10-K/20-F Analysis of Coca-Cola, PepsiCo, and Cadbury-Schweppes

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Table of Contents

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As the leaders in the soft drink industry pave the way for their followers, they continue to make improvements, struggle through rough times, and innovate ways to stay on the top. The top three companies, The Coca-Cola Company, PepsiCo Inc., and Cadbury-Schweppes, report their financial standing each year along with their explanations for their current standing. These annual reports filed on form 10-K (domestic businesses) or 20-F (foreign business) provide shareowners of a public company with information about the company's performance and prospects following the completion of a fiscal year. Annual reports are a financial reporting requirement for every public company and an opportunity for management to communicate its views on such issues as business strategy and progress, competitive and economic forces, financial structure and corporate governance, among others. The scope and depth makes the annual report on form 10-K one of the most important communications published by a corporation to its investors.

Individual investors, investment advisors, and equities analysts typically read annual reports to help them evaluate whether a company's shares are an attractive investment. Each type of investor may seek different data and information within the annual report in order to conduct their analysis and form their opinion. The 10-K or 20-F typically accompanies the annual report to allow for a full view of a company as an investment.

The Coca Cola Company

In fiscal year 2003, The Coca Cola Company achieved their 49th consecutive year of volume growth; and in 2004, they have increased their dividend for the 42nd year in a row. They have achieved these new levels of financial and operating performance in a particularly challenging business environment; which shows the dependability of the Coca-Cola system, the enduring appeal of their brands, their marketing and innovation capabilities, and their strong relationship with consumers and stockholders. The Coca-Cola Company defines part of their success by their ability to continually find ways to communicate with the stockholders and focus their resources on the areas of business that offer the highest potential. The company achieves this communication by sending out continual publications to their stockholders to inform them of the progress of their plans. They provide stockholders with information to assess their progress and their plans more efficiently by answering questions directly, and by providing a business overview that complements their financial statements. This information can be found in the Annual Report and the 10-K.

Cash and Marketable Securities

From 1993 to 1997, Coca-Cola's "Cash, Cash Equivalents and Marketable Securities" account grew from $1.08 billion to $1.84 billion. In 1998 the account dipped slightly to $1.80 billion, but regained growth for the next 5 years closing at $3.48 billion at the end of this fiscal year. A substantial increase of $1.1 billion in cash and cash equivalents can be can be accounted for due primarily to increased cash flows from operations. In 2003, the company's net cash flow from operating activities (as stated on the Statement of Cash Flows) was approximately $5.5 billion, a 15 percent increase from the previous year. In the near future (2004-2008), the company expects their cumulative net cash flow from operating activities to be in excess of $32 billion.

This balance of cash on hand demonstrates one of the company's fundamental strengths: the ability to generate significant cash flows to reinvest in the business. The principal uses of the company's cash flows include share repurchases, dividends, and capital expenditures. When a company reinvests in itself, it is a wise use of cash from the investor's standpoint.

Credit Policy

Credit is temporary capital and the objective of credit is lending with the purpose of increasing profits and sales. A sound credit policy in business is the key component to managing by measurement and benchmarks. Trade accounts receivables are recorded at net realizable value. According to DocLoan.com, “net realizable value” is “a method of determining the present value of a troubled asset to its present owner based on the assumption that the asset will be held for a period of time and sold at some future date” (JPL Networks, 2003). This value includes the appropriate allowance for estimated uncollectible accounts to reflect any loss that might be anticipated on the trade receivables account balance. This amount would be charged to a provision for doubtful accounts. The company calculates this allowance by evaluating past write-offs from previous fiscal years and also taking into account the economic status of their customers.

In an effort to retrieve accounts faster without having to charge them off, it is a possibility to offer discounts to customers who pay early. An example of this would be to offer a 10 net 30 discount; meaning that customers would receive a 10% discount if they paid their account prior to the 30 day cut-off. This would decrease their receivables turnover, possibly resulting in more accounts being paid. A downfall to this method would be that the company would be collecting less on the account. We believe this amount would be insignificant in comparison to the profit received from more accounts being paid.

Foreign Currency Transactions

The Coca-Cola Company manages most of their foreign currency exposures on a consolidated basis, which allows them to “net certain exposures and take advantage of any natural offsets” (Coca-Cola Company, 10-K, 2003). The five geographic operating segments (North America, Africa, Asia, Europe/Eurasia/Middle East, and Latin America) accounted for nearly 81 percent of 2003 operating income outside the United States. The company believes that weakness in one particular currency is often offset by strengths in others over time. The overall increase in total assets can be explained by the impact of a stronger Euro and Japanese Yen (impacting 2 of the operating segments) which in turn offset the impact of weakening currencies in the Latin America segment.

The Coca-Cola Company also engages in forward exchange contracts and purchases currency options (principally Euro and Japanese Yen) to offset the earnings impact relating to exchange rate fluctuations. By researching numerous International Bank Websites, we have determined that forward exchange contracts and currency options allow the company to take advantage of favorable exchange rate movements by buying or selling an amount of foreign currency at an agreed rate for a certain delivery date while protecting the company from the effects of adverse movements. The advantages of using these measures are that they provide a simple method of covering exchange risk, without having to worry about unfavorable movements in exchange rates; and they allow the company to overcome the problems in budgeting and simplifying the process since now the company can budget at a guaranteed rate of exchange.

It is important to stay abreast of economic and political conditions in the segments the company’s subsidiaries are located. A slight lapse in attention could be quite costly. It is important for Coca-Cola to maintain their relationships with foreign banks to continue contractual agreements to protect their investments abroad and increase profitability by utilizing the aforementioned foreign currency strategies.

<u>Inventory</u>

The Coca-Cola Company's inventories consist primarily of raw materials, supplies, concentrates and syrups. These inventories are valued at the lower of cost or market which means that if inventory values were to plummet, their valuations would represent the replacement costs. In normal times of steady price increase or decrease the cost is determined on the FIFO method (first in, first out). If the price increases, this method allows for the company to have a better indication of the value of ending inventory, but it also increases net income, when the older inventory is used to account for costs of goods sold, which can lead to increased income taxes.

A potential liability to this method could be if a pause in the economy, in terms of the beverage industry, occurs. In this event, the company could incur great costs by having to destroy inventory due to spoilage. However, since the Coca-Cola Company has been on the edge of every trend, we believe they would be able to use the resources elsewhere to accommodate the beverage needs of the consumers.

<u>Sources and Uses of Short-tem Financing</u>

As of December 31, 2003, the company had approximately $1.58 billion in lines of credit and other short-term credit facilities available, of which $246 million was outstanding. This amount of outstanding debt is attributed to their international operations. The issuances of debt in 2003 primarily included $304 million in commercial paper with maturities of 90 days or less. Their overall short term borrowings (loans and notes payable) consist mostly of commercial paper issued in the United States. Some of their short term notes payable are explained by their acquisitions of businesses. The lines of credit mentioned previously were available for general corporate purposes, including commercial paper back-up.

Commercial paper is usually issued by companies with high credit ratings, meaning that the investment is almost always relatively low risk. This is a sound way to manage short term debt since the interest rates are generally substantially lower than a straight bank loan. It is a great way for a company to obtain cash quickly for their inventory needs, for example. Another way that short term financing has been used is in the acquisition of businesses. This use can be either beneficial or detrimental. If the acquired company operates profitably, Coca-Cola would be able to use those profits t pay off debt; however, if the opposite occurs and the acquired company assumes a loss, Coca-Cola could suffer a dip in Net Income. The overall picture, however, shows that Coca-Cola has been around for quite some time and has been able to recover from poor decisions. One small acquisition is not going to end the reign of the Coca-Cola Company.

PepsiCo, Inc.

PepsiCo, Inc. is comprised of four divisions: Frito-Lay North America, PepsiCo Beverages North America (PBNA), PepsiCo International, and Quaker Foods North America. PepsiCo International and PBNA are the two divisions that manufacture and distribute beverages; however, their Annual Report and 10-K comprise PepsiCo as a whole.

From 2001 to 2002, PepsiCo witnessed a greater increase in operating profit (18.1%) and net income (25%) than compared to growth from 2002 to 2003 (11.3% and 18.9%, respectively). However, 2002 to 2003 had a slightly higher increase in net revenue (7.4%) than 2001 to 2002 (6.8%). This change in growth can be attributed to strategies related to marketable securities, credit policy, foreign currency transactions, inventory and sources and use of short-term financing. PepsiCo identifies its strength as their “strong cash generating capability and financial condition” (PepsiCo, Inc., 2003).

Cash and Marketable Securities

PepsiCo experienced a decrease of cash provided by operating activities from 2002 to 2003 of approximately $3 million. The operating cash flows obtained from net income are the company's main source of liquidity. The company attributes the decrease in working capital to higher net tax payments. To their advantage, their pension costs have decreased providing some relief. By continuing to lower their pension plan contributions and reducing tax payments they can reduce the margin and hopefully maintain, or increase, cash from operations in 2004.

In looking at their 2003 investing activities, PepsiCo invested $1.3 billion of their capital and spent $1 billion on short-term investments. Their capital spending decreased $100,000 from 2002 to 2003. They increased short-term investments of three months or less from a loss of $14 million in 2002 to a gain of $25 million in 2003. They apparently made excellent short-term investment decisions here potentially increasing working capital. The company anticipates capital spending will continue at a rate of 5% to 5.5% of net revenue in 2004. PepsiCo values its investors and believes strongly that they need to pay one-third of their previous year's net income in dividends. The company also believes it is necessary to use capital for new product concepts and innovations. Overall, their cash equivalent at the end of 2003 was $820 million. From 2001 to 2002 they increased cash 140% and from 2002 to 2003 they decreased cash by 50%.

Credit Policy

PepsiCo's products are sold on cash or credit. Their credit terms generally require payment within 30 days of delivery and may allow discounts for early payment. PepsiCo recognizes revenue upon delivery in accordance with written sales terms that do not allow for a right of return. They will remove damaged and out-of-date products when delivering to a store to ensure quality products are reaching the customers. The company reserves funds for “bad debt” each year through estimating and forecasting based on previous years. The bad debt has been consistent over the years.

Foreign Currency Transactions

PepsiCo manages its foreign currency exposures by contract timeframes. This allows them net profits with the exchange rates. Since PepsiCo uses exchange contracts to guard foreign currency exposure from company’s assets and liabilities; basically functioning to “dominate the purchases that are accounted for as cash flow” (Cambridge, 2003). Included in the three geographic operating segments, United Kingdom and Canada account for nearly 20 percent of the income outside the United States. The company offsets its foreign contracts by entering hedges with two-year restrictions. Overall, the pending contracts had a net unrealized loss of $30 million dollars explaining PepsiCo’s decrease in total assets.

In order for any company to survive in the foreign exchange industry, it should ensure the economy’s stability with contractual exchanges. Unfortunately, PepsiCo entered many hedge foreign relationships. This is understandable when economic markets are strong and exchange rates are steady; however, PepsiCo should consider limiting its exchange transactions until improved performance warrants net profit for the company.

Inventory

PepsiCo’s inventories consist of packaging materials, supplies, flavors and concentrates, syrups, and fuel and natural gas. These inventories are purchased in the open market and supplies are limited due to shortages. PepsiCo is subject to many price variations due to open market buying. Most situations cause PepsiCo to increase prices if the economy changes; this causes a price increase in the open market prices. PepsiCo tries to absorb the expense by increasing the consumer price. Successfully, PepsiCo has not encountered any major problems with this approach. However, PepsiCo should consider aligning with a major vendor for reduced price materials and decreased liability buy purchasing materials on the open market. By establishing the vendor relationship, the larger the quantities of merchandise, the higher the company discount for such materials. In addition, fuel and gas prices are increasing in relation to a low economy and political uneasiness. PepsiCo’s new structure of food and beverages is to build synergy between business establishments. This can be done by soliciting a strong vendor to partner with the company, which will add significant cost savings in sales, and marketing for its product’s. Again, PepsiCo can save by entering a short-term hedge with a major vendor.

<u>Sources and Uses of Short-Term Financing</u>

PepsiCo uses bank loans as their primary use of short-term financing. As of year-end 2003, PepsiCo maintained $1.3 billion of revolving credit, of which $753 million is due to capital spending. In June 2001, PepsiCo cancelled business relationships with facilities offering them $375 million in revolving credit. PepsiCo's new philosophy on short term financing is to limit the credit expense to only short-term debt. PepsiCo is confident that strong cash generating capabilities and financial conditions of the company gives them an advantage in the capital markets, which allows them to limit short term financing. Since PepsiCo's cancellation of credit relationships, they have managed to conduct mergers with major companies such The Quaker Oats Company and Frito Lays. This was largely due to strong cash flow allowing them to repurchase capital stocks to qualify for 'pooling of interest'. PepsiCo, second to Coca-Cola, should be cautious about limiting too many short-term financing options because of the bank loan policies that they can decline their line of credit request if the firm’s credit worthiness is not up to standards. With the economy acting as a roller coaster over the last three years, PepsiCo should consider locking into a revolving credit agreement in cases where high losses to the company could cause a decrease in the firm's credit capabilities.

Cadbury-Schweppes

Cadbury-Schweppes, the third leading company in the soft drink industry, prides itself on its high standards of corporate social responsibility. They plan to uphold their strong ethics and integrity throughout expansion. The company's core products are confectioneries and beverages. In 2003, Cadbury-Schweppes consolidated its major regional operating units from nine, down to five: America's Beverages; America's Confectionery; Europe, Middle East and Africa; Europe Beverages; and Asia Pacific. In the same year, they also acquired Adams making them number two in the global gum market. Over the past several years, the company has acquired other companies within different regional units. The company considers shareowners as a vital part of the company; therefore, they have stated one future goal is to provide an outstanding return to the shareholders.

Cash and Marketable Securities

The company's free cash flow decreased from 2002 to 2003 by £143 million. Their acquisition of Adams resulted in £82 million increase of net interest payments for financing and an increase in working capital negatively affecting cash flow. The company had announced before 2003 that they were not going to meet all of their goals in anticipation for the acquisition and realignment that occurred in February 2003. Despite this decline, the company still maintains high margins and ability to generate cash. Working capital has increased greatly since 2001. Their 2003 liquid resources are £242 million and £191 million at the bank on hand.

Credit Policy

The company risks credit related losses in the event that one of its counterparts does not meet performance expectations. To reduce this risk, the company only selects business counterparts with a high credit rating. The company has set a policy for debt maturities that at least 75% of year end net debt should have a maturity of one year or more.

In regards to their accounts receivables, Cadbury has a relationship with the GETPAID Corporation. This company is the worldwide leader in providing collections and dispute resolution software. GETPAID interfaces with any Accounts Receivables system to drive workflow and facilitate collaboration, allowing Cadbury to streamline receivables management and interaction with their customers. Cadbury Schweppes uses GETPAID to improve cash flow and reduce process related costs. Implementing GETPAID can typically reduce past due Accounts Receivables by 25% or more, lower Days Sales Outstanding by 10-20%, and decrease dispute volume by 30-50% (American Credit Association, 2003).

Foreign Currency Transactions

In 2003, currency movements caused a 3% decline in operating profits related to the weak US dollar that was partially offset by the Euro. The exchange differences, arising from retranslations from profits and/or losses from average rates taken from reserves, cause difficulties in evaluating the actual success from overseas subsidiaries. Schweppes ended 2003 with £3,317 million in foreign currency. Keeping in mind, foreign currency assets or liabilities do not generate any gains or losses in the company's profit margin. Schweppes participates in foreign currency contract to eliminate currency exposures that arise on sales. In 2003, Schweppes had £327 million worth of foreign currency to sell; however, in 2002 they had £570 million. Also, in 2003 they purchased £787 million in foreign currency compared to 2002 at a high of £879 million.

Inventory

Inflation in raw materials costs negatively impacted working capital in 2003. The price of cocoa increased, therefore decreasing the company's working capital. Other items such as milk, sugar, and packaging materials can experience price fluctuations as well. The company can attempt to recover these costs from its customers. If they are unable to do so, it may negatively affect them over the long-term. To reduce their losses related to price fluctuation, the company could enter commodities futures contracts with manufacturers.

Sources and Uses of Short-term Financing

The company deals with many banks and financial institutions across the globe. This puts them at risk in the event that one of their business counterparts does not meet financial expectations.

Conclusion

Increasing profits and revenue drive a company's decision-making. The public determines the company's sales and wealth; therefore, a company must consider the current needs of the population it serves when developing new products. A current trend has been the growing rate of obesity and the public's growing concern about their health. Food and beverage companies try to tap the market by fulfilling the needs of customers. All three of the companies discussed have created products that are health conscious and continue to change as the demands change. When identifying the best ways to manage working capital, a company considers investments, exchange rates, credit policies, and management of inventory. If a company monitors its own financial trends over the years in conjunction with societal trends, they can make informed business decision about how to manage their working capital. All of the companies discussed have presented innovation, consistency and strong business concepts. Their steadiness and growth demonstrate their ability to re-evaluate business methods and remain current.

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