BEHIND THE NUMBERS
Quality of Earnings Analysis
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Conagra Brands, Inc. (CAG) Earnings Quality Update

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

We are cutting our earnings quality rating of CAG to 2- (Weak).

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

Summary

CAG beat 3Q21 estimates by only 1-cent at 59-cents, which by itself is a red flag as it routinely has several short-lived items to help results and the outlook was 56-60 cents. This quarter was no exception. The income tax rate fell 90bp and added 1-cent to earnings. Lower travel-related spending added 0.6-cents, adding back legal and consulting fees was 2-cents. One of the bigger areas is reduced trade promotion, which is netted against sales rather than called out as an expense. In the 2Q, CAG said half its 1.5% pricing gains were from lower trade promotion which added 3.3-cents. In 3Q, CAG said half of the 3.6% in pricing gains came from less trade promotion, which added 7.1-cents.

We also think COVID-related spending should be getting lower at this point, not rising. In 2Q, CAG said COVID was 100bp drag on margins or $30 million. In 3Q, CAG said the drag was 180bp or $50 million and said that it is including $15 million of higher transportation costs in that figure.

The trucking costs being classified as COVID-related and the outlook for 4Q shows us that CAG is having a tough time navigating cost inflation. This is not a company that has had much success holding volume growth when it wants to take pricing and restocking demand may be largely complete now.

What is strong?

- Volume growth was higher last quarter than we expected at 6.1%. We knew there was some more channel restocking coming and winter storms likely helped too.

- CAG actually boosted SG&A-type advertising in the quarter. It was up $7.8 million as normalized operating activities resume.

What is weak?

- CAG is slashing promotional spending which is reported net of sales. This is inflating reported pricing and total sales by $45 million last quarter, which was a surge from $21 million in 2Q21. It also inflates operating margin via higher sales and higher operating income.

- CAG gained 7.1 cents in EPS from cutting trade promotions and it is still spending less than historical levels on traditional advertising. These activities have added 120bp to margins through the first 3Qs of fiscal 2021. We believe this will reverse going forward.

- Foodservice demand is normally about 10% of sales and fell to 7% with COVID. That should recover as restaurants open and seating capacity is expanded. However, Food Service has a margin of half the level of CAG's other businesses that serve grocery stores. Simply moving 3% of company sales from grocery to foodservice is a 30bp headwind on margins.

- Commodity inflation is starting to overwhelm CAG's pricing. Gross margin rose 130bp through 3Qs of fiscal 2021, but only improved 10bp in 3Q21. CAG is warning investors to expect price increases to lag cost inflation. CAG has a history of losing market share when it tries to raise prices faster than store-brands experiencing the same inflation.

What to Watch?

- The Outlook is calling for organic CAGR of 1%-2% for the three years ending in May 2022 (fiscal 2022). That guidance looks poor to us given that the four COVID quarters each divided by twelve is a 3-year growth rate of 4.4%. It is not a shock that volume growth should turn negative against COVID quarters, but there are several positives with

COVID that expanded margins that may not be sustainable under more normalized times beyond the marketing cuts and foodservice margins. Leveraging fixed costs over more volume may reverse. Higher sales also leveraged higher employee pay during COVID – does the high pay remain but the sales decline? Normal product turnover often requires marking down what's on the shelves to clear space for new items – panic buying under COVID cleared the shelves at full price. Discounting wasn't needed.

- CAG's results for the two years prior to COVID were awful as it sought to cut marketing and boost pricing. It resulted in large volume losses for many products and inventory was stacking up. CAG seems to be guiding that it will be able to navigate without marketing at past levels, lose some volume and maintain margins. We see items that may total more than 200bp of margin headwind. CAG can point to reducing COVID costs at about 100bp, but that would require it cuts employee pay too to recapture all of that.

Supporting Details

CAG Is Driving Sales and Earnings Results by Cutting Marketing

CAG reports marketing in two areas. The first is the more traditional SG&A-type advertising spending where details are given. The second is trade promotion, which includes coupons, discounts to retailers, slotting fees paid to retailers, and having people in the store pitching products and giving out free samples. This type of marketing is reported net of sales and is not always quantified.

Both types of marketing are important for a company that wants to boost prices. And investors should not forget that before COVID, CAG's entire business plan was centered on the concept of Value over Volume. It was willing to concede volume to boost price. Retailers tend to want higher volume items on the shelves that customers demand. If CAG's products aren't turning as quickly, they lose shelf space or need to pay more to stay. This is especially true with releasing new products. They have to take shelf space from another product. CAG has touted how it wants to have a high percentage of new products at all times. All of these goals, pricing, value over volume, and new products require marketing. Yet, CAG has been slashing its spending:

We have data on the traditional type of advertising and CAG saw it turn up last quarter, but is still below past levels when it didn't even own Pinnacle Foods:

Conagra Advertising	4Q	3Q	2Q	1Q
fiscal 21		$73.3	$63.6	$45.9
fiscal 20	$59.2	$65.5	$60.7	$45.3
fiscal 19	$73.9	$67.4	$69.4	$42.7
fiscal 18	$59.5	$78.2	$86.0	$54.9
fiscal 17	$75.5	$90.7		

We remember late fiscal 2019 and the early quarters of fiscal 2020 before COVID lockdowns caused retailers and customers to buy anything on the shelves. In the normal world, CAG had to fight for shelf space against many other competitors and compete on pricing and promotional spending to get grocery store real estate. Their results of trying to take some pricing and cutting marketing were awful:

- *Marie Callender's* down 20%
- *Hunt's* Tomatoes down 10%
- *Chef Boyardee* down 7%
- *Wish-Bone* salad dressing down double digits for years
- *Birdseye* seeing accelerating declines

As COVID ends, we think the competitive world will return. Customers will not need months of pantry stocking and CAG earnings were often made or missed by a single winter storm or hurricane threat causing people to stock up for a week. It will also mean stores will require suppliers to spend more money on their products to keep them turning rapidly and that means trade promotion should return in a big way.

During COVID, CAG did not need to invest as much in trade promotion. As that type of spending is netted against sales, when it doesn't happen, sales magically rise. In the last three quarters, CAG has given detailed discussions on how much the price component of sales came from having lower trade promotion and these cuts have been huge and getting larger:

	3Q21	2Q21	1Q21
Sales Growth from lower promotion	180bp	75bp	70bp
y/y higher sales from lower promotion	$45.340	$20.800	$17.800
Net of tax	$34.500	$16.000	$13.730
EPS growth	7.1 cents	3.3 cents	2.8 cents

In the last two quarters, CAG has pointed to half its pricing gain being due to lower trade promotion spending. Pricing was up 360bp in 3Q and 150bp in 2Q. On the 1Q call, they quantified the cut as 70bp of the 410bp pricing gain.

CAG is pointing to the $7.8 million increase in traditional marketing as proof it is investing in its brands again. That was a 1.2-cent headwind to EPS in the quarter. We are looking at the full picture and the $45 million cut in promotional spending added 7.1-cents to EPS for a net benefit of 5.9-cents for a company that beat by 1-cent.

We think CAG is still underspending on traditional marketing. Before CAG owned *Birdseye* and the other parts of Pinnacle, it was spending $80 million per quarter, now it's cheering $73 million? Every $6 million of higher spending is a 1-cent headwind to EPS. If the trade promotion normalizes, CAG has some significant headwinds on pricing for the next four quarters, which will hurt EPS, and revenue growth. It is also likely to create a picture where it appears CAG is not getting enough pricing to offset commodity inflation and it will translate into margin pressure.

Is 2022 and 3-year Guidance a Warning?

We think the company's fiscal 2022 guidance points to sales growth from COVID being over as the company is calling for only 1%-2% organic sales growth on a three-year CAGR ending in May 2022 that will include the recent COVID organic growth figures:

Organic Growth	3Q21	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20
Volume	6.1%	6.6%	10.9%	21.0%	-1.3%	1.0%	-2.5%
Price	3.6%	1.5%	4.1%	0.5%	-0.4%	0.6%	0.8%
Organic Growth	9.7%	8.1%	15.0%	21.5%	-1.7%	1.6%	-1.7%

The fiscal 2020 figures pre-COVID had 2Q20 with 1.6% growth that came against a horrendous 2Q19 when volume growth was -2.2% and organic growth was -1.6%. Adding COVID demand with no discounting, panic buying, followed by shelf restocking into the 3-year figure and they still only plan to hit 1%-2% growth is another illustration to us that CAG simply doesn't grow.
If CAG has to add back trade promotion spending too – which again cuts organic sales growth via reduced pricing – fiscal 2022 that could become a big drag. Having one-third of twelve quarters with growth at 10%- 20% in that CAGR should be enough to hold the growth rate higher than 1%-2%.

Guidance for fiscal 2022 also calls for an adjusted operating margin of 18%-19%. YTD in 2021, the adjusted margin is 18.6%. However, let's again look at marketing issues. If marketing should at least be at 2018 levels from the table in the previous section, CAG picked up $36.2 million in operating income from cuts in this area. Plus, it picked up $83.9 million from lower trade promotion that would cut sales and operating income. Just adjusting for the marketing, CAG's adjusted operating margin falls from 18.6% to 17.4%. The lack of travel expense that should return would cost another 16bp.

Investors should also consider that foodservice sales could also build back up going forward, but this is a lower margin business for CAG. Historically, it is 9%-10% of sales and the operating margin is 10%. With COVID restaurant closures and seating capacity restrictions, foodservice has only been 7% of sales as people eat at home more. We believe the lost restaurant sales went to grocery stores where CAG's margin has been over 24% for grocery and 20% for frozen food during COVID. A quick "back-of-the-envelope" analysis illustrates that moving 3% of total company sales from 20% margin to 10% margin business would cost total margins about 30bp.

At the same time, CAG has enjoyed margin gains during COVID due to high volume demand that allowed it to run production full-out and leverage fixed costs more. That's a huge change for a company whose best quarter of volume growth in the two years before COVID was 1.2% and there were six quarters of negative volume growth. CAG added 130bp of gross margin through the first three quarters of fiscal 2021. Here is where that came from:

- Massive panic buying by customers – volume gains of 21% and 11% to start COVID

- Retailers restocking inventory after the panic – volume gains of 6%+ the last two Q's

- Lack of trade promotion discussed above

- No mark-downs of prior excess inventories – Investors should remember how ugly CAG was pre-COVID. Not only was it taking impairments on brand assets and losing market share with negative volume figures, but it was carrying over 105 days of inventory – about 20-25 days too much. COVID cleared that overhang at full price.

With all that operating leverage going on and lack of mark-downs – CAG is only at their guidance figure for fiscal 2022, they are not crushing that figure at all. Yet, we see 166bp of pressure from marketing, travel, and the return of foodservice sales. Even CAG is forecasting negative volume growth after COVID and that should unwind some operating leverage. Kroger's inventory may only be light by about 1 day of sales versus 3 days last summer so CAG sales

to restock the channel are unlikely to be as strong. CAG is highlighting that it can grow its own inventories back to maintain operating leverage. Inventories were about 10 days light at the end of last quarter at 72 days vs. 82 the prior two years. There are two points there. First, the 82 days was likely a bit high already given the problems that were building with CAG's inventories as it was cutting guidance at that time. Second, the 72 days is being viewed against strong sales growth that is expected to turn negative. Negative growth will push the DSI figure up without building more inventory.

Finally, let's keep in mind that commodity pressures are growing and while CAG is working to boost pricing its margin gains are stalling. The 130bp of margin gain YTD was only 10bp in 3Q.

	3Q21	2Q21	1Q21
y/y Gross Margin gain	12bp	130bp	244bp
Price/Productivity/Synergy	460bp	440bp	610bp
Price/Prod/Syn w/o Promotion	280bp	365bp	540bp
COGS Inflation	270bp	200bp	220bp

- Keep in mind the pricing/productivity/synergies have been helped by lower trade promotion. We adjust for that in the third line 180bp in 3Q as discussed previously

- CAG's spread between cost savings and pricing vs. inflation was only 10bp last quarter.

- CAG guided on the call that it will seek to recover inflation but it will be on a lagging basis – which to us means gross margin could decline.

- The primary retailers like Kroger and Walmart and now Amazon as CAG touts digital sales – push back on price increases and customers can still trade down to store-brands and keep total spending lower.

- All of this points to lower margins too.

The only positive we can see to all these normal operating costs and pressures returning after COVID is CAG may see lower COVID-related costs. These have been about 100-120bp of headwind on margins. However, a fair amount of COVID costs are higher wages for employees – good luck taking that back. In the 3Q, CAG labeled another 60bp of headwind from higher freight costs to get more volume to market. Maybe CAG picks up 50-70bp of margin with lower COVID costs and selling less volume means it doesn't need as much in delivery costs. But are fuel prices going down? Trucking costs per unit could still rise in fiscal 2022 vs. 2021.

A forecast for flat margins looks very aggressive to us with over 200bp of normal operating items that should reverse and become headwinds.

Starwood Property Trust (STWD)

We are removing STWD from our On Deck Buy list as the stock is close to the top of our valuation range and we see limited upside. We maintain earnings quality coverage with a 5+ (Strong) rating.

- STWD highlighted in its March investor day how the floors on its floating rate loans help mute the impact of falling rates but still allow it to participate in a rising rate environment. Also, the company directly owns property which adds duration to its portfolio and allows it to collect rental income.

- Lending standards have increased significantly since 2009. Loan to values is limited to 60% versus 70% prior to the Financial Crisis. Only in-place rents are considered in evaluating loans and they are marked to market in the event of a sublease. Minimum debt service is 1.35-1.87x versus 1.05-1.35x before the crisis. Securitizations now have cash reserves and a guarantee from the sponsor and STWD hedges the interest rate risk and locks in the credit spreads.

- Liquidity remains strong and STWD as it maintains $250 million cash on hand. 45% of debt is unsecured or off-balance sheet. 75% has no margin calls. The duration of liabilities is 50 months versus 41 for mortgage assets which reduces refinancing risk. This also highlights STWD's use of A-Notes as financing over warehouse lines. For a typical commercial mortgage, it is 75% borrowed with 25% equity. STWD splits the 75% loan into an A-tranche of 56% and a B-tranche of 19%. It will then borrow against the A-tranche with A-Notes.

- STWD has $7 billion in liquidity now plus $3 billion in unencumbered assets. The goal going forward is to continue to boost unencumbered assets with more issuances of unsecured debt and securitizations to move debt off the balance sheet. We believe all of this activity continues to point to STWD's dividend being safe.

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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