BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Conagra Brands – 2Q '20
Maintain SELL

We are maintaining our SELL on CAG after beating adjusted EPS forecasts by 6-cents. A quick look shows that 3.3 cents of the beat came from cutting advertising as a percentage of sales. Given that CAG took a $27.6 million impairment to divest two smaller parts of the portfolio, we believe those units were not very profitable and removing them from adjusted results likely helped adjusted EPS too. It is interesting to note that both adjusted gross profit and adjusted operating margin still declined – down 105bp and 39bp. And as we noted last after 1Q, the company was relying on "easy comps" to boost sales in the 2Q – that won't be the case in 3Q.

- **Inventories remain very high at 79.9 days.** The 2Q'19 figure was skewed with the Pinnacle deal happening during the quarter and was 92.5 days. We will ignore that and look at prior years when **2Q inventories were 63.8 days in 2018 and 70.5 days in 2017. Just like 1Q20 – inventories still appear about 10-days too high.**

- **Inventories rose sequentially**, but 1Q and 2Q are the seasonal times for inventory build. Given the jump in 1Q and DSIs already running above historic levels by at about 10-days, we were still surprised to see inventories rise in dollar terms in 2Q'20, even the modest $15 million. **We believe that will still pressure gross margins and as noted, gross margin was down 105bp in the quarter y/y adding back one-time adjustments.**

- **Easy comps came through and CAG posted a 1.6% organic growth figure** for the quarter on 1.0% volume growth and 0.6% on price/mix. **This was against a y/y comp of -2.2% on volume and sequential drop in volume of -2.5% from 1Q20.** We would hope CAG could do something against that, but a 1.0% volume growth figure does not impress us. 3Q20's comp is going to be tough again against this quarter and 1.2% growth in 3Q19.

- **CAG continues to slash advertising – that doesn't bode well for boosting prices and taking market share in our view.** They are arguing that some of the spending is going to retailer incentives, which are recorded as a reduction of sales. However, that was the case in prior years too. CAG is also saying that they are finding synergies in advertising with Pinnacle. **However, CAG was spending $330-$350 million as a stand-alone company and Pinnacle $30 million. The combined entity just spent $247 million** on advertising for the trailing 12 months with several product launches. **We think this is the largest source of CAG's cost-cutting and this looks like cuts to muscle not fat.**

Advertising	2Q10	1Q20	4Q19	3Q19	2Q19
Adv $	$60.7	$45.3	$73.9	$67.4	$69.4
Adv $ year ago	$69.4	$42.7	$59.5	$78.2	$86.0
Adv in bp	215	189	283	249	291
Adv in bp year ago	291	233	303	392	396
Adv cut bp	-76	-44	-20	-143	-105

This quarter saw a 76bp cut on top of 105bp cut last year. That's a considerable amount of margin gain for CAG – and yet operating margin still declined 39bp in 2Q20.

- **Key products are also matching against very easy comps and still posting negatives.** For example, Birdseye retail sales are still negative, at about -2% for the quarter. However, CAG saw a huge improvement in distribution stocking, which had been running -12% last year. Even against that easy comp and a graph showing a surge in distribution – the y/y figure remains negative. That was the largest part of the Pinnacle deal. Hunt's Tomatoes grew volume by 0.7% in 2Q, after posting -10.8% in 4Q and -8.9% in 1Q. Chef Boyardee had a -4.5% volume figure in 2Q, but that came after two quarters of -6.7%. Wishbone came back to about a 0% figure against a -25% comp. **We see all of this as evidence that CAG has many key products that are still having problems and boosting prices will not be easy as CAG continues to tout value over volume. The lower gross margin shows this plan isn't producing much in results:**

CAG	2Q20	2Q19	2Q18*
Volume	1.0%	-2.2%	1.7%
Price/Mix	0.6%	0.6%	0.6%
Organic Growth	1.6%	-1.6%	2.3%
Gross Margin chg.	-105bp	-58bp	-100bp

*2Q18 had a 220bp positive increase in sales due to hurricane-related purchases

The weak volumes are simply offsetting pricing and hurting gross margins. This has been the case in looking at other quarters too. The last two 1Qs showed gross margin decay of 30bp and 60bp.

- **We remain extremely skeptical of CAG's ever-rising synergy targets. Every time CAG has something that reduces sales or products have to be rebuilt – they immediately claim they found even more synergies that won't cost much money.** In our view, Pinnacle Foods was a company owned by a financial group who stripped out all the fat after a series of acquisitions. Yet, CAG announced it could find synergies amounting to 700bp of sales from Pinnacle. After Pinnacle became a revenue and product disappointment that required extensive rebuilding – Pinnacle raised its synergy target and lowered the cost it would need to achieve it. **Now after divesting two units this quarter and posting another decline in gross margin, CAG announced it found another $20 million of synergies that will all come through this year (even as the rest of the savings announced over a year ago won't be achieved until 2022).** That $20 million will be recycled back into retailer incentives to try to help sales and margins. Despite the headwinds of lower margin, new synergies are supposed to allow margin forecasts to remain flat:

CAG 2020 Guidance	Prior to 2Q20	After 2Q20
Org. Sales Growth	1.0%-1.5%	1.0%-1.5%
Adj. Oper. Margin	16.2-16.8%	16.2-16.8%
Adj. EPS	$2.08-$2.18	$2.07-$2.17

So far organic sales growth for the year is 0.1%. CAG has to match against positive sales comps y/y and sequentially for 3Q20. Gross margins are down 73bp YTD with operating margins up 21bp. We know the operating margins are being fueled by cuts to advertising too. The operating margin YTD is 16.5% well within the guidance, but if sales growth is weak in 3Q against tougher comps and advertising cannot be cut to the same degree, CAG could have a problem on that forecast too. If the $20 million of additional synergies come in as $5 million in 3Q and $15 million in 4Q, the 3Q

results could look weaker as we would expect more brand-building investment sooner rather than later. That could hurt margins and sales.

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.

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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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