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ConAgra (CAG) Move to NEUTRAL from SELL (but problems remain)

With the stock down over 40% since our August warning, we are going neutral but continue to see several troubling signs for the company

Wow! – That didn't take long for CAG to post weak results after paying a premium for Pinnacle Foods. What is more disappointing is CAG's surprise that Pinnacle has a growth problem. They don't think it's the whole company, just roughly half the sales focusing on Birds Eye, Wish-Bone, and Duncan Hines. They are blaming it on only having public information to review before the bid, but we certainly saw it. Birds Eye growth was coming exclusively from acquisitions with pricing and volume metrics falling for years. Pinnacle talked about falling sales at Wish-Bone from 2015-18 in its public documents even after pulling older SKUs and launching new products. Duncan Hines had just rolled out new products, which often mean initial stocking to boost sales growth, but quickly fades. CAG is now expecting Pinnacle sales to come in 5% below forecasts.

We still believe investors should be concerned about several items – especially achieving synergies and holding market share. On top of that, higher interest rates and weaker results at Pinnacle are not a good combination to sustain the value of the new $10.5 billion in intangible assets following the acquisition:

- **Growth with new products hurts sales of existing products.** There is not a surge in additional people suddenly eating more frozen food – CAG and PF tout sales of new products but are vague on why total sales growth lags. The reason is new products take limited shelf/freezer space away from older products, which are discounted and replaced.

- **CAG has admitted that PF is not just a cost-cutting exercise at this point – they have to rebuild brands, products, and retake shelf space.** They also admit they need to

rework pricing too. Further, CAG noted that customers have switched to more store-brand product in some cases and competitors have taken more market share too.

- **Getting back on the shelves and freezers should require more pricing investments, more marketing, and more store support with displays and free samples.** That sounds like net prices will fall more at PF before they rise and costs will be increasing. We expect more disappointments in digesting the acquisition.

- **We remain very skeptical of finding $215 million in synergies or 700bp of margin at PF.** So far, the only areas of lower costs are incentive pay because the stock has fallen and options are not being exercised and cuts in advertising. CAG has not spelled out any plans beyond "applying the ConAgra Playbook." They are touting the strength and success of legacy CAG and expect gross margins of 30% and operating margins of 15%. With the disappointments at PF, it expects gross margins of 27%-28% and operating margins of just under 15%. Where is the room for 700bp of improvement at PF?

- **The balance sheet is a focus for CAG.** It expects to pull more working capital out of PF. We have noted that CAG has essentially stretched its payable to suppliers and will focus on doing the same with PF. It also sold Wesson Oil for $180 million and will likely retire debt. That will reduce sales about 2% and cost the company earnings and cash flow too – about 5-cents per share annually. The dividend at a 4% yield and only about 50% of cash flow doesn't look that suspect on the surface – but CAG has cut it in 2006 and 2016 to do restructurings and has already said no increases this year. That may be another source of cash to retire debt at 5x EBITDA if results don't materialize as forecast.

Nuggets of Growth Are Not Moving the Total Top-Line

ConAgra continues to tout that it has significant growth and points to some new items. However, the total top-line growth remains far below the rates being touted. The fiscal 2Q19 results were typical:

	2Q19	1Q19	4Q18	3Q18
Frozen Single Serve Meals	11.3%	10.0%	13.0%	13.2%

The company talks glowingly about huge growth and taking market share. However, it focuses on only one area of the business. In this case, it was frozen single-serve meals. Not in the discussion in 2Q19 is that the growth rate has already slowed from 15%-20% the year before as many of these products rolled out. Also, what gets left behind is discussion that ConAgra sales remain very weak despite the boom in frozen single-serve meals:

	2Q19	1Q19	4Q18	3Q18
CAG Legacy Sales Growth	1.3%	1.7%	3.1%	2.2%

In fiscal 2018, total CAG sales growth was negative at about -1%-2% which followed -5% growth in fiscal 2017. After two poor years, CAG saw total sales growth of low-single digit against years of easy comps and already that growth if vanishing.

There are two things going on here. First, older products are being replaced and therefore get marked down and not reordered. While not frozen food, a personal example of this illustrates the issue. My old electric toothbrush was dying and it finally occurred to me to buy a new one last weekend while in the toothpaste section. There were three models available – and I grabbed the 1000 model for $40 instead of the 3000 or 5000 for $75 or $89. The 1000 model said it was a close-out. When I checked out, the price turned out to be $10 – it was marked down an additional $30 or 75%. The stores simply do not suddenly have more shelf space and new products take shelf space from older ones. The growth rates for the older products become negative and offset sales of newer placements.

The other point to consider is new products can be a risk for the stores because they have to remove something else to place a new item. They may charge higher fees to manufacturers to get these new items on the shelves. Also, they may insist on the manufacturer provide more marketing support such as discounted prices, in-store displays, or customer samples. The manufacturer wants to prove the new product is in demand and growing so it sacrifices price for market share. CAG reports that it raised prices this year on the new frozen single serving meals and also continues to sell products on promotion. The rate of promotions fell noticeably in 1Q19 but bounced back in 2Q19.

This is why organic growth at CAG before the PF deal is negative. In the 2Q19, Grocery & Snacks were 42% of sales and had volume growth of -2.2%. Foodservice at 12% of sales had volume losses of -12.9%. Offsetting this was the highly touted Frozen & Refrigerated division at 36% of sales grew volumes at 0.5% and International at 10% of sales grew

volumes at 0.6%. The company is giving guidance for 1%-2% organic growth for the year – that already looks suspect to us.

The PF Deal Is Not Just About Cost-Cutting Anymore – Revenue Is a Problem

When this deal was laid out – we were very skeptical that CAG could hit its targets because it required cutting 700bp of costs out of Performance Foods. CAG laid out zero revenue synergies and on the 2Q19 call – continued to say revenue synergies are still not being forecast. According to the CFO, Dave Marberger:

> *"The synergies we say in the upside, these are the cost synergies right. So, the $215 (million) were cost synergies. <u>We did not build any revenue synergies into our model.</u> Now obviously the business is down relative to what we had modeled, so we have to do all the things we discussed to bring that business back. But when you talk about upside going out long-term, we believe that <u>there could be a side on revenue synergies. That's not in the updated cost synergy number that we will have."</u>*

We were skeptical of CAG achieving that much cost-cutting because PF was built via acquisition and rationalizing costs. PF already closed excess capacities to achieve better margins running the remaining facilities at higher utilization rates. It already reworked logistics, achieved scale in purchasing, rebuilt product lines. PF already had margins roughly equal to CAG. It is difficult to buy a company from another cost cutter and magically find a ton of fat to slash. See our August 2018 report for more details on this.

Now, CAG admits that PF has revenue problems and product line problems and are expecting PF sales to come in 5% below guidance. CEO Sean Connolly:

> *"On sales, we now estimate the Pinnacle portfolio will land calendar year '18 at roughly $3 billion, which is <u>about $160 million or 5% below Pinnacle's target</u>. Approximately $30 million of this miss is driven by our post close decisions to exit some year-end promotions that we saw as extremely low ROI. <u>At adjusted gross margin, we now estimate Pinnacle would have closed out calendar year '18 at approximately 28%, which is roughly 230 basis points below its internal targets."</u>*

In CAG's view, there are a myriad of issues to address. They believe Pinnacle chased low margin business and hurt pricing power. They also believe the pipeline at Pinnacle is weak and CAG is pulling many of the products and plans to remake the inventory lines. That means these problems will take time to resolve and boosting price again may be difficult:

> *"With regards to execution, Pinnacle over-extended new items in the same demand pool, favored high margins over high quality and highly competitive products, and missed some major consumer trends. These missteps ultimately undermined brand strength and pricing power, while gross productivity was insufficient to make up for operational offsets like a major product recall.*
>
> *Instead of improving the products more subpar SKU entered the market, which led to even more inefficient SKU proliferation. And then to try to jumpstart volume, low ROI trade was infused behind price promotion; compounding this unenviable situation with acute cost inflation, particularly in transportation and better innovation from the competition; and as you'd expect the side effect of disappointed customers. When Birdseye, Duncan Hines and Wishbone delve further into the virtue led cycle and brand performance stalled, customers reduced distribution. Since then, each brand has lost share with competition. Given these dynamics, the Pinnacle business will unfortunately under-deliver its pretty close internal standalone targets."*

This is not a one-quarter problem. CAG is seeing problems at PF that will last over a year even though they hope to get some new product ready before then,

> *"because of the weakness of the Pinnacle innovation, we have sprung into action to stop further proliferation of similar types of SKUs. But we've also sprung in action in terms of rebuilding a new innovation pipeline with the Pinnacle team and the ConAgra team working arm and arm to do that, but that's going to take some time. It's not going to be all at the exact same window, so it won't all be the beginning of the second half of 2020. Whatever we can get into the marketplace faster, we will get in."*

PF has conditioned customers to expect lower prices is what we are reading and its products are not what customer want. Both of those situations should make it difficult to raise prices which should pressure revenues and margins at PF. That's a far cry from the picture CAG laid out a few months ago. Moreover, competitors have taken share from PF. Displacing

competition likely means lower pricing and/or lower margins due to more support for the retailer. CAG is going to be asking them to make two decisions – eliminate an entrenched product from the shelves that apparently is selling and replace it with an unknown new product:

> *"Birds Eye is an extraordinary brand. It is number one in the veggie and veggie-based meal space. And good things are still happening within the franchise like the Veggie Meal. But the brand architecture has become too fragmented in this finalized space within vegetables with flat out passed over for being too low margin. <u>And when the consumer is hyper passionate about our space as they are about spiralized, you just can't opt out. You've got to give the consumer what they want and figure the margin challenge out as you go. If you opt out, the competitor will fill the vacuum and that's exactly what happened.</u>*
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> *So, the way that we think about this here at ConAgra is we think of Duncan Hines as a sweet treat brand not as a cake mix. We view perfect size for one not as a portion control cake, but as a convenient warm sweet treat. And as the frame of reference being different, the product design would've been different. And frankly, it would've been more appealing. And <u>unfortunately, the competition figured this out and has been stealing share, so we've got work to do. And then the third one that we pointed to was Wish-Bone. Now this is a big category. It's also a great brand. But frankly it has not benefited from enough disruptive innovation. What has been launched hasn't resonated</u>, for example the - yellow line and that will change."*

CAG will also need to displace some private label products. Generally, those are higher margin for the retailer and sell at a lower price for the consumer. CAG was asked about this on the call too:

> *<u>"How much of that Birds Eye loss destruction is a result of shelf loss at one major retailer that happen to introduce retailers branded SKUs and if that's a fairly local big reason why we're seeing the loss shelf and pain here.</u> Have we seen the biggest impact from that in the consumption data or might the year-over-year in the data look even worse from now?"*
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> *"That is a piece of it, Rob. I think another significant piece that I already talk -- big piece of this whole spiralized space has been a very, very big opportunity and a competitor has really taken that business at major customers. With respect to private label in frozen over time, here's how I think about that. <u>As we've said before, private</u>*

label make sense in highly commoditized subcategories but it really has never made sense for work historically in finished meals, side dishes, enhancers, appetizers and things like that. Every few years that I've been around the frozen space, you will have a retailer give it a go but it has never taken hold and it probably will happen again from time to time. It's happening a little bit now in vegetables, but the outcome is unlikely to be any different in these more -- these less commoditized subcategories. Ultimately, when customers see that their store brand advocacy is resulting in declining category sale, there is the there will be the exact same reversal we've seen before. So that's the dynamic that I've seen over and over again, and it plays out the same way almost every single time."

We don't know how CAG will take back shelf space in that scenario without cutting prices and/or ramping up promotional spending. We don't know how it launches new products that it doesn't even have yet without discounting. We don't know how CAG will beat back entrenched branded competitors without offering the stores a better deal. None of this sounds like a short-term issue. All of it sounds like a revenue and gross margin problem for the PF deal.

Where is the Cost Cutting?

One of our greatest pet peeves is when companies blow their guidance and then announce – "don't worry, we have magically found more restructuring opportunity to offset the problems." CAG rang this red flag and indeed is promising even greater savings with minimal details.

"As Sean mentioned, we are pleased with the progress we've made in identifying synergies and we expect to deliver more than the $215 million in total cost synergies we previously disclosed. As a reminder, our synergy estimates are net of additional reinvestments, and we expect this net synergy estimate to benefit the P&L between fiscal year 2019 and fiscal year 2022. We expect to over deliver on our synergy targets without incurring any cash costs to achieve above the estimated $355 million. We estimate that we will deliver approximately $20 million in synergy savings or about 10% of the originally disclosed amount for full year fiscal 2019. As for the sources of upside, we see incremental savings primarily in the areas of SG&A and procurement. We are still working the details but intend to deliver these higher savings as quickly as possible."

As we addressed above, PF has some significant revenue and margin pressures to deal with over many quarters. That alone is likely to offset some of any realized cost savings. We also think it is important to note that this is not a case of PF being a similar company with margins of 6% and CAG at 15% where it should be easy to understand where cost savings will emerge. These are both companies that have already cut costs for years and both already have essentially the same margins. Adjusted for one-time items such as restructuring costs and acquisition items, PF's operating margin in 2Q was 22%. CAG's 2Q margin was 17.1% or 19.3% before corporate expenses. CAG's guidance is that its own operations will post a 30% gross margin and 15% operating margin for fiscal 2019. It expects a lower gross margin of 27%-28% for PF but an operating margin of 14.6-14.9%.

Already, CAG has called out the new expenses for amortizing intangibles at PF as largely offsetting estimated cost savings plus some of the PF expenses will hurt CAG margins:

> *"We are estimating all-in Pinnacle adjusted operating margins of 14.6% to 14.9%. The Pinnacle reporting segment is being impacted by both the intangible asset amortization expense estimated at $17 million for the period and an estimate of $20 million in cost reduction synergies. Also included in those estimates are Pinnacle related expenses that will ultimately be recorded in total ConAgra corporate expense and not the segment for fiscal year 2019."*

The place where expenses are falling is advertising. 1Q19 was lower than 1Q18 and even adding PF to the mix for one month in 2Q19, the 2Q19 spending was below 2Q18.

	2Q19	2Q18	1Q19	1Q18
Advertising	$69.4	$86.0	$42.7	$54.9

Does this sound sustainable? If CAG plans to retake market share and restore PF sales, it will require advertising and promotion. Remember, it has to displace both branded competitors who have taken that market share and lower-priced private label products the filled the shelves also. As we noted in the August report, PF was already cutting items like this including R&D, coupons, advertising, and marketing accruals:

Pinnacle	2017	2016	2015	2014
R&D exp.	$16.1	$18.1	$13.0	$11.3

Advertising	$29.3	$33.0	$28.2	$35.9
Coupon Accrual	$2.4	$5.0	$2.0	$1.9
Broker Accrual	$7.0	$8.0	$4.5	$3.5
Market Accrual	$39.0	$51.1	$46.2	$36.2

ConAgra and PF teams are expected to work "arm in arm" rebuilding the product pipeline. That doesn't sound like R&D costs are coming down for PF either. Now the company is starting in the hole from what CAG said it was buying. On the call, CAG talked about over 200bp of margin compression. It now has to rebuild and launch new products in a bigger way and plans to do extensive relaunches on about half of PF's sales (Birds Eye, Duncan Hines, and Wishbone). It won't achieve all this in a year and all of that costs money and/or margin as they have to find ways to get back on the shelves.

The other area being cut is incentive pay which is tied to the stock price of CAG that has dropped significantly.

> *"Adjusted SG&A for the quarter was down 4.4% compared to the prior year and was 9.1% of net sales. The decrease was primarily driven by lower incentive base compensation in the legacy ConAgra business. This included lower stock-based compensation expense due to the lower share price, which was partially offset by the addition of expenses related to the Pinnacle Business."*

The Balance Sheet Goals Could Impact the Dividend

The current debt load at CAG is 5.0x EBITDA and stands at $11.1 billion net of cash (implying forward EBITDA of $2.2 billion). In 2.5 years, CAG expects to be at 3.5x EBITDA. Thus, EBITDA either needs to grow to $3.2 billion or as much as $3.4 billion of debt needs to be retired. On top of that, we have seen no change in the $355 million cash costs of merging the company and implementing restructurings. In fact, we'd argue that figure has increased as CAG now sets about trying to rebuild product lines and sales at PF.

The company has already announced an asset sale of $180 million to sell Wesson Oil – which will reduce that $2.2 billion figure. It also has highlighted that it wants to pull cash out of PF's working capital. We highlighted in July that CAG has helped its trade creditors factor receivables, which has enabled CAG to stretch its payables to as much as 60 days. However, in the last two years, PF was already over 50-days on its payables, which also illustrates again that PF was already run by financial people looking to maximize cash generation

before CAG came along. Going to 60 days would only free up about $30 million in cash. Thus, we cannot see asset sales and working capital as areas to produce significant amounts of cash. Those areas are unlikely to even cover the restructuring costs.

From $2.2 billion in EBITDA before losing Wesson Oil, CAG has guided to $390 million in interest expense, capital spending of about $350 million, a tax rate of 25% is going to result in tax expense of about $325 million, and the dividend is $400 million. That leaves $735 million to retire debt per year before paying restructuring costs.

That's $1.8 billion in reduced debt over 2.5 years if CAG applies all the remaining cash flow in that manner. That still leaves the $9.3 billion in debt to EBITDA at 4.25x unless EBITDA rises by $460 million. We consider that a very big question-mark considering:

- We think the chances of finding $215 million in cost savings at PF are low given that's a 700bp increase in margin there and PF and CAG margins are roughly equal now
- CAG would still need recover the lost sales and margin at PF, then all the $215 million in synergies and still grow EBITDA another $245 million
- The company is not forecasting any revenue synergies and currently revenue is coming in below target and they sold 2% of their sales with Wesson Oil
- Cuts in advertising have already occurred and now CAG needs to create and roll out new products – marketing support costs seem more likely to rise
- Both companies have already gone through years of restructuring
- PF will be fighting to maintain revenues and margins for some time as it develops new products and tries to win back shelf space – which could hurt cash flow

Over 2.5 years, the company will pay out $1.0 billion in dividends. It can probably make its leverage target if it diverts some of the dividend payment toward debt reduction. If $500 million reduced the debt figure to $8.8 billion, CAG would still need a $300 million increase in EBITDA via synergies and growth by then to reach a 3.5x leverage ratio. The company has already cut its dividend twice in recent years 2006 and 2016 – both times after having too many weakening divisions leading to big asset sales/spin-offs, wholesale restructuring, and efforts to ramp up marketing.

We continue to believe that CAG bought and overpaid for a low/no growth company that was already run by financial engineers for years who already slashed costs. By ballooning the debt and disappointing in the first month after closing the deal, we think CAG has a tough road ahead. Any write-downs in asset values due to impairments or any delays in showing some improvements seem likely to weigh on this stock and even CAG says improvements will take time. CAG added $10.5 billion in intangible assets that will have to be tested against weaker cash flows and likely a higher hurdle rate reflecting a weaker risk profile. Impairment charges may highlight the need to retire debt even faster – that could put pressure on the dividend. However, at 10x EPS, it's tough to be overwhelming negative on something the market is already focused on.

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