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Conagra Brands (CAG) Investor Day Update

After studying the plans from Investor Day this week for Conagra – our skepticism has not changed. We continue to rate the stock a SELL. The basic plan really has not changed. CAG believes it can boost margins significantly and that will drive up earnings and cash flow and enable it to deleverage the balance sheet. In making these predictions, it points to its own history of growing margins and therefore integrating Pinnacle Foods should simply require applying the same plan.

Historically, CAG's record of improving margins is overstated in our view and not only will it be difficult to boost margins to the levels now forecasted, the company has barely acknowledged the operating problems with Pinnacle Foods since it was amazed a few months after closing the deal how badly it was underperforming versus forecasts. We still believe CAG overpaid for PF and issued considerable debt and shares to pay for it. If forecasts are not realized, we still expect to see write-offs related to the deal and debt remain a cloud overhanging the stock. We already highlighted last week that CAG may have seen one-time benefits from winter storms and food stamp programs that could become headwinds in the current quarter:

- **The basic plan is for 1% sales growth with margin gains of 300-400bp by fiscal 2022.** The margin gains will be driven largely by synergies from the Pinnacle Foods merger and the forecast has been increased from \$215 million to \$285 million. The higher margins will drive EPS and cash flow and lead to debt reduction.

- **The first of three problems on forecasts are more shares outstanding after the deal.** To post flat EPS, CAG has to grow earnings about 9% next year. **Also, it only had about half a year of PF's lower margin sales and higher interest expense in 2019, those become bigger drags on earnings next year.**

- **Backing into the operating income figure need from EPS guidance, CAG needs about 220bps of margin gain driving $250 million in improved operating income next year. Yet, synergies are supposed to build through 2020 and finish at a $156 million run-rate, meaning they probably help by $100 million next year. Where's the rest of the income coming from?**

- **The higher synergy target is suspect.** The merger has already produced several negative surprises and newly outlined plans to redo product lines, rebuild vendor relations, and fight for market share will cost money. Yet, the forecast is for more cost savings to materialize? **Also, larger forms of restructuring synergies involving capital spending were cut under the new guidance.**

- **Charts showing CAG's margins improving by 420bp from 2015-18 are overstating their prowess in cost-cutting in our view**. In 2015, CAG still had Ral-Corp, its milling operations, and Lamb Weston potatoes. If we look at just the consumer operation which is what CAG is today – the margin gain is only 40bp.

- **Eliminating lower margin divisions drove margins up and CAG has continued to cut lower margin products. Yet margins only rose 10bp from 2017 to 2018 and that was with a 65bp cut in advertising and R&D.** Pensions are have also seen a positive swing from a cost to income in recent years of 77bp.

- **Pinnacle's margins were below CAG to start and were flat for years. It has already been underperforming by over 200bp on gross margin and CAG does not expect to turn it around before late 2020. But, this is the source of the higher synergy target and margin gains coming next year.**

The New Forecast Revealed

Conagra gave its outlook this week for earnings and synergies over the next three years. All of it interplays to boost EPS and pay down the onerous debt load with higher free cash flow as well as having the EBITDA figure rise to make the debt look more manageable.

They expect synergies to rise from $215 million to $285 million by the end of 2022, about 55% by the end of fiscal 2020. Moreover, they're going to save money achieving the synergies too. The original forecast in cash costs of $355 million will now only be $320 million.

	f2019	f2020	f2022
Sales Growth	1%	1%	1-2%
Oper. Margin	15%+	n/a	18%-19%
EPS low	$2.03	$2.10	$2.70
EPS high	$2.08	$2.20	$2.80

That would put sales in the $11.3-$11.5 billion range and the debt figure will decline to 3.5-3.6x EBITDA in FY21. So, interest expense will be falling and also helping drive EPS growth higher along with margin expansion. Based on the sales range, and margins improving by basically 300-400bp – that would be about $340-$460 million in higher operating income by the end of 2022. The $285 million of synergies is expected to play a big role there.

Headwinds for the Forecast

An obvious headwind is the share count is much higher now. There used to be about 407 million shares outstanding. There are 486 million now. CAG is guiding to 446 million for fiscal 2019 and it should be at 487 for fiscal 2020 plus anything issued for stock compensation. That is some sizeable dilution. **Net income of roughly $915 million for fiscal 2019 needs to rise by over 9% to $1.0 billion to post flat EPS next year.**

Interest expense will be higher in 2020 also. The PF debt will only impact 2019 for about two quarters. In 2020 it should be $170-$180 million higher than 2019 forecasts. We'll use a 25% tax rate for both years. That means operating income in 2019 of $1.6 billion would need to rise to over $1.9 billion.

If the company is going to grow EPS in 2020, to $2.15 per share – we think margins need to improve significantly next year:

	2019	2020
EPS	$2.05	$2.15
Shares	$446.0	$487.0
Net Income	$914	$1,047
Pretax Inc.	$1,219	$1,396
Interest	$390	$560
Op. Income	$1,609	$1,956
Sales	$10,500	$11,110
Op. Margin	15.3%	17.6%

On margins, Pinnacle is starting below where CAG thought it would be. See our January 10, 2019 report on this and the last section of this report. Its gross margins are more than 200bp below forecast and sales growth is negative. Pinnacle also had a lower margin than CAG as a starting point. So, CAG already has a considerable amount of ground to make up.

Also, look at sales - 2019 only has half a year of PF and 2020 will have a full year. So a lower margin and more troubled company will be about 25%-27% of sales in 2020 instead of 15% in 2019. Also negatively impacting sales is brand building with vendor fees that are accounted for as a reduction to sales. CAG has already said that it ramped this up for PF last quarter. That could tamper sales growth.

Moreover, as shown in the next section, CAG is not seeing much volume growth on sales. We reported last week that recent sales growth was largely negative this year until Food Stamps were paid early with an extra check in the prior quarter and winter storms nationwide spurred grocery shopping. Forecasts of 1% sales growth could actually be aggressive in the case of CAG.

As it is, to reach 2020 forecasts, sales growth and the full year of PF would get Operating income to only $1.7 billion. Margin expansion must produce the other $250 million. However, CAG's guidance only calls for the synergies to be 55% achieved with a $156 million annual run-rate by the end of 2020. That means synergies will likely come in somewhere closer to $100 million next year if fully achieved as they build through the year. Where's the other $150 million coming from? Synergies are supposed to be 60%-80% of the cost savings.

The synergy goals also look suspect. We are always wary when a company announces a cost savings figure then has the merger disappoint and magically announces they found more savings to offset the disappointment. In this case, we have three reasons for skepticism.

- CAG already found unforeseen problems at PF regarding negative sales, losing market share, lack of vendor support, and margin erosion. They admit they didn't see any of this coming. Yet, a couple of months after that bomb, they announce they're more pleased than ever with the deal and see even more areas to cut and boost the cost savings by 33%. We're supposed to ignore that they also mentioned PF requires more R&D, marketing, brand support, new design, new products… Is all that free? Or does that eat into the projected cost savings?

- As CAG boosted the synergy target, it cut the amount it would need to spend to achieve it. That's another red flag for us. Operating restructuring costs will rise from $213 million to $235 million. Most of that is the cost of laying people off and relocating systems and people. However, capital spending related to the deal will fall from $142 million to $85 million. Capital spending to us normally means buying newer equipment, eliminating bottlenecks by reconfiguring production, enlarging some plants. Basically, capital spending involves larger projects that take longer and target bigger goals. CAG is cutting spending there and saying they will boost savings beyond forecasts.

- This is the same company that bought Ralcorp in 2013 and wrote off huge amounts of it almost immediately for failure to achieve merger/integration goals. It later sold it about 3 years later.

New Forecast Is Based on Conagra's Past Growth Results

Conagra points to its history of margin growth as credibility for the PF deal and cost savings:

	f2018	f2017	f2016	f2015
CAG Op. Margin	15.0%	14.9%	11.9%	10.8%

That's quite an upward move overall. Shouldn't investors take comfort in that much margin gain? We don't think so for several reasons.

- Conagra had large commercial food operation that was milling and potatoes. These were lower margin than the consumer food business. Those were spun off or put into joint ventures where the company earns equity income now. That improved margins at the full company simply having them off income statement.

- Conagra had the disastrous Ralcorp deal that was owned from January 2013 to spring of 2015. On its best days, that was a 6% margin business and was 24% of sales. That was moved to discontinued operations and sold. That also helped the margin growth shown above.

- Looking at the consumer food operation by itself, it had a 14.6% margin in 2015 even with some minor charges that were listed as impacting both the consumer and at the time still remaining commercial units which we didn't adjust for. That is basically what remains of CAG now. So, actual margin growth was about 40bp since 2015, not 420bp.

Also helping margins was the company simply let lower-performing products fade away, become a smaller percentage of sales and be discontinued in the last couple of years. All of this should have helped margins:

Grocery & Snacks in 2018 –

> "The decrease in sales volumes reflected a reduction in promotional intensity, **planned discontinuation of certain lower-performing products**, retailer inventory reductions, which were higher than anticipated, and **deliberate actions to optimize distribution on certain lower-margin products"**

Grocery & Snacks in 2017 –

> "The decrease in sales volumes was the result of reduced trade promotions and the **planned exit of certain lower-performing products."**

International in 2018 –

> "The volume decrease for fiscal 2018 was driven by strategic **decisions to eliminate lower margin products** and to reduce promotional intensity."

Foodservice in 2018 –

> "The decrease in volumes compared to the prior-year period primarily reflected the impact of exiting a non-core business, **the planned discontinuation of certain lower-performing businesses**, and softness in certain categories."

Foodservice in 2017 –

> "The decrease in volumes primarily reflected the **impact of exiting a non-core business**."

The divestitures of JM Swank, Spicetec, and Wesson Oil have also likely helped. We're not calling this a bad plan. However, we are pointing out that when looking at more apples to apples – CAG's current business was doing 14.6% margins in 2015 and after much pruning of low margin products, it did 15.0% in 2018.

That still overstates the case in our view. Plus, look at advertising and R&D spending:

	f2018	f2017	f2016
Marketing	$278.6	$328.3	$347.2
R&D	$47.3	$44.6	$59.6
% Sales	4.11%	4.76%	4.70%

In just 2018, the company picked up 65bp of margin from those two areas as a percentage of sales vs. total margin gain of 10bp.

The company states that its reported margins rising from 10.8% to 15.0% have been adjusted for pension accounting. We won't look at that as a driver of cost savings. However, there was a significant expense in 2016 taken for pensions due to a $348.5 million recognized net actuarial loss. That one-time event that most people would add back – helped set up CAG to start producing pension income into earnings rather than expense:

	f2018	f2017	f2016	f2015
Pension Cost	-$49.0	-$0.9	$413.7	$13.30

We are not certain if CAG adjusted all of this out of the mix in margins above or just the one-time item in 2016. But it's worth noting that in 2015, pensions were 15bp of expense for margins and in 2018 they were 62bp of income on margins.

Pinnacle Foods Doesn't Start with Superior Margins Either

CAG sees PF operating margins at under 15%. More importantly, we know the margins here are under pressure and CAG has already admitted this about 3 months ago. CEO Sean Connolly:

> *"On sales, we now estimate the Pinnacle portfolio will land calendar year '18 at roughly $3 billion, which is about $160 million or 5% below Pinnacle's target. 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. 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."

Conagra also noted that all the major Pinnacle brands had lost market share and pricing power. It further noted that it bought Pinnacle to eliminate costs with the acquisitions and had not planned on needing to rebuild entire product lines and restore customer support. It also noted that it does not expect to see a turn-around in Pinnacle operations until late in fiscal 2020.

We were also surprised to hear CAG say it didn't see this coming. It was obvious to us via the public documents that PF had no pricing power or growth except through acquisitions:

Total PF	2017	2016	2015	2014	2013	2012	2011
Sales Growth	0.5%	17.8%	2.5%	5.2%	0.6%	0.4%	1.3%
Pricing	0.2%	0.2%	1.3%	-1.1%	0.2%	1.6%	2.0%
Volume	0.3%	0.0%	-0.7%	0.3%	-0.9%	-2.3%	-0.8%
Acquisition	0.0%	17.7%	2.3%	6.2%	1.6%	0.0%	0.0%

More importantly, we noted that PF's largest unit was Birds Eye and it after boosting margins from about 11% to 21% - sales and margins had been flat for years except during acquisitions:

Birds Eye	2017	2016	2015	2014	2013	2012	2011
Frozen Sales	$1,299.1	$1,304.8	$1,236.0	$1,115.2	$1,096.9	$1,103.1	$1,100.8
Adj. EBITDA	$278.2	288.8	$260.7	$243.5	$242.8	$228.1	$226.0
Margin	21.4%	22.1%	21.1%	21.8%	22.1%	20.7%	20.5%

We have two problems here. First, we're being told combining a flat margin business with a falling margin business is going to produce higher margins. Second, it is the area that is producing disappointment on sales, entire product lines, margins, numerous negative surprises, and needs reinvestment where CAG is claiming it will find even more synergies than it expected.

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