BEHIND THE NUMBERS
Quality of Earnings Analysis

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Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

Behind the Numbers

Companies in this Issue

Costco Wholesale Corp. (COST)
Initiation of Earnings Quality Coverage

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

We are initiating earnings quality coverage of COST with a 5+ (Strong) rating.

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

Summary

Costco does not have much in the way of earnings quality issues that concern us. There are a few moving parts such as LIFO charges and gasoline prices impacting sales and margins to be aware of, but in the big picture, COST is about as clean as it gets. The company does not use non-GAAP EPS. Thus, some of the accounting procedures can be positive or negative in any given quarter and COST is very upfront in pointing this out and quantifying it. For a company that just made $13.14 in EPS for fiscal 2022 (ending in August) and is expected to earn $14.59 for fiscal 2023, items that amount to a few pennies are not very concerning in our view.

- Balance Sheet positives – Cash of $11 billion exceeds total debt of $6.5 billion; intangible assets are only $993 million vs $20.6 billion in equity.

- Cash flow is seeing inflation-driven inventory investments in dollars rise faster than payables which cut into cash flow by $2.1 billion in fiscal 2022. COST still covers its dividend and capital spending easily.

The bigger issue may be that Costco has been posting rapid sales growth and successfully leveraged its SG&A costs. That is why it trades for 32x forward EPS. Same-store sales comps have accelerated the last two years from 8% to 16% and now 14% in fiscal 2022. How much of the growth is due to inflation and will it slow if inflation does? That is the question we are going to try to answer and why much of this will focus on the operating model.

What is Strong?

- Inventory DSIs look in line with pre-Covid levels. There was concern that non-food inventories grew, but COST sees that more as an issue of having levels about 10% too low last year. Really, inflation and new stores are the bulk of inventory growth in dollar terms. **(See Below).**

- We still hear fully domestic operating companies with no real exposure to China or semiconductors blaming Covid for their woes. Costco didn't even add back $1.1 billion in spending in that area to its results. They address headwinds and tailwinds like this and quantify it in the SEC documents and earnings calls. So, we give them very high marks for this and consider the quality of their results among the highest we have seen.

- Same-store sales comps are being driven by higher selling prices and higher traffic. With its focus on offering lower unit prices to customers than competitors, it is pulling in more members and existing members are renewing. We think this is where inflation is helping growth and earnings at Costco. It is picking up volume and members may continue to shop there even if inflation declines. **(See Below).**

- Membership fees are the big hidden asset here. Customers pay $60 to join the club and $120 to join the executive level where they can earn 2% reward coupons on some purchases that can be used at the store. With 119 million members and growing, membership fees generated just under 2% of total revenues. However, at almost no cost, the $4.2 billion in member fees was 54% of its operating profit in 2022. COST has not raised the price here but has seen more members upgrade to the higher levels. If they boosted the price by $1-$5 per year, it would add $0.20-$1.00 to EPS. This may be something they would consider if inflation cools. **(See Below).**

- Membership fee accounting looks conservative to us. Customers pay the annual fee and Costco defers the cash payment and records it as revenue over one year. Deferred revenues are about half of annual revenues which we would expect. Renewals are 93% in the US. The timing of renewals or upgrading levels can impact the size of deferred revenue. Given the short time frame of one year for the revenue recognition process, we do not see an issue here. **(See Below).**

What to Watch?

- Inflation is impacting cash flow because payables did not rise nearly as much as inventory in 2022. This cut free cash flow by $2.1 billion last year. We don't see this as a critical problem. COST has more than enough liquidity and it still covers its dividend easily. **(See Below).**

- Gasoline sales can skew some numbers in the income statement. The gross profit per gallon stays fairly constant and there is almost no SG&A expense. When the selling price falls, total sales decline, gross margin rises, but SG&A as a percentage of sales increases. When the price increases with inflation, the reverse happens. Higher volumes will drive sales and profits higher, but we do not see much impact on results from inflation or deflation of gas prices. **(See Below).**

- Merchandise margins are under pressure from inflation. Management is seeing some signs that relief is coming in a few areas. We believe with a fast inventory turnover, COST likely won't get killed if inflation cools and leads to lower selling prices. However, its operating model requires it to lower prices faster than competitors. The problem is a low retail profit margin of about 160bp. On recent numbers, we estimate that a 25bp drop in selling prices could hit magins by 19bp and EPS by 81 cents. **(See Below).**

- The LIFO charge was something COST hadn't seen for several years as the value of its inventory under LIFO or FIFO was equal. In fiscal 2022, inflation led to a $438 million charge or 74 cents of EPS to move inventory to a LIFO fair market valuation. If inflation slows, the size of this charge should decline. That could offset the impact of selling prices declining faster than costs. Since COST doesn't adjust out the LIFO charge from reported earnings, it is tempering inflation positives now but should add to y/y earnings changes if inflation cools. **(See Below).**

- Overhead costs are rising with inflation. Primarily this applies to wages. From March 2021-July 2022, COST has given five pay raises to employees. Also, 28% of sales comes from California which is a high-cost area to operate in from a labor standpoint. This looks like permanent increases in the cost structure. If inflation cools, the selling prices for much of its products should drop, but we doubt wages will. **(See Below).**

Costco's Sales Model Is Helped by Inflation

Because it sells in bulk and customers buy memberships for $60-$120 per year, customers are loyal and shop at Costco frequently. This is also driven by the goal of offering lower prices for comparable food and other products. Costco can raise prices during inflation too, but the goal is still to offer a lower price per unit than competitors. This is very similar to what happens with beef and chicken.

- Beef rises from $8/lb to $12/lb – people may buy only 80lbs at $12 vs. 100lbs at $8 – The beef seller sees his revenue go up from $800 to $960 selling less volume

- Chicken at the same time may rise from $3/lb to $5/lb – but the chicken seller sees volume rise from 100lbs to 120lbs – his revenue rises from $300 to $600

That is not the perfect analogy for this situation, but Costco is the type of store that can gain on pricing and have customers shop there more often. It may sell higher volumes of BOTH beef and chicken under this type of consumer shopping. Costco touts in its same-store sales comps that it is picking up more transactions and higher tickets per transaction and that has been happening for years – even before inflation:

Same-Store Comps	f2022	f2021	f2020	f2019	f2018	f2017
Total Company	14%	16%	8%	6%	9%	4%
w/o Gas or FX	11%	13%	9%	6%	7%	4%

- The key is that COST saw comps accelerate before, during, and again after Covid.

- During some periods on calls, they will highlight if there were more transactions or higher per ticket sales, but the comp is being driven by both.

If we look at total sales and gross margin and SG&A, it is clear that higher comp sales are helping margins and dollar profits at the gross and operating levels. These are the GAAP figures, and we will discuss some items in the cost figures later in this report. This also leaves out the membership revenues that add to operating income:

Income Statement	f2022	f2021	f2020	f2019	f2018	f2017
Total Sales	$222,730	$192,052	$163,220	$149,351	$138,434	$126,172
Merch. Costs	$199,382	$170,684	$144,939	$132,886	$123,152	$111,882
Gross Profit	$23,348	$21,368	$18,281	$16,465	$15,282	$14,290
SG&A Exp.	$19,779	$18,537	$16,387	$15,080	$13,944	$13,032
Retail Op. Profit	$3,569	$2,831	$1,894	$1,385	$1,338	$1,258
Gross Margin	10.48%	11.13%	11.20%	11.02%	11.04%	11.33%
SG&A % Sales	8.88%	9.65%	10.04%	10.10%	10.07%	10.33%
Retail Op. Margin	1.60%	1.47%	1.16%	0.93%	0.97%	1.00%

What jumps out instantly is gross margin has been remarkably consistent until fiscal 2022. Also, COST had almost a flat percentage on SG&A as a percentage of sales of 10.04%-10.10% for three years until it started to leverage well in fiscal 2021 and fiscal 2022.

A big part of this is gasoline sales and inflation in that area. Gasoline accounts for a large amount of the company's sales but produces little gross profit. Also, when gas prices increase the sales grow, but the gross profit per gallon stays fairly flat. Think of the company selling gas at $2 per gallon and making 20 cents per gallon gross profit – the gross margin is 10%. However, at $4 per gallon, the gross profit per gallon is often still 20 cents – so the gross margin is now 5%. That's where gross margin gets punished with inflation even though COST's members are buying more gallons and pushing up total gross profit in dollar terms. Gasoline changes were:

Gasoline Impact	**f2022**	**f2021**
Higher Gas Volume	$3,847	$1,469
Impact on Sales	200bp	90bp
Higher Gas Price	$9,230	$1,636
Impact on Sales	481bp	100bp
Gross Margin w/o Gas Inflation	10.94%	11.22%

The other part of gasoline sales is there is almost no SG&A cost. So when gas prices rise and drive up total sales, that leverages SG&A as a percentage of sales. Thus, SG&A was 8.88% of sales in 2022, but taking out the $9.23 billion in price inflation from sales, SG&A would be 9.26% of sales in 2022. For 2021, SG&A would by been 9bp higher at 9.74% offsetting the 9bp drop in gross margin.

On gasoline, we conclude that rising prices or falling prices should only impact EPS to the extent it changes gasoline sales volume. If we strip out the gasoline price inflation from sales, gross profit stays the same and SG&A stays the same thus operating profit on the retail operations would be the same.

What about merchandise? Looking back at the first table in this section on sales comps, we think price inflation as well as more traffic are driving the comps. When the comps are now 11%-13% vs. 6% before Covid, there should be a large amount of pricing gains driving the sales figure. And look at the leaps in operating profits. After three years of $1.3-$1.4 billion in retail operating profits in fiscal 2017-2019, we know Covid helped lift it to $1.9 billion in 2020. But now it has jumped to $2.8 billion and almost $3.6 billion in the last two years. (Some of this growth was Covid spending in 2020 and 2021).

COST says its model is to offer lower unit prices to consumers than its competitors do. It is already pointing to gross margin getting squeezed. Management said on 2022 results, *"This [Gross Margin Decline] was primarily due to a 33 basis-point decrease in core merchandise categories, predominantly driven by decreases in fresh foods and foods and sundries, and 19 basis points due to a LIFO charge for higher merchandise costs."*

If we try to isolate just some inflation-driven pricing gains and not pull out any volumes that were realized, then merchandise costs and SG&A costs should be largely the same. Let's assume that pricing had been just 25 bps lower. Sales were $192 billion in 2021. We know merchandise comp sales were up 11%. If 25bp of price hikes had not occurred and comps were up 10.75%, then sales in 2022 should have been $480 million lower. It's the low operating margin that makes that have an outsized impact on EPS.

EPS for fiscal 2022 was $13.14. With other costs staying the same, $480 million in lower sales would cut 81 cents off EPS. Gross margin would have been 19bp lower and SG&A would have been 2bp higher. This appears to be the largest risk to COST's recent earnings growth. That is especially true as it is more likely that food prices would decline faster than wages, which could squeeze margins as prices fall.

Inflation Is Creating a LIFO Charge Headwind for EPS – This Could Disappear if Inflation Slows

COST uses the LIFO method and adjusts ending inventory to approximate current valuation. In most years, the difference between LIFO and the fair market value of inventory has been essentially the same. This changed in fiscal 2022:

	f2022	f2021	f2020	f2019	f2018
LIFO Charge	$438.0	$38.4	$0.0	$0.0	$0.0
Basis Points	-19.0	-2.0	0.0	0.0	0.0
EPS impact	-$0.74	-$0.07			

Given inflation, this charge grew throughout fiscal 2022:

	4Q22	3Q22	2Q22	1Q22
LIFO Charge	$223.0	$130.0	$70.0	$15.0
Basis Points	-28	-25	-14	-3
EPS impact	-$0.37	-$0.22	-$0.12	$0.03

Take note that COST saw this figure come in below forecast in 4Q22. Yet, the company still only met consensus estimates for EPS. Here were the comments from the CFO on the call:

> *"The other comment* ***you asked about is it [LIFO charge] seemed like it'd be even higher in Q4. The fact is, is we, too, thought halfway through the quarter, it would be higher than this.*** *Part of that was if I bifurcated Q4 into the first 8 weeks and the second 8 weeks,* ***the first 8 weeks showed a level of increase that would have required a larger LIFO charge. It seemed to, in some cases, flatten out a little bit during the last several weeks of the quarter, which meant that it came down from what our expectation was.***
>
> *So again, I think that is consistent with I mentioned about we're seeing a little light at the end of the tunnel. I'm not just -- and there's little [Technical Difficulty] some of the buyers about a couple of items going down in price. And you can rest assured that our partners are calling the suppliers. As you said, the price went up because of steel prices. Well, steel prices are down. What gives? And so we'll continue to do that. But it's a slow road. And -- but we are, again,* ***seeing a little bit of improvement at least in the second half of the fourth quarter. And we'll see where it goes from here."***

There are some positives to the LIFO charge going forward:

- It is already tempering the positives of inflation. So while we think inflation helped EPS in 2022, the LIFO charge cut 74 cents off EPS at the same time.

- As inflation reverses at some point and hurts margins, the LIFO charge should also be falling and preserving EPS.

- Costco turns its inventory fast enough that if pricing for goods falls and stabilizes this charge could likely disappear just like it didn't exist for several years before the end of 2021.

Overhead Costs Are Also Impacted by Inflation

Because COST does not make non-GAAP adjustments to earnings, there are some one-time items that boosted the cost structure that should vanish:

- It wrote off some technology assets amounting to $118 million in 2022 and $84 million in 2021.

- Covid-related pay and cleaning was $515 million in 2021 and $564 million in 2020.

	f2022	f2021	f2020
Total Sales	$222,730	$192,052	$163,220
Retail Op. Profit	$3,569	$2,831	$1,894
Tech Write-Off	$118	$84	$0
Covid Spending	$0	$515	$564
Adj. Retail Op. Profit	$3,687	$3,430	$2,458
Reported Margin	1.60%	1.47%	1.16%
Adj. Margin	1.66%	1.79%	1.51%

When we adjust for the extra charges, especially Covid, the margin improvement does not look as amazing. However, inflation is causing some permanent costs to come into the income statement. This is primarily wages:

- In March 2021, COST gave employees a $400 million increase in pay.

- In October 2021, COST raised pay by 50 cents per hour.

- In March 2022, pay was raised by 75cents per hour.

- In March 2022, it added $75 million to payroll to give employees an extra day off.

- In July 2022, pay was raised another 50 cents per hour.

- We will also point out that California is 28% of sales, and that state is not n as a cheap place to operate, especially in the area of wages. There are often moves to boost employee pay further.

- Just as a point on the California cost burden – we read the legal issues filed against Costco and it is full of cases about, "didn't provide enough seats for employees to use," "didn't provide seats deemed comfortable enough," "didn't provide enough sick pay," "didn't reimburse for meals quickly enough," "used temporary workers," and issues regarding overtime pay all filed under the California Labor Laws. None of this looks material, but it costs time and money. They even have officers being sued over "chicken welfare."

While food costs may rise and fall on the inflation front and thus result in changing selling prices – these wage increases are unlikely to decline. Thus, overhead costs could be rising y/y and selling prices declining y/y at some point in the future. We don't want to try to time that, but we can see that impacting the EPS growth rate.

We also want to point out that COST is building out its own logistics operation. In the past, it hired third parties to deliver and set up large purchases that customers purchased such as exercise equipment, appliances, and electronics. In recent years, it acquired a logistics company and has been building it out. We can understand if it has the sales volumes to keep a logistics fleet busy, that it may have lowered its total costs in this area. However, as they build this out, they are adding to finance leases.

Finance leases result in only the interest portion of the lease payment going through the income statement. The principal payment goes through the financing section of the cash flow statement. So the use of financing leases boosts profit compared to operating leases where the whole payment is expensed. Here is where COST is picking up a few basis points of margin:

	f2022	f2021	f2020
Total Sales	$222,730	$192,052	$163,220
Fin Lease Payment	$176	$67	$49
basis points	8	3	3

We're not going to call this a huge red flag by any means, and as shown in the cash flow statement when inventory is discussed below, handling this payment is not a problem. We just want to point out this is an area where cash payments are rising on a permanent basis.

Membership Fees Are a Large Part of Overall Profits

Membership Fees look conservative. COST charges $60 per year in the US for membership (foreign members have different amounts for fees). These memberships run for one year and then need to be renewed. The company collects the cash upfront but recognizes the revenue over the course of one year. The growth numbers remain strong for adding new members and renewals. We would expect to see deferred revenue of about 6 months of recognized revenue. The timing of new sign-ups and renewals can play with the amount of deferred revenue at any given time:

	f2022	f2021	f2020
Memberships (mm's)	118.9	111.6	105.5
Growth	6.5%	5.8%	7.1%
Renewal Rate US	93%	91%	91%
Renewal Rate World	90%	89%	88%
Total Revenue	$4,224	$3,877	$3,541
Deferred Revenue	$2,174	$2,042	$1,851
Rev % of Total	1.9%	2.0%	2.1%

- Membership fee revenue is rising faster than memberships due to customers upgrading to executive level.

The other issue here is while the membership fees are less than 2% of total revenue (that's slightly impacted by the inflation, particularly in gasoline) they have almost no cost. So they make up a huge part of total operating profits and operating income:

Income Statement	f2022	f2021	f2020
Total Retail Op. Profit	$3,569	$2,831	$1,894
Member Fees	$4,224	$3,877	$3,541
Total Op. Profit	$7,793	$6,708	$5,435

One area analysts are looking at is "why doesn't COST raise the price from $60?" That looks like an obvious lever COST could pull at some point to help future growth. With 118.9 million members, an extra $1 per year becomes 20 cents in EPS.

The executive members already pay an additional $60 and receive 2% rewards on some purchases with a possible maximum of $1,000 per year. Those rebates are netted against sales and effectively cost the company 1-3 basis points of gross margin as the products bought with the reward checks effectively lowers the selling price of what they buy.

This is another area where COST is very revenue-focused. To achieve the reward, those members spend much more than other members and they pay a $60 premium. COST is not concerned about the 2% rebate or lost bps on margins because the higher sales overall drive comps and leverage SG&A.

Inventory Levels Do Not Look Out of Line – But Inflation is Hurting Cash Flow

	Aug	May	Feb	Nov
Fiscal 22 Inv.	$17,907	$17,623	$16,485	$16,942
DSIs	31.6	31.9	30.4	32.4
Fiscal 21 Inv.	$14,215	$13,975	$13,865	$14,901
DSIs	29.1	29.8	29.8	33.4
Fiscal 20 Inv.	$12,242	$11,010	$11,850	$13,818
DSIs	29.5	28.7	29.2	36.0
Fiscal 19 Inv.	$11,395	$11,304	$11,356	$12,205
DSIs	30.9	31.4	31.1	33.5

- The growth in store count, same-store sales, and warehouses is growing inventory nearly every year. That results in inventory growth simply through COST doing normal business. COST tries to break this out on its earnings calls and highlighted that this was about 11% of the 26% inventory growth.

- Inflation overall is up too, so the same amount of inventory costs more to replace. This was another 12% of the 26% inventory growth.

- There are also different merchandise categories such as food, jewelry, and electronics. COST does not give a breakdown here and there were concerns in recent quarters that inventory might be too high in the non-food areas. It was also being compared to periods when stocks were low last year. COST says stocks in non-food were about 90% of what it wanted to carry last year. So far, COST has not reported weakness in non-food items.

The bigger issue with inventories is the growth in dollar terms is a drag on cash flow. That is normally offset by payables rising in dollar terms too even with days outstanding staying fairly constant. However, in fiscal 2022, inventories grew faster than payables:

Cash Flow	**f2022**	**f2021**	**f2020**	**f2019**	**f2018**
Inventory	-$4,003	-$1,892	-$791	-$536	-$1,313
Payables	$1,891	$1,838	$2,261	$322	$1,561
Net Cash Inv/Pay	**-$2,112**	**-$54**	**$1,470**	**-$214**	**$248**
Cash from Ops	$7,392	$8,958	$8,861	$6,356	$5,774
Cap Exp.	$3,891	$3,588	$2,810	$2,998	$2,969
Free Cash Flow	**$3,501**	**$5,370**	**$6,051**	**$3,358**	**$2,805**
Dividends	$1,498	$5,748	$1,479	$1,038	$689
Repos	$439	$496	$196	$247	$328

Going forward, if inflation calms down, which COST is saying there are some early signs of, we expect the inventory and payables to more closely track each other. This would put Free Cash Flow at about $5 billion with a dividend of $1.5 billion (obviously there was a special dividend in fiscal 2021).

Cintas Corporation (CTAS)
Earnings Quality Update

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

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

Summary

CTAS reported non-GAAP earnings of $3.39 for its first fiscal quarter ended 8/22 which was 25 cps ahead of target and sales came in about $80 million above the consensus estimate. The company raised the midpoint of its EPS guidance for the year ended 5/23 by 28 cps and its sales guidance midpoint by $235 million, both more than their respective first-quarter beats. We note that stock compensation fell by almost 8 cps. We saw two other items that could have provided material benefits to earnings in the quarter:

- We noted in a previous review that the company increased its reserve for obsolete inventory in the 5/21 quarter by $44 million due to excess personal protection equipment (PPE) after the initial wave of Covid. However, this reserve remained elevated for the last four quarters before falling by $11.2 million sequentially in the most recent 8/22 period. This alone could have added about 9 cps to earnings. However, even after that decline, the reserve percentage of almost 16% remains well above its pre-pandemic norm of 9%. We estimate this could be another approximate 30 cps of non-operational benefit that could benefit future earnings growth.

- In addition, we believe a lower-than-forecast tax rate could have accounted for 4-8 cps of the reported earnings beat.

The Jump in the Reserve

We discussed in a previous review how the company's reserve for obsolete inventory spiked in the 5/21 quarter due to excess personal protection product inventory. Many companies we follow also increased inventory reserves or wrote amounts off altogether to reflect declining demand

and falling market prices for masks and other Covid protection items they had stocked up on during the initial waves of the pandemic.

Some companies chose to write these amounts off and dispose of the inventory. However, some chose to increase reserves and leave the product in inventory and in most, cases, the charges to write down the inventory were added back to non-GAAP results as if they didn't happen. Our concern in those cases stems from the fact that the cost basis of these inventories was reduced and will result in unusually large profits when the product is sold at a later time. For example, Abbot Laboratories (ABT) wrote down PPE inventory and added the charge back to non-GAAP profits. However, to its credit, it later sold the inventory and removed the excess profits from non-GAAP results in the quarters when it was sold.

We have been watching CTAS's inventory reserve for over a year waiting for it to decline. Finally, in the 8/22 period, the reserve dropped as seen in the following table showing the inventory reserve as a percentage of gross inventory for the last twelve quarters:

	8/31/2022	05/31/2022	2/28/2022	11/30/2021
Total Net Inventory	$473.888	$472.150	$486.750	$464.864
Reserve for Obsolete and Slow-Moving Inventory	$89.100	$100.300	$103.000	$106.600
Reserve % of Gross Inventory	15.8%	17.5%	17.5%	18.7%

	8/31/2021	5/31/2021	2/28/2021	11/30/2020
Total Net Inventory	$463.692	$481.797	$533.211	$534.128
Reserve for Obsolete and Slow-Moving Inventory	$110.200	$111.000	$63.600	$52.300
Reserve % of Gross Inventory	19.2%	18.7%	10.7%	8.9%

	8/31/2020	5/31/2020	2/29/2020	11/30/2019
Total Net Inventory	$488.165	$408.898	$352.924	$348.304
Reserve for Obsolete and Slow-Moving Inventory	$48.200	$45.500	$34.100	$33.800
Reserve % of Gross Inventory	9.0%	10.0%	8.8%	8.8%

	8/31/2019	5/31/2019	2/28/2019	11/30/2018
Total Net Inventory	$336.290	$334.589	$339.805	$321.874
Reserve for Obsolete and Slow-Moving Inventory	$33.400	$32.700	$32.600	$31.900
Reserve % of Gross Inventory	9.0%	8.9%	8.8%	9.0%

Notice that the reserve percentage was running in the 9% range before the pandemic when the 5/21 charge more than doubled that level. The company offered little in the way of explanation. The 5/21 10-K stated:

*“Inventories are recorded net of reserves for obsolete inventory (excess and slow-moving) of $111.0 million and $45.5 million at May 31, 2021 and 2020, respectively. The inventory obsolescence reserve is determined by specific identification, as well as an estimate based on Cintas' historical rates of obsolescence. The disruption created by the COVID-19 pandemic beginning in the fourth quarter of fiscal 2020 resulted in larger quantities of inventory on hand as of May 31, 2021 and 2020**. As of May 31, 2021, our Uniform Rental and Facility Services and First Aid and Safety reportable operating segments held an excess amount of personal protective equipment inventory on hand. The excess inventory, determined through specific identification, resulted in an increase to the obsolescence reserve of $43.6 million as of May 31, 2021, in comparison to May 31, 2020.** As of May 31, 2020, an incremental obsolescence reserve was recorded within our Uniform Direct Sales operating segment due to larger quantities of inventory remaining on hand, at the consolidated balance sheet date, as a result of disruption created by the onset of the COVID-19 pandemic.*

*Obsolete inventory reserves are recorded in selling and administrative expenses on the consolidated statements of income. The judgment applied to increase the obsolete inventory reserve as of May 31, 2021 and 2020, beyond our historical policy was deemed to be reasonable and supportable based on the data available as of the consolidated balance sheet dates**. Once a specific inventory item is written down to the lower of cost or net realizable value, a new cost basis has been established, and that inventory item cannot subsequently be marked up.”***

Management stated the following in the conference call for the 5/21 quarter:

*“Operating margin increased 660 basis points to 19.4% in the fourth quarter of fiscal '21, compared to 12.8% in the fourth quarter of fiscal '20. **Fiscal '20, fourth quarter operating income was affected by many items caused by COVID-19, including additional reserves on accounts receivable and inventory, severance and asset impairment expenses and lower incentive compensation expense. Excluding these items, the fiscal '20 fourth quarter operating margin was 15.5%**. All of these items were recorded in last year's selling and administrative expenses.*

However, the statement in the conference call is not referencing the huge increase to the reserve in the 5/21 quarter but rather the much smaller increase in the 5/20 period. We asked the company for more detail on the reserve spike but it could not comment beyond what was disclosed in the conference call or SEC filings.

The 10-K for the year ended 5/22 indicated that the portion of the reserve related to PPE had fallen to $28.5 million at the end of the year versus the initial $43.6 million in last year’s fourth quarter. We assume the decline is related to some of this inventory being sold. It is possible that margins on these PPE sales are artificially high because of writing down the cost basis. We are not especially worried about that, particularly given the company’s reference to recent margin growth benefitting from a shift in mix away from lower-margin PPE versus other products.

However, what we are concerned with is the peculiar decline in the reserve in the 8/22 quarter which we look at more closely below:

Why the Sudden Drop in the Reserve?

What stands out as unusual about the reserve is the sudden drop in the 8/22 quarter following four straight quarters of being relatively flat at the elevated level. Let’s look at the data the company has disclosed on the reserve during that time:

	8/31/2022	5/31/2022	2/28/2022	11/30/2021	8/31/2021	5/31/2021	2/28/2021
Inventory Reserve	$89.100	$100.300	$103.000	$106.600	$110.200	$111.000	$63.600
PPE Portion		$28.500				$43.600	
Non-PPE Portion		$71.800	-	-	-	$67.400	-

It took all of FY22 for the PPE reserve to decline by $15.1 million, likely from selling off PPE inventory. We don’t have PPE reserve data for the 8/22 quarter, but we see the total reserve declined by $11.2 million despite total inventory increasing sequentially. Did the company sell almost a year’s PPE in one quarter, or was there a decline in non-PPE inventory? The latter seems more plausible. This leads us to the fact that the non-PPE portion of the reserve is still significantly higher than it was before the pandemic. Below, we show our estimate of the non-PPE reserve as a percentage of non-PPE inventory for the last four fiscal years. We assume that the PPE reserve wrote the inventory down to half its value, so our estimate of gross PPE inventory is simply two times the PPE reserve amount:

	FY22	FY21	FY20	FY19
Reported Net Inventory	$472.150	$481.797	$408.898	$334.589
Estimated PPE Inventory	$57.000	$87.200	$0.000	$0.000
PPE Reserve	-$28.500	-$43.600	$0.000	$0.000
Estimated Net Core Inventory	$443.650	$438.197	$408.898	$334.589
Core Reserve	$71.800	$67.400	$45.500	$32.700
Estimated Gross Core Inventory	$515.450	$505.597	$454.398	$367.289
Core Inventory Reserve %	13.9%	13.3%	10.0%	8.9%

Our estimate starts with reported net inventory and removes the estimated net value of the PPE inventory. We then add the known value of non-PPE portion of the reserve back to get an estimated gross core inventory we use to calculate a core reserve percentage. We see that the current core inventory reserve level stands at almost 14% compared to just 9% before Covid (FY19) and only 10% in the middle of the pandemic (FY20). (And remember from above, the jump to 10% warranted a comment in the 10-K and the conference call.)

It appears to us that there is quite a bit of fluff in the inventory reserve that is not related to PPE which makes the unusual decline in the 8/22 quarter even more concerning.

Putting This in Perspective

The $11.2 million decline in the inventory reserve had the potential to add almost 9 cps to earnings in the 8/22 quarter. Longer-term, the total reserve as a percentage of gross inventory is still at almost 16% versus the more normal 9% range which we estimate leaves another 30 cps of potential benefit left from a continued reduction in the reserve. This trend should be watched very closely in the upcoming quarters and profit growth accompanying a decline in the reserve should be viewed with skepticism.

Tax Rate Higher but Still Likely Well Below Forecasts

CTAS's effective tax rate was 14.8% in the 8/22 quarter, well above the year-ago quarter's 11.4%. Management explained this as being due to *"certain discrete items (primarily the tax accounting for stock-based compensation)."* While this was about a 13 cps drag on EPS growth in the quarter, the more important point when comparing results to estimates is what analysts were expecting in their models. The company had guided for a full-year fiscal 2023 tax rate of 20% in the 5/22 fourth quarter conference call:

“Our fiscal 2023 effective tax rate is expected to be approximately 20%. This compares to a rate of 17.9% in fiscal 2022 after excluding the gains and their related tax impacts. The expected higher effective tax rate will negatively impact fiscal 2023 diluted EPS by approximately $0.32 per share and diluted EPS growth by approximately 290 basis points.”

Consider the tax rate for the last eight quarters:

	8/31/2022	5/31/2022	2/28/2022	11/30/2021
Adjusted Effective Tax Rate	14.8%	22.8%	19.7%	18.0%

	8/31/2021	5/31/2021	2/28/2021	11/30/2020
Adjusted Effective Tax Rate	11.4%	19.4%	14.4%	14.1%

While the first quarter can often have the lowest rate of the year, given management’s outlook going into the quarter and the trends in the tax rate above, it seems reasonable to us to believe that the average analyst would have been expecting a tax rate closer to 17%. For perspective, every 100 bps decline in the effective rate costs the company about 4 cps in earnings. This makes us believe that the tax rate could have easily accounted for 4-8 cps of the reported earnings beat.

Conagra Brands, Inc. (CAG)
Earnings Quality Update

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

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

Summary

CAG's 1Q23 adjusted EPS of $0.57 beat by 5 cents. It is interesting to note that CAG did not raise guidance following the beat. The earnings quality was not as ugly as in 4Q22, but we still saw some issues that are likely unsustainable:

- CAG guided to higher advertising and promotional spending, saying they would grow faster than sales. Yet 1Q23 advertising came in slightly below last year at $61.9 million vs. $62.2 million. CAG also said that promotional spending in 1Q23 came in at record lows. Sales growth was 9.7% and if that means advertising should have come in 10% higher then CAG picked up 1 cent here.

- JV income from flour milling was up $29 million from $20.2 million which added 5 cents to EPS. They guided to results here moderating and this was the best quarter ever for that unit. This quarter, the comp is $29.5 million and then the comps get very tough for the fiscal third and fourth quarters:

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

- Depreciation dropped by $3.4 million and added 0.5 cents to EPS.

- CAG guided to a 24% tax rate and it came in at 22.9% which added 0.7 cents to EPS.

What to Watch

- We noted in the last update that CAG has frequently written down the value of its brand names. Now in 1Q23, they took an impairment on *Birds Eye* of $244 million and $141.7 million writedown of goodwill for its refrigerated & frozen division. This comes after $209 million of write-downs in fiscal 2022. What is interesting to note is the impairments happened in 1Q23 because CAG used a higher discount rate of 7.75% instead of 6.50%. That still sounds very low to us and ROI is only 9% here. CAG still has $11.2 billion in goodwill and $3.6 billion in other intangibles. How much more of those assets are at risk if CAG uses an 8%-9% discount rate?

- Inventory levels are above Covid levels and we remember that CAG had too much inventory early in fiscal 2020 (August 2019 and November 2019) and margins were under pressure.

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

- Guidance still does not seem stellar to us. They see 15% adjusted operating margins and 4%-5% sales growth. Even with price increases already taken and planning for more price hikes in 2Q23 and 3Q23 – CAG would still come in at one of the poorest years for margin. And don't forget, much of their actual margin gain has come from cutting advertising and promotion – now it is guiding for that to rise:

Adj Oper. Margin	f23	f22	f21	f20	f19	f18
1Q	13.7%	14.1%	20.2%	15.7%	14.6%	15.4%
2Q		14.6%	19.6%	17.1%	17.5%	16.7%
3Q		13.7%	16.0%	15.7%	16.3%	15.0%
4Q		15.0%	14.0%	17.1%	13.2%	13.0%

CAG expects stock compensation to rise in fiscal 2023 after it fell from $63.9 million to only $26.1 million in fiscal 2022. It was already up from $2.6 million to $23.0 million in 1Q23. CAG says all of SG&A is expected to grow faster than sales.

- CAG continues to shed volume. Inflation is letting it take sizable pricing gains, but when that slows, we expect it will be tougher to push through price hikes without losing volume. That has historically been the story for CAG. Even 1% of price hikes would cost it volume. The only time volume actually grew was during Covid. If they cannot fully pass through price increases as planned, this could lead to EPS misses. 1% of pricing is worth 4.7 cents of quarterly EPS. CAG did offer customers higher discounts on invoices if they paid faster in 1Q too, which produced better cash flow as receivables declined. **Interesting to note as well that the impairment charges included, "*a downward revision to our sales forecasts***," according to the 10-Q. CAG is also forecasting some supply disruptions for 2Q23 that will hurt volumes stating that "***<u>we are planning for this quarter's volumes to be impacted by the supply chain disruptions</u>***, *I just outlined and from our most recent wave of inflation driven pricing introduced to the market in early Q2."*

	1Q23	1Q22	1Q21	1Q20	1Q19	1Q18
Pricing	14.3%	1.6%	4.1%	0.8%	1.2%	2.2%
Volume	-4.6%	-2.0%	10.9%	-2.5%	0.0%	-5.3%

Walmart had this to say about price increases for food in mid-August:

> *"We had our U.S. store manager meeting last week and amongst other topics, we shared examples of* ***<u>items where we are holding prices down or rolling them back. Those tend to be opening price point, private brand, food and consumables items.</u>*** *We want to help families put meals on the table with great value in our other private brands to relieve the pressure they are feeling."*

- Also, remember that CAG is now using a 3-year lookback to compare current results. That was pre-Covid, but it was also the time when Pinnacle Foods was blowing up on them so it's a very easy comp. And yet it was still more profitable than now. CAG cut guidance on December 19, 2019, and again on February 17, 2020. Here are the fiscal 2020 comps that CAG is using. 4Q20 ends in May and is the first period of Covid:

	4Q20	3Q20	2Q20	1Q20
Pricing	0.5%	-0.4%	0.6%	0.8%
Volume	21.0%	-1.3%	1.0%	-2.5%

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.

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