Danger Zone: Mondelez International (MDLZ)

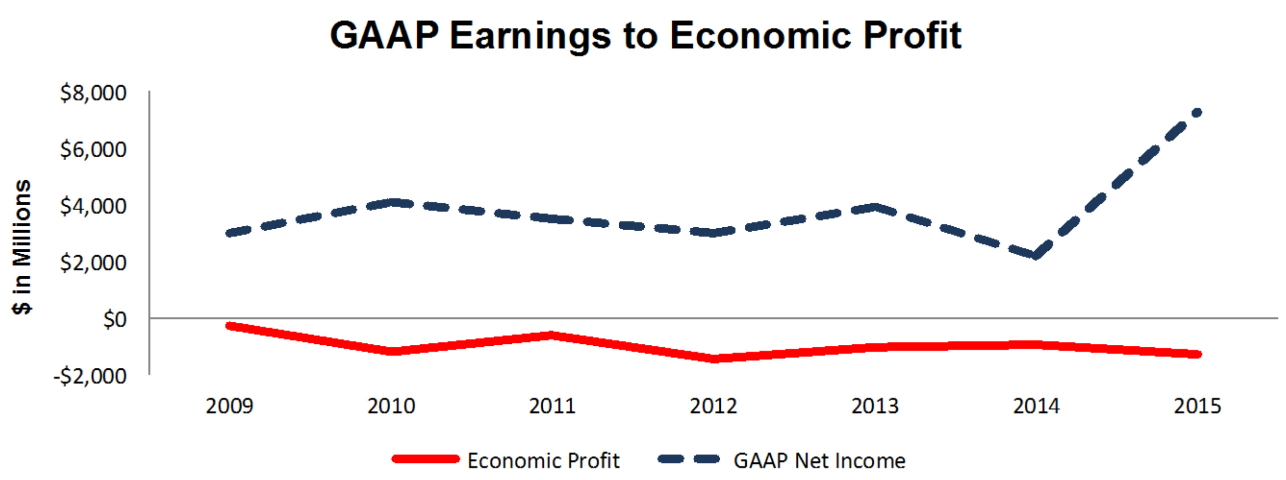
Check out this week's Danger Zone interview with Chuck Jaffe of Money Life and Marketwatch.com

Stop us if you've heard this story before: slowing organic revenue growth, questionable non-GAAP metrics, and a large investment by activist Bill Ackman. No, we're not talking about Valeant Pharmaceuticals (VRX), which is down 53% since we put it in the Danger Zone in late February. This time, we're talking about Mondelez International (MDLZ: $40/share), which lands in the Danger Zone this week and looks a lot like VRX.

2015 Results Artificially Propped Up

Mondelez's GAAP net income grew 233% year over year in 2015. At the same time, economic earnings, or true cash flows, declined from -$949 million in 2014 to -$1.32 billion in 2015. The large discrepancy comes from Mondelez's $6.8 billion of non-operating income related to gains on coffee business transactions and divestitures. Over the long-term, Figure 1 shows results are no better. Despite GAAP net income growing 16% compounded annually since 2009, economic earnings have remained negative and fallen from -$281 million in 2009 to -$1.32 billion in 2015.

Figure 1: The Disconnect Between GAAP & Economic Earnings



Sources: New Constructs, LLC and company filings

The decline in economic earnings follows the decline in Mondelez's return on invested capital (ROIC). Since earning a high of 8% in 2002, Mondelez's ROIC has slowly declined to its current 5%. As Mondelez has grown, acquired stakes in other brands, and entered/exited new businesses, the company's operations have become less efficient.

Watch Out For Questionable Non-GAAP Metrics

Non-GAAP metrics present significant dangers to investors. We remain surprised by how often companies use non-GAAP metrics to cover up weak businesses, and Mondelez is an egregious user of non-GAAP metrics. Here are details:

1. Organic Net Revenue – net revenue excluding the impacts of acquisitions, divestitures, historical coffee business, Integration Program costs, and currency rate fluctuations.
2. Adjusted Gross Profit – gross profit excluding the 2012-2014 restructuring program, the 2014-2018 restructuring program, the Integration Program, other acquisition integration costs, incremental costs with coffee business transactions, and the operating results of divestitures.
3. Adjusted Operating Income – operating income that excludes 15 separate items including costs associated with coffee business, impairment charges related to goodwill and intangible assets, and acquisition costs.

4. Adjusted EPS – diluted EPS attributable to Mondelez, which excludes 15, separate items, including spin off costs, hedging gains or losses, impairment charges, and acquisition related costs.

Cleary, these contrived metrics remove numerous standard costs of doing business, especially for an international company like Mondelez. Perhaps, most misleading is Mondelez's removal of currency rate fluctuations from "Organic Net Revenue" given that 76% of sales generated outside of the U.S. in 2015. Not surprisingly, Mondelez reported "Organic Net Revenue" growth of 3.7% year over year in 2015, while GAAP revenue declined 13%.

Low Profitability Is A Competitive Disadvantage

Companies with lower ROICs have lower pricing power. In 2015, Mondelez pushed rising input costs onto consumers by increasing prices for its goods. This move only temporarily delays further margin contraction. MDLZ executives have openly stated that they expect price competition or delayed price increases by competitors to affect net revenue and/or market share. As the least profitable among its peers (see Figure 2), MDLZ will likely continue to be the first to raise prices and the first to lose market share to competitors who can withstand higher input costs for longer.

Figure 2: Mondelez's Lagging Profitability Creates Issues

Company	Ticker	Return On Invested Capital (ROIC)
Hershey Company	HSY	18%
J&J Snack Foods	JJSF	15%
Campbell Soup Company	CPB	11%
PepsiCo	PEP	10%
Kellogg Company	K	10%
General Mills	GIS	9%
ConAgra Foods	CAG	8%
Mondelez International	MDLZ	5%

Sources: New Constructs, LLC and company filings

Bulls Need To Accept Lower Growth as "The New Normal"

Lower profitability and growth are the new normal for Mondelez, and the stock's value will eventually align once investors stop believing in non-GAAP earnings. Mondelez's revenue has declined 14% compounded annually, and its net operating profit after-tax (NOPAT) has declined 13% compounded annually since 2011. We do not believe a return to growth achieved prior to 2011 will happen given the company's weak competitive position and limited growth prospects in a crowded and competitive market.

Making matters worse, MDLZ has become more expensive as operations have deteriorated. In 2011, MDLZ had a price to economic book value (PEBV) ratio of 2. This ratio implied that MDLZ could grow NOPAT by 200%. Since then, as revenue and profits have fallen, MDLZ's PEBV has increased to 2.8, which would imply the company can grow NOPAT by 280%, an assumption that seems ever more unlikely.

We think too many investors are being fooled by the "adjusted" metrics and do not realize that the company's business is deteriorating instead of improving.

MDLZ Unlikely To Be Acquired, But Overvalued Nonetheless

Of the competitors in Figure 2, only PepsiCo (PEP) has a higher market cap. With Mondelez owning many different brands ranging from cookies to gum to chocolate, it would seem possible that the company spins off some of these assets. However, when stocks are as expensive as MDLZ, we think it helps to quantify what, if any, acquisition hopes are priced into the stock.

First, investors need to know that Mondelez has large (hidden) liabilities that make it more expensive than the accounting numbers would initially suggest.

1. $16.7 billion in fair value of total debt (27% of market cap)
2. $4.8 billion in net deferred tax liabilities (8% of market cap)

3. $2.8 billion in underfunded pensions (5% of market cap)
4. $658 million in outstanding employee stock options (1% of market cap)

Looking past these hidden liabilities, Mondelez doesn't represent an attractive takeover target at its current price. For the sake of argument, let's assume PepsiCo wishes to acquire MDLZ. If we assume that MDLZ immediately achieves PepsiCo's margins and ROIC, Mondelez would still have to grow NOPAT by 13% compounded annually for six years to justify purchase at its current stock price. Keep in mind that over the past six years, MDLZ's NOPAT has declined by 4% compounded annually. A more realistic price PepsiCo should pay is $22/share (45% downside from current share price), which is the value of Mondelez's business based on the value of the firm if it achieves PepsiCo's 12% NOPAT margin in year one of the acquisition.

Assuming the firm is not acquired, if Mondelez can grow NOPAT by 7% compounded annually for the next decade, the stock is worth only $23share today – a 43% downside.

Market "Wake-Up" Could Sink MDLZ

While we don't expect MDLZ to fall as violently, some lessons can be taken from VRX and could foreshadow a fall in MDLZ.

1. Companies can only prop up earnings through non-GAAP metrics for so long. Eventually, even the artificial growth comes to an end, at which point, no "adjusted" metrics will satisfy the market.
2. Executive compensation that is tied to poor metrics, as we'll show below, leads to strategic decisions that maximize short-term gains while destroying shareholder value.

Lastly, stocks in the Danger Zone have taken quite a beating over the last year. It seems that more investors are paying attention to our warnings. Many of our best Danger Zone picks from 2015 were companies whose management teams relied heavily on non-GAAP metrics to keep investors in the dark. It's not a matter of "if", but rather, "when" the non-GAAP metrics can no longer mask problems.

Insider Sales and Short Interest Remain Low

Over the past 12 months 960,000 shares have been purchased and 582,000 shares have been sold for a net effect of 378,000 insider shares purchased. These purchases represent <1% of shares outstanding. Additionally, there are 19 million shares sold short, or just over 1% of shares outstanding.

Executive Compensation Still Flawed, But May Be Improving

Mondelez's executive compensation in the past has failed to focus on metrics that drive shareholder value. Annual executive cash bonuses are paid based on "Organic Net Revenue" growth, "Adjusted EPS", and defined free cash flow. Two of these metrics we detailed above and allow management significant leeway in ensuring they meet their target. Performance share bonuses have in the past been based upon "Organic Revenue Growth", "Adjusted EPS" growth, and total shareholder return. Beginning in 2014, MDLZ chose to replace "Adjusted EPS" with Adjusted Return on Invested Capital. We view this as a positive development, as there is a clear correlation between ROIC and shareholder value. Unfortunately, ROIC only determines one fourth of the stock unit bonus and doesn't affect cash bonuses. As it stands, MDLZ's executive compensation plan is misaligned with shareholder value, but the addition of ROIC as a performance benchmark is a step in the right direction.

Impact of Footnotes Adjustments and Forensic Accounting

In order to derive the true recurring cash flows, an accurate invested capital, and a real shareholder value, we made the following adjustments to Mondelez's 2015 10-K:

Income Statement: we made $12.3 billion of adjustments with a net effect of removing $4.1 billion in non-operating income (14% of revenue). We removed $4.1 billion related to non-operating expenses and $8.2 billion related to non-operating income.

Balance Sheet: we made $15.4 billion of adjustments to calculate invested capital with a net increase of $13.7 billion. The most notable adjustment was $9.9 billion (19% of net assets) related to other comprehensive income.

Valuation: we made $25.4 billion of shareholder value adjustments with a net decrease of $24.6 billion. The largest adjustment was the removal of $16.7 billion (27% of market cap) in total debt, which includes $863 million in off balance sheet operating leases.

Dangerous Funds That Hold MDLZ

The following fund receives our Dangerous rating and allocates significantly to Mondelez International.

1. Primary Trend Fund (PTFDX) – 5.3% allocation and Very Dangerous rating.
2. John Hancock US Global Leaders Growth Fund (USGLX) – 4.0% allocation and Dangerous rating.
3. Gabelli SRI Fund, Inc. (SRIAX) – 3.9% allocation and Very Dangerous rating

Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, style, or theme.

New Constructs® – Profile

How New Constructs Creates Value for Clients

We find it. You benefit. Cutting-edge technology enables us to scale our forensic accounting expertise across 3000+ stocks. We shine a light in the dark corners of SEC filings so our clients can make safer, more informed decisions.

Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?
ANSWER: They should not.

Don't judge a fund by its cover. Take a look inside at its holdings and understand the quality of earnings and valuation of the stocks it holds. We enable you to choose the best fund based on its stock-picking merits so you do not have to rely solely on backward-looking technical metrics.

The drivers of our forward-looking fund ratings are Portfolio Management (i.e. the aggregated ratings of its holdings) and Total Annual Costs. The Total Annual Costs Rating (details here) captures the all-in cost of being in a fund over a 3-year holding period, the average period for all fund investors.

Our Philosophy About Research

Accounting data is not designed for equity investors, but for debt investors. Accounting data must be translated into economic earnings to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. Economic earnings are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

Additional Information

Incorporated in July 2002, New Constructs is an independent publisher of investment research that provides clients with consulting and research services. We specialize in quality-of-earnings, forensic accounting and discounted cash flow valuation analyses for all U.S. public companies. We translate accounting data from 10Ks into economic financial statements, i.e. NOPAT, Invested Capital, and WACC, to create economic earnings models, which are necessary to understand the true profitability and valuation of companies. Visit the Free Archive to download samples of our research. New Constructs is a BBB accredited business and a member of the Investorside Research Association.

DISCLOSURES

New Constructs®, LLC (together with any subsidiaries and/or affiliates, "New Constructs") is an independent organization with no management ties to the companies it covers. None of the members of New Constructs' management team or the management team of any New Constructs' affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs' Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first 15 days after New Constructs issues a report on that security.

DISCLAIMERS

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs' reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.