BEHIND THE NUMBERS
Quality of Earnings Analysis

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Conagra Brands, Inc. (CAG)
Earnings Quality Update- 8/21 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 coverage of CAG at 2- (Weak) and moving it back to the Top Sell list.

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

Summary

CAG reported a 2-cent adjusted EPS beat for 1Q22. Non-operating items created all of the beat: an increase in pension income was 0.4 cents, the equity-income investments – primarily the flour milling business, which CAG spun-off because its margins were too low – is enjoying higher demand, and the higher income there added 2.2 cents to CAG's results. CAG noted that it earned 1-cent from rounding its results. FX provided 0.5% benefit too which was as much as another 2.2-cents. We would argue that this collection of 5-6 cents in additional EPS has nothing to do with CAG's operations.

The company also noted that it had to deal with $25.4 million of Covid-related supply chain issues, but that was down y/y. We can't quantify the change, but we know that helped EPS too. Plus, the higher wages and shipping costs may be here to stay for much of this year.

The company is also facing several headwinds as Covid-driven demand wanes, sales require more advertising and promotion, and cost inflation is limiting the impacts of price increases. CAG believes its price hikes will even out with commodity costs more in 2Q and 3Q and exceed the costs in 4Q results resulting in a back-loaded year. Guidance for a 16% operating margin will return CAG to 2018's and 2017's results before they devoted years and hundreds of millions of dollars to restructuring that is still continuing. CAG also picked up $13.9 million, or 2.2 cents per share, from a year-over-year decline in stock option expense.

What is weak?

- CAG is cherry-picking how it reports results by using a two-year comparison to show that it is actually growing. Management reports that organic growth fell 0.4% y/y from 1Q21, but is up 7.0% against 1Q20. However, people should remember the history here. In fiscal 2018 and 2019, CAG bought Pinnacle Foods and watched it blow up on them with enormous product portfolio problems, disappointing sales, and several quarters of reduced sales. During fiscal 2019 and fiscal 2020, CAG was pushing its "Value over Volume" plan whereby it would raise prices more than competitors and concede volume if necessary – (We don't hear much about that plan anymore do we?). Inventory was piling up at CAG before Covid and they couldn't sell it. But if we start in 2017 and track organic volume change – it appears that consumers are not buying any more CAG products than they did 5-years ago:

	1Q22	1Q21	1Q20	1Q19	1Q18	1Q17
CAG Vol Change	-2.0%	10.9%	-2.5%	0.0%	-5.3%	
Index from 2017	100.3	102.4	92.3	94.7	94.7	100.0

- What about Pricing and Operating Margins over this time? CAG is always restructuring and reducing costs as well as pushing for more price hikes. And pricing is up over the last five years, with much of that coming from reduced promotional spending in stores in fiscal 2021:

	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%	

  The company is forecasting an adjusted operating margin of 16.0% for fiscal 2022. That is lower than 2020 (16.5%) and 2018 (16.1%) and almost even with 2017's (15.8%). This company has restructured for years, culling lower margin units, raising prices, streamlining processes, renewing product lines. What we see is they have not become more profitable, pricing, for the most part, offsets higher commodity/supply-chain costs, and consumers are not buying any more product now than in 2017. But, CAG is touting a 7% growth rate with rising profitability.

- Promotional spending returned in the quarter too. For all of fiscal 2021, CAG reported a 3.1% pricing gain. About half of that was due to steep cuts in store promotions which are netted against sales. On the 4Q21 call, CAG touted that they would be very selective in adding back promotional spending and had a rather detailed discussion with one analyst who agreed with our thesis that as panic buying ends, the normal supplier/retailer model

will return, and higher promotional spending will cut into pricing gains. Basially, why will the retailers give CAG free space on the shelves when others are paying for space? CAG pushed back hard against that notion saying that in the past much of that traditional store-promotion spending was inefficient and they're so good at pulling costs out, they could actually see more areas to cut back promotional spending further to offset spending that is restored.

Flash forward only a couple of months and CAG reported a 70bp headwind to pricing (taking its commodity-induced price hikes from 2.3% to 1.6%). That cost CAG 3-cents in EPS in the quarter and they clearly would have missed forecasts without the surge in equity investment profits. It is worth noting that this $18.8 million headwind was related to boosting their trade allowance that was cut in 4Q20! So, it pulled down the allowance FIVE quarters ago, which helped earnings at the start of Covid – AND it has not had much in the way of promotional spending again until just recently. This looks like a headwind that could continue to rise going forward. CAG's forecast of having pricing look stronger in 2Q, but not fully offsetting cost inflation – may be the result of more promotional spending.

Advertising is rising too - $62.2 million vs. $45.9 million y/y. In the past, we have noted that CAG is spending less on advertising after acquiring Pinnacle Foods than what it spent as a smaller company. These cuts added about 60bp to margins but seem to be returning. For a company really touting many new product roll-outs to help pricing – we do not see how they can avoid higher promotional spending and advertising.

- Don't look now – but CAG's Inventory DSIs are rising again. They are arguing seasonality ahead of the holidays, but before their Pinnacle and Value over Volume ordeals – inventories were normally about 76 days vs. the current 90.

	1Q22	1Q21	1Q20	1Q19	1Q18
Inv. DSIs	90.1	77.1	92.8	76.1	75.9

On the positive side, this may make some supply disruptions more manageable. On the negative side, rising input costs and growing the number of days outstanding is consuming cash flow. Rising input costs creating higher pricing also means receivables rise in dollar terms and consume cash. As a result, CAG's net debt is flat as it spent cash on hand to meet the shortfall from lower cash flow and EBITDA falls against the Covid numbers. Debt/EBITDA is now 4.0x vs. the target of 3.5x. Mangement expects this ratio to decline going forward, but it's not as though EBITDA comps get easier in the next couple of quarters.

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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