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Conagra Brands, Inc. (CAG) Earnings Quality Review 11/20 Qtr.

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 CAG with a 2+ (Weak) rating.

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

Summary

Conagra beat 2Q21 forecasts by 7-cents. Sales exceeded consumer sell-through again. CAG did not quantify it this quarter, but this allowed the company to boost sales and leverage fixed costs. In 1Q21, this was 600bp of sales growth. **Every 100bp of that type of demand helped 2Q21 EPS by 1-cent and we think this was 3-4 cents of EPS**. **Every 25bp of gross margin pick-up from leveraging fixed costs adds 1-cent** too. 2Q21 saw 140bp of gross margin gain. **Plus, every 25bp of pricing added another 1-cent** and pricing was up 150bp with help from reduced in-store marketing. 3Q21 guidance expects only a 30-80bp y/y pick-up in operating margin vs. 250bp in 2Q – the number one reason given was CAG expects less operating leverage. CAG picked up considerable EPS in 1Q21 from reversing a marketing accrual. It guided to higher marketing expense for both in-store promotions and in general for 2Q. The first was down again and the second was flat – both helping EPS. Lower travel expenses added 1-cent more and CAG offset higher incentive pay with wage and 401(k) cuts. Of course, **there were more never-ending restructuring charges and those were added back for 3-cents in EPS.**

What is strong?

- COVID helped CAG tremendously by clearing the stores and warehouses of inventory that likely would have required big mark-downs. Inventory ended 2Q20 at 106 days of sales and bottomed at only 58 days in 4Q20 (May). It finished at 70 days for 2Q21. The reason for the plus on our rating is we believe CAG could still pick up some operating leverage beyond current guidance by rebuilding its inventory in 3Q which could help replace lower retail channel stocking as a reason to outproduce demand.

- CAG has a very easy comp for sales for 3Q21 of -1.7% which includes -1.3% on volume. That is the last one for some time going forward. Historically, that was when the company was able to post positive organic growth.

What is weak?

- CAG's organic growth is already falling rapidly. The last two quarters were helped by restocking the retail channel and lower in-store marketing cost that is netted against sales. Historically, CAG's sales sit in a range of -2% to +2% y/y change. Guidance of 6%-8% growth for 3Q21 looks high to us after 2Q's 8% figure as the primary restocking demand figure is easing.

- Guidance for very little pick-up in y/y margin for 3Q21 is troubling too – 30-80bp vs. 250bp in 2Q21. One of the reasons given is seasonally slower sales are expected which would deleverage fixed costs on production. With retailers still building inventories and CAG looking to expand its own inventory on hand, that should create enough short-term production increases in our view to create higher operating leverage.

What to watch

- Cost inflation is growing. CAG saw inflation of 3.1% in 1Q and guided to low-mid 2%. It came in at 2.8% in 2Q and now the company is guiding to 3.5%. We think that will come out of CAG margins going forward because retailers are still investing in price and pushing their private label products.

- Investors do not have to go back very far to find CAG results when it tries to take pricing and retailers do not. It happened in 2019 when CAG lost market share, had large drops in volume, even took impairment charges against particular brands, and cut guidance repeatedly.

- For all the synergy and cost-cutting work that CAG touts – we continue to see the bulk of their gains coming from culling lower-margin units (about 400bp of margin) and cutting advertising (about 100bp of margin). COVID has let CAG stretch that rubber band further with even deeper advertising cuts. That seems likely to snap back and hurt margins. Even CAG is guiding to that.

- There may be other headwinds for EPS going forward beyond advertising increasing. Travel and entertainment costs should return. CAG will lap the cost savings from layoffs and it notes that remaining employees are earning more.

Supporting Detail

Can CAG Maintain Its Sales Gains Beyond this Quarter?

4Q20 and 1Q21 were the key parts of COVID-related demand with customers doing pantry stocking for the May quarter that was 4Q and that continuing in the August 1Q along with retailers restocking. CAG guided to 6%-8% growth for the November 2Q.

Organic Growth	2Q21	1Q21	4Q20
Volume	6.6%	10.9%	21.0%
Pricing	1.5%	4.1%	0.5%
Total Org. Growth	8.1%	15.0%	21.5%

We think it is important to focus on a few factors for these results:

- In 1Q21, the company noted that 600bp of its volume came from stores restocking inventory. That was actually lighter than what CAG could have achieved if was not supply-constrained itself according to management.

- In 2Q21, CAG did not quantify the amount of volume due to restocking the channel but acknowledged that it did help drive 2Q volume. It specifically called out Birdseye as a large product area that was not able to fully fill orders in 1Q that saw the restocking bleed into 2Q.

- We can see Kroger's figures that show this big restocking demand. Inventories have been lower on higher sales for much of 2020:

Kroger Inventory	Nov. 20	Aug. 20	May. 20	Feb. 20
Inventory	$7,478	$6,344	$6,297	$7,084
COGS	$22,901	$23,551	$31,454	$22,507
Inventory DSIs	29.8	24.6	18.3	28.7
	Nov.19	Aug. 19	May. 19	Feb. 19
Inventory	$7,412	$6,526	$6,707	$6,846
COGS	$21,798	$22,007	$28,983	$21,955
Inventory DSIs	31.0	27.1	21.1	28.5

- In our view, Kroger was still 2.5 days below normal after 1Q and closed that gap to 1.2 days after 2Q. Wal-Mart also commented that it was restocking inventory in the quarter that ended in October 2020. **We think this restocking continues to help for 3Q21 – but not to the same extent.**

- We believe if CAG's actual volume growth apart from industry channel stocking in 1Q21 was closer to 5% vs. the reported 11% - then 2Q21's 6.6% may be closer to 2% and CAG admits some of the restocking continued in 2Q.

- **Pricing appears even more unsustainable than volume. CAG reports pricing net of in-store promotional spending.** The company used to disclose the percentage of sales drag from promotional spending but not these days.

- In 1Q21, CAG reversed an accrual of in-store spending which added 70bp to sales. We also know that in 1Q20 the spending was a 170bp drag on sales. The net change in pricing y/y in 1Q21 was 410bp. However, 240bp came from this change to in-store promotion, so the real pricing power was only 170bp.

- Guidance for 2Q21 was that in-store promotion would increase, from the 1Q21 call, "***we expect to increase our marketing support both above the line [in-store spending that nets against sales] and below the line [in SG&A].*** *We believe there are opportunities to increase brand-building investments where capacity permits.*"

- In 2Q21, CAG actually spent less in this area, 2Q21 call, *"organic net sales was primarily driven by a 6.6% increase in volume related to the growth of at-home food consumption. The favorable impact of price mix, which was evenly driven by favorable sales mix and* ***less trade merchandising*** *also contributed to our growth."*

- 2Q21 said pricing increased 150bp. For 2Q20, trade spending was a 120bp drag. The company did not quantify how much it fell in the 10-Q or the earnings call. We simply know it was lower than the prior year after guiding for an increase.

EPS Impacts and Conclusions on Sales Issues

We believe CAG will need to boost in-store promotion going forward. If that occurs it will become a drag on y/y pricing changes. In 1Q21 – 240bp of sales from promotional changes generated over 8-cents in EPS. In 2Q21 – the benefit was likely less than that. It was not quantified, but every 25bp change produced 1.1-cents in EPS. **We would not be surprised if CAG picked up 2-cents on lower promotional spending in 2Q21.**

The volume gains from restocking the channel should help the current quarter still. However, this benefit should also be waning. In 1Q21, this was 600bp of sales. Using operating margins as what fell to the bottom line – this added 3.5-cents to EPS. Using gross margins – this added 6.2-cents to the bottom line. The 1Q benefit should be somewhere between those figures.

For 2Q21, the restocking demand was not quantified. But we know CAG's volume growth is normally negative. In 2Q, volume growth was 660bp. Every 100bp from restocking added 1.3 cents based on gross margin or 0.9 cents based on operating margin. **We would not be surprised if CAG picked up 300-400bp in volume in 2Q given how much retailers were reloading inventory and added 3-4-cents in EPS.**

For 3Q21, CAG is guiding to 6%-8% organic growth. We think pricing will have a very minor impact on that guidance. The company is saying promotional spending will rise and that lowers pricing. Also, the operating margin guidance is only for a 30-80bp pickup for 3Q vs. 250bp in 2Q. Since price increases add almost no operating cost, we believe this points to little pricing power in this quarter.

On volume, it appears that the retail channel still needs more restocking but it should make a smaller impact in 3Q than 1Q or 2Q. Some of the volume growth should also come from the last easy comp that CAG will have. For 3Q20, CAG saw -1.7% organic growth driven by a -1.3% change in volume. We think investors should be concerned that CAG is guiding to lost operating leverage of fixed costs due to the normal seasonality where 3Q sales are below 2Q. A normalization may indicate the COVID inflated sales are vanishing. That is despite some additional channel building of inventory. That is also despite CAG needing to rebuild some of its own inventory levels as noted on the call, "***we are seeing orders that are strong because we're replenishing to be able to have the right stocks to support the demand***." We also think DSOs point to a need for CAG to grow its own inventory too:

Conagra Inventory	2Q21	1Q21	4Q20	3Q20
Inventory	$1,623	$1,580	$1,378	$1,647
COGS	$2,104	$1,868	$2,165	$1,844
Inventory DSIs	70.4	77.2	58.1	81.5
	2Q20	1Q20	4Q19	3Q19
Inventory	$1,770	$1,756	$1,563	$1,639
COGS	$1,530	$1,663	$1,838	$1,805
Inventory DSIs	105.6	96.3	77.6	82.8

We know 2Q20 inventory was too high, the prior year it was 99 days. We believe 70 is too low now and CAG is talking about building its inventory levels too. Between that production and more restocking in the retail channel, we would expect more fixed cost leverage. However, CAG is downplaying that in guidance. **Thus, there are conflicting issues on volume but with weaker pricing, CAG may need volume growth to accelerate y/y for 3Q. That may be tough difficult to achieve given how much recent volume growth was one-time in nature.**

Miscellaneous EPS Issues

It would not be Conagra without some special "one-time" items. For the adjusted EPS, 2Q21 was not too bad:

EPS Impacts in Adjusted Figures	2Q21 $mm	EPS Impact
Rise in Pension Benefit	$1.8	$0.3
Lack of Travel/Ent. Expense	$4.6	$0.7
Increase in Share Comp.	-$3.4	-$0.5
Increase in Incentive Comp.	-$9.7	-$1.5
Wages saved by layoffs, cut to 401-k	$12.5	$2.0
Total help to EPS	$5.8	$1.0

Our view is travel and entertainment spending should rise going forward. Also, the higher incentive pay should remain high in 3Q and then start to decrease as CAG faces tough comps and growth rates normalize. There is likely a greater headwind for 3Q than 2Q saw in those areas.

Also, cost savings from layoffs will lap soon too and we would expect CAG to boost 401-k spending following all the COVID impacts. The company even noted that the remaining employees are being paid more. All in all, this may go from a 1-cent tailwind for 2Q21 results to a 1-cent headwind for 3Q21.

As usual, CAG added back restructuring charges of 3-cents. This has been a recurring item for years, which by itself is aggressive – when does the restructuring become a normal part of the company's operating model? Also, like an acquisition, where a company ignores the purchase price and integration costs but only touts the higher sales and lower per-unit costs – CAG has a similar situation here. It touts the cost savings from lay-offs and does not add those back, but the expenses incurred to achieve those savings are ignored.

Looking at advertising expense in SG&A (not the in-store promotion netted against sales). It is obvious to us that CAG continues to pick up EPS in this area. It was simply spending more money on advertising before it bought Pinnacle Foods. COVID allowed it to reduce spending further as sales were driven by panic buying and lockdowns. For a company that claims to be brand builders and likes to promote its products with a value over volume philosophy, this still looks like a future source of EPS headwinds. Every $6 million in higher advertising is 1-cent in lower quarterly EPS:

Conagra Advertising	4Q	3Q	2Q	1Q
fiscal 21			$63.6	$45.9
fiscal 20	$59.2	$65.5	$60.7	$45.3
fiscal 19	$73.9	$67.4	$69.4	$42.7
fiscal 18	$59.5	$78.2	$86.0	$54.9
fiscal 17	$75.5	$90.7		

CAG spent $69.4 million on advertising in 2Q19 when it owned Pinnacle Foods for only a few weeks. Since that time, the combined company has only exceeded that figure in one quarter out of eight.

The GAAP tax rate fell due to CAG releasing a tax benefit valuation allowance of $25.2 million in 2Q21. This was worth 5.2 cents in EPS. This is a one-time item in our view. The benefit was removed from adjusted EPS and CAG used a comparable tax rate of 23.2% vs. 22.8% last year.

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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