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Quality of Earnings Analysis

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A Precursor of Inventory-Related Problems

Six Companies Whose Inventory Accounting May Lead to Disappointing 1Q'22 Results

Summary

While it is not news that inflation has picked up significantly over the last year, we have noticed that several companies may have more problems than it appears. After reviewing 4Q earnings, we believe several companies have either sought to avoid buying new inventory at higher costs or faced difficulty in replacing inventory with logistics problems as their inventories have dropped in dollars and DSIs even as volume demand improved. On top of that, they have taken price increases while selling their cheaper inventory. We think this will make 1Q and 2Q earnings estimates more difficult to meet as eventually, these companies may have to bite the bullet and pay up for higher-cost replacement inventory that will start flowing through Cost of Goods Sold.

The key point to realize is losing 10-30 bps of gross margin is a material amount of EPS for these companies. The list includes General Mills, Inc. (GIS), The Coca-Cola Company (KO), The Hershey Company (HSY), Post Holdings, Inc. (POST), Ball Corp (BLL), and Mondelez International, Inc. (MDLZ).

- General Mills uses LIFO inventory accounting which already puts it at a disadvantage to peers who use FIFO or Average Cost. GIS has let inventories run down of late as it delayed replacing them at higher costs. Every 10 bps of lost gross margin costs GIS 2 cents in EPS and margins were off 330bp last quarter.

- Coke's earnings are helped by using FIFO and Average Cost accounting during inflation. It also has opted to let raw material levels of inventory decline during 2021 until 4Q. It was helped by price hikes and its lower margin bottling operation being a smaller part of the total mix, yet gross margins were only up 30bp in 4Q. We think the rate of cost increases will continue to push through Coke's earnings and every 10bp of lost margin costs it 1 cent in EPS.

- Hershey uses LIFO for 60% of inventory and FIFO for the rest. It is already guiding to lower gross margins. It too has cut its inventory DSIs by 8 days of late and may be forced to pay up for new inventory. It may have benefited from liquidating LIFO layers as it reduced inventory stocks. A 10 bp lower gross margin than expected would cost HSY 4 cents in EPS and margins have already fallen more than that.

- Post uses FIFO accounting which should help its results, yet margins are not seeing much improvement and it has drawn down inventories by 10-15 days. Post is guiding to inflation becoming benign after its February results (fiscal 2Q22) for its forecasts. A 10 bp miss on gross margins costs POST 8 cents in EPS.

- Mondelez uses average cost accounting and already missed on gross margins for 4Q21. It also took down raw materials inventory from 3Q21. It also looks evident that MDLZ took more pricing gains than inflation warranted, which may make further price hikes more difficult. Every 10bp it misses on gross margin costs it 2 cents in EPS.

- Ball Corp. uses the FIFO and Average Cost inventory methods. Aluminum costs are skyrocketing while raw materials inventory was essentially flat sequentially in the 12/21 quarter. Costs may have benefitted from delaying rebuilding inventories. Every 10 bp miss in gross margin costs BLL a penny per share in earnings.

General Mills, Inc. (GIS)

GIS uses LIFO accounting for US inventories, carries its grain inventory at net realizable value, and non-grain inventories outside the US at FIFO. This compares to many of its peers who use FIFO or average cost. Shouldn't Raw Materials in Inventory be Rising amid Heavy Inflation – Grain Just Did?

Inventory	11/28/2021	8/29/2021	5/30/2021	2/28/2021	11/29/20	8/30/20	5/31/2020	2/23/2020	11/24/2019
Raw Materials	$422.1	$425.1	$411.9	$420.4	$432.8	$436.3	$392.2	$387.1	$398.0
Grains	$206.4	$128.0	$111.2	$119.0	$113.3	$78.5	$93.6	$90.8	$99.2
Finished Goods	$1,457.4	$1,640.5	$1,506.9	$1,418.5	$1,360.4	$1,286.4	$1,142.6	$1,273.7	$1,433.6
FIFO over LIFO	-$288.6	-$258.4	-$209.5	-$199.1	-$194.0	-$196.1	-$202.1	-$209.5	-$211.3
Total Inventory	$1,797.3	$1,935.2	$1,820.5	$1,758.8	$1,712.5	$1,605.1	$1,426.3	$1,542.1	$1,719.5

- FIFO over LIFO is showing that international inventories at FIFO would be valued $288 million higher under LIFO. That higher cost would be crimping gross margin, and you can see that the difference has risen over 30% from a fairly constant $200 million.

- Grain is carried at net realizable value and was running consistently at $100 million. In one quarter, it jumped to over $200 million.

- We know packaging materials, proteins, and other inputs are increasing in price – how are raw materials not rising? Plus, they are actually going down compared to 12-months ago.

- Finished goods also declined sequentially and are worth watching now. They are essentially flat with pre-Covid times from 2019. It appears that GIS may have drawn down inventories in the 11/21 quarter and simply did not replace them. That may mean that the gross margin for the 11/21 quarter was helped by breaking into lower-cost LIFO layers. The question is can GIS continue this?

DSIs Are already at Low Levels as GIS has drawn down inventory levels to avoid paying the higher costs from inflation.

	11/28/2021	8/29/2021	5/30/2021	2/28/2021
DSI	48.2	59.8	56.3	54.0

	11/29/20	8/30/20	5/31/2020	2/23/2020
DSI	52.0	52.7	42.9	50.5

	11/24/2019	8/25/2019	5/26/2019	2/24/2019
DSI	54.9	59.2	52.5	51.0

	11/25/2018	8/26/2018	5/27/2018	2/25/2018
DSI	51.4	55.8	60.5	50.3

GIS saw adjusted gross margin fall 330bp for fiscal 2Q22 to 32.2%. That follows 1Q22's decline of 150bp to 34.7%. They had everything working for them, price hikes and not replacing inventories at higher prices and perhaps even some LIFO layer liquidations. We think as inventory rebuilds this will pressure margins more. Every 10bp of lost gross margin is 2 cents in EPS at GIS.

The Coca-Cola Company (KO)

KO uses FIFO and Average Cost inventory accounting. Both would help margins during inflation. The company didn't even mention raw materials inflation in early 2021, yet was drawing down inventories in dollar terms until 4Q21:

Inventory $	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20
Raw Materials	$2,133	$1,914	$2,024	$2,097	$2,106	$2,069	$2,265	$2,282
Total Inventory	$3,414	$3,182	$3,281	$3,356	$3,266	$3,264	$3,501	$3,558
y/y Case Vol	9%	6%	18%	0%	-3%	-4%	-16%	-1%

We know actual case volume was up 9% against a -3% comp in 4Q21. But inventory in dollar terms was up only 4.5% y/y and likely represents lower volume carried at inflated dollars.

DSIs are showing the problem even better as the Cost of Good Sold figure is rising with inflation too. Normally DSIs are 85 days +/- 2 days. Coke is running 10 days below normal:

	12/31/21	10/1/21	7/2/21	4/2/21
Adj. COGS	$4,042	$3,908	$3,904	$3,556
Inventory	$3,414	$3,182	$3,281	$3,356
DSI	76.9	74.1	77.3	85.9

	12/31/20	9/25/20	6/26/20	3/27/20
Adj. COGS	$3,661	$3,508	$3,038	$3,291
Inventory	$3,266	$3,264	$3,501	$3,558
DSI	86.5	84.7	104.9	94.1

We think Coke has resisted replenishing inventory at higher prices in the hopes that some of the inflationary pressures would reverse. Also, avoiding higher-priced purchases would limit the pressure on gross margin from average cost accounting. Some sales leverage with stronger case volumes helped gross margins as did enormous price hikes in 2021. However, with 10% pricing gains in 4Q21 against a 0% in 4Q20, KO just saw gross margin tick down:

	12/31/21	10/1/21	7/2/21	4/2/21
Pricing	10%	6%	11%	1%
Case Volume	9%	6%	18%	0%
Gross Margin	57.3%	61.1%	61.4%	60.6%

	12/31/20	9/25/20	6/26/20	3/27/20
Pricing	-3%	-3%	-4%	0%
Case Volume	-3%	-4%	-16%	-1%
Gross Margin	57.4%	59.4%	57.7%	61.6%

KO is reporting that gross margins were up 30bp in 4Q21 y/y due to lower margin bottling operations being less of the total mix as was the case for much of 2021 when it helped 20 bps in 3Q, and an unspecified large amount in 2Q, and hurt by 10 bps in 1Q21. We would not count that as a tailwind that will last forever and expect commodity inflation to hurt all segments. Also, KO is calling out the BodyArmor acquisition in mid-4Q21 as the headwind that pushed gross margins down.

The company didn't even mention commodity inflation in discussing gross margin in 2Q21's or 1Q21's 10-Q filings. Now it's calling for mid-single-digit commodity pressure for 2022. They have already taken pricing, they have already delayed buying higher-cost inventory, and unless Coke can continue to have bottling shrink as a percentage of the total – we think the cost pressure on margins is going to intensify going forward.

Coke is expecting only 7%-8% organic growth in 2022 – they were getting more pricing than that in 2021. Now they are starting to rebuild inventories at higher costs too. FIFO will help some, but the average cost method will boost inventory costs immediately. So less pricing and higher inventory costs for 2022 vs 2021. Every 10bps of lower gross margin costs KO 1 cent in EPS.

The Hershey Company (HSY)

HSY uses LIFO for 60% of its inventories (largely the US) and FIFO for the other 40%. It is interesting to note that the LIFO inventories declined by $16.4 million for 4Q21 vs. 4Q22. That's dollar terms. Wouldn't units be down even more with the backdrop of inflation? We also noticed that inventory levels were rising early in 2021 before falling noticeably in 4Q21. On DSIs which would adjust for inflation with a higher COGS figure, the inventory is down 8 days:

	12/31/2021	10/3/2021	7/04/2021	4/04/2021
Raw Materials	$395.358	$403.374	$412.728	$428.678
Goods in Process	$110.008	$131.523	$140.868	$116.894
Finished Goods	$649.082	$662.073	$677.254	$534.660
Adjustments to LIFO	-$165.937	-$170.429	-$170.428	-$170.430
Total Inventory	$988.511	$1,026.541	$1,060.422	$909.802

	12/31/2020	9/27/2020	6/28/2020	3/29/2020
Raw Materials	$388.600	$326.556	$347.999	$324.674
Goods in Process	$104.841	$120.132	$132.235	$117.818
Finished Goods	$645.664	$686.999	$694.351	$564.906
Adjustments to LIFO	-$174.898	-$175.204	-$175.205	-$175.205
Total Inventory	$964.207	$958.483	$999.380	$832.193

	12/31/2021	10/3/2021	07/04/2021	04/04/2021
Raw Materials DSI	26.8	28.3	35.3	32.3
Goods in Process DSI	7.5	9.2	12.0	8.8
Finished Goods DSI	44.0	46.4	57.9	40.3
Adjustments to LIFO DSI	-11.2	-11.9	-14.6	-12.8
DSI	67.0	71.9	90.7	68.6

	12/31/2020	09/27/2020	06/28/2020	03/29/2020
Raw Materials DSI	30.2	26.1	34.6	24.7
Goods in Process DSI	8.1	9.6	13.2	9.0
Finished Goods DSI	50.1	54.8	69.1	42.9
Adjustments to LIFO DSI	-13.6	-14.0	-17.4	-13.3
DSI	74.9	76.5	99.4	63.3

Because HSY does use LIFO for 60% of the business, it is already feeling more of the impacts of inflation. Gross margin has been falling y/y for much of 2021:

	12/31/2021	10/3/2021	07/04/2021	04/04/2021
Adjusted Gross Profit Margin	43.5%	44.3%	46.4%	45.8%

	12/31/2020	09/27/2020	06/28/2020	03/29/2020
Adjusted Gross Profit Margin	43.9%	45.4%	46.4%	46.6%

Hershey is already guiding to a lower gross profit margin for 2022 despite more price hikes. They expect 8%-10% sales growth with 3%-4% coming from acquisitions, which means organic sales growth should be closer to 5%-6%. They noted that pricing will "partially offset" the inflationary pressures for labor, logistics, and raw materials and it believes better marketing spending will help too.

The risks we see are:

- Every 10 bps of lost gross margin costs HSY about 4 cents in annual EPS. It would be easy to have this come in worse than expected in our view. It fell 40 bps and 110 bps in 4Q21 and 3Q21 already.

- With raw material DSIs low, HSY may have to replace those at even higher prices than what 3Q21 and 4Q21 saw. And with LIFO, they will be moving through COGS more quickly.

- With LIFO inventory down in dollar terms y/y – did HSY benefit from liquidating some LIFO layers and selling product with a lower cost but charging more for it?

- It appears that HSY is past the transitionary stage of inflation, they have already taken price hikes, they have already drawn down cheaper inventory stocks, and it sounds like price hikes will not be as high as 2021 on sales guidance.

Post Holdings, Inc. (POST)

POST's inventory declined significantly to end fiscal 4Q21 (September). This is alarming to us because of the commodity inflation that is impacting much of the economy. POST uses FIFO accounting which should mitigate some of the impact of inflation as it sells its cheapest products first against higher revenues reflecting price increases. However, Days of Inventory dropping 13 days in 4Q21 makes us think POST was hoping for inflation to slow before it replenished materials. We think POST will now have to buy inventory at even higher prices than in August and September. That may pressure results even more than expected and POST is guiding to lower EBITDA this year already.

DSIs	4Q	3Q	2Q	1Q
fiscal 2021	42.8	55.1	56.5	53.2
fiscal 2020	56.3	61.8	49.2	54.5
fiscal 2019	53.4	52.4	54.1	46.2

In 1Q22 (December) DSIs did rise but only to 46.5 days. We believe inventory will need to rise further going forward. Already, margins were under pressure and POST has sought to boost prices. Adjusting for hedging gains and mark-to-market items, gross margin fell to 23.8% in 4Q21 from 30.3% in 4Q20. Given that POST is still selling cheaper products under FIFO, the gross margin adjusted for hedging and mark-to-market rose to 28.1% from 27.4% for 1Q22 vs. 1Q21.

POST's accounting gives it the most shield from inflation, but we still believe the company faces headwinds here. It has to compare price increases and drawing down inventories in 2021 to periods of smaller price hikes and building inventories in 2022. Plus, guidance of 4%-7% EBITDA growth assumes that inflation will be flat after 2Q21 in March. That's a big "if" in our view. 10 bps of gross margin going away costs POST 8 cents in EPS.

Mondelez International, Inc. (MDLZ)

MDLZ loves price hikes and believes they can offset cost inflation. The company guided to higher gross margins and gross profit dollars for 4Q21, and saw margins fall 200bp and dollars only rise 0.7% by adding back FX – otherwise dollars were down too. Guidance for 2022 calls for 4%+ growth in gross profit dollars, but that is expected to be back-loaded for the year.

Inventory levels are a concern. MDLZ uses average-cost accounting for inventory so with cost inflation happening, any new product it buys at higher costs should boost cost of goods and pressure gross margin. It looks to us that MDLZ has tried to wait out inflation issues hoping cost pressures would decline**. Inventory levels in dollars are up only 2% y/y on 3% volume growth. That is likely worse given that the inventory in dollars is rising faster than units given inflation.** We think MDLZ could be forced to buy more inventory in 1Q and 2Q of 2022 than it did in 3Q and 4Q of 2021 and that will pressure gross margin even more.

	4Q21	3Q21	2Q21	1Q21
Inventory	$2,708	$2,922	$2,925	$2,635
COGS	$4,825	$4,358	$4,011	$4,272
DSIs	51.3	61.2	66.5	56.3
	4Q20	**3Q20**	**2Q20**	**1Q20**
Inventory	$2,647	$2,840	$2,710	$2,441
COGS	$4,426	$3,873	$3,580	$4,256
DSIs	54.6	66.9	69.1	52.3
	4Q19	**3Q19**	**2Q19**	**1Q19**
Inventory	$2,546	$2,742	$2,731	$2,620
COGS	$4,154	$3,839	$3,593	$3,945
DSIs	55.9	65.2	69.4	60.6

MDLZ already missed on gross margin in 4Q21, costing it 8 cents in EPS despite letting inventories decline. Raw materials dropped from $822 million in 3Q to $770 million in 4Q, more than 6%. Again, costs are rising so units are likely down double-digits. MDLZ admitted on the earnings call that its inventory levels are too low, that it expects supply chain issues to remain and make it difficult to rebuild, and to expect more pressure on sales volumes.

MDLZ also is saying that it has raised prices again for January and it expects higher pricing to offset commodity inflation as 2022 moves into summer and beyond. We think it is important to note that not only does MDLZ need to buy more inventory at higher prices than it could have paid in late 2021, it has already taken more pricing than the commodity inflation justified for the first three quarters of 2021:

	4Q21	3Q21	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20
Price gains on Op. Inc	$190	$207	$130	$151	$127	$129	$120	$118
Higher costs on Op. Inc	$225	$179	$20	$49	$120	$63	$102	$107
Net	-$35	$28	$110	$102	$7	$66	$18	$11

We're not going to set off alarms over $7 and $11 million differences, but MDLZ took much higher price increases than the costs warranted in 1Q21 and 2Q21. It then let its inventories run down in 4Q21. It may be difficult for MDLZ to take as much pricing as it wants as it buys inventories at higher costs. Every 10 bps of lost gross margin costs MDLZ 2 cents in EPS.

Ball Corp. (BLL)

The price of aluminum, BLL's major raw material, has skyrocketed along with most other raw materials. Many companies have seen their inventory balances rise due to cost inflation, even though the number of units in inventory has not grown. BLL's total inventory balance jumped by 20% YOY in the 12/21 quarter. However, aluminum prices are up over 30% compared to a year ago, indicating that inventory unit growth is much more subdued. This is consistent with the company's narrative that demand is outstripping supply and it is selling every new can it is producing with its new capacity.

However, we were struck by the fact that the raw materials component of inventory was essentially flat sequentially in the 12/21 quarter as seen in the following table:

	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Raw Materials & Supplies	$1,064	$1,012	$945	$868	$889	$852
Work in process and finished goods	$821	$716	$639	$624	$557	$551
Inventory Reserve	-$90	-$90	-$94	-$93	-$93	-$94
Total Inventory	$1,795	$1,638	$1,490	$1,399	$1,353	$1,309

The following table shows the components of inventory on a DSI basis for the last twelve quarters:

	12/31/2021	9/30/2021	6/30/2021	3/31/2021
Raw Materials & Supplies DSI	32.8	32.7	31.2	31.3
Work in process and finished goods DSI	25.3	23.1	21.1	22.5
Inventory Reserve DSI	-2.8	-2.9	-3.1	-3.4
DSI	55.4	52.9	49.1	50.5

	12/31/2020	9/30/2020	6/30/2020	3/31/2020
Raw Materials & Supplies DSI	33.4	32.3	36.0	34.0
Work in process and finished goods DSI	20.9	20.9	24.6	25.2
Inventory Reserve DSI	-3.5	-3.6	-4.0	-3.5
DSI	50.8	49.6	56.6	55.6

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Raw Materials & Supplies DSI	34.4	28.0	26.2	27.6
Work in process and finished goods DSI	23.4	21.1	21.1	26.2
Inventory Reserve DSI	-3.5	-3.2	-3.0	-2.8
DSI	54.3	45.9	44.3	50.9

We see several points worth noting in the data:

- While total DSI is up from 50.4 in the 12/20 quarter to 55.4 in the 12/21 quarter, Raw Materials and Supplies DSI declined YOY despite the rising aluminum prices.

- BLL utilizes the FIFO and Average Cost methods of inventory accounting. Under the FIFO method, it is expensing its older, lower-cost inventory first. It turns its inventory roughly every 55 days so it is not keeping inventory on the books for long. However, the company also utilizes the Average Cost method for inventories as well. Higher-priced inventory purchased under Average Cost will increase Cost of Goods Sold in the quarter it is purchased even if the inventory is not sold. The delay in rebuilding inventories could conceivably result in higher reported profits than if the company had replenished the inventories at higher cost. The apparent decline in raw materials on a unit basis makes us wonder if the company was hoping to delay purchases until it could realize lower prices.

- Unfortunately, aluminum prices have gone straight up since mid-December and this may be reflected in higher costs in the upcoming March quarter. The company will be protected to some degree by its pass-through arrangements.

- Given that raw materials inventory did increase versus a year ago and the fact the Raw Materials DSI decline was less than two days, we don't see this being as large an overhang for the upcoming 3/22 quarter as it may be for the other companies discussed.

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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