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Conagra Brands (CAG)– 1Q'21 Update
Upgrade to NEUTRAL from SELL

CAG is one of the stronger beneficiaries of COVID and the lockdowns. **When we last wrote about CAG, it was still cutting guidance for the third time on both sales and margins.** It further had too much inventory on hand. **Enter COVID and the mad scramble for anything in a grocery store, and CAG suddenly touts that its multi-year disappointment with the Pinnacle Foods acquisition is now a rousing success. We remain skeptical** of that and the fact that it was still taking impairments on acquired intangibles after COVID illustrates our concerns.

We are moving our rating on CAG to NEUTRAL based largely on COVID cleaning up the balance sheet. It beat EPS estimates by 13-cents by posting an adjusted 70-cents in 1Q21. **It wouldn't be Conagra if it didn't add back 4-cents from its continual restructuring. It picked up 7.3-cents from in-store advertising switching from a $30 million drag on sales last year to a $16 million credit in 1Q21.** Going forward, CAG expects in-store advertising to become a rising expense again. It gave amazingly low guidance in our view given seasonal tailwinds along with COVID issues. **ROI is only 11.9% giving CAG full credit all the COVID increased earnings and reversal of marketing. It falls to 10.5% with minor adjustments** in those areas and assuming some of the cash on hand is used to rebuild working capital:

Items that deteriorated

- Guidance looks weak at 6%-8% organic sales growth for 2Q21 after stating that sales should stay elevated for a much longer period.
- Recent sales growth of 15% in 1Q21 was padded by retailers restocking inventory adding 600bp to growth.

- Retailers are still rebuilding inventories and 2Q also has a seasonal build-up. CAG could pick up another 600bp of sales growth simply from this source again – meaning adjusted sales may be back to pre-COVID growth rates already.
- Even with all these potential sales and high operating rates, CAG's guidance for margins is forecasting a sequential decline and a y/y gain of only about 100bp vs. about 400bp of gains during COVID.
- Some of its newest products that CAG had high hope for took an impairment charge in 4Q20 due to lower than expected sales and profit margins – this was during COVID.

Items that improved

- Net Debt is down $1.3 billion y/y in 1Q21. That is a combination of cash increasing and hefty debt repayments in 4Q20.
- Net Debt to EBITDA is down to 3.7x at this point.
- CAG has positive volume gains for the first time in years due to COVID and stores still need to restock further.
- Operating leverage drove large gains in operating margins and profits.

Ongoing Issues

- CAG's focus on raising prices to drive future sales growth runs counter to what retailers want as they want to reduce prices to consumers.
- Kroger store brands are taking market share and CAG has a history of disappointment when it boosts prices but other brands do not.
- In-store promotional spending is a drag on sales. By reversing an accrual in this area vs. a sizeable cost in 1Q20 – CAG picked up 7-cents in EPS last quarter. It simply didn't need to do much promotion in the worst of COVID. That is expected to become a rising drag on sales going forward. Guidance is CAG will see less operating leverage too and hurt operating margins going forward.
- Can CAG drive volume gains once restocking is complete?
- CAG's own inventory looks very low and should require rebuilding. The big debt paydown and cash build was the result of pulling almost $400 million in cash from inventory and payables. Those may reverse in 2Q to a much larger degree than even 1Q and boost net debt levels.

Sales Growth Was Poor Pre-COVID and Guidance is Very Poor in Our View

The goal at CAG is to drive organic growth with pricing even if that means some volume loss. That has been the trend for years:

Org. Growth	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19	4Q18	3Q18
Volume	-1.3%	1.0%	-2.5%	-1.2%	1.2%	-2.2%	0.0%	-0.1%	-2.8%
Price	-0.4%	1.8%	2.5%	0.7%	2.1%	1.1%	2.1%	2.1%	0.6%
Retail Inv.	n/a	-1.2%	-1.7%	-0.2%	-1.4%	-0.5%	-0.9%	n/a	n/a
Organic Growth	-1.7%	1.6%	-1.7%	0.5%	1.9%	-1.6%	1.2%	2.0%	-2.2%

- Coming into COVID – CAG had positive volume growth twice in 10-quarters and both times after horrendous quarters the year before.
- In 3Q20, CAG said retail investments to support products were a headwind – likely pricing was positive but became negative when netted against the marketing.
- Before and after 2Q20, guidance for the year was 1.0%-1.5% organic growth. During 3Q20, guidance was cut to 0.0-0.5% organic growth. After 3Q20, CAG simply said it expected to beat the 0.5% figure.

What happens with COVID? Volume suddenly takes off at unheard of rates. People are stuck at home. They panic buy what they can:

Org. Growth	1Q21	4Q20
Volume	10.9%	21.0%
Price	4.1%	0.5%
Retail Inv.	n/a	n/a
Organic Growth	15.0%	21.5%

- 4Q figures were extreme and retail investing dropping considerably. We did not see it quantified.
- **1Q21, it looks like the good times are still really good. But, according to the company, 600bp of volume was due to stores restocking inventory – not consumer sell-through. Also, retail investment accruals were reversed and added 70bp to**

pricing. That makes adjusted growth 8.3% in the quarter with the most COVID issues.

- Guidance is even more puzzling – We know from Kroger that it still wants to build inventories higher and there is a seasonal build that happens in this quarter too. CAG says it sees the same thing – yet guidance for 2Q21 is for 6%-8% organic growth! If they pick up another 400-600bp in restocking demand – organic growth may already be declining back to pre-COVID levels for CAG.
- A further headwind will be marketing spend in the stores will return. This will net against pricing in organic growth. According to the earnings call, *"Relative to Q1 operating margin, we expect less operating leverage benefit and* ***we expect to increase our marketing support both above the line and below the line."***
- Some of the key sources of growth in 1Q21 – were brands with amazingly easy comps:
    - Wishbone up 16.9% in 1Q21 – we know Wishbone had negative sales growth in 2015, 2016, 2017. It then fell more than 20% in 2018, it fell 15%-20% in 2019 and was up slightly in 2020.
    - Hunt's up 14.7% in 1Q21 – In late 2019 and early 2020 – Hunt's was down 11% in 4Q19 and 9% in 1Q21.
    - Chef Boyardee up 5.6% in 1Q21 – after being down 6.7% in 4Q19 and 1Q20 triggering an impairment charge on these assets.
    - A year ago, Marie Calendar's fell 20% - it didn't make the list of growing brands in 1Q21.

Guidance for Adjusted 2Q21 Operating Margin Also Looks Weak

CAG is guiding to 18.0%-18.5% adjusted operating margin. That sounds very low in our view, given that 2Q is normally the highest margin period:

	1Q21	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19
Adj Op. Margin	20.2%	17.1%	15.7%	17.1%	15.7%	13.2%	16.3%	17.5%

- Even in 2018, 2Q was the highest level of operating margin, with the normal seasonality as holiday stocking began.
- The higher sales level expected – especially on volume, should leverage fixed costs and boost margin. Yet, CAG expects margins to fall by about 200bp sequentially.

- Not only do CAG customers need to build inventory, but CAG needs to boost its own inventory in what is seasonally the time for a build-up and it's starting 20 days below the year before due to heavy COVID demand:

	1Q21	4Q20	3Q20	2Q20
Inventory	$1,579.6	$1,377.9	$1,646.5	$1,770.4
Adj. COGS	$1,867.9	$2,165.3	$1,843.6	$1,530.4
DSI	77.2	58.1	81.5	105.6

	1Q20	4Q19	3Q19	2Q19
Inventory	$1,755.7	$1,563.3	$1,638.6	$1,729.7
Adj. COGS	$1,662.9	$1,837.8	$1,805.1	$1,594.0
DSI	96.3	77.6	82.8	99.0

- As we have shown in past reports, CAG's margin gains over time have much more to do with culling/divesting lower-margin units out of the results. The company has continued to do that in fiscal 2020 and fiscal 2019:
    - 3Q20 – sale of Lender's bagels for $32.2 million
    - 2Q20 – sale of Direct Store Delivery snacks for $137.5 million
    - 4Q19 – sale of Gelit frozen pizza for $80.1 million
    - 4Q19 – sale of Wesson oil for $168.3 million
    - 1Q19 – sale of Del Monte Canada for $32.2 million
- CAG also claims it exceeded synergy targets in fiscal 2020 and gained even more in 1Q21. It believes it has taken costs out of the supply chain as the biggest driver of these synergies.
- In 1Q21 they had supply constraints, they had short periods when production was shut-down due to Covid-Issues and ways to protect employees were created.

CAG has just seen operating margins rise y/y by almost 400bp for two quarters on the back of enormous operating leverage as volume growth hit record levels. It has seasonality in its favor, it has inventory building at customers, and its own inventory needs driving what should be the 3rd best volume quarter ever. Yet, the guidance is for operating margins to increase only about 100bp this quarter? What happens when production levels are at normal levels? What happens when more retail investment is needed and/or CAG has a tougher time taking pricing?

The Battle of Branded Goods at Higher Prices vs Store Brands Remains – CAG Still Taking Impairments

One of the issues we have had with CAG's operating model is it is difficult to take pricing because competitors get on the shelves by cutting prices. Also, the supermarkets have their own store brands, organic brands, and health-conscience brands too that typically sell for less than branded goods.

We talked about this issue many times in past reports where CAG was losing market share with Hunt's canned tomatoes to store brands and Chef Boyardee was losing share in prior quarters as well to the point that CAG took impairments against assets. The reason for the market share losses was CAG boosting prices while store brands didn't follow suit widening the price gap.

We saw Kroger's CEO Rodney McMullen announce that it is committed to investing its restructuring efforts into lower pricing for customers and its goal is to make it cheaper to shop at Kroger:

> *"**We've promoted throughout the pandemic**. Now we did change what we promoted, because obviously, you want to promote what you have, so we would have not promoted paper towels and toilet paper and certain meat items and things like that because just the availability of supply. But we've had promotions throughout the pandemic and it's really on the things that matter.*
>
> ***We continue to invest in price and we think it's really important** that we think customers will look at it reflectively that we've been there to support them throughout to help them stretch their budgets. So the – **as Gary mentioned, waiving the pickup fee, continuing to invest in promotions, continuing to invest in price, all of those are things that we believe will pay off. Our customers will reward us for what we're doing over time.***
>
> *On market share, I specifically talked about fresh, but **we continue to gain share in the center store fresh and all areas of the store and our own brands continue to gain share as well.**"*

Gary Millerchip - Chief Financial Officer added:

> *"I think, as we've shared kind of consistently, our goal is really to be balanced in the business model and **continue to balance the [price] investments we'll be making in supporting the customer which is certainly our continued intent with the savings that we achieved through sourcing benefits** and then of course alternative profit being accelerator of gross margin as well."*

The CEO also talked about its products gaining popularity and taking market share:

> *"Our customers are eating more at home, and we are seeing some customer segments trade up to the larger pack sizes as well as more premium quality foods and natural and organic foods.**Our larger sized big pack platform is up well over 50%. Private Selection is up over 17% and Simple Truth is up over 20% in the second quarter. Our brands continue to tap into emerging trends and evolving customer needs,** delivering new flavors and innovative new items like the new plant-based Emerge grinds and patties, which launched in late 2019.*
>
> ***A recent third-party industry study reconfirmed that Simple Truth is the most loved natural and organic brand in the U.S. Simple Truth significantly outperformed competitors on strength of brand,** which is a combination of awareness, willingness to recommend and strength as the driver of store selection. In continuing to exceed our customers' expectations of value and quality, while also consistently delivering innovative new items our customers love, our brands remain one of our most powerful competitive advantages."*

Gardein is another case in point. This was an acquired brand for meatless products that CAG couldn't stop raving about the potential only a year ago. New products, appeals to health, a new source of growth off a low base…. Here is what CAG said about *Gardein* one year ago in 1Q20:

> *"Another brand in our portfolio with **significant growth opportunity is Gardein**, which we spoke about at length last quarter. **We're working hard to continue to build out the Gardein brand to capitalize on the explosive growth in the plant-based meat-alternative space**. The Gardein foodservice business grew an impressive 25% in the first quarter and continues to accelerate penetration across multiple Foodservice channels. As we shared with you last quarter, the brand is the second largest in the plant-based meat alternative space and has already quadrupled in size over the past four years.*

<u>In retail, we expect our Gardein to gain prominence in both frozen and refrigerated as we introduce more high-quality innovation. On-trend brand with modern attributes, Gardein is uniquely positioned to generate superior velocities</u> *by leveraging Conagra's culinary capabilities, differentiated packaging techniques, and our diverse portfolio of power brands. And we are well-positioned to support Gardein's continued growth with new capacity coming online during Q2."*

In 4Q20, CAG took a $146.2 million impairment charge against intangible assets. The rationale was:

*"**<u>The more notable brands with impairments include Frontera®, Gardein®</u>**, Glutino®, Hungry Man®, and Udi's®. While most of our recently acquired brands continue to remain on track with previous assumptions, **<u>these brands have had lower than expected sales or profit margins</u>** which have led to some revisions in our original assumptions (most notably declines in our assumed royalty rates)."*

Credit to CAG for Paying Down Debt with COVID Cash

In 4Q20, the rise in income and the release of cash from inventory and payables allowed CAG to retire debt and boost cash on hand to effectively lower net debt by over $700 million. Net debt fell by over $1.2 billion during the full year and was also helped by nearly $200 million in proceeds from divestitures:

	1Q21	4Q20	2020
Cash from Ops	$284.5	$936.1	$1,842.6
Cash from Inv/AP	-$182.0	$386.1	$11.8
Divestitures	0.0	3.2	194.6
Debt Paid	$133.4	$281.6	$947.5
Cash Increase	-$5.1	$444.3	$316.7
Chg. Net Debt	-$128.3	-$725.9	-$1,264.2

We are pleased to see the company accelerate debt reduction when income and cash flow are strong. The high debt level was one of our primary negative parts of the CAG story in the past. It seems likely that working capital will be a drag in 2Q and reclaim some of the cash on the balance sheet, but they have the liquidity to handle that.

However, if CAG's results drop from the amazing levels of the last two quarters and/or the cash balance falls to rebuild working capital - the net debt to EBITDA ratio of 3.7x may actually rise. Here is the current situation:

	1Q21
Financed Debt	$9,616.8
Cash on Hand	$438.2
Net Debt	$9,178.6
Adjusted EBITDA	$2,462.9
Net Debt/EBITDA	3.7

- If rebuilding working capital consumes $200-$300 million – the ratio increases to 3.8-3.9x
- We know that CAG had 70bp of sales come from reversing an accrual on in-store marketing in 1Q21. It had a 170bp drag on sales from the same item in 1Q20 that fell out of EBITDA – that's a positive $46.4 million swing and the company says in-store promotion is returning.
- We know that CAG offered employees a lump-sum settlement of pension payments in 2020 and booked an outsized expense of $42.9 million that was added back to adjusted EBITDA. We would argue that expense would have been recognized over time and not added back if dealt with under the original terms.
- Adjusting for these three items – the ratio rises to 4.0x.

The recent trailing four quarters of EBITDA have certainly been helped by rising sales and nearly 400bp of margin gains. Pre-COVID, adjusted EBITDA was running about $2.0-$2.1 billion:

	1Q21	4Q20	3Q20	2Q20	1Q20
Adj. TTM EBITDA	$2,462.9	$2,297.0	$2,065.4	$2,104.6	$2,015.0

Guidance is for the margin gain to be much more subdued in 2Q21 and for sales growth to be at best half of 1Q21's level. This is a bit crude, but what if organic sales growth had been 5% lower for both 1Q21 and 4Q20 and margins improved by only 200-350bp. What impact would that have on EBITDA:

- 1Q21 saw 15.0% organic sales growth and 450bp of adjusted operating margin gain. That resulted in y/y operating income growth of $165.8 million. That went into the new higher EBITDA figure.

- If 1Q21 had only 10.0% sales growth and only 350bp of margin gain, EBITDA would have grown by $119.3 million – lighter by $46.5 million. At a 250bp margin gain, EBITDA would have grown by $93.6 million - $72.5 million lighter.

- 4Q20 saw 21.5% organic sales growth and 390bp of margin gain. That added $218.4 million to EBITDA.

- If 4Q20 had only 16.5% sales growth and the 17.1% margin was 16.1% instead, operating income would have only grown by $135.1 million – a drop of $83.3 million. A margin of 15.1% would have resulted in EBITDA falling by $113.0 million.

The reason we are showing this is CAG is already giving guidance closer to this type of growth, with guidance of 6%-8% revenue growth, not 15%, and 100bp of margin gain, not 450bp. The company is forecasting that it holds some of the higher levels of sales for a longer period of time. Also, the huge growth figures are going to remain in trailing EBITDA for a year. But, if margins start coming in below 4Q20 and 1Q21 going forward, and sales don't top those +15% and +21% gains – CAG is going to report lower EBITDA in the future.

Our conclusion is it does not take much of the bloom off recent results to assume operating income growth may have seen $130 million that won't be sustained ($46.5 million in 1Q21 and $83.3 million in 4Q20). That would be a combination of lower volumes and pricing pressure due to more in-store advertising hurting sales and margins.

If we add that to the $46 million positive swing in 1Q21 on accruals that helped results and the pension cost of $43 million – It may be more realistic to view EBITDA as being closer to about $2.25 billion going forward. If we assume $200 million in cash rebuilds working capital, the debt to EBITDA ratio becomes 4.2x again ($9.4b in net debt over $2.25b of EBITDA).

Explanation of EQ Rating Scale

Rating	Explanation
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

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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