BEHIND THE NUMBERS
Quality of Earnings Analysis
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# Conagra Brands, Inc. (CAG)
# Earnings Quality Update- 2/22 Qtr.

| |
|---|
| 6- Exceptionally Strong |
| 5- Strong |
| 4- Acceptable |
| 3- Minor Concern |
| 2- Weak |
| 1- Strong Concern |
| |
| + quality improving |
| - quality deteriorating |

*We are maintaining our earnings quality rating of CAG at 2- (Weak).*

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

## Summary

CAG's adjusted EPS of 58 cents met forecasts and the company reduced guidance. The company noted that inflation is running hotter than expected which is hurting results, but it is happy to hit fiscal 3Q22 forecasts despite that. What we saw is it cut advertising to pick up 1.3 cents, another 0.2 cents from rounding up results, 1.2 cents from lower stock and incentive pay, and it has reduced third party commission expense as part of its restructuring of the supply chain, which added another 1.1 cents. We point out the commissions because CAG is still saying supply chain issues are difficult and it has a tough time replacing inventory which may lead it to using more third-party brokers again.

The company picked up 2.7 cents from the first three areas or 3.8 cents total which may not be sustainable and yet it still only just met forecasts. Plus, adjusted EPS was down from 59 cents last year. More importantly, its flour milling operation, which it spun off years ago because it was a lower margin operation and its ownership stake is now an equity-method investment, produced

an additional 5.6 cents in the fiscal 3Q22. Plus, only about 39% of the equity-method earnings are coming in as cash.

- Ardent Mills is prospering with the current inflation. Our initial review of CAG pointed out that the bulk of the improvement in operating margins that CAG achieved since 2014 came from spinning off lower-margin units from its commercial foods business such as Ardent Mills and Lamb Weston along with cutting advertising. Commerical foods generated a 12% operating margin with businesses like grocery and frozen running at 17%-20%. Culling the milling business boosted the total company's margin and it now is reported as an equity-method joint venture for CAG's remaining stake.

- Milling operates as a pass-through business. Historically wheat prices rose and fell and the revenues and cost of goods sold saw the price changes for wheat flow through to those areas. There may be a small short-term lag in some cases, but inventory turned quickly and gross margin remained very constant at 17% through rising and falling wheat prices.

- However, the SG&A (overhead costs) changed more slowly in dollar terms. It didn't require extra staff or overhead to process a ton of wheat that cost $6 vs. processing a ton that cost $4. There may be some bonus payments based on higher total income or higher wheat prices may result in higher volumes to process. So the higher dollar sales from increased commodity prices leveraged the overhead costs and milling could see 100-150bp of increased operating margin:

| Comm. Foods | 2012 | 2011 | 2010 | 2009 | 2008 | 2007 | 2006 |
|---|---|---|---|---|---|---|---|
| Revenue | $4,886 | $4,301 | $4,077 | $4,700 | $4,128 | $3,482 | $3,189 |
| Operating Income | $547 | $505 | $539 | $584 | $512 | $413 | $364 |
| Margin | 11.2% | 11.7% | 13.2% | 12.4% | 12.4% | 11.9% | 11.4% |

The commercial foods operations had flour milling, potato processing, and a few other businesses in it so this is not a pure look at wheat and flour. But it was clear that revenues and COGS were moving with commodity prices but the margin stayed flat. Right now, wheat prices have had several spikes with inflation, higher fertilizer and fuel prices, plus the Russian/Ukraine fighting. That is giving CAG a boost to earnings that remains very lumpy because wheat prices have been rising since 2020 with some occasional large spikes and corrections. Wheat spiked very high after the 3Q22 ended so there may still be a larger bit of income in 4Q22 in May. CAG is guiding to 3 cents extra from equity method income in 4Q22 vs. the 5.6 cents in 3Q.

| Equity Method Income | 4Q | 3Q | 2Q | 1Q |
|---|---|---|---|---|
| fiscal 2022 | | $48.1 | $29.5 | $20.2 |
| fiscal 2021 | $33.4 | $21.5 | $23.0 | $6.5 |
| fiscal 2020 | $22.9 | $10.4 | $27.6 | $12.3 |

- CAG uses FIFO accounting which should further be helping its margins amid inflation. However, it is having a tough time maintaining inventory balances. We also think investors should be asking why after years of restructuring and culling low margin SKUs and lower margin businesses are margins not seeing any improvement except during Covid?

| Inventory DSIs | f22 | f21 | f20 |
|---|---|---|---|
| 1Q | 90.1 | 77.1 | 92.8 |
| 2Q | 73.6 | 70.3 | 79.9 |
| 3Q | 72.7 | 71.6 | 80.3 |

| Adj Oper. Margin | f22 | f21 | f20 | f19 | f18 |
|---|---|---|---|---|---|
| 1Q | 14.1% | 20.2% | 15.7% | 14.6% | 15.4% |
| 2Q | 14.6% | 19.6% | 17.1% | 17.5% | 16.7% |
| 3Q | 13.7% | 16.0% | 15.7% | 16.3% | 15.0% |

- Food Service sales returning is a margin pressure as we forecast. Food Service is a 6% margin business vs. Grocery and Frozen at 2-3x that level. During Covid, Food Service sales dropped and became higher Grocery and Frozen sales. Food Service in 3Q22 was the highest source of organic growth for CAG at 18.9% and its only source of volume growth at 10.5%. We think this type of trend will continue and will pressure EPS by a few cents.

- CAG continues to point to growth figures compared to some of its weakest comps. For example, it points to two-year growth figures for canned tomatoes of 9.8% and shelf-stable dinners of 19.1%. However, when we look back two years, CAG was taking impairment charges in these areas and reporting horrible sales results:

| Sales trends | 2Q20 | 1Q20 | 4Q19 |
|---|---|---|---|
| Hunt's Tomatoes | 0.7% | -8.9% | -10.8% |
| Chef Boyardee | -4.5% | -6.7% | -6.7% |

We also will say again, CAG's use of two-year comps to eliminate Covid as a one-time event is still misleading in our view because its Pinnacle Foods deal was a dumpster fire two years ago before Covid. The company had huge inventories it couldn't sell, was seeing pricing pressure and volume growth was negative – 3Q20 (pre-Covid) saw -0.4% pricing and -1.3% volume and the company was saying it would take it a year to remake its product line and was guiding to lower sales and margins.

- Guidance continues to focus on taking more pricing and having inflation cool. On the call, it noted that current fiscal 2022 guidance is for $2.35 BUT – if all their price increases were in place for a longer time – EPS would be $2.65 by management's estimate and inflation doesn't increase anymore. When have they been right on this?

| forecasts | 3Q22 | 2Q22 | 1Q22 | 4Q21 | 3Q21 |
|---|---|---|---|---|---|
| Expected Inflation | 16% | 14% | 11% | 9% | 6% |
| FY22 EPS guidance | $2.35 | $2.50 | $2.50 | $2.50 | $2.70 |

# 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.

1 (Strong Concern)- 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 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 upcoming quarters. 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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