BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Conagra Brands – 1Q '20
Maintain SELL

We are maintaining our SELL on CAG after F1Q20 results. The company beat forecasts on EPS, but it misses a fair amount of the time too and often does on revenue like it did again last quarter. **After last quarter, we think investors should be concerned with the inventory levels rising above historic levels at the same time they are posting negative sales growth** in many key product lines. The three main parts of the Pinnacle Foods acquisition have all posted sizeable sales declines since being acquired by CAG and weakness in the Legacy CAG brands continued through 1Q too.

The bull case for CAG is that it will boost sales with higher prices, gross margin as it culls lower margin products and invigorates brands with new products, and operating margins with cost-cutting. A year before the Pinnacle deal and now a year after the Pinnacle deal – we are seeing scant evidence that this blueprint is at work beyond a couple of quarters when matched against a very weak comp the year before.

- Value over Volume has led to 0% or negative change in volume five times in the last eight quarters.

- Gross Margin is not rising either – it has not been higher y/y the last 5 quarters in a row, and had two modest increases of 20bp in F2018 sandwiching quarters of -160bp and -100bp.

- The most common reason given on the last call for better sales growth in the future was easy comps will be key.

- All three main units of the Pinnacle deal and three of Conagra's main brands have all shown problems of late in losing market share and large drops in sales. This is not a simple cost-cutting program anymore – CAG has to rebuild major sources of revenue.

- Inventories jumped in 1Q20 to very high levels. Even dealing with seasonality, DSIs look at least 10 days too high. We do not believe this is related to inflation as raw materials DSIs are flat.

- CAG is still selling heavily to discount retailers – yet it needs to move extra volumes in our view and wants to boost prices. This looks like an area for disappointment next quarter.

- The cost-cutting efforts of late do not look sustainable to us. The bulk if not more than 100% of cost-cutting in recent quarters has come from reductions in advertising and stock compensation. The company announced that it plans to ramp up marketing more and it is essentially done with headcount reductions.

Where are the Results for Value over Volume?

The goal that CAG always discusses is Value over Volume. It is willing to concede lower margin sales in return for better pricing. The price hikes should also drive up gross margin. However, isolating the Legacy CAG organic growth figures – this is not happening beyond shedding volumes:

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

For the last three first quarters, CAG has seen at best flat volumes and gross margin pressure. In the last eight quarters, volume has only been positive twice. On top of that, the only time pricing offsets the poor volume is when they match against a big negative the year before. The company cannot even post a positive y/y figure against a 2% comp:

Legacy CAG Vol. Chg.	4Q	3Q	2Q	1Q
F 2019	-1.2%	1.2%	-2.2%	0.0%
F 2018	-0.1%	-2.8%	1.7%	-5.3%

Legacy CAG Organic Chg.	4Q	3Q	2Q	1Q
F 2019	-0.7%	1.9%	-1.6%	1.2%
F 2018	2.0%	-2.2%	2.3%	-3.0%

The problem we see is there is little evidence that the higher prices are driving margins higher at all. Losing 50-100bp of gross margin against flat to negative sales doesn't grow earnings. Also, their touted goal is to shed low margin business. Look at 2018 before the Pinnacle deal – CAG was taking much greater hits in gross margin against flat sales.

Legacy CAG Gross Margin Change	4Q	3Q	2Q	1Q
F 2019	-100bp	-20bp	-58bp	-65bp
F 2018	+20bp	-160bp	-100bp	+20bp

It is probably worth noting as well that throughout the last earnings call, when asked "what will actually help sales going forward?" – there were six mentions by management that they are counting on "easy comps" to help. That is not the real long-term solution in our minds.

Other examples of value over volume strategy in specific products also do not point to much success:

- 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. What is the solution? Welcome to 1988 – they are going to hold higher prices and give out more "promotional support" to help drive volumes. After two horrible quarters, CAG thinks sales will return in the 2H of 2020.

- In 4Q19, CAG rolled out new Marie Calendar'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 Calendar's! CAG did continue to blame weakness in some of the frozen food on major retailer transitioning many of the frozen foods – which CAG considers temporary. To us, it sounds like CAG is part of that transition – with its goal to rapidly remade products. It also sounds like since it conceded market share to the competition, it's not the competition that's going to be given less shelf space in the near future. It caught our eyes too that the company made this comment in the last call, "We plan to build upon our category-leading position in frozen by introducing our strongest innovation slate to date throughout the balance of fiscal 2020…with premium, nutritious ingredients and increasing sustainability, all at **affordable price points**." CAG has been all about having higher prices to drive growth.

- Wish-Bone Salad Dressing was purchased by Pinnacle Foods in 2013. Pinnacle reported negative sales growth for Wish-Bone in 2015, 2016, and 2017. We know during 2018, CAG showed us Wish-Bone sales were falling more than 20% from 2017 levels with distribution down over 30% at times. In fiscal 2019, CAG showed Wish-Bone down 15%-20% against 2018's figures and finally after all these easy comps, Wish-Bone just posted a single quarter of basically flat results. In 2013, Pinnacle paid 3x the $190 million of sales at Wish-Bone. From the rough figures we have seen on its sales, it does not take much effort to ballpark sales at Wish-Bone are currently at $90-$100 million. And the plan is to fix this business by raising prices too?

- Duncan Hines and Birdseye were also key parts of the Pinnacle Foods deal. Both were showing declining and negative sales growth y/y before the deal and that has accelerated after the deal. At the time, CAG assured investors that what made this acquisition easy was Pinnacle had strong brands and there was no need to fix revenue – just cut duplicate costs. The first quarter of the deal saw significant revenue problems. Both brands have been posting negative growth rates for a year and that continues now. CAG has talked that it sees signs that they may stabilize in another two quarters and is talking about new products. In the meantime, the margins at Pinnacle continue to drag down CAG.

Inventories Point to More Gross Margin Pressure

As CAG continues to talk about its plans to boost prices, investors should remember that one-quarter of its sales are to Walmart. Kroger is another huge grocer that has been investing in lower prices for its customers. At the same time, while CAG also claims it wants value over volume – it has a considerable amount of volume to move at this time:

	1Q20	4Q19	3Q19	2Q19
Inventory	$1,755.7	$1,563.3	$1,638.6	$1,729.7
DSI	92.8	74.9	76.5	92.5

	1Q19	4Q18	3Q18	2Q18
Inventory	$1,108.5	$988.7	$1,016.7	$1,059.2
DSI	76.1	64.9	66.5	63.8

	1Q18	4Q17	3Q17	2Q17
Inventory	$1,068.8	$927.9	$1,046.4	$1,113.7
DSI	75.9	63.5	70.2	70.5

There is definitely some seasonality to the business and inventories are highest coming out of 1Q. Also, ignore the 2Q19, that was the quarter that included only a few weeks of Pinnacle Foods sales.

However, we believe inventories are running at least 10 days too high based on past results and a company that actively is working to maximize cash flow and digest an acquisition. Also keep in mind that at this point, no acquisitions have been made while CAG made three small divestitures: Del Monte's Canadian canned fruit/vegetables, Wesson Oil, and Gelit frozen pasta.

It also does not look like inflation in raw materials catching up – the growth is all in finished goods. Raw materials have held in the same 13-14-day range for two years.

	1Q20	4Q19	3Q19	2Q19
Raw DSI	13.9	13.1	13.1	14.2
Fin Gds DSI	67.0	52.5	51.5	63.1

	1Q19	4Q18	3Q18	2Q18
Raw DSI	13.1	13.3	14.0	12.3
Fin Gds DSI	53.7	42.5	42.3	41.1

While we expect higher inventories after 1Q, the current levels appear higher than normal. CAG is trying to sell higher volumes at higher prices to discount customers who want lower prices and have limited shelf space. We think this points sales pressure at CAG and more pressure on gross margins.

Conagra Also Touts its Cost Cutting Skills Too – We're Still Skeptical That the Cuts Are Sustainable

In the last four quarters, CAG has posted essentially no sales growth and lost gross margin in every quarter. However, the company is touting that its restructuring and cost-cutting are working well. Operating margins have been up for three of the last four quarters and more than offset the weakness in gross margins:

CAG Adj Op Margin	1Q20	4Q19	3Q19	2Q19
Adj Margin	15.7%	13.2%	16.3%	17.5%
Adj Margin Yr Ago	14.6%	13.9%	15.0%	15.7%
Y/Y change	1.1%	-0.7%	1.3%	1.8%

The problem we see is they are cutting advertising and have not booked as much stock compensation – which accounts for nearly all this improvement:

Advertising	1Q20	4Q19	3Q19	2Q19
Adv $	$45.3	$73.9	$67.4	$69.4
Adv $ year ago	$42.7	$59.5	$78.2	$86.0
Adv in bp	189	283	249	291
Adv in bp year ago	233	303	392	396
Adv cut bp	-44	-20	-143	-105

Stock Comp	1Q20	4Q19	3Q19	2Q19
Stock C. $	$10.2	$11.2	$3.8	$7.3
S/C $ year ago	$11.4	$11.2	$9.0	$9.5
S/C in bp	43	43	14	31
S/C in bp year ago	62	57	45	44
Adv cut bp	-19	-14	-31	-13

So, if we look at 3Q19, CAG reported adjusted operating margin was up 130bp, but it picked up 174bp from cuts to advertising and stock compensation. In 1Q20, more than half the 110bp improvement came from reduced advertising and stock compensation.

We doubt anyone should expect either of these cuts to continue. People like being paid, so we'd expect the stock compensation to rise again. At the same time, the company is touting that it will boost marketing across many channels – not just vendor investments that are accounted for as reductions to net sales.

We would expect head-count reduction after the merger to help some – and CAG announced on the call that is now substantially complete and do not expect much of a tailwind for margins in that area going forward.

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 Concerns"	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 may 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 the next quarter. 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

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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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