BEHIND THE NUMBERS
Quality of Earnings Analysis

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Behind the Numbers

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Conagra Brands, Inc. (CAG)
Earnings Quality Update

Rating
6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

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

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

Summary

CAG reported adjusted EPS of $0.81 for 2Q23, which beat estimates by 15 cents. The company faced some headwinds in the quarter, so the beat was real – but entirely due to pricing gains coming in above guidance. CAG boosted fiscal 2023 sales guidance by 3% due to higher pricing. But with 1% of pricing being worth 80bp of operating margin, it only boosted margin guidance

by 30-50bp. We have serious doubts about the sustainability of the recent trends. If the 17% price increase came in at only 16% - it would have cost CAG 5 cents in EPS and 80bp of operating margin. Only a 14% price hike like 1Q23, after which CAG was guiding to only 4%-5% organic growth, and it would have missed estimates.

CAG Had Headwinds That Should Continue:

- Pension income dropped by $10.1 million y/y due to higher interest costs costing CAG 1.6 cents.
- Stock compensation rose $24.3 million y/y costing CAG 3.8 cents. 3Q could be a tough comp here again and in 4Q, CAG had a credit last year for stock compensation.

CAG Had Tailwinds That Could Be Tough to Continue:

- CAG's JV income grew by $19.8 million y/y adding 3.1 cents. This is a flour-milling operation that passes through higher costs, but wheat is off 30% from 4Q22 and CAG has guided to this source of earnings cooling. Comps get tougher this quarter:

Equity Method Income	4Q	3Q	2Q	1Q
fiscal 2023			$49.3	$49.2
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

- Advertising continues to come in below guidance, as CAG has said it expects it to grow faster than sales. YTD sales are up 9.1% organically with advertising up 5.3%. This improved in 2Q with sales up 8.6% and advertising up 10.4% - but the total spending still looks low compared to historical levels and the comps get tougher. CAG used to spend 300-400bp of sales on advertising, now it is closer to 200bp.

Advertising	4Q	3Q	2Q	1Q
fiscal 2023			$78.8	$61.9
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

- Depreciation declined by $4.4 million y/y which added 0.7 cents to 2Q23 EPS. It's worth noting that as part of the never-ending restructuring programs – CAG has accelerated $72.8 million of depreciation over 14-15 quarters that continues to be added back to adjusted EPS. This has been over 11 cents of EPS in the last 3.5 years. Also of note, CAG cut its capital spending plans from $500 million to $425 million after the quarter.

- Pricing gains are being helped by low promotional spending at CAG and even with the gains, operating margins remain below historical levels. Can this last? CAG is talking about staying low here, but many of its competitors are planning to boost their promotional activities.

- Price hikes are crushing volume and CAG's comparison to five other peers ignores that its 3-year comparison's starting point was a pre-Covid period when CAG's sales were crashing. CAG had the easiest volume comp of this group of seven and came in the worst in our view for 2Q23.

What to Watch

The real driver for 2Q results was a 17.0% price increase. CAG is touting this to boost guidance for organic growth this year going from 4%-5% to now 7%-8%. That in turn is expected to leverage fixed costs better and allow adjusted operating margin guidance to increase from 15% to 15.3%-15.6%. Let's look at several issues for this:

- Even the operating margin guidance does not stand out based on historical results and 2Q is normally seasonally higher given holiday sales:

Adj Oper. Margin	f23	f22	f21	f20	f19	f18
1Q	13.7%	14.1%	20.2%	15.7%	14.6%	15.4%
2Q	17.0%	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%

A 1% change in pricing is worth +/- 80bp of operating margin for CAG. Yet despite a huge increase in pricing last quarter and a 3% boost to annual sales guidance – CAG only boosted margin forecast by 30-60bp. That either sets the company up for easy forecasts to top in 3Q and 4Q, or management doesn't expect this level of price hike to last. Comps are getting tougher – especially for fiscal 4Q23:

Price Hikes	Q4	Q3	Q2	Q1
fiscal 2023			17.0%	14.3%
fiscal 2022	13.2%	8.6%	6.8%	1.6%

- The higher pricing is crushing volumes. Here are the 2Q results for several years:

	2Q23	2Q22	2Q21	2Q20	2Q19	2Q18
Organic Growth	8.6%	2.6%	8.1%	1.6%	-1.6%	2.3%
Pricing Growth	17.0%	6.8%	1.5%	0.6%	0.6%	0.6%
Volume Growth	-8.4%	-4.2%	6.6%	1.0%	-2.2%	1.7%
Volume Index	94.0%	102.6%	107.1%	100.5%	99.5%	101.7%

The key is CAG has had negative organic volume growth since fiscal 2017. It has given up all of its Covid gains and then some in two years.

- CAG is touting that it is performing better than a group of competitors based on volume over the last three years. We would disagree for two reasons. First, we will point out again that CAG is purposefully using a starting point when its sales were collapsing which gives it an easy 3-year comp. The starting point being used by CAG is the four quarters ending fiscal 2Q20 (November 2019) where it had recent volume growth of 1.0%, -2.5%, -1.2%, and 1.2%. The company had conference calls during that time frame where it said: its acquired Pinnacle brands sales were coming in 500bp below forecast, competitors were taking market share, missteps were undermining brand strength, it would require more than a year to fix, it needed several remakes of product lines…

Second, we looked at the list of companies CAG is comparing to and it had the easiest volume comp of the bunch this year and still posted a horrible drop. These are the most recent quarters for each company as Q-0 and the same quarter for the prior 3-years:

Volume Growth y/y	Q-0	Q-4	Q-8	Q-12
Conagra	-8.4%	-4.2%	6.6%	1.0%
Gen. Mills	-12.0%	-1.0%	4.0%	0.0%
Campbell's	-1.0%	-6.0%	6.0%	-1.0%
Kellogg's	-2.3%	1.4%	3.3%	-0.7%
Kraft-Heinz	-3.8%	-0.2%	2.6%	-2.1%
Smuckers	-6.0%	4.0%	5.0%	0.0%

General Mills had a -39% volume change for its international unit that drove their -12%. Other than that, none of these companies performed as poorly on volume as CAG in the last quarter.

- Having too much inventory normally leads to lower pricing to convince retailers to buy more of your stock. For all the talk about supply chain problems, CAG has managed to grow inventories to levels not seen since the period when they couldn't sell product prior to Covid when they were marking down prices and telling investors it may take them two years to rebuild their product lines.

Inventory DSIs	F23	f22	f21	f20
1Q	92.8	90.1	77.1	92.8
2Q	89.8	73.6	70.3	79.9
3Q		72.7	71.6	80.3
4Q		80.6	77.5	56.8

- Promotional allowances for retailers are also an issue. Sales are reported net of these allowances, which largely disappeared during Covid. Promotional allowances effectively reduce pricing in organic sales. We know that other companies are ramping up spending in this area and retailers are asking for more support from suppliers. Yet, CAG continues to state that it is not growing spending in this area and that it is operating at pre-Covid levels that we know were already very low as the company's operating model then was to sacrifice volume for better net pricing. We have written about this in the past that volumes would drop any time CAG tried to take pricing of more than 1.0%-1.5%. We think

it would be easy to see competition force CAG to lose 100bp of pricing to higher promotional levels.

- Its competitors ARE boosting promotional spending. In their most recent earnings call, Kellogg's said promotional spending is increasing. Campbell's said it saw promotional spending rise at one unit and it should grow in the future. It was also going to start breaking out promotional spending from sales so investors could see the amount being spent (and likely see that its pricing is not directly getting weaker). Smucker's said it sees promotional spending normalizing now and Kraft-Heinz said promotional spending came in lower than expected because of shipment timing, but sees that as temporary and promotional expenses are not being cut.

- More large impairments could happen if CAG continues to see huge volume declines or pricing growth doesn't last. It already took $414 million of impairments of intangibles in 1Q23. That was due largely to a 125bp increase in the discount rate used as it rose to 7.75%. Since that test, rates have continued to increase and CAG's ROI is only about 9%. The test assumes future cash flows for the next five years. Can they forecast mid-teens for pricing growth that long? How much of the already-seen volume decay was part of the forecast last summer? In 1Q23, CAG saw volume decline by 4.6% after a 2.0% decline in 1Q22. CAG has $11.2 billion in goodwill and $3.6 billion in other intangibles on the balance sheet – Equity is only $8.7 billion.

- Commodity prices for wheat, corn, soybeans, beef, chicken and milk have all turned down from the highs. We looked at egg prices in our last POST update and believe the supply shortage will correct later in 1Q23. Fuel prices are down too along with steel. Big retailers are unlikely to accept accelerating price hikes from CAG much longer. Pricing gains do not have to drop to 2% in the near term for CAG to start seeing some margin and earnings problems -- going to 12% could be an issue.

EPR Properties (EPR)
Earnings Update

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are resuming our earnings quality coverage of EPR with a 4- (Acceptable) rating.

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

Summary

EPR has been through some amazing events in the last three years. Our initial concerns about credit risks related to tenants have come to fruition several times. Now add in rising interest rates for financing new growth and perhaps impacting the carrying value of assets and there are still hurdles to examine for EPR. The 8.9% yield on a price of $37 is attractive though so we wanted to revisit this name after it sold off from $55 in August with the Cineworld bankruptcy. The counterparty risk is real with AMC being 14.5% of rent and Cineworld 9.0%. The positive is that unless tenants liquidate, EPR should still receive rent. The negative is that many of its customers have high debt loads and that news could continue to weigh on EPR as it has done several times in recent years. Also, EPR is pulling back on new projects at this time as rates increase. That could make this solely a dividend play.

What is Strong:

- There is good coverage on the $3.30 annual dividend with trailing twelve months AFFO of $4.72. EPR only has a payout of 70% for a REIT and is yielding 8.9%. The dividend has room to expand and pre-Covid the annual dividend was $4.59.

- Debt is 5.2x the 3Q22 adjusted EBITDA of $129.5 million multiplied by 4. The total enterprise value with preferred stock is only 11.25x. That's not outrageous. Too often we

see REITs being valued for 15-20x EBITDA that want to spin the story that they do not need to grow to maintain that premium valuation, but they have a difficult time paying their dividend and covering any growth spending without borrowing. EPR trades at a lower multiple and 3Q22 AFFO of $96.2 million paid $3.9 million in convertible preferred dividends and $61.9 million in common dividends leaving $30.4 million in excess cash flow for investing.

- Debt is carrying interest rates between 4%-5% and most of EPR's debt does not mature until 2025 or after.

- EPR's AFFO definition is more conservative than GAAP earnings. Straight-line rent is non-cash income and EPR adjusts that out of its AFFO definition. It also subtracts maintenance capital spending even as a triple-net lessor. ***(See Below)***

What is Weak

- Many of EPR's customers carry high levels of debt. In the case of Cineworld, it is already in bankruptcy and didn't pay rent for September 2022, but did pay for October and November. Other restructurings could happen within the customer base, despite recent improvements in some of the underlying properties post-Covid:

Tenant	Rev % 3Q22	Debt	EBITDA	other notes
AMC	14.5%	$5,382	$191	
Cineworld	9.0%	In bankruptcy now		
Cinemark	6.6%	$2,495	$402	
Top Golf	14.9%	$1,066	$535	
Vail Resorts	4.4%	$2,838	$845	has $1.1 billion in cash
Six Flags	2.7%	$2,400	$460	Attendance fell 25% y/y
Premier Parks	4.9%	Not available, but grew via borrowing		

We are most concerned with Six Flags, AMC, and Cineworld. Bad news from any of these companies is likely to depress EPR's stock. However, unless these properties cease operations, EPR is likely to receive rent payments even in bankruptcy. The tenants asking for rent reductions may be the larger risk. **(See AMC below)**

- EPR's results are inflated with the collection of deferred rent as customers are paying both current and deferred rent from Covid. In 3Q22, this was $9.9 million or 13 cents of the $1.22 in AFFO. There is only $130 million left on the deferred rent figure and $92 million is from Cineworld where it may be negotiated down in the bankruptcy.

- Interest expense is capitalized on projects under development. This is a minor item that was $1.57 million in 2021 and $606,000 in YTD in 2022 – so about 0.6-1.6 cents in AFFO.

- EPR has $400 million of mortgage loans outstanding. These are paying an average of 9%. The drawbacks are the loans are fixed-rate so the value should be declining with higher market rates. The bulk of these do not mature until after 2030, with only $49 million maturing from 2025-29. Most require only interest payments, so EPR is unlikely to get many prepayments with rising market rates. Finally, mortgage loans do not provide a depreciation shield that owning property does. That means as a REIT, EPR needs to dividend out nearly all this interest income. In 3Q22, this interest income was $0.12 of the reported $1.22 in AFFO.

- Some of EPR's newer investments are costing more than properties did in the past. That can create issues if single properties run into financial difficulty. For example, EPR has a $200 million ground lease for a casino in New York. In 3Q22, it spent $43.6 million to acquire a conference center and committed to invest another $50 million to redevelop it into a hot springs resort. EPR has a $71 million investment in a single Nashville hotel. By comparison, since 2017 – EPR spent a net $704 million buying/building 37 new megaplex theatres (many with adjoining retail properties), upgrading the bulk of its 180 theatres with reclining seats, new sound systems, IMAX video, and new food/bar operations. It sold six of these theater properties for $112 million that is included in the net $704 million. That spending went to a much greater diversity of locations.

- Can EPR afford to grow at past rates? The cost of debt is rising and the company is moderating its growth plans to reflect this. The dividend of nearly 9% is a solid return, but if there is no growth, will investors find that enough given some of the counter-party issues?

Accounting Has Conservative Features

Much of EPR operates as a triple net lease. That means that tenants pay for property maintenance, insurance, and taxes along with rent and utilities. EPR is paid rent of course, but has little additional cash outflows for the existing operation.

Adjusted Funds from Operation (AFFO) is a REIT statistic that is viewed as a proxy for static cash flow. It starts with net income for common shareholders and adds back lumpy/one-time items such as gains/losses, impairments, debt issuance/transaction costs, and credit losses. As a cash flow proxy, AFFO also adds back recurring expenses such as depreciation and stock compensation. It also adds back convertible preferred stock dividends, but increases the number of shares to reflect dilution.

EPR's AFFO is more conservative than GAAP in that it removes the non-cash portion of straight-line rent. Straight-line rent involves taking the total rent over the life of a contract, including rent escalators and dividing the rent by the life of the contract to recognizing revenue evenly. Assuming a 5-year contract with $10 in base rent that rises by $1 per year – here is the rent a tenant would pay:

	yr1	yr2	yr3	yr4	yr5	total
Rent	$10	$11	$12	$13	$14	$60

Under straight-line accounting, $60 over 5 years would mean rent would be $12 per year for all five years. The company would book a receivable in years one and two when the tenant only paid $10 and $11 and that receivable would decline as cash higher than $12 came in for years four and five. But clearly, the cash flow is back-loaded.

EPR records its straight-line rent with the GAAP rules for revenue, but its cash flow in AFFO reflects the actual cash received instead. So, AFFO lowers the revenue figure vs. GAAP.

EPR is also using a more conservative application for straight-line rent. It has two tenants where the receipt of the fully contracted amount of rent is not reasonably assured: AMC and Cineworld. Thus, it only books revenue when it receives the cash. That effectively lowers GAAP revenue and earnings and thus AFFO as well since that starts with GAAP earnings.

Finally, EPR does subtract a minor amount from AFFO for maintenance capital spending. As a triple-net lease company, that probably is not necessary. So this is conservative too. We would

call out that the amount of deferred rent being received is helping results too – but only $38 million remains outstanding at this point from customers other than Cineworld which owes $92 million. That amount may be reduced as part of Cineworld's bankruptcy proceedings:

- AFFO is $96.2 million or $1.22 per share for 3Q22.
- Adding back share compensation is worth 5 cents.
- Subtracting maintenance spending was 0.5 cents and eliminating the non-cash portions of straight-line rent and expense cost AFFO 2.4 cents.
- The collection of deferred rent was $9.9 million, or 13 cents of AFFO.

AMC's Troubles Are Not Over Yet

The movie theater company AMC was 14.5% of EPR revenues in 3Q22. This continues to carry substantial debt despite several equity raises in recent years. AMC also had an unforeseen stroke of good luck as a well-publicized short squeeze on its stock drove the price from under $2 per share to $38 in the spring of 2021, which allowed the company to raise more capital and enhance liquidity.

EPR still records AMC's rent only when it is received in cash and has since 1Q20 due to concerns that future rents from AMC were not assured. That eliminated non-cash straight-line rent revenues from the equation. It wrote off $9.2 million of straight-line receivables when it switched to this policy and it also deferred rent for AMC. AMC has been paying deferred rent since 2Q21.

The problem we see with AMC is that while recent results have been improving, they remain very poor with large cash burn. Plus, while pre-Covid results were stronger, AMC still looked likely to need help with its balance sheet. Cash flow at that time was helped by landlord contributions to capital spending to upgrade theatres and asset sales:

	YTD 22	YTD 21	2021	2020	2019	2018	2017
EBITDA	$32	-$451	-$292	-$999	$771	$929	$823
Debt	$5,382	$5,529	$5,501	$5,812	$4,853	$5,283	$4,887
Debt/EBITDA	n/a	n/a	n/a	n/a	6.3	5.7	5.9
Cash from Ops	-$595	-$661	-$614	-$1,130	$579	$523	$537
- Landlord Payments	$16	$18	$22	$44	$107	$128	$133
Adj. Cash from Ops	-$611	-$678	-$636	-$1,173	$473	$396	$404
Maint. CapEx	$63	$37	$74	$47	$130	$129	$115
Fin. Lease payments	$8	$6	$9	$6	$11	$71	$71
Non-Growth Free Cash	-$682	-$721	-$719	-$1,226	$332	$196	$218
Growth CapEx/Acq	$85	$23	$27	$127	$400	$448	$1,089
Asset Sales	$22	$38	$42	$26	$23	$273	$259

- Pre-Covid, AMC was carrying 6x EBITDA in debt. Operations have improved considerably in 2022, but remain far below 2017-19 levels.

- Adding reclining chairs, new sound and video technology, and food/bar options to theaters was partially paid for by landlords. This was a large part of cash from operations pre-Covid too.

- If AMC was not growing, pre-Covid results net of maintenance spending and financing lease payments was $200 million per year in free cash flow for a company carrying $5 billion in debt.

- Growth spending was higher during pre-Covid and EPR was frequently selling assets to help pay for things. Now, selling off a few theaters or used equipment is really the only source of asset sales.

- Recent results are impaired further because AMC is paying current rent and deferred rent from Covid. It still owes $196 million in additional payments on deferred rent.

- AMC still had $685 million in cash at the end of September – down from $1.6 billion in December 2021. It reported that it retired $471 million of 11.25% debt in October using cash and $363 million of new debt.

AMC is positive about 2023 having a larger number of movies released and expects its results to recover further. It is not spending nearly as much on capital spending at this time and forecasts 2022 to come in at $150-$200 million.

Our conclusion on AMC is that even 2017-19 results do not look high enough to support the company's balance sheet. It appears it has underinvested in maintenance spending for three years in a row now. It is still burning cash and has seen the cash balance decline from $1.8 billion after 2Q21 to perhaps under $500 million now. It does not have another meaningful amount of debt due until 2026, but we can not rule out that AMC's balance sheet wouldn't need to be restructured at some point. EPR cannot rule that out either as it continues to list AMC payments as being less than certain and only records them when cash arrives. This may continue to create noise for EPR and its stock price and be a risk factor many investors do not want to endure. On the positive side, unless AMC ceased operations and liquidated – even a company restructuring its balance sheet would still need to continue showing movies. That could delay rent payments for a month or two, and AMC could ask for rent concessions – but they would need the theaters still and would likely resume payments even in a bankruptcy situation. This is what Cineworld has already done as its rent payments have resumed with EPR only missing the month of September 2022.

The J.M. Smucker Company (SJM)
Earnings Quality Updates

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are lowering our earnings quality rating of SJM to 3- (Minor Concern)

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

Summary of the Quarter

SJM beat non-GAAP earnings targets by 15 cps in the 2Q23 ended October. However, we see this beat as being far less robust than it appears at first glance after considering likely unsustainable benefits. The fact that management raised the top and bottom ends of its EPS guidance range for the full year by 15 cps (same as the beat) also seems to indicate that there is little in the way of real momentum expected to carry forward. Weakness that prompted our cut to the rating included:

- Advertising declined again. After coming in at 5.1% of sales in the July quarter, management reiterated that it expected advertising for the fiscal year ended April 2023 spending to be 5.5% of sales. The advertising percentage for the most recent October quarter was again 5.1% which we believe could have been below many analysts' models. For reference, 40 basis points of sales amounts to about 7 cps, or half the earnings beat. ***(See detail below)***

- Stock compensation expense was a credit of $2.6 million compared to an expense of $5.3 million in the year-ago quarter. This beneficial swing added about 6 cps which we doubt was expected. This coupled with the benefit from lower advertising could have accounted for the bulk of the earnings beat. ***(See detail below)***

- Cash flow has been boosted by extending payables via a supplier financing program started in 2020. Since then, days payable have risen to almost 80 from closer to 40 before the program's start. For a different perspective, payables have risen to over 100% of inventories compared to the 50% in the same time frame. Short-term rates are rising which makes this program more expensive and its continued expansion unlikely. A reversal of the program could have a detrimental impact on cash flow growth. Keep in mind that one day of sales is $25 million. ***(See detail below)***

- SJM carries $6 billion in goodwill, $2.6 billion of indefinite-lived intangibles, and another $2 billion of amortizing intangibles on its balance sheet with about half related to pet food acquisitions and half from coffee. It has already taken almost $600 million in impairment charges related to the pet food assets and has warned that the cushion between fair value and carrying value is thin. With discount rates rising, we believe the risk of another impairment is high. This makes the company's practice of adding intangibles amortization back to non-GAAP earnings more unrealistic in addition to being unusual for a company in the packaged food industry. ***(See detail below)***

Marketing Expense Decline May Have Added 7 cps

Marketing expense continued to decline YOY on both an absolute basis and as a percentage of sales as seen in the table below:

	10/31/2022	7/31/2022	4/30/2022	1/31/2022
Revenue	$2,205	$1,873	$2,034	$2,057
Marketing	$112	$96	$128	$111
Marketing % of Sales	5.1%	5.1%	6.3%	5.4%

	10/31/2021	7/31/2022	4/30/2022	1/31/2022
Revenue	$2,050	$1,858	$1,920	$2,077
Marketing	$121	$98	$159	$129
Marketing % of Sales	5.9%	5.3%	8.3%	6.2%

After the July quarter, management stated that it expected marketing expense to increase to 5.5% of sales for the full year ended April 2023. Consider the following comment by management from the July quarter conference call:

"So, we did experience some SG&A favorability in the first quarter associated with marketing. However, we remain committed to spending the dollars that we planned at the beginning of the year and are still maintaining our guidance of 5.5% of net sales spend against our brands."

Considering management was forecasting an advertising percentage of 5.5% for the full year after reporting 5.1% in the first fiscal quarter, we expect most analysts would have been expecting advertising to come in closer to 5.5%. This makes us believe that the lower advertising was likely an unexpected benefit to the quarter. For reference, the 40 basis point difference would have amounted to about 7 cps which accounts for almost half of the earnings beat.

Share-Based Compensation Credit Adds 6 cps

Another interesting item is the decline in share-based compensation expense which was a credit of $2.6 million compared to an expense of $5.3 million in the year-ago quarter as seen in the following table:

	10/31/2022	7/31/2022	4/30/2022	1/31/2022
Share-Based Compensation	-$2.6	$7.9	$7.1	$4.6

	10/31/2021	7/31/2021	4/30/2021	1/31/2021
Share-Based Compensation	$5.3	$5.3	$7.8	$7.5

The $7.9 million beneficial swing in stock compensation added about 6 cps to EPS growth in the quarter. Such a credit typically results from changes in assumptions surrounding the likelihood of options being exercised. We doubt analysts were expecting a credit. This benefit, coupled with the lower advertising spending could have accounted for the bulk of the earnings beat.

Supply Chain Financing Benefit to Cash Flow Could Reverse

In 2020, SJM started a supply chain financing program (SCF) under which suppliers could sell their receivables from SJM to third-party banks. This allows suppliers to collect their cash early while SJM can pay the bank at a later date. This has allowed SJM to boost its cash flow by

extending payment terms on its suppliers which has driven up its days payable (DPOs) as seen in the table below:

Days payable	10/31/2022	7/31/2022	4/30/2022	1/31/2022
Accounts Payable	$1,261	$1,243	$1,193	$1,007
Accounts Payable Days	78.7	88.9	79.6	68.9
	10/31/2021	7/31/2021	4/30/2021	1/31/2021
Accounts Payable	$1,031	$1,041	$1,034	$897
Accounts Payable Days	71.9	79.0	77.1	63.4
	10/31/2020	7/31/2020	4/30/2020	1/31/2020
Accounts Payable	$857	$781	$782	$575
Accounts Payable Days	63.2	59.2	54.7	43.4

The scope of the increase in payables is even more pronounced when viewing the ratio of payables to inventory:

	10/31/2022	10/31/2021	10/31/2020	10/31/2019
Total Inventory	$1,358	$1,100	$994	$1,013
Accounts Payable	$1,261	$1,031	$857	$522
Payables % of Inventory	92.8%	93.7%	86.3%	51.5%

DPOs peaked in the July quarter but they are still increasing year-over-year. We can see in the following table that the amount of payables that have been submitted to the SCF is still growing:

	10/31/2022	7/31/2022	4/30/2022	1/31/2022
Payables Elected and Sold to Third Parties	$370.700	$353.200	$314.300	$259.900
% of Payables in Tracking System	29.4%	28.4%	26.3%	25.8%
Quarterly Amounts Paid to Banks for Payment Obligations	$353.600	$338.800	$268.100	$244.400
	10/31/2021	7/31/2021	4/30/2021	1/31/2021
Payables Elected and Sold to Third Parties	$279.400	$278.200	$304.200	$260.200
% of Payables in Tracking System	27.1%	26.7%	29.4%	29.0%
Quarterly Amounts Paid to Banks for Payment Obligations	$262.700	$267.700	$198.500	$171.900
	10/31/2020	7/31/2020	4/30/2020	
Payables Elected and Sold to Third Parties	$185.600	$192.300	$157.500	
% of Payables in Tracking System	21.7%	24.6%	20.1%	
Quarterly Amounts Paid to Banks for Payment Obligations	$171.000	$122.100	na	

However, keep in mind that most of the growth in this program came when short-term rates were near zero, meaning it cost suppliers little to utilize them. With short-term rates rising, suppliers may be more reluctant to use the programs which could be a hit to SJM's cash flow growth. To put how much a reversal in payables could impact SJM's cash flow growth, one day of sales equals almost $25 million. Also, consider the warning in the April 2022 10-K:

> *"We work with our suppliers to extend our payment terms, which are then supplemented by a third-party administrator to assist in effectively managing our working capital.* ***If the extension of payment terms is reversed or the financial institution terminates its participation in the program, our ability to maintain acceptable levels of working capital may be adversely affected."***

Sizeable Goodwill and Intangibles Subject to More Write-Offs

SJM has a huge goodwill and intangibles balance amounting to over 70% of total assets, the bulk of which was the result of its 2015 acquisition of Big Heart Pet Brands and the 2008 acquisition of Folgers. The company has already written off over $600 million of the goodwill related to pet food and it warned in the April 2022 10-K that the cushion between fair value and carrying value is still thin:

> *"As of April 30, 2022, goodwill and indefinite-lived intangible assets totaled $6.0 billion and $2.6 billion, respectively. The carrying values of the goodwill and indefinite-lived intangible assets were $2.4 billion and $1.1 billion, respectively, within the U.S. Retail Pet Foods segment, and $2.1 billion and $1.2 billion, respectively, within the U.S. Retail Coffee segment, which represent approximately 80 percent of the total goodwill and indefinite-lived intangible assets as of April 30, 2022.* ***Furthermore, the goodwill within the U.S. Retail Pet Foods segment remains susceptible to future impairment charges due to narrow differences between fair value and carrying value, which is primarily attributable to the recognition of these assets at fair value resulting from impairment charges in recent years.*** *To date, we have recognized $465.0 of impairment charges related to the goodwill and indefinite-lived intangible assets acquired as part of the Big Heart Pet Brands ("Big Heart") acquisition in 2015, primarily as a result of reductions in our long-term net sales and profitability projections. Furthermore, during 2022, we recognized an impairment charge of $150.4 related to the Rachael Ray Nutrish brand that was acquired as part of the acquisition of Ainsworth Pet Nutrition LLC*

("Ainsworth") in 2019, primarily driven by the re-positioning of this brand within the Pet Foods brand portfolio, which led to a decline in the current and long-term net sales expectations and the royalty rate used in the valuation analysis. We reassessed the long-term strategic expectations for the Rachael Ray Nutrish brand and reclassified this brand as a finite-lived intangible asset on January 31, 2022. For additional information, refer to Note 6: Goodwill and Other Intangible Assets.

We do not believe that the Pet Foods reporting unit or any of the indefinite-lived assets within the U.S. Retail Pet Foods segment are more likely than not impaired as of April 30, 2022. However, further changes to the assumptions regarding the future performance of the U.S. Retail Pet Foods segment or its brands, an adverse change to macroeconomic conditions, or a change to other assumptions could result in additional impairment losses in the future, which could be significant. *As of April 30, 2022, the estimated fair value was substantially in excess of the carrying value for the remaining reporting units and material indefinite-lived intangible assets, and in all such instances, the estimated fair value exceeded the carrying value by greater than 10 percent."*

Remember that all else equal, rising rates depress the estimated fair value of goodwill and intangibles due to higher discount rates used to estimate fair value. This makes another write-down after the review of those assets in the April 2023 quarter a meaningful risk.

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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