BEHIND THE NUMBERS

Quality of Earnings Analysis

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Conagra Brands, Inc. (CAG)
Earnings Quality Update- 11/21 Qtr.

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 at 2- (Weak) and our Top Sell rating.

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

Summary

CAG's fiscal 2Q22 (ending November 28, 2021) saw the company miss non-GAAP forecasts by 4-cents. That included earning an extra 1-cent from having lower stock compensation and higher pension income. It also included an extra 1-cent from higher earnings at its Flour milling JV.

More importantly, CAG uses FIFO accounting – which should be a benefit for earnings amid commodity inflation. Further, it emerged from 1Q22 with almost record inventory levels of over 90-days vs. the normal 76. CAG was buying product BEFORE the inflation really took off (during the summer of 2021). Adding in price increases of 6.8%, CAG's results should be stellar. But, gross margin is declining – down 480bp from 2Q21 and 340bp from the horrific results CAG was posting in 2Q20 when it was cutting guidance. On the call, CAG noted that cost of goods was only up $20 million more than expected, that's 3-cents. But they missed by 4-cents and benefited from non-operating items helping by 2-cents.

What is weak?

- CAG's advertising expense is rising again. That should be a good thing if not a required item given that cutting it was a huge source of margin gain since the Pinnacle deal. CAG likes to point this out as a headwind of $7.8 million in 2Q22 or 1 cent in EPS. We expect this to keep growing as CAG wants to take more pricing and introduce new products. It is simply a cost of business. There was no quantification for promotional spending which is a reduction to sales. We know that has been a headwind for several quarters as normalcy returned to the grocery stores.

- We think CAG is about to spend heavily for inventory after drawing it down from 1Q ending in August. Given that it uses FIFO accounting, CAG should be selling off the cheaper inventory first and replacing it with more expensive supplies. It is normal for inventory to decline from 1Q to 2Q due to preparing for the holidays, but we think DSI's should have risen y/y in 2Q more than 3 days from inflation alone:

DSIs	FY 22	FY 21	FY 20
fiscal 1Q	90.1	77.1	92.8
fiscal 2Q	73.6	70.3	79.9

- We noted last quarter that after years of culling lower margin units and SKUs, taking restructurings every period, plus taking pricing that investors should be asking why are operating margins down? Here are 1Q and 2Q:

	1Q22	1Q21	1Q20	1Q19	1Q18	1Q17
CAG price chg	1.6%	4.1%	0.8%	1.2%	2.3%	
Index of price	110.4	108.6	104.4	103.5	102.3	100.0
Adj. oper margin	14.1%	20.2%	15.7%	14.6%	15.4%	

	2Q22	2Q21	2Q20	2Q19	2Q18	2Q17
CAG price chg	6.8%	1.5%	0.6%	0.6%	0.6%	
Index of price	110.4	103.3	101.8	101.2	100.6	100.0
Adj. oper margin	14.6%	19.6%	17.1%	17.5%	16.7%	

And remember, CAG just cut margin guidance.

What to Watch?

- The outlook looks suspect to us. CAG noted that it expects price hikes to boost organic growth to 3% up from 1%, but inflation will rise 14% vs. the 11% expectation. Plus, the price hikes should leverage costs like depreciation, advertising, and FIFO accounting should help too. Yet, CAG cut its margin forecast from 16.0% to 15.5% for fiscal 2022. However, EPS forecasts are the same? An extra 2% of sales growth is worth $200 million in revenues, but the 300bp of higher COGS is about $240 million. Advertising is rising, and so are wages, but CAG is only forecasting a drop of 50bp in operating margin which is $25 million vs. the $40 million drop in gross profit. $25 million in lower operating income is 4-cents in EPS. They already missed by 4-cents in 2Q22 and 1Q's 2-cent beat was low quality too.

- The commodity inflation is taking a toll on CAG's cash flow due to working capital expansion along with margin contraction. The company isn't broke, but Cash from Operations fell to only $262 million YTD from $541 million last year. Debt-to-EBITDA is now 4.3x. It was only 3.6x at the end of May 2021. Their goal is 3.5x, which could require more debt reduction going forward.

- The two-year comps that CAG is touting – comparing fiscal 2022 quarters to pre-Covid will lap after fiscal 3Q in February. As we noted last quarter, that is not a conservative comparison. The Pinnacle Foods deal was in full catastrophe mode in late 2019, so CAG's results were terrible and represent very easy comps. Covid saved the situation by allowing all the excess inventory to be sold. We fully expect the two-year comp to vanish from the CAG lexicon for 4Q in May as the easy comps end. However, investors should focus on the fact that CAG's results in terms of margin are much lower than those easy comps. Also, while no one expected CAG to match favorably against Covid's volume comps, CAG is simply not selling much more product than it did 5-6 years ago. For 1Q, the volume trend results in flat results. For 2Q, if we run an index, CAG is 6% ahead of 2017 and that includes an early period when multiple hurricanes in the Gulf helped boost results by 2.2%

- Food Service (Restaurant) sales are returning. That is going to cannibalize sales in grocery stores and Food Service sales have about one-half the margin of the other divisions. This unit was 90% of pre-Covid levels for 2Q22 even with very large prices hikes of 9%. So this headwind for earnings should continue as well. Every $60 million in sales that Food Service recovers at a lower margin costs CAG about 1-cent in EPS.

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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