PRESCIENCE POINT
CAPITAL MANAGEMENT

Kellogg Company

NYSE: K

TARGET PRICE: $39.50

In 2018, Prescience Point published two research reports (the "Initiation Report" and the "Q3 18 Update Report") on Kellogg Company ("K", or "the Company"). We predicted K would be forced to (1) reduce FY 18 guidance and (2) cut its dividend or else lose its credit rating. Part one of our thesis was proven correct when K slashed its FY 18 adjusted EBIT and earnings growth guidance in Q3 18. Moreover, after Kraft Heinz's ("KHC") recent disastrous results and dividend cut, we are even more convinced that it's only a matter of time before K follows suit as K is less profitable and more financially strained by comparison. K's new disclosures and persistent deceptive tactics reinforce our expectations for more pain to be inflicted on K shareholders. We believe K (1) will be forced to cut its dividend or lose its credit rating and (2) will miss and/or need to reduce FY 19 guidance.

Prescience Point Research Opinions:

- **KHC's recent debacle should terrify K shareholders; K is in much worse shape but has been able to hide behind aggressive financial engineering:** On 02/21/19, KHC announced (1) very poor Q4 18 results and FY 19 guidance, (2) a dividend cut, (3) a $15.4 billion impairment, and (4) receipt of an SEC subpoena. In response, KHC shares traded down over 27.0% and it was put on negative credit watch by S&P. We believe K will share the same fate as it is not only less profitable and more financially strained than KHC but has weaker corporate governance and has concealed severe deterioration using accounting gimmicks. K's premium equity valuation and better credit ratings relative to KHC are unwarranted.

- **Guidance for strong second-half in FY 19 is setting shareholders up for more disappointment:** K continues to kick the can down the road while management is still not being forthright with shareholders. Sell-side analysts continue to anchor expectations to K's overly optimistic guidance, setting investors up for more disappointment, especially as accounting excesses "un-wind."

- **New Risk Factor confirms "un-wind" of DSO & DPO build will wreak havoc on performance:** K added a new Risk Factor in its FY 18 10K that corroborates the working capital "un-wind" will lead to a financial reckoning.

- **K is not the dividend stalwart shareholders believe it to be; cash is extremely tight and risk of a dividend cut or credit downgrade is high and rising:** K doesn't generate enough cash to cover dividends and short-term obligations. As a result, we believe K's recently announced asset sales are not opportunistic, but necessary to fund buybacks, pay dividends, and shore up the balance sheet.

- **Shares are trading at an unjustifiably high valuation:** Based on our adjustments, K is trading at 15.4x NTM P/E and 12.7x EV/EBITDA vs. KHC at 11.1x and 10.6x, respectively. Further, K's adjusted leverage ratio of 4.4x remains in-line with high yield CPG peers. We reiterate our K price target of $39.50. Shares still have ~30% downside.

SHARE PRICE
$54.77

AVG DAILY VOLUME
3.30M

MARKET CAP
$19.0B

NET DEBT
$8.6B

ENTERPRISE VALUE
$27.6B

THIS RESEARCH REPORT EXPRESSES SOLELY OUR OPINIONS. Use Prescience Point Capital Management's research opinions at your own risk. This is not investment advice nor should it be construed as such. You should do your own research and due diligence before making any investment decisions with respect to the securities covered herein. Forward-looking statement and projections are inherently susceptible to uncertainty and involve many risks (known and unknown) that could cause actual results to differ materially from expected results. You should assume we have a short interest in Kellogg stock and therefore stand to realize significant gains in the event that the price of such instrument declines. Please refer to our full disclaimer located on the last page of this report.

Thesis Update: Kellogg has Temporarily Avoided the Same Fate as Kraft Heinz by Concealing Fundamental Deterioration with Aggressive Financial Engineering

We remain short shares of Kellogg Company with high conviction. Kellogg's Q4 18 results and FY 19 guidance did little to assuage any of our concerns. In fact, we believe shareholders may be in for another disappointing year as the working capital "un-wind" discussed in our prior reports continues and profit growth is pushed out to FY 20 at the earliest - just as we predicted.

In addition, we believe Kraft Heinz's recent atrocious results/guidance and dividend cut are a harbinger of more pain for Kellogg shareholders, as Kellogg is substantially less profitable and more financially strained.[1] For comparison:

- Kraft Heinz is over 50.0% more profitable
- Kellogg's DSOs are ~3x higher
- Kellogg's DPO is ~15.0% higher
- Kellogg's self-proclaimed "Best-in-Class" working capital is actually worse in each of the last three years
- Kellogg's Audit Committee has minimal to no accounting/finance experience or educational background
- Kellogg has a higher credit rating despite an equivalent adjusted leverage ratio
- Kellogg trades at an ~40.0% premium to adjusted FY 19 P/E

All said, we are not trying to minimize the issues at hand for Kraft Heinz or to pour salt on its wounds, but rather to underscore how serious problems are for Kellogg. Over the last several years, we believe it's evident Kraft Heinz benefited from unsustainably low SG&A levels that certainly had negative implications with respect to (1) relationships with its customers and (2) neglect of marketing certain brands and/or product categories. However, we find it hard to believe Kraft Heinz's profitability would need to be cut by one-third (to be in-line with Kellogg's profitability) to remedy these issues. Despite clear problems at Kraft Heinz, we believe Kellogg is still in much worse shape.

There were also several notable items since our Q3 18 Update Report that further corroborate our thesis that Kellogg shareholders are in for a drawn out and painful period, ultimately ending with a dividend cut or loss of investment grade credit rating. Specifically:

- New FY 18 10K Risk Factor related to extended terms for customers and suppliers confirms reversal of DSO and DPO build will wreak havoc on performance

[1] The Kraft Heinz Company ("KHC").

- Kellogg's deceptive behavior continued as it (1) claimed FY 18 cash was "roughly even" with pre-recasted FY 17 cash flow despite a negative differential of 16.3% and (2) continued to tout improved working capital performance without acknowledging its receivable factoring program

- Kashi impairment could be forthcoming as excess fair value diminished and FY 18 disclosure does not agree with FY 17

- Capital structure remains under pressure as Kellogg's liquidity for dividends and short-term obligations is beyond tight

We reiterate Kellogg's recent results indicate the financial reckoning we predicted in April 2018 is upon us and gaining speed. We continue to believe Kellogg is substantially less profitable, more levered, and more expensive than meets the eye.

Kellogg is Less Profitable than Kraft Heinz, Significantly More Aggressive in its Accounting, & Has More Questionable Expert Oversight

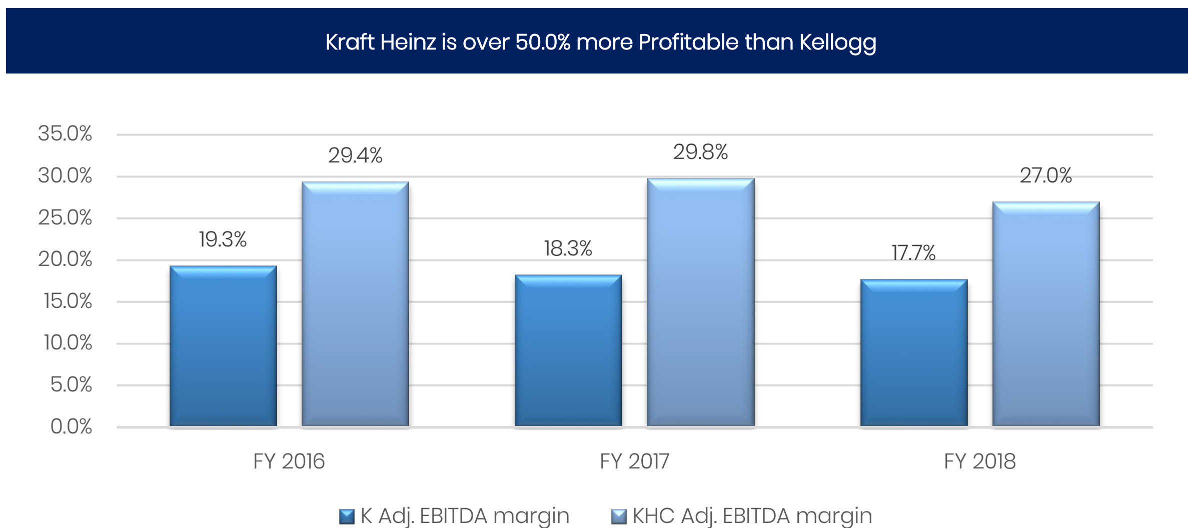
On 02/21/19, Kraft Heinz reported Q4 18 results and provided FY 19 guidance that were both well below expectations. In addition, Kraft Heinz announced (1) it would reduce its quarterly dividend by 36.0% from $0.625/share to $0.40/share, (2) a non-cash impairment of $15.4 billion related to the Kraft and Oscar Mayer trademarks and US Refrigerated and Canada Retail reporting units, and (3) it received a subpoena from the SEC in October 2018 associated with an investigation into the Company's procurement area (including accounting policies, procedures, and internal controls). In response, Kraft Heinz shares plunged over 27.0%.

In our Initiation Report nearly a year ago (April 2018), we predicted Kellogg would need to cut its dividend or risk losing its investment grade credit rating. After Kraft Heinz's recent disastrous results and dividend cut, we are even more convinced that Kellogg will need to follow suit as Kellogg is in much worse financial shape. Indeed, our original thesis has already begun to unfold; Kellogg shareholders should be terrified as they could share the same fate.

Kellogg is substantially less profitable than Kraft Heinz

It's no secret Kraft Heinz has industry leading margins driven by its now infamous Zero-Based-Budgeting (ZBB) tactics. However, some might find it surprising Kraft Heinz's profitability was over 50.0% higher than Kellogg's; even more surprising when you consider Kellogg instituted its own ZBB initiative in FY 15 and spent the last decade in a perpetual state of "restructuring" to improve margins.

Kraft Heinz is over 50.0% more Profitable than Kellogg



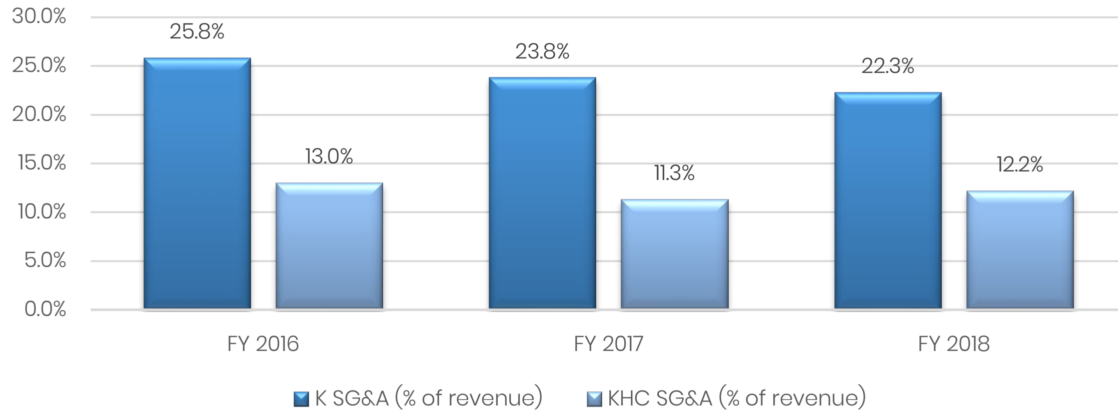
Source: K & KHC Earnings Releases

So, why the huge margin disparity?

The majority of the divergence stems from selling, general, & administrative (SG&A) cost leverage. Kellogg's SG&A costs as a percentage of revenue are roughly 2x higher than Kraft Heinz's. We believe Kraft Heinz's atrocious Q4 18 results and FY 19 guidance are evidence that its SG&A levels may have been unsustainably low and certainly had negative implications with respect to relationships with its customers and neglect of certain brands and/or product categories. However, we find it hard to believe Kraft Heinz would need to

double its SG&A spend to remedy its indiscretions. In other words, despite clear problems with Kraft Heinz's ZBB cost cutting strategy, we believe Kellogg is still less profitable by comparison.

Kellogg's SG&A Levels are Roughly Double Kraft Heinz's



Source: K & KHC Earnings Releases

Kraft Heinz may have factored receivables, but Kellogg is in a league of its own; Kellogg's adjusted DSOs are ~3x higher

Pre-factoring (Kellogg started in Q1 16), Kellogg's DSOs were consistently in the mid-30 range. Kraft Heinz stopped its US factoring program in Q2 18 and its smaller International program in Q3 18; DSOs in the back-half of FY 18 were in the high-20s. While Kellogg may have inherently longer collection periods than Kraft Heinz (perhaps due to its smaller size and less leverage with customers), it's hard to find a plausible explanation to justify DSOs that are ~3x higher.

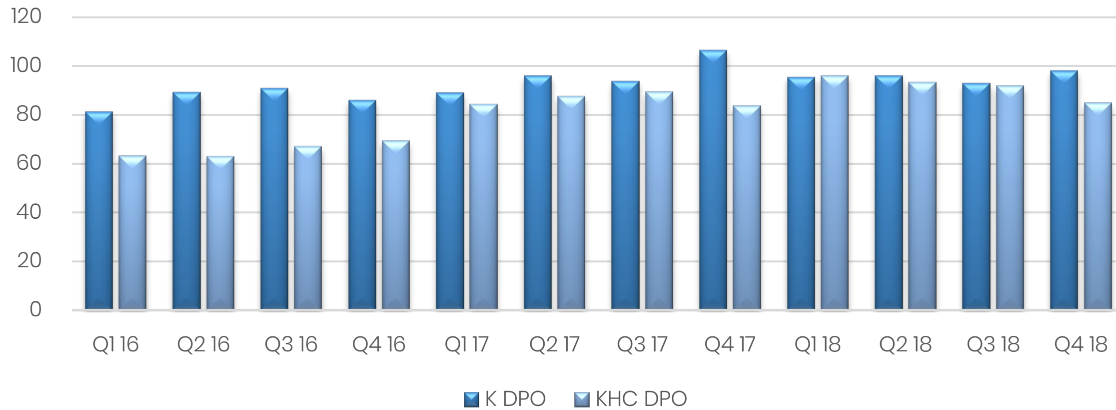
Kellogg's DSOs ~3x Higher than Kraft Heinz

Source: K & KHC 10Ks, 10Qs
*DSO = Average Adj. AR / 3M Sales * 91.25*
Adj. AR = AR + AR sold, but still outstanding

Kellogg and Kraft Heinz were both able to extend DPO in recent years, but Kellogg was much more aggressive
Since FY 14, Kellogg has used a reverse factoring arrangement (or "payable tracking system") which allowed suppliers to sell payment obligations from Kellogg to designated third-party financial institutions (i.e. banks) and thereby extended Kellogg's DPO. Kraft Heinz was also able to extend its DPO, although not to the same extent as Kellogg. In its FY 16 10K, Kraft Heinz indicated changes in accounts payable were favorable due to payment term extensions from vendor renegotiations.

While Kraft Heinz took advantage of longer payment terms to its suppliers as well, we believe there is a nuanced, but important difference. According to Kraft Heinz's disclosures, we believe it was able to renegotiate with suppliers instead of having to use a reverse factoring arrangement. Consequently, Kraft Heinz payment obligations remain due to its suppliers rather than a bank; Kellogg's reverse factored payment obligations are due to a bank, not the supplier. Perhaps more important, is the fact Kellogg was much more aggressive in unsustainably extending its DPO. Since Q1 16, Kellogg's average DPO was 93 days vs. Kraft Heinz's 81 days (~15.0% higher).

Kellogg's DPO Higher than Kraft Heinz



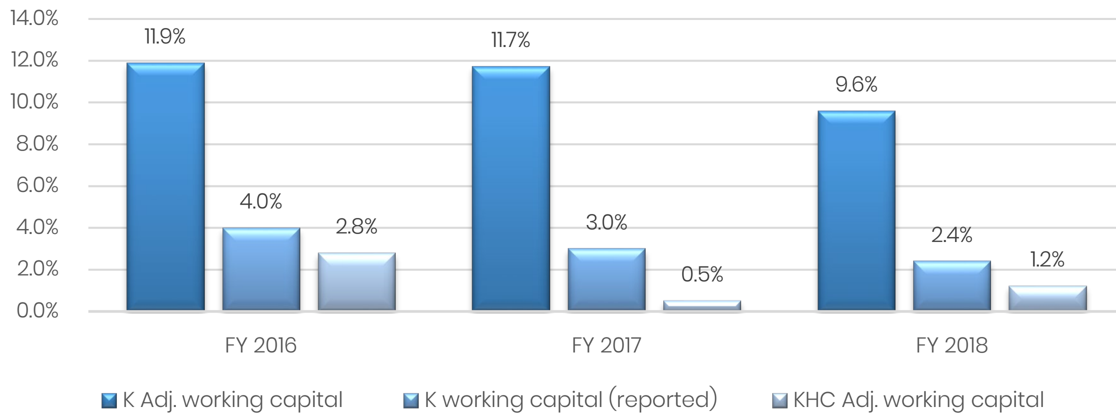
Source: K & KHC 10Ks, 10Qs

Kellogg's self-proclaimed "Best-in-Class" working capital appears to be a farce; Kraft Heinz's was better in each of the last three years

Since FY 16, Kraft Heinz's adjusted working capital levels bested Kellogg's on both an adjusted and reported basis. We have two takeaways: (1) Kellogg is less efficient with its working capital than Kraft Heinz and (2) Kellogg's "Best-in-Class" and "industry leading" proclamations are simply untrue.

Kellogg is Less Efficient with its Working Capital vs. Kraft Heinz

(% of LTM revenue)



Source: K & KHC 10Ks, 10Qs, Prescience Point estimates

Adjusted core working capital = (LTM average adj. trade receivables + LTM average inventory – LTM average payables) / LTM revenue

Kraft Heinz's Audit Committee has significantly more finance and accounting experience than Kellogg's

While Kellogg's Audit Committee members have significant business and operating experience, none of them appear to have any in-depth accounting/finance experience or educational background. Conversely, Kraft

Heinz's Audit Committee includes a former CFO, hedge fund executive, and a private equity executive. Not to mention Mr. Warren Buffet was on the Board of Directors until the spring of 2018.

Based on the significant amount of accounting irregularities we have identified at Kellogg, we are extremely concerned the intricacies and nuances may not be fully understood by an Audit Committee without requisite experience and expertise. Moreover, if a misstep of this magnitude and an SEC Subpoena related to accounting policies, procedures, and internal control can happen under the watch of experts at Kraft Heinz, how much worse could it be for Kellogg? It's a recipe for disaster.

Kellogg Audit Committee	
Member	Experience
Dr. Stephanie Burns (Chair)	• Previously Chairman, President, and CEO of Dow Corning • Long-standing career in scientific research and management
Mr. Carter Cast	• Venture Partner at Pritzker Group • Award-winning clinical professor teaching entrepreneurship and leadership • "Vast" experience in digital arena • MBA with focus on strategy and marketing
Mr. Richard Dreiling	• Previously was CEO of Dollar General and CEO of Duane Reade • Diverse retail industry experience with roles in marketing, manufacturing, distribution, merchandising, and retail operations • Bachelor's degree in Industrial Relations
Mr. Don Knauss	• Previously Executive Chairman and CEO of The Clorox Company • Held several executive level positions at The Coca-Cola Company and its subsidiaries including SVP Marketing, SVP General Manager, President & COO • Bachelor's degree in History
Ms. Erica Mann	• Previously President and GM of Pfizer Nutrition and President of Bayer's Consumer Health Division • Degree in Analytical Chemistry and Marketing Management

Kraft Heinz Audit Committee	
Member	Experience
Mr. John C. Pope (Chair)	• Chairman of PFI Group, R.R Donnelly and Sons Co. Talgo S.A., Waste Management • Previously was Director, Vice Chairman, President, COO, and CFO of United Airlines (and its parent UAL) • MBA
Mr. Feroz Dewan	• CEO of Arena Holdings Management • Previously was Head of Public Equities at Tiger Global Management • Bachelor's in Engineering with Certificate in Applied Mathematics
Ms. Jeanne P. Jackson	• Founder/CEO of MSP Capital • Previously held executive roles at NIKE and Walmart.com • MBA

Kellogg's adjusted leverage ratio is practically equivalent to Kraft Heinz's, yet Kellogg has a stronger credit rating; we don't think that will last

Fitch's credit rating for Kellogg and Kraft Heinz is the same, BBB-. Moody's rates Kellogg at Baa2, one notch above Kraft Heinz at Baa3. Standard and Poor's (S&P) rates Kellogg and Kraft Heinz the same, BBB. However,

on 02/22/19, S&P revised Kraft Heinz's outlook to negative from stable (Kellogg's outlook is stable) on "weakening credit metrics" after Kraft Heinz reported Q4 18 results.[2] We believe Kellogg warrants the same level of scrutiny from the credit ratings agencies, if not even more, as Kellogg's accounting excesses dwarf those at Kraft Heinz.

Kellogg & Kraft Heinz Leverage Ratio Nearly Identical

($ in millions)	K	KHC
Net debt	$10,637.0	$30,155.0
*FY 19E adjusted EBITDA**	$2,402.0	$6,680.0
Adjusted net debt/EBITDA	4.4x	4.5x
Credit Rating		
S&P	BBB	BBB
Moody's	Baa2	Baa3
Fitch	BBB-	BBB-

**See Appendix for K adj. EBITDA calculation*
KHC adj. EBITDA = Thomson Reuters consensus estimate

Kellogg is now trading at an unwarranted premium to Kraft Heinz

Kraft Heinz's shares and valuation multiple were rightly hit after its disastrous results. However, by comparison, Kellogg is still substantially less profitable and significantly more exposed to the negative implications of massive accounting excesses. Based on our conservative estimates, Kellogg is currently trading at a ~40.0 premium to Kraft Heinz's FY 19 P/E and a ~20.0% premium to FY 19 EV/EBITDA. We believe this premium is completely unwarranted.

Kellogg Trades at a ~40.0% Premium to Kraft Heinz P/E

	FY 19E
Kellogg P/E*	15.4x
Kraft Heinz P/E**	11.1x
Kellogg EV/EBITDA*	12.7x
Kraft Heinz EV/EBITDA**	10.6x

Source: Prescience Point & Thomson Reuters estimates
**Prescience Point estimate. See Appendix for calculation*
***Thomson Reuters consensus estimate*

New Risk Factor Confirms Our Prediction the Reversal of DSO & DPO Build will Wreak Havoc on Performance

[2] https://www.standardandpoors.com/en_US/web/guest/article/-/view/type/HTML/id/2171045

In our Initiation and Q3 18 Update Reports, we discussed Kellogg's extended terms and reverse factoring programs at length and the negative repercussions the "un-wind" will have on revenue growth and cash flow. In Q4 18, factored receivables and adjusted DSOs continued to trend lower, consistent with our prior expectations.[3] In short, we continue to believe customers are sitting on too much channel inventory and no longer want to purchase more inventory than required (i.e. utilizing extended term options). Instead, we believe customers want to take advantage of early payment discounts which will continue to negatively impact Kellogg's revenue and profitability. In Q4 18, DPO remained unsustainably high. We continue to believe this will reverse course in the intermediate term and negatively impact cash flow.

In its FY 18 10K, Kellogg added a new Risk Factor that specifically addressed the negative working capital implications if the Company's extended payment term arrangements for customers and/or suppliers were reversed (i.e. "un-wound").

> *We utilize extended payment terms for customers and suppliers supplemented with third party financing programs to assist in effectively managing our core working capital.* ***If the extension of payment terms are reversed or financial institutions terminate their participation, our ability to maintain current levels of core working capital could be adversely impacted.***
>
> *Our principal source of liquidity is operating cash flows supplemented by borrowings for major acquisitions and other significant transactions. We utilize third-party financing programs to offset the negative impact of offering extended customer payment terms. In addition, in combination with extending supplier payment terms, structured payables programs are available to our suppliers which enable suppliers, at their sole discretion, to enter bilateral agreements to sell Company payment obligations to designated third-party financial institutions.*
>
> *Changes in financial markets or interest rates could make these third party financing programs less attractive to the financial institutions purchasing trade accounts receivables and Company payment obligations thereunder and these financial institutions may seek to terminate their participation. In the event of such termination or if our extended payment terms are reversed, our ability to effectively manage core working capital could be adversely impacted.*
>
> *(FY 18 10K) [emphasis added]*

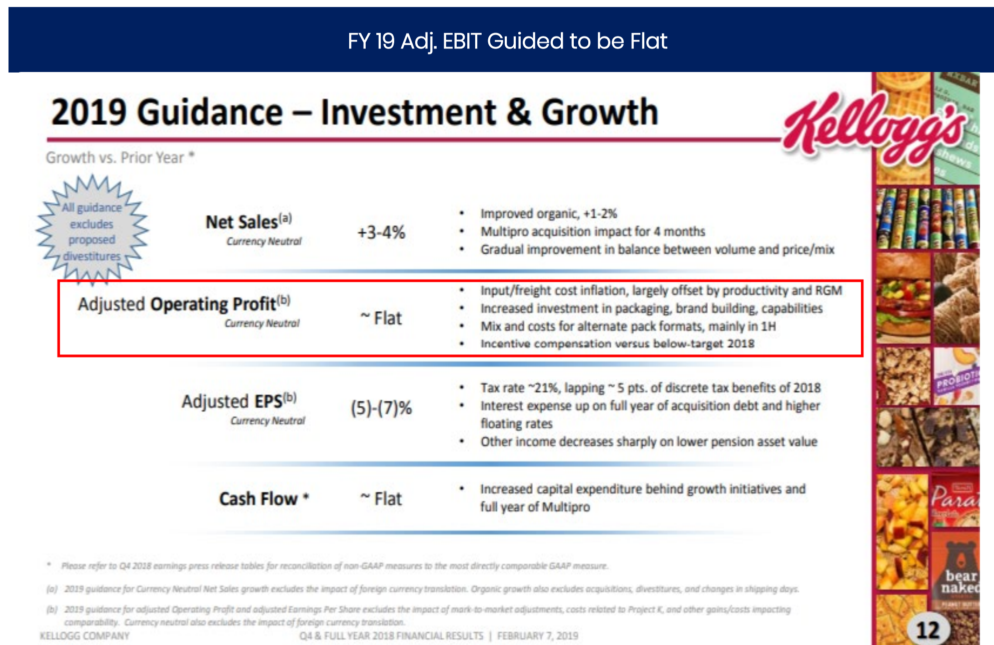
Kellogg started its reverse factoring program in the beginning of FY 14 and its receivable factoring program in FY 16. So, why was this Risk Factor just added now?

We suspect it's due to substantially less interest by customers and vendors in Kellogg's extended term arrangements. Moreover, we can't stress enough that Risk Factors are somewhat of a proxy for a legal disclaimer to investors; Risk Factors are used to address risk and uncertainties that could materially adversely affect a company's business. In other words, if the share price tanks, a company can point investors to its Risk Factors and say "see, we warned you this could happen."

FY 19 EBIT Guidance Flat (As We Predicted); Guidance for Strong Second-Half is Setting Investors Up for Disappointment

In our Q3 18 Update Report, we predicted "FY 19 operating profit growth will be well below initial expectations and any hope of profit growth will be pushed into FY 20 at the earliest"
Kellogg's FY 19 guidance confirmed our prediction; profit growth will have to wait until at least FY 20.

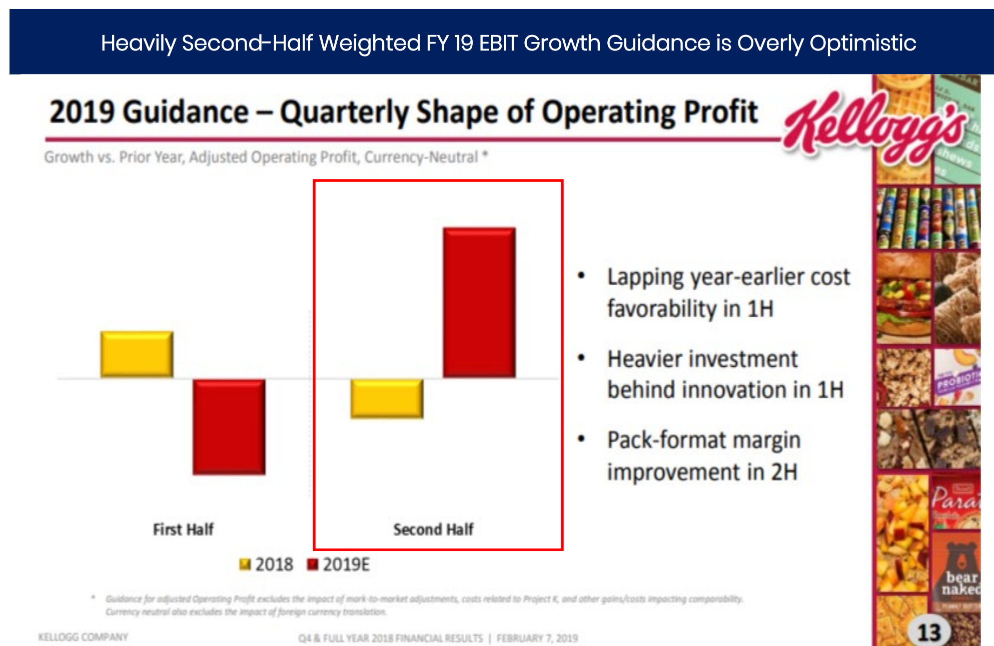
[3] See Appendix for factored receivables and DSO tables updated for Q4 18.



Source: K Q4 18 Investor Slides, 02/07/19

Kellogg continues to kick the can down the road; heavily weighted second-half FY 19 adj. EBIT guidance is setting investors up for disappointment

Kellogg guided for adjusted operating profit to decline in the first-half of FY 19 but be offset by growth in the second-half. We have seen this story before. Heavily weighted back-half growth can be inherently problematic; everything must go right in order to just meet guidance. We believe Kellogg's second-half growth guidance is overly optimistic and remain concerned sell-side estimates anchored to Kellogg's guidance are not appropriately discounting the havoc the receivable "un-wind" will have on revenue growth and profitability.



Source: K Q4 18 Investor Slides, 02/07/19

Kellogg Continues to be Disingenuous with Investors

In our prior Reports, we specifically called out multiple instances were Kellogg appeared to be disingenuous and, in some cases, even misleading to investors. For example:

- Touted improved and Best-in-Class" working capital levels without accounting for factored receivables
- Removed working capital slide from Investor Presentations as soon as the reported metric started to deteriorate
- Contradictory commentary regarding FY 18 guidance reduction and previous re-iterations
- Eliminated North America business unit-level disclosures

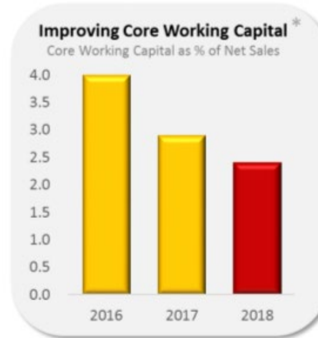
In Q4 18, the mischievousness continued. Kellogg shareholders should be extremely cautious as this type of behavior is a hallmark example of a company trying to hide something.

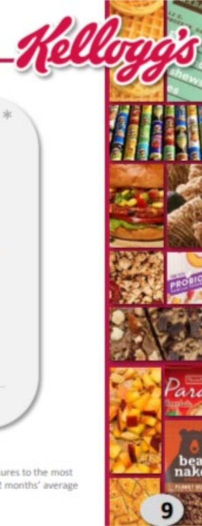
Slide 9 of Kellogg's Q4 18 Investor Deck contained two very misleading statements
First, FY 18 cash flow of $958.0 million was "roughly even" with pre-recast FY 17. Second, improving core working capital. We will debunk each below.

Cash Flow + Working Capital Claims are Very Misleading

Cash Flow – Durable and As Expected

- **2018 cash flow of $958 million,*** roughly even with pre-recast 2017
- Includes $(162) million after-tax voluntary pension contribution
- Increased capital expenditure for growth
- Improved core working capital efficiency





* Cash Flow defined as cash from operating activities, less capital expenditure. Please refer to Q4 2018 earnings press release for reconciliation of non-GAAP measures to the most directly comparable GAAP measure. "Core Working Capital" is an internal Kellogg metric defined as last 12 months' average trade receivables and inventory, less 12 months' average trade payables, divided by last 12 months' net sales.

KELLOGG COMPANY Q4 & FULL YEAR 2018 FINANCIAL RESULTS | FEBRUARY 7, 2019

Source: K Q4 18 Investor Slides, 02/07/19

Kellogg said FY 18 cash flow was "roughly even" with pre-recast FY 17 cash flow but FY 18 was actually 16.3% lower! Since when is 16.3% "roughly even"?

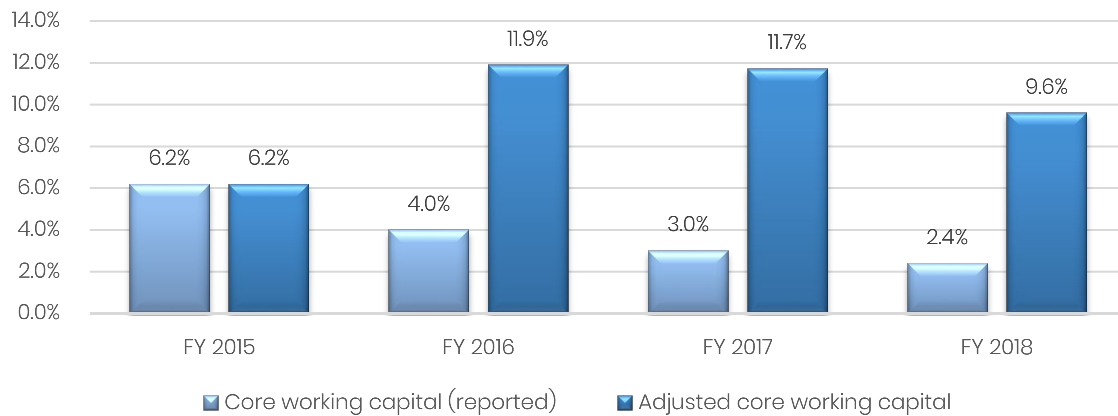
FY 18 Cash Flow was 16.3% Lower than Pre-Recast FY 17

($ in millions)	FY 17	FY 18
Cash flow	$1,145.0	$958.0
Y/Y change	--	*(16.3%)*

Source: K 10Ks

Kellogg re-added graphic in its Q4 18 Investor Deck to show "improved" working capital but it's all a farce; adjusted working capital levels are 4x higher!

Adjusted Working Capital Levels are 4x Higher than Reported



Source: Company filings, Prescience Point estimates
Adjusted core working capital = (LTM average trade receivables + LTM average inventory + receivables sold, but outstanding – LTM trade payables) / LTM revenue.

Kashi impairment could be forthcoming; FY 18 10K fair value disclosure doesn't agree with FY 17 10K

In its FY 17 10K, Kellogg indicated it had $207.0 million of goodwill related to Kashi and the percentage of excess over fair value was "approximately 30.0%."

> *We have $207 million of goodwill related to our Kashi reporting unit, which was primarily a result of establishing Kashi as a separate operating segment in 2015, which required an allocation of goodwill from our U.S. Snacks operating segment. The 2017 fair value of the Kashi reporting unit was estimated primarily based on a multiple of net sales and discounted cash flows.* ***The percentage of excess over fair value was approximately 30%.*** *The use of modestly different assumptions in the valuation could have resulted in an impairment.*
>
> (*FY 17 10K*) *[emphasis added]*

In its FY 18 10K, Kellogg indicated its excess over fair value was only 12.0%, well below the reported level in FY 17. However, more peculiar is the fact the FY 18 disclosure stated FY 17 excess over fair value was 9.0%, not 30.0% as disclosed in the FY 17 10K.

> *The Company has $207 million of goodwill related to the Kashi reporting unit, which was primarily a result of establishing Kashi as a separate operating segment in 2015, which required an allocation of goodwill from our U.S. Snacks operating segment. The 2018 fair value of the Kashi reporting unit was estimated primarily based on a multiple of net sales and discounted cash flows.* ***The percentage of excess over fair value was approximately 12% and 9%, in 2018 and 2017****, respectively, using the same methodology on a year-on-year basis.*
>
> (*FY 18 10K*) *[emphasis added]*

Both the FY 17 and FY 18 10K indicated the estimated fair value was primarily based on a multiple of net sales and discounted cash flows but provided no further discussion as to specifics. We hypothesize Kellogg may have updated its valuation multiple and/or discount rate for Kashi in FY 18 to adjust for a weaker outlook, thereby resulting in a lower excess fair value vs. the original FY 17 disclosure. Consequently, we believe weaker-than-expected Kashi performance could suggest an impairment may be forthcoming.

Capital Structure Remains Under Pressure, Kellogg is Still Significantly More Leveraged Than It Appears

Liquidity for dividends and short-term obligations remains extremely tight

The only adjustment we made to FY 19 consensus EBITDA was a 50% addback of Project K/restructuring charges. We continue to believe this estimate is extremely conservative. So, even with conservative estimates, Kellogg's liquidity for dividends and short-term obligations is beyond tight. We continue to believe it's highly probable run-rate EBITDA could be materially lower as accounting excesses reverse.

Kellogg has Limited Capital Flexibility

($ in millions)	
Prescience Point FY 19 adjusted EBITDA*[4]	$2,402.0
Less: interest expense**	$315.7
Less: capital expenditure**	$594.0
Less: income taxes*	$323.0
Amount left to cover debt obligations and dividends	**$1,169.3**
Less: dividends***	$801.6
Amount left to cover debt obligations	**$367.7**
Less: current maturities of long-term debt	$510.0
Less: notes payable	$176.0
Surplus/(deficit)	($318.3)

Source: K 10Ks, 10Qs, 8Ks
**Prescience Point estimate*
***FY 19 Thomson Reuters estimates*
**** Prescience Point estimate based on 347 million average shares outstanding and Thomson Reuters estimate of FY 19 dividends of $2.31/share.*

K is still significantly more leveraged than it appears

Nearly all of Kellogg's peers with net debt/EBITDA above 4.0x have non-investment grade credit ratings and/or are on negative credit watch. We continue to believe Kellogg's adjusted net debt/EBTIDA of 4.4x suggests it may soon join its non-investment grade peers. Again, while a high net debt/EBITDA does not mean Kellogg's credit rating should be instantly downgraded, we do believe it corroborates the fact that Kellogg has limited capital structure flexibility.

[4] See Appendix for detailed calculated of adjusted EBITDA.

Adjusted Net Debt/EBITDA of 4.4x Suggests Credit Downgrades may be Imminent	
($ in millions)	**Q4 18**
Current maturities of long-term debt	$510.0
Notes payable	$176.0
Long-term debt	$8,207.0
Receivables sold, but still outstanding	$993.0
Estimated amount of extended DPO	$1,072.0
Cash	($321.0)
Prescience Point Adjusted Net debt	$10,637.0
Prescience Point FY 19 adjusted EBITDA	$2,402.0
Adjusted net debt/EBITDA	4.4x

Source: K 10Ks, 10Qs, 8Ks, Prescience Point estimates

Appendix

Prescience Point FY 19 adjusted EPS calculation

Prescience Point Adjusted EPS Calculation	
($ in millions)	FY 19E
FY 19 adjusted operating income (consensus estimate)	$1,879.0
(-) Restructuring charges adjustment (50.0%)	($25.0)
Prescience Point adjusted operating income	$1,854.0
Interest expense estimate	$315.7
Prescience Point adjusted net income	$1,538.3
Tax rate (per K guidance)	21.0%
Tax expense estimate	$323.0
Prescience Point adjusted net income	$1,215.3
Fully diluted shares	347.0
Prescience Point adjusted EPS	$3.50

Source: Prescience Point & Thomson Reuters estimates

Prescience Point Enterprise Value calculation

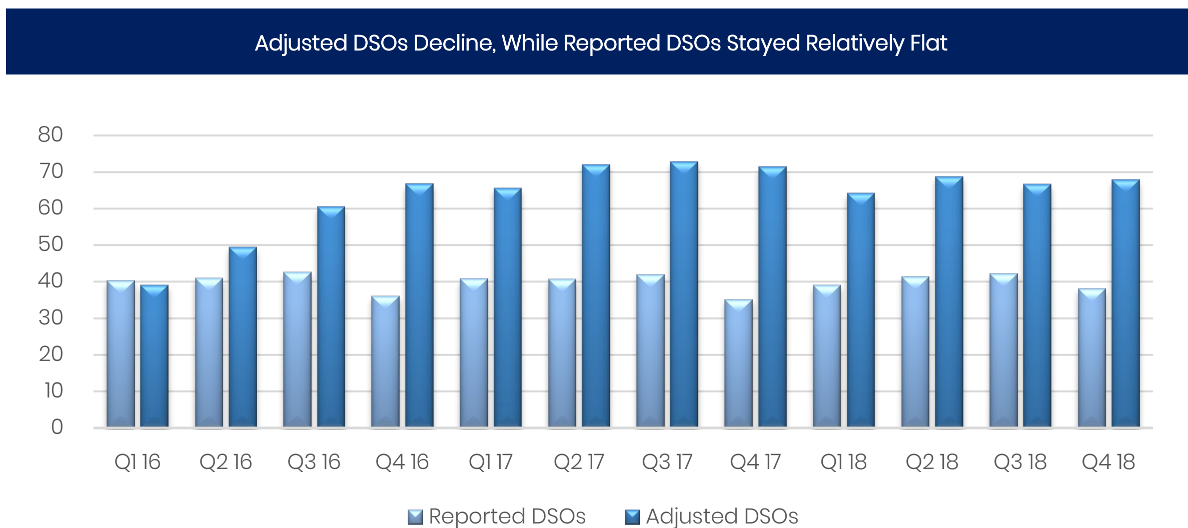
Prescience Point Enterprise Value Calculation	
($ in millions)	EV
Current equity value	$19,000.0
Prescience Point adjusted net debt	$10,637.0
Minority interest	$558.0
Prescience Point adjusted Enterprise Value	$30,195.0

Source: Prescience Point & Thomson Reuters estimates

Factored receivables continued to decline year-over-year

Source: K [10Ks and 10Qs]

Adjusted DSOs declined year-over-year, but remained well above reported DSOs



Adjusted AR = AR + AR sold, but outstanding
*DSO = Average AR / 3M Sales * 91.25*

Prescience Point adjusted EBITDA calculation

Prescience Point Adjusted EBITDA	
($ in millions)	FY 19E
Consensus estimate	$2,427.0
(-) Restructuring charges adjustment (50%)	($25.0)
Prescience Point adjusted EBITDA	$2,402.0

Source: K 10Ks, 10Qs, 8Ks, Prescience Point estimates

Restructuring charges adjustment

In our Initiation Report, we argued excluding "non-recurring" restructuring charges that persist for more than five years does not accurately reflect the costs associated with running the business. If a business needs perpetual restructuring, the costs should not be excluded as "non-recurring." In addition, persistent restructuring charges provide the Company an opportunity to bucket normal recurring costs as "restructuring" and have them excluded from non-GAAP results. An argument could be made that all restructuring charges should be included in comparable operating income (and EBITDA), but to be on the more conservative side, we only included 50% of the restructuring charges in our adjusted EBITDA metric.

Restructuring Charges Adjustment	
($ in millions)	FY 19
Project K & cost restructuring guidance (at midpoint)	$50.0
Prescience Point adjustment (%)	50.0%
Prescience Point adjustment ($)	$25.0

Source: K 10Ks, 10Qs, 8Ks, Prescience Point estimates

Disclaimer

This research report expresses our research opinions, which we have based upon certain facts, all of which are based upon publicly available information, and all of which are set out in this research report. Any investment involves substantial risks, including complete loss of capital. Any forecasts or estimates are for illustrative purpose only and should not be taken as limitations of the maximum possible loss or gain. Any information contained in this report may include forward looking statements, expectations, and projections. You should assume these types of statements, expectations, and projections may turn out to be incorrect for reasons beyond Prescience Point Capital Management's ("Prescience Point") control. This report should only be considered in its entirety. Each section should be read in the context of the entire report, and no section, paragraph, sentence or phrases is intended by its authors to stand alone or to be interpreted in isolation without reference to the rest of the report. The section headings contained in this report are for reference purposes only and may only be considered in reference to the detailed statements of opinions in their respective sections. This is not investment advice nor should it be construed as such. Use of Prescience Point's research is at your own risk. You should do your own research and due diligence before making any investment decision with respect to securities covered herein.

You should assume that as of the publication date of any report or letter, Prescience Point (possibly along with or through our members, partners, affiliates, employees, and/or consultants) along with our clients and/or investors has a short position in all stocks (and/or are long puts/short call options of the stock) covered herein, including without limitation Kellogg Company ("K"), and therefore stands to realize significant gains in the event that the price of its stock declines. Following publication of any report or letter, we intend to continue transacting in the securities covered therein, and we may be long, short, or neutral at any time hereafter regardless of our initial recommendation.

This is not an offer to sell or a solicitation of an offer to buy any security, nor shall any security be offered or sold to any person, in any jurisdiction in which such offer would be unlawful under the securities laws of such jurisdiction.

To the best of our ability and belief, as of the date hereof, all information contained herein is accurate and reliable and does not omit to state material facts necessary to make the statements herein not misleading, and all information has been obtained from public sources we believe to be accurate and reliable, and who are not insiders or connected persons of the stock covered herein or who may otherwise owe any fiduciary duty or duty of confidentiality to the issuer, or to any other person or entity that was breached by the transmission of information to Prescience Point. However, Prescience Point recognizes that there may be non-public information in the possession of K or other insiders of K that has not been publicly disclosed by K. Therefore, such information contained herein is presented "as is," without warranty of any kind – whether express or implied. Prescience Point makes no other representations, express or implied, as to the accuracy, timeliness, or completeness of any such information or with regard to the results to be obtained from its use.