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ConAgra Brands

We are moving CAG back to a SELL recommendation after the recent pop in stock price over Q3 results that gave people some relief because they were not a surprise on the level as Q2. The company still cut revenue and gross margin guidance after Q3 results. It is still highlighting minor parts of its portfolio posting growth, while the bulk of the portfolio is posting weaker sales. It still believes that success will be determined by turning Birdseye, Duncan Hines, and Wishbone around from negative sales growth situations, which is what hurt Q2 results so much and results continue to lag there. We believe that much of Q3 sales gains were the result of easy comps and some one-time events. Readers should refer back to the January 10, 2019 report where we discuss that digesting Pinnacle Foods now requires fixing major revenue issues, not just cost-cutting and the August 9, 2018 report that pointed out that Pinnacle Foods already cut many costs and had not been seeing much if any top line gains.

There is an Investor Day on April 10 coming up where ConAgra plans to unveil more new products and marketing ideas along with updating synergy targets. That is a short term wild card that could give the stock another boost.

- Legacy CAG continues to show nuggets of growth, but overall new products offset losses in old products and total dollar sales growth continues to decline. It has dropped from 3.1% to 0.7% overall growth in four quarters.

- 3Q19 sales were helped by easy comps after the hurricanes hurt volume by 220bp in 2Q and by a horrible -6.3% comp from 3Q18. Margins are also aided by sales gains, if sales growth drops, margin pressure could become an issue too.

- Kroger and Wal-Mart both reported that their last quarter had a significant push from people stocking up on food ahead of numerous winter storms and the government shutdown essentially pulled food stamp spending forward by giving people 2 payments in December and an early February payment.

- CAG should have benefitted in 3Q19 from these same factors and because its quarter ended in late February it captured even more of the bad storm sales than Kroger and Wal-Mart whose quarters ended in late January and early February. Wal-Mart expects a headwind next quarter.
- Pinnacle sales continue to fall. The change in retail sales has been swift falling from 2.1% growth to -4.6% growth in four quarters. Distribution volumes are falling at 5%-15% rates for the key brands and CAG does not expect this to improve much until 9-12 months from now.

- CAG held sales guidance and is projecting operating margin to come in at the high end of forecast at Pinnacle which may already be an aggressive forecast. It is removing SKUs, boosting store advertising, which is a reduction to sales and margin and the gross margin is under pressure.

- Pinnacle's sales are already coming in below initial forecast, that is a headwind that will offset any synergies CAG achieves here. After 2Q, gross margin was coming in 230bp below forecast, even if that improves a bit, that is still a big headwind to offset planned synergies.

- Synergies are expected to be $215 million. $100 million of lost sales at the prior gross margin is about $30 million in headwind, 100bp of lost gross margin on forecasted sales is also $30 million. CAG is facing both situations. It is also ramping up marketing at a rate faster than synergies. It reported $12 million achieved in Q3, it boosted marketing by $17 million.

How About That Legacy ConAgra Business?

Again, in the third quarter, CAG highlights some smaller areas of the portfolio and reports great sales growth in terms of Retail Dollars:

	3Q19	2Q19	1Q19	4Q18	3Q18
Frozen Single-Serve Meals	8.3%	11.3%	10.0%	13.0%	13.2%
Snack Foods	7.5%	6.4%	3.2%	5.8%	5.7%

At the same time, the company as a whole, is seeing weaker results in Retail Dollar Growth:

	3Q19	2Q19	1Q19	4Q18	3Q18
CAG Legacy	0.7%	1.0%	1.7%	3.1%	2.2%

That continues to look like what we would expect, new products get higher pricing and post better growth, but older products are marked down and cleared to make room for the new product. The grocery stores have not suddenly found significant new selling space nor do we believe people are suddenly eating more food overall. If they ate a frozen single-serve meal – they probably didn't buy canned spaghetti at the same time. One sale is made and one sale is lost.

It is also important to realize how easy the comps were for growth in 3Q19. This was the first time, CAG called out some expenses related to brand building that are accounted for as a reduction to sales. This is not a new policy for in-store displays, vendor slotting fees, etc. But, it is new in that CAG is pointing out that it ramped up spending in this area to get product into stores.

Organic Growth	3Q19	2Q19	1Q19
CAG Legacy Vol	1.2%	-2.2%	0.0%
CAG Legacy Price	0.7%	0.6%	1.2%
Brand Building	1.4%	0.0%	0.0%
	3.3%	-1.6%	1.2%

We know the company said in 2Q that hurricanes had a negative impact on volumes of 2.2% and that should have effectively moved some sales into 3Q. But look at the comps they faced in more detail sequentially and year over year:

Grocery/Snacks	3Q19	2Q19	1Q19	4Q18	3Q18
Volume	2.1%	-2.2%	0.1%	-0.3%	-4.1%
Price/Mix	0.8%	0.3%	0.0%	1.4%	-2.2%
Total	2.9%	-1.9%	0.1%	1.1%	-6.3%

Grocery/Snacks is 43% of legacy sales. They had a negative -6.3% organic comp from 3Q18. Going backwards, that means the $838.3 million in sales this unit posted in 3Q18 fell by $56.4 million. That's a super easy comp, and CAG didn't even recover half of that total in 3Q19 when it posted a $24.3 million y/y gain. On top of that, the weak hurricane hampered 2Q19 should have pushed sales into 3Q19 too to create sales growth – the company estimates it gained 50bp of sales from this in the grocery unit. This is the division that includes the retail sales dollar growth of 7.5% in 3Q and 6.4% in 2Q for snacks like powdered cocoa mix, popcorn, and Slim-Jims. There are clearly other products offsetting those gains.

Refrigerated	3Q19	2Q19	1Q19	4Q18	3Q18
Volume	3.5%	0.5%	0.5%	2.9%	1.8%
Price/Mix	-1.1%	0.0%	0.9%	2.3%	0.8%
Total	2.4%	0.5%	1.4%	5.2%	2.6%

Refrigerated is 36% of legacy sales. 3Q18 was not awful but look at the comp they face in 4Q. They also had a weak 2Q19 that should have pushed some business into 3Q this year.

The remaining 21% of legacy is International and Food Service – both of which posted negative results driven by drops in volume of 2.0% and 6.7%.

After this glowing quarter – CAG cut revenue guidance from 1-2% growth to +1% growth even though it forecasts a late Easter helping 4Q by as much as 150bp y/y on sales. We think the gains in 3Q were juiced further by other one-time events too.

Looking at margins for the two key units, it is clear that there is no substitute for sales gains to drive margins. If sales growth falters, it could hurt margins too:

Op. Margin change	3Q19	2Q19	1Q19	4Q18	3Q18
Grocery/Snack	142bp	-2bp	-129bp	121bp	-257bp
Refrigerated	17bp	100bp	-162bp	109bp	-58bp

Recent Grocery Sales Helped by Food Stamp Timing and Winter Storms

We think a big reason CAG sales were better than many anticipated was the grocery stores reported very strong comp sales in their most recent quarter too. They also did it against the toughest comp registered a year before:

Kroger	Q4	Q3	Q2	Q1
2018	1.9%	1.6%	1.6%	1.9%
2017	1.5%	1.1%	0.7%	-0.2%

Wal-Mart	Q4	Q3	Q2	Q1
2018	4.2%	3.4%	4.5%	2.1%
2017	2.6%	2.7%	1.8%	1.4%

This did not just happen out of the blue that people decided to eat at home more and buy more stuff at grocery stores. The government shutdown played a role. Food Stamp cards were refilled for January before December 21. The February payment was pulled forward too and paid by January 20. The result was recipients received funding twice in December and had their February payment pulled forward into January. This extra and early money was spent in the stores.

Also, heavy winter storms hit much of the country between December and February. Ice and snow closed restaurants, stopped pizza delivery, closed businesses so people stayed at home. Many people were warned to stock up on additional food at home by weather people in the media. Well – they did! Here are some anecdotal reports:

Seattle Times discussing the results of an early February snowstorm

> *"But if Snowmageddon taketh away, it also giveth. Many grocery stores landed in the "winner" column.* ***<u>QFC stores, most of which are in the Puget Sound region, saw a 50 percent increase in grocery sales and a 30 percent increase in customer traffic Thursday and Friday, compared to those days last year.</u>*** *For the week, the chain saw "more in sales than we typically do during Thanksgiving week," spokesman Zach Stratton said."*

Detroit Free Press talking about the January Polar Vortex:

> *" Gary Winters, store manager at Busch's Fresh Food Market on Sheldon and Five Mile in Plymouth, said they were extremely busy this past weekend and being shopped heavily on Monday…This weekend, Winters said they did 40 percent more business than normal. Hot items were bread, ground beef, eggs, milk, water and bananas. At Busch's, they also had a 20 percent off wine sale. Winters said they set records with the wine sale, up 40 percent over last year.* ***<u>"With every snowstorm, we</u>***

> ***always have an increase in sales,***" *said Tom Violante Jr. of Holiday Market in Royal Oak. "The hoarding mentality is alive and well."*

CBS in Birmingham, Alabama in January:

> *"'I am getting some essentials: oreos, sausage, lettuce, things to make grilled cheese, soup and I'm headed to bread,' said Lauri Soong, a customer. "Milk, bread, the staples and some cheese," said Dan Brown. "We got bread and some snacks I like because we don't have school tomorrow," said Rachel French. The shelves kept being refilled by employees at the Piggly Wiggly in Homewood trying to keep up with the demand. "Kind of crazy but fun at the same time because you get a lot of new faces that you normally don't have, kids come in and do the same thing, want to stock up in case it's a long haul," said Emanuel Turner, manager at Piggly Wiggly.* ***The manager said every time before a weather event, the crowds pour in."Snacks go fast. Soups, canned vegetables, can soup, snack food goes real fast,*** *" said Turner."*

Kroger was asked about food stamps and weather for sales and said 44bp of its comp sales last quarter was due to those events. Wal-Mart said early food stamps were 40bp of its comp sales. It also noted that winter storms drove strong sales but did not quantify it. It further noted that food stamps will be a headwind for it in the current quarter because it clearly pulled sales forward last quarter.

The other thing to keep in mind is Kroger and Wal-Mart did not experience the full winter storm impact in their results, but ConAgra did. Kroger's quarter ended on February 2, Wal-Mart on January 25, and ConAgra on February 24. So, the grocers may still have a bit of strength in their first quarters, but ConAgra already reported another month of people buying food ahead of storms.

The other headwind that may occur is people loaded up on more stuff for storms and then have to work off the pantry inventory at home. That could also mean weakness for the current quarter. We used to follow Energizer and if there was a hurricane warning – Energizer sales would pop as people stocked up on batteries – then sales would crater because they wouldn't need any more until Christmas. Canned food and frozen food could likely have similar trends because the shelf life at home is longer just like batteries.

Pinnacle Sales Continued to Fall and May Offset Synergies

Considering that grocery stores had so many boosts to 3Q sales – Pinnacle Foods products should have benefited right? Think again – their decay accelerated at that time:

Pinnacle Retail	3Q19	2Q19	1Q19	4Q18	3Q18
Sales change	-4.6%	-3.0%	-1.4%	1.1%	2.1%

During this time, the three major brands: Birdseye, Duncan Hines, and Wishbone have seen distribution volumes fall at 5%-15% so the company is shedding market share. We are actually surprised CAG did not cut the sales forecast again for these brands. We also should remind readers that all three brands were posting flat to negative sales growth despite efforts to refocus products while at Pinnacle Foods. **CAG did confirm that it does not expect improving trends at Pinnacle Foods until the second half of fiscal 2020 (essentially 9-12 months from now.)**

ConAgra held its guidance flat for this unit which is sales light $160 million for the current year and gross margins running 230bp below forecast. To put this in bigger terms – PF had $3 billion in sales for calendar 2018 and a gross margin of over 30%. Let's just call that $900 million in gross profit that was expected. Being light on margin by 100bp is $30 million of lost gross profit as it being light on $100 million of revenue. CAG faces both issues now. If going forward, this acquisition produces $2.8 billion in sales at 28% margin, the expected gross profit would fall to about $800 million. If we allow that CAG could cull lower margin business and sacrifice sales to restore gross margin – and they hit 30% on $2.7 billion in sales, that's still only $810 million in gross profit vs the forecasted $900 million. Any margin gain from combining facilities or buying product better than Pinnacle did would be part of the cost saving from synergies. We think the current situation with this acquisition of weaker sales and margins could be a sizeable offset to any integration savings.

ConAgra is touting that is looking for $215 million in synergies and no revenue synergies. It reported that it already has $12 million in cost-cutting completed. However, it may have already lost $100 million in annualized gross profit given current Pinnacle Foods results, which could offset nearly half the synergies investors are expecting. This is a key point as ConAgra did not expect to have to rebuild PF's brands, product lines, and rekindle revenue and gross margins. They were looking to simply merge production lines, cut management, combine distribution assets and reduce costs against the revenue and gross margins PF was reporting.

Also, we noted earlier that CAG called out its organic sales growth in 3Q19 was 140bp lower because it ramped up branding building investments to pay stores to stock and pitch new products. The 140bp in lower organic sales in 3Q was about $28 million. It paid for some of this with a reduction of nearly $11 million in advertising expense that is reflected in SG&A. This is still new investment of $17 million in 3Q19 that did not appear called out when this merger was completed. We thought more marketing would be needed, and if this continues then that will offset some more of the cost synergies CAG is forecasting which so far are only $12 million.

This change also effectively lowered gross margin by reducing sales. In the past, the advertising would have come at the SG&A level and not impact sales or gross margin. So, Pinnacle saw a 100bp additional hit to gross profit from this change and it will impact total CAG gross margin too and is likely a reason behind the reduced margin guidance. We are not adjusting for this when we discussed the 200bp drop in margins above. Just be aware, this is likely an ongoing item and it will make the margin look even lower and the company is guiding to more brand-building investment. Margin at Pinnacle came in at 14.4% before inventory valuation adjustments. CAG is guiding to 14.6%-14.9% for the fiscal year, which indicates they see Pinnacle results improving likely via cost-cutting offsetting weakness in sales and gross margin. Given the sales trends and gross margin issues – we would consider that forecast aggressive.

The company would not be pinned down much on repeated questions trying to see how lower Pinnacle sales could fall before they start to rise nor would they comment on margins beyond next quarter. The 10-Q is not available yet and the company is promising to give more color on synergies in April at the Investor Day.

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