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Conagra Brands (CAG)- EQ Review Update

Conagra released 1Q19 results last week where it missed on EPS by 2-cents and revenues by $20 million. What is even more surprising about that is we highlighted falling advertising expense as an area that has driven past earnings and could become a headwind. Yet, advertising fell another $12.2 million in the quarter y/y, which added 2.3-cents to EPS and the company still missed by 2-cents. We are updating the July 26, 2018 report on CAG in this report.

We were concerned with the following items:

Cash Flow Declining.

This happened again in the 8/18 quarter with Cash flow dropping from $136 million to $95 million and capital spending doubling from $43 million to $86 million. The company made no repurchases in the quarter. On a trailing 12-month basis, cash flow after repurchases continues to be negative and dividend coverage is tighter:

TTM	18-Aug	18-May	17-May
Cash Ops	$879	$920	$1,141
CapX	$296	$252	$242
Free Cash Flow	$583	$668	$899
Dividend	$342	$342	$415
Dividend % FCF	59%	51%	46%
Repurchases	$667	$967	$1,000
Cash Flow after Repurchases	-$426	-$642	-$516

Accounts Payable Continue to Rise as Seen by DSPs.

This happened again and reached 67 days in the 8/18 quarter.

	18-Aug	18-May	18-Feb	17-Nov
A/P - DSPs	67	60	57	53

	17-Aug	17-May	17-Feb	16-Nov
A/P - DSPs	60	53	46	50

These jumped by 7 days last quarter y/y, which is following a jump y/y jump for several quarters now. Stretching payables is becoming more common in the food industry to help cash flow. We still think there are limits as to how much this can grow and think investors should be concerned that it is not helping CAG's cash flow.

We also noted in the July 26 report, CAG has set up a third-party system whereby suppliers can get advances against the payables that CAG owes them. The amount advanced was flat from 5/18 to 8/18 at $103 million. This may be a signal that suppliers may not be willing to go much longer on payment terms with CAG and it may not be able to stretch payables the same rate going forward.

	18-Aug	18-May	18-Feb	17-Nov	17-Aug
Accts Pay	$984	$915	$870	$887	$846
Utilized 3rd Party Advances	$103	$103	$81	$69	$59
% of total Payables	10.5%	11.3%	9.3%	7.7%	7.0%

The Pension Benefit to Income Did Decline. We noted that CAG was very clear that after paying into its pension in recent years, changing the terms for salaried and non-qualified employees, and changing its investment focus that after booking pension income of $56 million and $21 million in fiscal 2018 and 2017 it would decline. CAG's forecast is a $46 million drop for fiscal 2019. In the 8/18 quarter, the drop was $5.9 million in pension benefit. This is an area where EPS probably came in 1 cent ahead of expectations and CAG still missed forecasts.

Advertising Expenses Declined Again. We were concerned that CAG would see a headwind to earnings as advertising and promotional costs would need to rise again in the future. They declined by another $12.2 million y/y in the 8/18 quarter and continued to help EPS by 2-cents.

TTM	18-Aug	18-May	17-May	16-May
Sales	$7,968	$7,938	$7,827	$8,664
Utilized 3rd Party Advances	$267	$279	$328	$347
% of total Payables	3.3%	3.5%	4.2%	4.0%

Pinnacle Foods Deal Expected to Close Ahead of Schedule. We addressed many of the problems we have with this acquisition including the price paid, the debt involved, and forecasted synergies being unlikely in our August 9, 2018 issue. We do not think paying a premium price for assets that have already seen extensive cost-cutting will have an abundance of low-hanging fruit to pick in another wave of restructuring.

Essentially, CAG will issue more shares and considerable debt to buy Pinnacle. It does not intend to resume share repurchases until debt is at 3.5x EBITDA. That could take over 4 years for a company projecting about $500-$700 million in free cash flow. Also, the dividend where coverage is getting tighter is not expected to grow in this fiscal year.

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