) rating.

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

YUM beat forecasts for 4Q20 by 14-cents and posted $1.15 in adjusted EPS. The adjustments were only 7-cents, of which 70% was related to a charitable contribution. We would quibble with 1.5 cents related to the early retirement of some employees and accelerating some issues for Pizza Hut as not being one-time. For the past four quarters, YUM beat by 60-cents with 68-cents in adjustments – the largest being an impairment for Habit Burger.

The biggest help was releasing tax valuation allowances in 4Q that drove the tax rate to 5.7%. For the year, we saw allowances helped by $22 million, and adjustments to deferred tax items at both federal and state levels were $17 million. Together, those two items were worth 13-cents in EPS during the year, and it does appear that helped 4Q more than other periods. There were another 9-cents in taxes added back in 2020 for transferring intangible assets within the company. Guidance is for a 21%-23% tax rate so we don't expect this source of EPS to continue. YUM also realized 3-cents from bad debt expense coming in $12 million below 2019 and 7-cents from a $26 million swing in advertising royalties not collected in 2019 to a credit in 2020.

Overall, YUM carries more debt than it should in our opinion at 5.2x EBITDA. It has also franchised 98% of its properties so that external source of cash should be much smaller going forward and that along with borrowing drove share repurchases to help past EPS growth.

What is strong?

- YUM is largely complete on its refranchising process. This leaves it a business that largely collects royalties and should see slow steady growth. The dividend may consume over 70% of free cash flow in 2021 vs 45% the last two years but appears sustainable.

- EBITDA should recover in 2021 with sales. YUM will need to ramp up marketing but is guiding to higher revenues leveraging G&A expenses. The debt at 5.2x EBITDA is expected to be at 5.0x or lower by 2Q21 with the higher EBITDA.

What is weak?

- Share repurchases fueled recent incremental EPS growth of as much as 10%-13%. We do not think YUM can afford to buy stock at those same rates. It paid for it with proceeds from refranchising stores and that process now covers 98% of stores. It further paid for the stock repurchases by borrowing and debt is now over 5x EBITDA.

- YUM may actually need to spend $200-$300 million on share repurchases just to offset share dilution from stock compensation. Even that level of spending looks tight as the company is forecasting a rise in capital spending and the dividend was raised.

- YUM had a positive $300 million swing in cash flow in 2020 by drawing down working capital. Now that will need to be rebuilt as it funds higher advertising in advance and collects from franchisees on a lagging basis. It expects higher capital spending too.

- We believe there will be a widening divergence between EBITDA and free cash flow in 2021 making it tougher to count on growing its debt load for another year. It also points to some aggressiveness in EBITDA as capital spending exceeds depreciation effectively making depreciation a cash expense. Also, there are areas of franchising where YUM collects cash payments upfront, which it spent already – but is recognized as revenue over time as non-cash income that becomes part of EBITDA.

What to watch

- YUM's overall plan can work – some organic revenue growth at the restaurant level boosting royalties to YUM and thus higher cash flow and EBITDA. It will then boost debt to 5.0x EBITDA again and use that and free cash flow to pay dividends and repurchase stock.

- Investors should watch how long it takes actual free cash flow to start rising again. Ultimately, that's what needs to be available to cover the debt. We do not think business at usual starts up again for YUM in 2021. It has to overcome a higher dividend outlay, higher capital spending, working capital being rebuilt and advertising outlays being prepaid.

- Items like cutting bad debt reserves and tax allowances, and even minor drops in YUM's own advertising helped out results in 2020. We think the company essentially still posted EPS beats ahead of these small boosts to income. However, it is tough to make a case that any of those items do not become neutral at best in 2021 or a headwind at worst.

Supporting Detail

Cash Flow Does Not Support YUM's Past EPS Growth

	2020	2019	2018	2017	2016
Cash from Opers.	$1,305	$1,315	$1,176	$1,030	$1,248
Cap. Exp.	$160	$196	$234	$318	$427
Free Cash Flow	$1,145	$1,119	$942	$712	$821
Acquisitions	-$202	$0	-$266	$0	$0
Refranchising Cash	**$19**	**$110**	**$825**	**$1,773**	**$370**
Cash for stock	$962	$1,229	$1,501	$2,485	$1,191
Dividends	$566	$511	$462	$416	$744
Stock Repurchases	$239	$815	$2,390	$1,960	$5,403
Cash +/-	$157	-$97	-$1,351	$109	-$4,956
Net shares repurchased	0	6	26	23	65
wgt avg shares o/s	307	313	329	355	400
EPS Growth from Repo	1.4%	3.7%	9.8%	12.5%	13.0%

YUM should get some bounce in net income in 2021 as operations do not have Covid restrictions like in 2020. There are some headwinds and tailwinds too for items like taxes and working capital items in our view that may offset some of that. We think investors should focus on four other major things here:

- Guidance is for capital spending of $250 million in 2021, which is a $90 million headwind on free cash flow.

- Refranchising cash is only expected to be about $50 million in 2021 and YUM has already franchised 98% of its stores.

- The cash dividend is now $600 million so that is another $34 million headwind

- Even at the height of refranchising, YUM was still outspending that cash and borrowing billions more to fund repurchases. Net debt is $10 billion now and exceeds YUM's target of 5.0x EBITDA. That's simply not a source of additional cash to tap now.

Historically, YUM was picking up 10%-13% of EPS growth from hefty repurchases. The stock now trades for over 25x EPS and growth may more closely mirror sales growth at the underlying restaurants which is mid-single digits – with some easy comps for early 2021, which should help further in the short term. It is also worth noting that employees receive 2-3 million shares of stock per year via stock compensation plans. With the stock over $100, YUM has to spend $200-$300 million on stock repurchases to hold the share-count flat.

Cash Flow May Diverge Negatively from EBITDA in 2021

Investors understand that YUM earns a percentage of sales from franchised properties as well as an advertising cooperative payment that is also a percentage of franchisee sales. People would also not be surprised that with total sales declining in 2020, the amount of fees paid to YUM also declined.

Under the accounting policies, YUM books these revenues and bills for them monthly. Thus, the revenues become part of earnings and EBITDA as they become receivables, but the cash flow recognition lags until the receivables are paid:

- Franchise fees from the 10K: *"Continuing fees represent the substantial majority of the consideration we receive under our franchise agreements. Continuing fees are* ***typically billed and paid monthly*** *and are usually 4% - 6% for store-level franchise agreements."*
- Advertising fees from the 10K: *"We have determined we act as a principal in the transactions entered into by the advertising cooperatives we are required to*

consolidate based on our responsibility to define the nature of the goods or services provided and/or ***our commitment to pay for advertising services in advance of the related franchisee contributions****. Additionally, we have determined the advertising services provided to franchisees are highly interrelated with the franchise right and therefore not distinct. Franchisees remit to these consolidated advertising cooperatives a percentage of restaurant sales as consideration for providing the advertising services. As a result, revenues for advertising services are recognized when the related restaurant sales occur based on the application of the sales-based royalty exception within Topic 606.* ***Revenues for these services are typically billed and received on a monthly basis.”***

What this means is 2019 had higher figures for both royalties than 2020, $2.66 billion vs. $2.51 billion for franchise revenues and $1.39 billion vs. $1.33 billion for advertising. That also means since there is a lagging impact on cash flow, YUM collected more cash in 2020 than it reported in revenues from these items. This could be seen in cash flow through the working capital items:

	2020	2019	2018
change in A/R	$62	-$56	-$66
change in prepaid	$8	-$8	$0
change in A/P	$128	-$36	-$68
Working Capital change	$198	-$100	-$134
Cash from Opers	$1,305	$1,315	$1,176

There was essentially a positive $300 million swing for cash flow in 2020 from 2019 due to working capital being liquidated. We think that will reverse in 2021 and become a headwind. In fact, it may be worse because the advertising is paid in advance by YUM and collected on a lagging basis and the figure should be larger in 2021. The company seldom has more than $1.2-$1.3 billion in cash from operations so rebuilding working capital could be a sizeable drain on that figure. At the same time, cash flow is getting hit by this change, EBITDA of just over $2.0 billion will be rising as sales recover against negative comps. It is also worth pointing out that YUM deferred collection of about $60 million in royalties from franchisees in 2Q20. However, less than $1 million remained outstanding at the end of 2020 so that source of cash flow also came in already in 2020.

It is also worth noting two other areas where EBITDA may be inflated vs. Cash Flow:

- **Upfront franchise fees are often collected when a new franchise agreement is signed. Cash comes in and YUM amortizes the payment into revenue over the life of the agreement.** We don’t have an issue with that policy at all. But, given that 98% of the stores are now franchised, the cash was received (and spent). This is now a non-cash source of revenue that is inflating EBITDA, where the base of the calculation starts reported income.

- **Capital spending exceeds Depreciation and Amortization in most years and 2021 should see this again given guidance for $250 million in capital spending.** This is not a bad thing for YUM in our view. But it does point to depreciation and amortization being a necessary cash expense and since EBITDA does not record any outflow in this area, we would view it as inflated:

	2020	**2019**	**2018**
Depreciation & Amortization	$146	$112	$137
Capital Spend.	$160	$196	$234

We understand what YUM wants to do. Grow sales at restaurants, add more restaurants and have that produce a growing EBITDA figure for YUM. That would enable it to borrow more money and keep debt at 5x EBITDA while repurchasing more stock. When we look at 2021, we simply think that plan needs to be on hold because we believe actual cash flow that does support the debt may well decline this year.

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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