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

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Cintas Corporation (CTAS)
Earnings Quality Update

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

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

Summary

CTAS's February quarter EPS of $3.14 came in 11 cps ahead of estimates while revenues topped targets by $37 million. The company raised its full-year guidance for the fiscal year ended 5/23 to $12.70 to $12.90 versus the previous guide of $12.50-$12.80, or 15 cps at the mid-point. However, we are maintaining our 3- (Minor Concern) rating due to continuing unusual activity in the inventory reserve account, and the degree to which recent growth has depended on outsized growth in First Aid and Safety Services.

- Instead of continuing to decline from unusually high levels, the reserve for obsolete inventories showed an atypical $13 million jump in the quarter. This increases our concern that future quarters could receive an artificial boost from the reserve being reversed into earnings. ***(See below for detail).***

- We discussed in past reviews how the other assets component of other long-term assets spiked in the 5/22 quarter. We were concerned this was signaling an increase in the rate of expenses capitalized at the beginning of contract terms. The balance has continued to outrun sales into the 2/23 quarter. Any tailwind received from an increase in capitalization should end after the upcoming 5/22 quarter. ***(See below for detail).***

- First Aid and Safety Services gross margin continued its rapid expansion, rising over 100 basis points sequentially to 51.6%. This is well above the pre-Covid level of the high 40% range. Despite being only 10% of sales, this segment accounted for over 50% of total reported profit growth.

Inventory Reserves Rose and Remained Unusually High

We have highlighted in past reviews how CTAS boosted its reserve for obsolete inventories in 2021 to reflect the decline in the value of PPE inventories after the initial Covid wave. The following table shows the reserve as a percentage of gross inventories for the last sixteen quarters:

	2/28/2023	11/30/2022	8/31/2022	5/31/2022
Total Net Inventory	$531.270	$514.839	$473.888	$472.150
Reserve for Obsolete and Slow-Moving Inventory	$83.000	$70.200	$89.100	$100.300
Reserve % of Gross Inventory	13.5%	12.0%	15.8%	17.5%

	2/28/2022	11/30/2021	8/31/2021	5/31/2021
Total Net Inventory	$486.750	$464.864	$463.692	$481.797
Reserve for Obsolete and Slow-Moving Inventory	$103.000	$106.600	$110.200	$111.000
Reserve % of Gross Inventory	17.5%	18.7%	19.2%	18.7%

	2/28/2021	11/30/2020	8/31/2020	5/31/2020
Total Net Inventory	$533.211	$534.128	$488.165	$408.898
Reserve for Obsolete and Slow-Moving Inventory	$63.600	$52.300	$48.200	$45.500
Reserve % of Gross Inventory	10.7%	8.9%	9.0%	10.0%

	2/29/2020	11/30/2019	8/31/2019	5/31/2019
Total Net Inventory	$352.924	$348.304	$336.290	$334.589
Reserve for Obsolete and Slow-Moving Inventory	$34.100	$33.800	$33.400	$32.700
Reserve % of Gross Inventory	8.8%	8.8%	9.0%	8.9%

Points to note:

- Before Covid, the inventory reserve was typically 9-10% of gross inventories before the company ramped it to the high teens in 2021 to reflect the drop in value of PPE inventories.

- We expected the reserve to quickly return to normal as those PPE and excess hand sanitizer inventories were either sold or disposed of and warned that any sales of those inventories could be at artificially high margins.

- The reserve did not begin to decline until the 8/22 and 11/22 quarters despite the company noting that PPE sales have all but dried up. This made us wonder if the company was releasing the reserve into earnings. We asked management about the reserve increase last year but it could not comment beyond what was already publicly disclosed.

- However, instead of continuing to decline, the reserve actually jumped by $13 million in the 2/23 quarter. We find this increase to be very unusual. Investors should keep a close eye on this account in future quarters. While it may help CTAS meet its earnings estimates in 2023, we will be skeptical of the quality of earnings in any quarter in which the reserve declines.

- For perspective, the sequential increase in the reserve percentage was an approximate 7.5 cps headwind to earnings n the quarter.

Other Assets Continue to Rise

We noted in our last review that the “other asset” component of “other long-term assets” has been increasing, as shown in the following table:

	2/28/2023	11/30/2022	8/31/2022	5/31/2022
Sales	$2,190.0	$2,174.9	$2,166.5	$2,074.7
Other	$121.4	$117.5	$107.5	$105.0
Days of Sales	5.0	4.9	4.6	4.7

	2/28/2022	11/30/2021	8/31/2021	5/31/2021
Sales	$1,960.5	$1,922.3	$1,897.0	$1,835.7
Other	$67.3	$62.4	$64.9	$81.0
Days of Sales	3.1	3.0	3.1	4.1

	2/28/2021	11/30/2020	8/31/2020	5/31/2020
Sales	$1,777.1	$1,757.0	$1,746.6	$1,619.6
Other	$72.3	$45.9	$39.1	$31.1
Days of Sales	3.7	2.4	2.1	1.8

Points to note:

- We suspect this is related to amounts paid to customers at the beginning on contract terms which are capitalized and amortized over the life of the contract.

- An unusual increase in the account could be signaling an increase in the rate of capitalization of those amounts. The jump in the 5/22 quarter was the most pronounced and most concerning, yet the balance still outran sales growth in the last two quarters. Any tailwind from an increase in the rate of capitalization should disappear after the upcoming 5/23 quarter.

Conagra Brands, Inc. (CAG)
Earnings Quality Update

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 $0.76 for 3Q23, which beat estimates by 12 cents. There are some give and takes here, but we do not consider this a quality beat, nor do we consider the ongoing gains from pricing sustainable:

- Ardent Mills JV was 8 cents of EPS flat y/y – but more than double what CAG considers normal. ***(See Below for Detail)*.**

- Pricing gains of 15.1% on top of 8.6% last year on top of 3.6% two years ago are driving results. CAG already admits transportation costs are lower and input inflation growth is coming down. Every incremental point of pricing added 5 cents to EPS. ***(See Below for Detail)***

- CAG is brushing off volume losses – which are accelerating. It continues to see larger volume losses than several peers. ***(See Below for Detail)***

- Large price hikes at the Refrigerated unit against easy comps drove profit margins up and added 15 cents to EPS in 3Q. We see several reasons this could reverse The comps are now tougher and management admits in the 10-Q it is being hurt by declining operating leverage with lower volume. It already took big impairments here in 1Q23. ***(See Below for Detail)***

- CAG continues to forecast a 24% tax rate. It came in at 22.8% this quarter adding 1 cent.

- After rebounding in 1Q and 2Q, stock compensation declined to only $9.8 million in 3Q23 – adding almost half a cent.

- Pension income declined by $10.1 million due to higher interest costs – hurting EPS by 1.6 cents.

- Advertising rose by $15.6 million to $80.5 million. However, CAG also noted that it continues to do less promotional spending which it did not quantify. It specifically called out less promotional spending in canned tomato products, canned pasta, and frozen vegetables. There have been impairment losses in the past due to lost market share in those markets for CAG. Maybe, this combination of higher advertising and lower promotional spending was a $5-$10 million headwind for 1 cent. There is a tough comp for 4Q as advertising was only $46 million in 4Q22.

- Corporate expense rose by $8 million which CAG attributes to higher incentive pay for a 1.3-cent headwind.

- Guidance for fiscal 2023 rose to $2.70-$2.75 from $2.60-$2.70 which is less than the 12-cent beat in 3Q23. The operating margin forecast is now 15.3%-15.6% vs. the 15.9% achieved through nine months and the prior forecast of 15.5%-15.6%.

- It is worth noting that CAG reported a recall of canned meats that cost it 50bp of sales and $8 million in incremental costs as it experienced manufacturing disruptions. All of that is not expected to recur in 4Q and yet it is forecasting lower margins and only moved the sales guidance to 7%-8% from 7%-7.5%.

Ardent Mills JV Received Clarifying Discussion

Investors should recall that CAG spun this unit off several years ago for being low margin and it reported that profitability rose by not having it in the mix. Removing Ardent Mills, Lamb and Weston, and Ralston caused CAG's operating margins to rise about 400bp on an apples-to-oranges basis.

When wheat prices went straight up with inflation and the Russian/Ukraine war, this JV started to report sizeable increases in income:

Milling JV	4Q	3Q	2Q	1Q
2023		$50.5	$49.3	$49.2
2022	$47.5	$48.1	$29.5	$20.2
2021	$33.4	$21.5	$23.0	$6.5
2020	$22.9	$10.4	$27.6	$12.3

We believed that as wheat prices declined the unit would return to normal levels. **On the call, management was asked about this, and the view was indirectly spelled out that the normal operations here are about $70 million per year and the $200 million it is posting now is largely related to trading operations in the volatile market.** Having this JV return to normal levels would shave off 5 cents per quarter for CAG's EPS. The current guidance of $2.70-$2.75 assumes Ardent Mills comes in lower than 3Q results.

Big Price Hikes Are Tougher to Justify

Without big pricing gains, CAG's results would look considerably worse. CAG is grabbing price because of inflationary pressure but even it sees this dropping off rapidly. CAG noted that lower transportation helped drive EPS in the quarter too. Here is what they reported for the recent quarters from commodity pressure:

Inflation	Q4e	Q3	Q2	Q1
fiscal 2023	5.5%	8.0%	11.0%	15.0%

Despite the inflation coming down, CAG is still booking large price increases and claims to be spending less in promotion which is reported net of sales and offsets pricing. The comps for price hikes get very tough next quarter and all of the next fiscal year.

Price Hikes	Q4	Q3	Q2	Q1
fiscal 2023		15.1%	17.0%	14.3%
fiscal 2022	13.2%	8.6%	6.8%	1.6%

Every 1% in pricing that CAG cannot push through would cost it about 80bp in operating margin. It also costs it 5 cents in EPS.

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	16.9%	13.7%	16.0%	15.7%	16.3%	15.0%
4Q		15.0%	14.0%	17.1%	13.2%	13.0%

Pricing masks many problems and it also falls heavily to the income line. Yet, CAG isn't seeing margins that are materially different than pre-Covid. We know that larger customers like Kroger and Walmart are pushing for lower prices from their suppliers. We also know that CAG's history is when it tries to be the stand-out and take more pricing than competitors its sales get slammed. We saw this in 2018 and 2019 with several products.

CAG Continues to Shed More Volume Than Peers

We noted three months ago that looking at CAG's fiscal 2Q and several other companies for the same calendar quarter y/y for four years that CAG was losing more volume than many other branded food companies. We have pointed out the last two years that CAG had one of the smaller Covid bounces and has already lost all of its Covid bump. It is now selling less volume than it did in 2017-19. 3Q results showed this again and we do not think the declining volume bodes well for CAG to leverage fixed manufacturing and delivery costs over lower volume.

	3Q23	3Q22	3Q21	3Q20	3Q19	3Q18
Organic Growth	6.1%	6.0%	9.7%	-1.7%	1.9%	-2.2%
Pricing Growth	15.1%	8.6%	3.6%	-0.4%	0.7%	0.6%
Volume Growth	-9.0%	-2.6%	6.1%	-1.3%	1.2%	-2.8%
Volume Index	91.3%	100.3%	103.0%	97.1%	98.4%	97.2%

Here is volume growth for some other food companies. We then looked at the same quarter for the prior three years as well. CAG leads the group in volume decay of late. That was true when looking at four years of quarters that match with CAG's fiscal second quarter too.

F3Q Vol Growth y/y	Q-0	Q-1	Q-2	Q-3
Conagra	-9.0%	-2.6%	6.1%	-1.3%
Gen. Mills	0.0%	-4.0%	5.0%	-1.0%
Campbell's	-2.0%	-8.0%	4.0%	1.0%
Kellogg's	0.6%	-3.6%	-1.4%	1.2%
Kraft-Heinz	-4.8%	0.1%	1.2%	-4.2%
Smuckers	-4.0%	-2.0%	8.0%	0.0%

F2Q Vol Growth y/y	Q-0	Q-1	Q-2	Q-3
Conagra	-8.4%	-4.2%	6.6%	1.0%
Gen. Mills	-6.0%	0.0%	4.0%	1.0%
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	-5.0%	4.0%	3.0%	0.0%

Historically, CAG does not do well when it tries to take larger price hikes, trim promotional spending, and argue that volume losses are OK. Here are some examples of past efforts at CAG to take pricing in excess of what the market will accept which may be a warning of what will happen to CAG as the world normalizes more:

- In 4Q19, the company raised prices on *Hunt's* canned tomatoes and *Chef Boyardee* while store brands did not. The result was sales dropped meaningfully with the higher prices – 50% of the organic sales decline in 4Q came here. In 1Q20, *Hunt's* and *Chef Boyardee* did not recover and 68% of the organic sales decline came here. *Hunt's* fell 10.7% and 8.9% y/y in the two quarters. *Chef Boyardee* fell 6.7% y/y in both quarters. They took an impairment on *Chef Boyardee* too.

- In 4Q19, CAG rolled out new *Marie Callender's* products and boosted prices as competitors lowered prices. CAG saw sales fall 20%, the competitor grew sales by 75%. Guess what had no mention on the 1Q20 call? That's right Marie *Callender's`!*

- Taking pricing over volume in the pre-Covid days did not boost CAG's margin either:

CAG	1Q20	1Q19	1Q18
Volume	-2.5%	0.0%	-5.3%
Price/Mix	0.8%	1.2%	2.3%
Organic Growth	-1.7%	1.2%	-3.0%
Gross Margin chg.	-30bp	-60bp	+26bp

The Refrigerated Retail Unit Had a Big Bounce in 3Q

CAG cheered the results for Refrigerated Retail which includes its frozen offerings too. Organic growth was 5.6% and adjusted operating margins were 20.7% up from 14.2% y/y. Total adjusted profit rose $94 million, which added 15 cents to EPS. We think much of this is again not sustainable and expect the situation to start declining again after 4Q23.

Here are the recent results for this unit:

Ref/Frozen	3Q23	2Q23	1Q23	4Q23	3Q22	2Q22	1Q22	4Q21
Volume	-9.8%	-5.5%	-2.5%	-8.1%	-4.5%	-4.7%	-3.8%	-8.9%
Pricing	15.4%	16.0%	12.1%	12.4%	8.4%	8.6%	2.1%	3.4%
Org. Growth	5.6%	10.5%	9.6%	4.3%	3.9%	3.9%	-1.7%	-5.5%
Adj. Op. Margin	20.7%	18.2%	14.5%	15.0%	14.2%	14.7%	14.8%	16.6%
Adj. Op Profit	$270.7	$259.0	$175.7	$185.4	$176.7	$188.8	$162.6	$198.0
y/y Change	$95.0	$70.2	$13.1	-$12.6	-$45.5	-$82.7	-$83.7	-$69.0

- Notice that volume was falling here even before the large price hikes. In fact, it is even accelerating. Going back further, we can see that this unit had exactly four quarters of volume growth with Covid and was a weak grower at best before that:

Ref/Frozen Vol.	4Q	3Q	2Q	1Q
2023		-9.8%	-5.5%	-2.5%
2022	-8.1%	-4.5%	-4.7%	-3.8%
2021	-8.9%	7.8%	6.4%	12.8%
2020	17.8%	-0.4%	0.5%	0.2%
2019	-1.5%	3.5%	0.5%	0.5%

- This improvement looks solely due to multiple price hikes building on each other. Plus, management specifically called out lower promotional spending in this unit for 3Q, which would have helped pricing even more. We know commodity input growth is slowing per management and it is enjoying lower transportation costs as it takes large price hikes. We don't see that lasting much longer.

- Investors should remember that CAG took $386 million in impairments for this unit only 6 months ago in 1Q23.

- The easy comps are largely gone now. 4Q23 has to compare to a 12.4% price increase the year before. Simply having pricing of 14.4% vs 15.4% in this unit for 3Q23, would have cut 2 cents off EPS and lowered margin by 80bp.

- Management on the call said, this represents their skill at building scale, *"The only other color I would give on Frozen specifically is something I mentioned at CAGNY, which is to be very* ***profitable in Frozen, you have to have scale.*** *And we have been very deliberate over the last several years and continuing to build our scale in Frozen because* ***when you've got scale, you can drive that profit and that margin improvement."***

- We agree with the concept that profits rise when a company can spread more units over flat fixed costs in manufacturing and storage and delivery. **However, when volumes are vanishing the reverse is true.** From CAG's 10-Q, management talks about they are losing operating leverage here:

> *"Operating profit in our Refrigerated & Frozen segment for the third quarter of fiscal 2023 reflected an increase in gross profits of $110.3 million compared to the third quarter of fiscal 2022. The increase was driven by the net sales growth discussed above and* ***lower transportation costs****, partially offset by the impacts of input cost inflation,* ***unfavorable fixed cost leverage****, and continued elevated supply chain operating costs."*

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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