BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Conagra Brands (CAG) Update
Cuts Guidance Again – Strike Three?
Maintain SELL

CAG cut guidance again during the holiday this week blaming poor sales in December and January as an industry problem. We are maintaining our SELL recommendation. The WSJ had an article on Wednesday about how the grocery stores have more control over products these days than the food companies and are emphasizing more store-brand products. It also noted that Clorox lost selling space for Glad products when it boosted prices. We see situations like that as key problems for CAG's Value over Volume plans of raising prices. The company already reported the bottom fell out of multiple products in prior quarters when it raised prices and store-brands did not. At a conference on Tuesday, CAG never mentioned its Value over Volume plan.

We think investors should be alarmed about the following issues:

- **This is not the first time CAG has cut guidance.** After the Pinnacle Foods deal, revenue forecasts were cut in 3Q19 and missed for FY19. FY20 forecasts for revenue were cut after FY19 and FY20 EPS was cut after 2Q. Now it has cut revenues and EPS again. FY20 forecasts call for lower EPS two years after the merger as the best case.

- **After Pinnacle Foods became a rescue plan for the products and revenues instead of merely integrating two companies and cutting overhead – CAG touted its prowess in remaking brands with new products. Pinnacle's portfolio was going to roll-out many new products in 2H20 and return sales to high levels. They just cut 2H20 sales forecasts.**

- **CAG also cut margin forecasts.** We cannot recall a quarter when management didn't tout that they are exceeding synergy goals and achieving them earlier than planned. Also, they are divesting lower margin weak brands. We have noted that CAG's history of growing margins is much less about brand building and more about divesting lower-margin items.

- **We noted that inventories looked at least 10-days too high coming out of 2Q20. We believed that would pressure pricing, lead to more incentives, and write-offs. CAG noted that it is reducing guidance because it will write-off more inventory in 2H20.**

- **The company had easy comps in the 1H20 and sales were still very weak with a 1% volume gain in 2Q20. Now comps get tougher and CAG is posting lower to negative sales overall and in key products.**

- **We have pointed out in the past that rolling out new products juices reported sales growth because CAG is essentially stocking the channel and doesn't need retail sale-through to equal to the inventory filling the store shelves. There is a one-time bump from that, but it has downsides on existing merchandise. CAG is owning up to those downsides at the Tuesday conference.**

Guidance History Shows Lots of Cuts

CAG came out of fiscal 2018 with EPS of $2.11 after posting organic sales growth of -0.2%.

- Fiscal 2019 guidance was for 1-2% organic sales growth

- Fiscal 2020 was expected to see EPS accretion of low-single digits from 2018

- 2Q19, guidance for 1-2% organic sales growth added total EPS forecast of $2.03-$2.08 with PF diluting results

- **3Q19, guidance for organic sales growth was cut to 1%**

CAG finished fiscal 2019 with EPS of $2.01 - a miss, and organic sales growth of 0.3% - a miss. Legacy CAG had sales growth of -1.6% and posted $2.15 in EPS. PF came in at -$0.14

- **Fiscal 2020 guidance was for 1.0-1.5% organic sales growth - a cut** and EPS of $2.08-$2.18. The low end would be negative vs. the accretive forecast after the PF deal.

- **2Q20 guidance is cut for EPS** range of $2.07-$2.17.

- **Within 3Q20, guidance is cut to 0%-0.5% organic sales growth and EPS of $2.00-$2.07 – all below original guidance.**

- **Operating margin guidance falls from 16.2%-16.8% to 15.8%-16.2%**

Organic growth and Margins have not been very strong at CAG to begin with:

	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19	4Q18	3Q18
Volume	1.0%	-2.5%	-1.2%	1.2%	-2.2%	0.0%	-0.1%	-2.8%
Price	1.8%	2.5%	0.7%	2.1%	1.1%	2.1%	2.1%	0.6%
Retail Inv.	-1.2%	-1.7%	-0.2%	-1.4%	-0.5%	-0.9%	n/a	n/a
Organic Growth	1.6%	-1.7%	0.5%	1.9%	-1.6%	1.2%	2.0%	-2.2%
Adj. Op Margin	17.1%	15.7%	13.2%	16.3%	17.5%	14.6%	13.9%	15.0%

One of the reasons we were expecting a disappointment in 3Q20 was CAG only posts growth after an abysmal quarter. In 2Q20, it had an awful 1Q20 and 2Q19 to match against. And yet, margins declined.

The Second Half of 2020 Was When Pinnacle Foods Was Supposed to Shine

The biggest miss and admission that Pinnacle Foods was overpriced at more than 15x EBITDA was only months after the acquisition – CAG announced that Pinnacle sales were falling rapidly. It also noted that it would need to remake much of the product lines and rebuild the brands. This surprised CAG too. It expected to see cost synergies only, but to soften the blow of falling margins and revenues – it announced with 2Q19 results that it could find revenue synergies.

> *"The synergies we say in the upside, these are the cost synergies right. So, the $215 (million) were cost synergies. <u>We did not build any revenue synergies into our model.</u> Now obviously the business is down relative to what we had modeled, so we have to do all the things we discussed to bring that business back. But when you talk about upside going out long-term, we believe that <u>there could be a side on revenue synergies. That's not in the updated cost synergy number that we will have."</u>*

> *"On sales, we now estimate the Pinnacle portfolio will land calendar year '18 at roughly $3 billion, which is <u>about $160 million or 5% below Pinnacle's target</u>. Approximately $30 million of this miss is driven by our post close decisions to exit some year-end promotions that we saw as extremely low ROI. <u>At adjusted gross margin, we now estimate Pinnacle would have closed out calendar year '18 at approximately 28%, which is roughly 230 basis points below its internal targets."</u>*

It was also going to remake the Pinnacle brands and expand them with many new products starting in the 2H20 – which is now. That would continue to follow with even more.

> *"because of the weakness of the Pinnacle innovation, we have sprung into action to stop further proliferation of similar types of SKUs. But <u>we've also sprung in action in terms of rebuilding a new innovation pipeline with the Pinnacle team and the ConAgra team working arm and arm to do that, but that's going to take some time. It's not going to be all at the exact same window, so it won't all be the beginning of the second half of 2020.</u> Whatever we can get into the marketplace faster, we will get in."*

On the call this Tuesday, CAG said it is getting new product rolling out faster than anticipated and it has rebuilt the Pinnacle pipeline. After 2Q19 results, they were touting that they had fixed Birdseye and Duncan Hines:

> *"As expected, sales and distribution on Birds Eye declined as we removed lower performing SKUs from the market. Now, the brand's distribution trend is starting to bend behind new innovation launches…Throughout the balance of*

fiscal 2020, we'll build upon our category of leading position in frozen with strong innovation. The innovation we launched in the first half of fiscal 2020 is just starting to pick up momentum and we expected to continue to perform well on the second half of the year, and we're not going to slow down our Birds Eye."

"We're also making great progress on our work to reframe Duncan Hines as a sweet treat to unlock significant growing demand spaces. Our strategy includes refreshed packaging, fund and novel flavors and new shelf-stable and frozen snacking platforms. And as you can see on slide 25, our earliest work, focused on the core shelf-stable baking mixes, has begun to result in share gains as the holiday baking season kicked off. We're building on this momentum by introducing more innovation in the second half, including on-trend keto-friendly cakes and co-branded Oreo cake cups."

They released monthly sales results for October through January for some key product lines:

- Frozen Single Serve Meals started at 6.6% growth which fell to 2.3% growth
- Frozen Vegetables started at -2.4% growth stayed negative and finished at -2.7%.
- Canned Tomatoes started at -5.6%, turned positive in November and fell to -3.0%

Remember, originally sales growth for 2020 was going to be 1%-2%. That was cut to 1%-1.5%. Now it is supposed to be 0%-0.5% after all the product launches for 2H20.

How Can Margin Guidance Decline?

We have never believed CAG was very good at improving profitability. Instead, it was very good at removing low-margin units from the mix and that boosted margins. We have pointed this out a couple of times in the past. CAG touts that from 2015-2018, it boosted its operating margins by 400bp. However, looking more closely it divested the money-losing Ralcorp and sold its lower margin potato business.

Adjusting for those divestitures, legacy CAG only had 40bp of margin gain after years of restructuring.

So far CAG sold Lender Bagel and some other smaller assets. It intends to continue doing this focusing on eliminating brands that are chronic drags on results, lower than average returns, and consistently underperforming. All of that discussion sounds like lower margin businesses to us. Taking that out of the mix should boost margin. Regarding the discussion this week about divestitures lowering targets sales and margin targets – CAG adjusts for acquisitions and divestitures in its organic and adjusted figures. So, this isn't a case of losing total dollars when they look at profits and sales as organic and adjusted figures are what is followed. Pulling a lower margin unit out of both periods should boost adjusted margins over-reported. Pulling it out of only the current quarter should really boost both adjusted and reported margins y/y.

If investors want to talk destruction of capital – we'll point out CAG paid over 15x EBITDA for Pinnacle Foods and the laggard stuff it is selling is probably fetching 5-6x EBITDA. But we only focusing on margin impacts here.

We have also talked about how CAG cut over $100 million from annual advertising to pick up margin. CAG points out that it sees traditional advertising as a low-ROI proposition and is pushing more of it into retail investments that are recorded as a reduction of sales. At 1% of organic sales that is about $28-$30 million per quarter. Also, some of that was already being done in the past so it's not as though the $28-$30 million in retail investments started at zero as CAG cut advertising by $25-$30 million per quarter. In the last two quarters, the retail investment levels are already declining too. They fell from 1.7% in 1Q20 to 1.2% in 2Q20. Against 3Q19, the level was 1.4%, which may set CAG up for an easier comp there – but they reduced the margin forecast.

Synergies are also higher than forecast according to CAG. At first, they were going to find $215 million in cost savings by integrating Pinnacle. As Pinnacle's revenue derailed, CAG said it would find more synergies and raised the target. Now they have increased it to $305 million. Some of this is also coming in faster than anticipated. $23 million in cost savings is worth about 1% in margin per quarter to margins and CAG cut the forecast by 40-60bp for the year.

Pricing is also what is driving sales by 1%-2% per quarter. This is normally a big margin driver. It doesn't cost any more to make, package, and ship a frozen dinner if is priced at $3 or $4. Most of the higher pricing should drop to the operating income line.

What scared us the most about this as a sell recommendation is there are 4-levers working toward higher margins. Even if synergies and pricing come in lighter than forecast, they should still boost margin. Culling lower margin units and cutting advertising almost guarantee higher margins too. With CAG cutting forecasts on margin amid those tailwinds, we see that as a significant red flag.

We See Margin Decay and Weaker Sales from the Inventory Change-Over

The growth story according to CAG is rolling out new products and inventing brands. Giving retailers more support to carry the new products and ensuring they help the retailer drive traffic and sales. That is supposed to enable CAG to boost prices and profitability as its sales grow too.

We have pointed out several problems with this strategy in the past and the first one is what do you do with current inventory on the shelves? The retailer has limited space and people still only eat so much in a given day. Rolling out new products often requires the existing inventory to be marked down and moved.

Coming out of 2Q20, we wrote that CAG's inventory looked about 10-days too high. 2Q20's inventory was 79.9 days. In 2Q19, the inventory figure was skewed by having the Pinnacle deal happen in the quarter. **Compared to 64 and 70 days in the prior years, 2Q20 at basically 80 days looked high and 1Q20's figure also looked very high.**

	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

At the conference this week, CAG announced that current inventories have two problems. First, it's older and needs to be cleared. Second, retailers are less keen to order more when CAG is promising them these products will be discontinued. **As a result, CAG is forecasting an increase in inventory write-offs for the 2H20. That should impact pricing and likely will cause more retailer incentives to rise too. Both should reduce growth and lower margins.**

The next problem with clearing the shelves is that discounted inventory does get sold to consumers. Whether its frozen pot-pies, broccoli, or cake mix – consumers take advantage of the bargain and their pantry inventory grows. **Now, when the new product shows up with a new label or larger-size – there is a group of potential consumers who don't need any more as they work off their pantry inventory at home.** Also, CAG is showing up with higher prices for the new products and the consumers have been conditioned to pay discounted prices and it will take them longer to buy again for that reason too. That slows retail sell-through of the new inventory.

The initial stocking of the channel offsets some of those write-offs and discounts. However, retailers also require higher incentives and investments to bring in a new product, especially at a higher price. CAG reports sales net of these incentives so that mitigates sales and margins too. Other products at lower prices whether branded-food competitors or store-brand also are competing with the new products. **Only a year ago, CAG was seeing Marie Calendar sales fall swiftly and steeply because retailers allocated space to lower-cost competitors** as CAG was booking price increases.

The key takeaway is none of this happens in a vacuum. Retailers make higher profits on their own brands most of the time. They simply are not going to give space away to higher-priced goods. We think this causes the new products to produce an initial pop, but it takes longer for sales to build than many think and then they lap the roll-out and sales growth y/y disappears and depends on retail sell-through instead of initial inventory stocking. This is why many of CAG's earnings presentations will call out a couple of products with new rollouts growing at double-digit rates. Yet, total sales are growing at less than 1%. The next quarter another product is touted and the prior one forgotten. **CAG talks about inventing this system since 2015 – when have total sales ever grown very much?**

	2Q20	2019	2018	2017
Organic Growth	0.1%	0.3%	-0.2%	-5.0%

Finally, CAG seldom does well against a tough comp and 3Q20 faces one of the toughest comps of the last two years and a strong sequential comp when sales have already been negative y/y for several key products in the current quarter.

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.
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