BEHIND THE NUMBERS
Quality of Earnings Analysis

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BTN Thursday Thoughts

Updates and New Developments on Active BTN Ideas

Companies covered in this issue:

Conagra Brands, Inc. (CAG) Earnings Quality Update

We are maintaining our earnings quality rating of CAG at 2- (Weak).

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

Summary

CAG's adjusted EPS of 65 cents beat forecasts by 2 cents. It was not a quality beat in our view.

- CAG cut advertising to $46.1 million from $75.2 million last year and $59.2 million in 4Q20. That drop alone in dollar terms was 4.7 cents of EPS for the quarter.

- Stock compensation fell from $22.8 million to a credit of $0.7 million. This added 3.8 cents to EPS in 4Q22.

- Even the company expected its JV income to rise again from the milling operations. This occurred, rising to $47.5 million vs. $33.4 million last year adding 2.3 cents this quarter.

- Depreciation fell by $8.2 million adding 1.3 cents to EPS.

- We will also point out that CAG took 13.2% in price hikes for 4Q22, which is understandable with inflation. However, we know stores are pushing back on this. If CAG lost 100bp of the price increase and only could push through a 12.3% increase it would have cost them 4.4 cents in quarterly EPS.

- Guidance for 4%-5% organic growth for fiscal 2023 looks very poor in our opinion. The company just reported organic sales growth of 3.8% for fiscal 2022 and 6.8% for 4Q22. That was built from pricing gains of 7.6% and 13.2% with a negative volume of 3.8% and 6.4%, respectively. It is reporting more price hikes for 1Q23 and 2Q23 on top of already implemented pricing – yet it is saying organic growth will decline. That sounds like severe drops of volume are expected.

What Is Weak

- **Adjusted operating margin grew from 14.0% to 15.0% y/y in 4Q20. CAG frames this as its operating skills at work and is guiding to a 15.0% margin for fiscal 2023. That alone should be a disappointment. But let's look closer:**

    - Stock compensation falling by $23.5 million added 81bp to margin.

    - Depreciation fell by $8.2 million adding 46bp to margin.

    - Amortization was basically flat but added 3bp to margin due to the price hikes.

    - If sales growth only had 12.3% price increases, sales and adjusted operating profit would have both been $27.3 million lower and cut 81bp off of margin.

- **We noted last quarter that CAG uses FIFO accounting, which normally delivers higher margins amid inflation as cheaper inventory is sold with price hikes. The**

company has actively culled lower margin SKUs from inventory too. Results should be improving in a big way – and they're just not – except for Covid-related quarters:

Adj Oper. Margin	f22	f21	f20	f19	f18
1Q	14.1%	20.2%	15.7%	14.6%	15.4%
2Q	14.6%	19.6%	17.1%	17.5%	16.7%
3Q	13.7%	16.0%	15.7%	16.3%	15.0%
4Q	15.0%	14.0%	17.1%	13.2%	13.0%

As we noted above, the 100bp improvement in 4Q22 does not look like a real improvement and it still wouldn't be that spectacular if it was, given the story of brand building and new product roll-outs that CAG spins.

Higher DSIs for inventory now with FIFO accounting could be a minor tailwind for margins in the near term. We would not compare to fiscal 4Q20 as that represented the Covid panic buying in grocery stores:

Inventory DSIs	f22	f21	f20
1Q	90.1	77.1	92.8
2Q	73.6	70.3	79.9
3Q	72.7	71.6	80.3
4Q	80.6	77.5	56.8

- **Speaking of brand-building skills – when are investors going to ask about all the impairments CAG is taking for its acquired brand assets?** They just wrote off another $209 million for fiscal 2022. Do growing product lines with expanding margins see these types of charges every year?

	f22	f21	f20	f19
Brand Impairments	$209.0	$90.9	$165.5	$89.6

- **We knew that CAG loved to compare results on a two-year basis under the guise of wanting to ignore Covid-induced sales growth from March 2020-2021. However, in reality, CAG's numbers from 2019 and early fiscal 2020 before Covid were**

abysmal because the Performance Food acquisition had blown up on them with rapid declines in sales and new orders. We knew they were not going to tout two-year growth figures for 4Q22 or 1Q23 because that would be comparing results to the height of Covid panic-buying. We thought they would go back to a normal year-over-year comparison. We were wrong. CAG is now touting a three-year growth performance so it can keep its lowest possible starting point to calculate growth.

- Pages 12-14 of the 4Q22 earnings presentation report present 3-year growth rates for 4Q22 of 20% for frozen food, 34% for snacks, and 10% for staples.

- This is par for the course in CAG presentations- tout a few areas of growth and ignore the overall picture which is the company posted negative volume growth for three out of four years and the only source of growth here has been price increases. They are guiding to accelerating volume decay.

- If we make a simple index from CAG's organic growth figures since 2018, it is clear that CAG is selling less product now than 2018:

	4Q22	**4Q21**	**4Q20**	**4Q19**	**4Q18**
Price Index	117.4%	103.7%	101.0%	100.5%	100.0%
Volume Index	97.6%	104.2%	119.5%	98.8%	100.0%

- We're looking at PepsiCo reporting positive volume growth amid large price hikes and voicing concerns that may be tough to maintain. CAG is touting how its elasticities are outperforming after posting five straight quarters of negative volume comps.

What to Watch

- **Has JV income topped out?** The bulk of this is related to flour milling that CAG spun off years ago because it was a low-margin business. We've talked about this before that the growth story at CAG revolves around margin expansion of several hundred basis points. The first big round of margin expansion came from getting rid of Arden Mills flour milling and Lamb Weston potato processing. These were low-margin commodity businesses and simply removing the high sales and low margins made the remaining business look much more profitable. It is an apples-to-oranges comparison. But CAG still has a piece of the flour milling. Coming out of Covid, wheat prices rose from $4 to $8 a bushel and then spiked to over $12 with the Russian/Ukraine war and fertilizer shortages. It has since fallen back to under $8. The results at CAG's milling JV income follows the surge in prices, but it stopped growing in 4Q22:

Equity Method Income	4Q	3Q	2Q	1Q
fiscal 2022	$47.5	$48.1	$29.5	$20.2
fiscal 2021	$33.4	$21.5	$23.0	$6.5
fiscal 2020	$22.9	$10.4	$27.6	$12.3

- **Walmart and Kroger are not just rubber-stamping price increases from food and household product companies.** And here's CAG taking price hikes and slashing advertising.

  In two weeks, Walmart will start charging suppliers like CAG a fee to cover the rising transportation and logistics costs when Walmart picks up inventories from suppliers and delivers to stores. Walmart said on its last conference call that it wants to keep food prices as low as possible for consumers and it will go back to suppliers to help make that happen.

  Kroger is committed to offering lower prices too and touted the math for its private-label offerings that are taking market share.

  > "*So if you think about, in some cases, a national brand item may cost $3 and Our Brand might be $1.5 or $2. So that would show up and would cause our inflation rate not to be as high as what's in the marketplace."*
  >
  > *"I also think it's important to remind people that on -- when you look at Our Brands overall, our gross margin is about 600 basis points better than the national brand. And if you look at profit per item, it's similar or in many cases, actually higher."*

- How long can CAG continue to cut advertising? We have noted that much of CAG's improved operating margin over the last 8 years has come from cutting advertising. Even in fiscal 2021 when it rebounded it was still very low compared to historical levels.

  CAG's growth plan is to roll out new and improved products on a continual basis that will get better pricing and stimulate new consumer sales. However, shelf space is limited in grocery stores and stores require investments to remove a product and replace it with something new such as advertising, coupons, in-store discussions, and samples. CAG is responding by cutting advertising:

Advertising	4Q	3Q	2Q	1Q
fiscal 2022	$46.1	$64.9	$71.4	$62.2
fiscal 2021	$75.2	$73.3	$63.6	$45.9
fiscal 2020	$59.2	$65.5	$60.7	$45.3
fiscal 2019	$73.9	$67.4	$69.4	$42.7

  Kroger said last quarter that 92% of its customers bought at least one store-brand product and its store-brand comps were 6.3% vs. its overall comp of 4.1%. Walmart and Target both said customers are trading down to store-brands more often too. Why should these stores stock CAG products with no supplier support?

PepsiCo, Inc. (PEP)

We are maintaining our earnings quality rating of 3- (Minor Concern)

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

Summary

PEP reported non-GAAP EPS of $1.86 which topped consensus estimates by 12 cps. The company raised its guidance for full-year organic revenue growth to 10% from its previous estimate of 8%. However, it left its previous guidance for core EPS of $6.63 in place.

- PEP reported organic revenue growth of 13% but this relied on a 12% boost from net pricing. While Europe was the only segment reporting negative volume growth, PEP's developing market segments all showed healthy volume increases despite prices boosting growth by 9-15%. Management comments seemed to indicate it is less than confident that price inelasticity will hold as strongly in the second half.

- In addition to increasing prices, PEP has been diligent in cutting costs which helped adjusted operating margins to jump 40 bps to 16.9%. However, what we think may be getting lost by some is the powerful leverage impact provided by price increases which essentially all flow to the bottom line. Should the company experience unexpected pushback on pricing, this positive impact will work in reverse.

- Management expects inflation to worsen in the back half, stating in the call: *"Balance of the year inflation is higher than it is for the first half of the year. I think we've mentioned in the past, we're in the teens in terms of commodity inflation. That will continue, but a little bit higher in the back half."* Inventories appear to be flat when viewed on a unit basis. With unit volumes increasing, the company will have to replenish inventories at higher prices which may hit margins, especially if the company gets pushback on price increases.

- The Latin America segment has been providing the bulk of non-GAAP profit growth for several quarters. Despite accounting for just 12% of revenue, Latin America represented $149 million of the total company's $198 million non-GAAP operating profit growth in the quarter. This was due to organic growth of 22% which was a product of 7% volume growth and 15% pricing growth. Investors should appreciate how much of PEP's growth is a result of what seems like the unsustainable resilience of the Latin American consumer.

- PEP recorded a $224 million pretax brand impairment charge related to its decision to sell certain non-strategic brands. This was added back to non-GAAP results.

- Non-GAAP adjustments also included a $1.4 billion charge related to impairments and costs related to the company's Russian and Ukrainian operations.

Breakout of Revenue Growth

The following table shows segment sales and the source of revenue growth for the last six quarters:

PEP Segment Sales

	6/11/2022	3/19/2022	12/25/2021	9/04/2021	6/12/2021	3/20/2021
Frito Lay North America	$5,181.0	$4,839.0	$6,167.0	$4,653.0	$4,552.0	$4,236.0
Quaker Foods North America	$675.0	$713.0	$912.0	$618.0	$575.0	$646.0
PepsiCo Beverages North America	$6,120.0	$5,353.0	$7,644.0	$6,402.0	$6,156.0	$5,074.0
Latin America	$2,415.0	$1,474.0	$2,799.0	$2,100.0	$1,967.0	$1,242.0
Europe	$3,023.0	$1,797.0	$4,345.0	$3,612.0	$3,286.0	$1,795.0
Africa, Middle East, and South Asia	$1,696.0	$1,004.0	$1,928.0	$1,665.0	$1,602.0	$883.0
Asia Pacific, Austalia/NZ, and China	$1,115.0	$1,020.0	$1,453.0	$1,139.0	$1,079.0	$944.0
Total Sales	$20,225.0	$16,200.0	$25,248.0	$20,189.0	$19,217.0	$14,820.0

Growth Breakout

Total Company	6/11/2022	3/19/2022	12/25/2021	9/04/2021	6/12/2021	3/20/2021
Organic Volume	1.0%	3.0%	5.0%	4.0%	7.0%	-1.0%
Pricing	12.0%	10.0%	7.0%	5.0%	5.0%	4.0%
Organic Growth	13.0%	14.0%	12.0%	9.0%	13.0%	2.0%
Acquisitions and Divestitures	-5.0%	-3.0%	0.5%	1.0%	4.0%	5.0%
FX	-3.0%	-1.0%	0.0%	2.0%	3.0%	-0.5%
Reported GAAP Revenue Growth	5.0%	9.0%	12.0%	12.0%	21.0%	7.0%

Frito Lay North America	6/11/2022	3/19/2022	12/25/2021	9/04/2021	6/12/2021	3/20/2021
Organic Volume	0.0%	2.0%	4.5%	1.0%	2.0%	-1.0%
Pricing	14.0%	12.0%	9.0%	4.0%	4.0%	4.0%
Organic Growth	14.0%	14.0%	13.0%	5.0%	6.0%	3.0%
Acquisitions and Divestitures	0.0%	0.0%	0.0%	0.0%	0.0%	0.5%
FX	0.0%	0.0%	0.0%	0.5%	1.0%	0.0%
Reported GAAP Revenue Growth	14.0%	14.0%	13.0%	6.0%	7.0%	4.0%

Quaker Foods North America	6/11/2022	3/19/2022	12/25/2021	9/04/2021	6/12/2021	3/20/2021
Organic Volume	2.0%	-1.5%	4.5%	-4.0%	-21.0%	-4.0%
Pricing	16.0%	12.0%	9.0%	4.5%	6.0%	5.0%
Organic Growth	18.0%	11.0%	13.0%	1.0%	-14.0%	1.0%
Acquisitions and Divestitures	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
FX	0.0%	0.0%	0.0%	1.0%	1.0%	0.5%
Reported GAAP Revenue Growth	17.0%	11.0%	13.0%	2.0%	-13.0%	1.5%

PepsiCo Beverages North America	6/11/2022	3/19/2022	12/25/2021	09/04/2021	6/12/2021	3/20/2021
Organic Volume	0.0%	4.0%	6.0%	3.0%	16.0%	-4.5%
Pricing	9.0%	8.0%	6.0%	4.0%	4.5%	6.0%
Organic Growth	9.0%	13.0%	12.0%	7.0%	21.0%	2.0%
Acquisitions and Divestitures	-9.0%	-7.0%	0.0%	0.0%	2.0%	3.0%
FX	0.0%	0.0%	0.0%	0.5%	1.0%	0.0%
Reported GAAP Revenue Growth	-1.0%	5.5%	13.0%	7.0%	24.0%	5.0%

Latin America	6/11/2022	3/19/2022	12/25/2021	9/04/2021	6/12/2021	3/20/2021
Organic Volume	7.0%	6.0%	6.0%	6.0%	4.0%	-2.0%
Pricing	15.0%	16.0%	11.0%	13.0%	12.0%	4.0%
Organic Growth	22.0%	22.0%	17.0%	19.0%	16.0%	3.0%
Acquisitions and Divestitures	-1.0%	-1.0%	0.0%	0.0%	0.0%	0.0%
FX	2.0%	-3.0%	-1.0%	8.0%	9.0%	-8.0%
Reported GAAP Revenue Growth	23.0%	19.0%	16.0%	27.0%	24.0%	-5.0%

Europe	6/11/2022	3/19/2022	12/25/2021	9/04/2021	6/12/2021	3/20/2021
Organic Volume	-8.0%	0.0%	1.0%	6.0%	10.0%	0.0%
Pricing	17.0%	11.0%	8.0%	2.5%	5.0%	-1.0%
Organic Growth	9.0%	11.0%	9.0%	8.0%	15.0%	0.0%
Acquisitions and Divestitures	-5.0%	-2.0%	0.0%	0.0%	0.0%	0.0%
FX	-12.0%	-8.0%	-1.0%	0.0%	5.0%	-2.0%
Reported GAAP Revenue Growth	-8.0%	0.0%	8.0%	9.0%	21.0%	-2.0%

Africa, Middle East, and South Asia	6/11/2022	3/19/2022	12/25/2021	9/04/2021	6/12/2021	3/20/2021
Organic Volume	14.0%	11.0%	5.0%	12.0%	7.0%	2.0%
Pricing	9.0%	7.0%	2.0%	8.0%	8.0%	-3.0%
Organic Growth	23.0%	18.0%	8.0%	20.0%	15.0%	-1.0%
Acquisitions and Divestitures	-10.0%	-2.0%	4.0%	5.0%	38.0%	42.0%
FX	-7.0%	-2.0%	1.0%	8.0%	9.0%	-1.0%
Reported GAAP Revenue Growth	6.0%	14.0%	13.0%	33.0%	63.0%	40.0%

Asia Pacific, Austalia/NZ, and China	6/11/2022	3/19/2022	12/25/2021	9/04/2021	6/12/2021	3/20/2021
Organic Volume	14.0%	2.0%	16.0%	4.0%	4.0%	17.0%
Pricing	9.0%	8.0%	-2.0%	5.0%	2.0%	2.0%
Organic Growth	23.0%	9.0%	13.0%	9.0%	6.0%	18.0%
Acquisitions and Divestitures	-10.0%	-0.5%	3.0%	1.0%	26.0%	44.0%
FX	-7.0%	-1.0%	2.0%	2.0%	9.0%	8.0%
Reported GAAP Revenue Growth	6.0%	8.0%	18.0%	12.0%	41.0%	70.0%

Points to note:

- At the company level, despite aggressive pricing of 12%, PEP managed to hang on to positive volume growth of 1%. The company raised its forecast for full-year organic sales growth from 8% to 10%. However, management seemed less confident about price inelasticity enduring, stating in the conference call:

> *"We're still watching elasticities closely as Ramon just mentioned. Elasticities are good right now. We don't plan for them to be as strong in the back half, and we'll see what happens with that. It's certainly hard to gauge because inflation is having so much impact on the consumer in so many ways."*

- Europe was the only segment reporting volume declines (-9%) as inflation and the Ukrainian crisis took their toll on results. This segment also saw the largest hit from foreign exchange losses.

- Latin America, AMESA, and Asia Pacific all saw solid volume gains despite price increases ranging from 9-15%. However, foreign exchange offset much of the growth in AMESA and Asia Pacific.

- Quaker Foods volume growth remained positive only because of an easy comparison against a 20% volume decline in the year-ago quarter. However, this is by far the smallest segment and not as integral to growth.

Inventories Do Not Appear to Be Keeping Up With Unit Growth

Management noted in the call that cost inflation is running in the mid-teens and it expects it to increase in the back half of the year:

> *“Balance of the year inflation is higher than it is for the first half of the year. I think we've mentioned in the past, we're in the teens in terms of commodity inflation. That will continue, but a little bit higher in the back half.”*

However, the various components of inventory have been lagging the inflation rate, as seen below:

Inventory Component Growth	6/11/2022	3/19/2022	12/25/2021	9/04/2021	6/12/2021	3/20/2021
Raw Materials & Packaing	15.5%	10.4%	10.3%	7.1%	11.3%	21.6%
Work in Process	-58.5%	-50.0%	-26.3%	-35.3%	10.8%	11.2%
Finished Goods	7.2%	7.0%	2.3%	9.6%	21.1%	32.9%
Total Inventory	5.6%	4.5%	4.2%	5.5%	16.0%	26.6%

Commodities have been increasing 15% over the last couple of quarters yet raw materials and finished goods have not been exceeding that which implies inventories are likely down on a unit basis. However, volumes continue to increase. DSIs have also not increased meaningfully:

DSI by Inventory Component	6/11/2022	3/19/2022	12/25/2021	9/04/2021
Raw Materials & Packaing DSI	21.4	22.8	17.5	17.2
Work in Process DSI	1.4	1.7	1.4	1.6
Finished Goods DSI	24.3	29.3	21.2	20.2
DSI	47.2	53.8	40.1	39.0
	6/12/2021	3/20/2021	12/26/2020	9/05/2020
Raw Materials & Packaing DSI	19.7	23.0	18.5	18.5
Work in Process DSI	3.6	3.9	2.2	2.8
Finished Goods DSI	24.1	30.5	24.1	21.2
DSI	47.4	57.4	44.8	42.6
	6/13/2020	3/21/2020	12/28/2019	9/07/2019
Raw Materials & Packaing DSI	22.1	20.6	16.7	16.5
Work in Process DSI	4.1	3.8	2.4	3.4
Finished Goods DSI	24.9	25.0	20.9	20.1
DSI	51.1	49.4	40.0	40.0

PEP uses FIFO accounting for over 90% of its inventories. It turns its inventories in less than 50 days which is a relatively short time so it is not benefitting as much from matching older, lower-cost inventories against higher prices items sold as some of the food companies we have looked at. Still, non-GAAP gross margins surprisignly improved in the 6/22 quarter due largely to price increases:

	6/11/2022	03/19/2022	12/25/2021	09/04/2021
Non-GAAP Operating Income Margin	16.9%	14.8%	10.9%	16.1%
	06/12/2021	3/20/2021	12/26/2020	09/05/2020
Non-GAAP Operating Income Margin	16.5%	15.3%	12.7%	16.8%
	06/13/2020	03/21/2020	12/28/2019	09/07/2019
Non-GAAP Operating Income Margin	15.8%	15.3%	13.2%	17.2%

Management expects inflation to worsen in the back half which will put PEP in a position of replenishing inventories at higher costs. This could pressure margins more than some are expecting, particularly if there is pushback on the company's price increases. Further improvement in gross margins may prove difficult.

Disproportionate Growth from Latin America

Investors should appreciate the extent to which the company's Latin America segment has been contributing to overall profit growth. The first table shows non-GAAP operating profits for each segment and the second shows the YOY dollar growth to make it easier to see each segment's contribution to total non-GAAP profits.

Non-GAAP Operating Profit (before corp)	6/11/2022	03/19/2022	12/25/2021	09/04/2021	06/12/2021	3/20/2021	12/26/2020	09/05/2020
Frito Lay North America	$1,451	$1,299	$1,662	$1,359	$1,385	$1,257	$1,584	$1,356
Quaker Foods North America	$135	$159	$193	$107	$128	$150	$182	$145
PepsiCo Beverages North America	$783	$450	$515	$776	$811	$371	$567	$743
Latin America	$511	$329	$417	$407	$362	$220	$350	$255
Europe	$383	$65	$360	$459	$420	$142	$395	$493
Africa, Middle East, and South Asia	$293	$182	$160	$318	$265	$140	$223	$205
Asia Pacific, Australia/NZ, and China	$209	$216	$78	$202	$196	$208	$99	$169
Total	$3,765	$2,700	$3,385	$3,628	$3,567	$2,488	$3,400	$3,366

YOY Operating Profit Growth	6/11/2022	03/19/2022	12/25/2021	09/04/2021
Frito Lay North America	$66	$42	$78	$3
Quaker Foods North America	$7	$9	$11	-$38
PepsiCo Beverages North America	-$28	$79	-$52	$33
Latin America	$149	$109	$67	$152
Europe	-$37	-$77	-$35	-$34
Africa, Middle East, and South Asia	$28	$42	-$63	$113
Asia Pacific, Australia/NZ, and China	$13	$8	-$21	$33
Total	$198	$212	-$15	$262

Despite being just under 12% of company revenue, Latin America has been providing the bulk of the growth in non-GAAP profits for some time. In the 6/22 quarter, Latin America produced $149 million of the $198 million increase in total company non-GAAP operating profits. Here is the commentary from the 10-Q regarding Latin American profit improvement:

> *"Operating profit increased 18%, primarily reflecting the net revenue growth and productivity savings, partially offset by certain operating cost increases and a 40-percentage-point impact of higher commodity costs, primarily cooking oil and packaging material. Impairment and other charges associated with our decision to sell or discontinue certain non-strategic brands reduced operating profit growth by 23 percentage points.* ***Certain indirect tax credits in Brazil and lower charges taken as a result of the COVID-19 pandemic contributed 7 percentage points and 4 percentage points, respectively, to operating profit growth."***

The impairment charges were adjusted out of the non-GAAP results so that was not a factor in the non-GAAP profit improvement. However, it does not appear that the lower COVID charges and the tax credits were adjusted out of non-GAAP results. We will ignore the 7 points of growth coming from lower COVID costs. While that tailwind will disappear for growth in upcoming quarters, it does not represent a surprising source of profits in the 6/22 quarter. However, we estimate the tax credits only added about a penny per share to EPS. Thus, the bulk of the profit growth is coming from the massive increases which have yet to meet with volume declines. Let's revisit the components of Latin America's organic growth in the last few quarters:

Latin America	6/11/2022	3/19/2022	12/25/2021	9/04/2021	6/12/2021	3/20/2021
Organic Volume	7.0%	6.0%	6.0%	6.0%	4.0%	-2.0%
Pricing	15.0%	16.0%	11.0%	13.0%	12.0%	4.0%
Organic Growth	22.0%	22.0%	17.0%	19.0%	16.0%	3.0%
Acquisitions and Divestitures	-1.0%	-1.0%	0.0%	0.0%	0.0%	0.0%
FX	2.0%	-3.0%	-1.0%	8.0%	9.0%	-8.0%
Reported GAAP Revenue Growth	23.0%	19.0%	16.0%	27.0%	24.0%	-5.0%

Latin America volume growth was 7% despite a 15% increase which was the fifth straight quarter of mid-teens price increases. Clearly, consumers in Latin America have been willing to spend money on drinks and snack food despite higher prices. Management made the following observations regarding the demand in Latin America in the conference call:

> *"Your question on Latin America, we're seeing -- and I think it relates to the amount of transfers, money transfers that are coming from the U.S. into Latin America. We're seeing that number really high as a consequence of the high employment in the U.S. and the higher salaries. We're seeing that money being transferred to a lot of the economies in LatAm, and that's helping a lot of disposable income in those countries. And we're seeing, to our surprise really, from the beginning of the year, very low elasticity. It's actually positive elasticities even though, obviously, we're passing price to the consumer in those markets in intelligent ways and in ways that consumers will feel less pressure on.*
>
> *But I think disposable income in LatAm is above what it was in the past, a consequence of developed economies doing very well and money going into LatAm and the consumer is feeling good in Latin America. Also, post-COVID we're seeing behaviors of social expansion, if you want. So consumers coming out of the houses, consumers having more fun externally in LatAm and in many parts of the world. That tends to drive higher consumption of categories because people get together and have fun and we are part of fun experiences normally. So that's how we're seeing the trends in our categories."*

We can't say that the next quarter is the one where Latin American consumers will cut back on spending. However, investors should appreciate how much of PEP's recent growth has come from unusually strong demand from this one region.

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.

Disclosure

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