

ConAgra Brands (CAG)

Maintain SELL

Welcome to 1985 – just raise prices and ignore private label. CAG’s first strike was the admission that Pinnacle Foods sales are eroding and results are coming in below forecast. After strike two with CAG’s Legacy business posting disappointing fiscal 4Q19 results, we are maintaining our SELL recommendation. The company posted weaker sales at all units except international which had a product roll-out in Canada. Volume was shed and it appears that pulling Food Stamp delivery forward with the government shutdown that helped 3Q results reversed and created a tough 4Q for CAG. Weakness in margins also remains an issue as the company needs both sales and margin gains to reach EPS and debt reduction targets:

- **Kroger and Wal-Mart confirmed that CAG’s 3Q was helped by accelerated food stamp payments and numerous winter storms.** Out of the blue, CAG reported volume gains in the prior quarter with little explanation. KR and WMT said their sales jumped as more people received an additional food stamp payment due to the government shut down and storms caused people to stock up on supplies. KR and WMT forecast a reversal and just confirmed it. **CAG reported a typical quarter of negative volume and found it tough to hold pricing.**
- **CAG continues to focus on boosting pricing for growth.** We noticed it cut marketing and brand building that was supposed to support the higher prices and product roll-out and that alone likely added 2-cents to EPS last quarter. Legacy CAG is now joining Pinnacle Foods and posting negative growth
- **Looking at a couple of small parts of the portfolio show growth is slowing and not offsetting areas of negative growth for CAG.** We noticed that Pinnacle’s sales continued to decline at an accelerating rate again too. After much hype around *Wish-Bone* and *Duncan Hines* in the spring – they received no attention in 4Q results or presentation beyond a comment, “they are moving toward stabilization.”

- **Taking pricing when the rest of the market does not – swiftly cuts volumes. CAG saw this hit three product lines in the last quarter – *Hunt's Tomatoes*, *Chef Boyardee*, and *Marie Calendar's*. CAG noted that it will stick to its guns and hold higher pricing.**
- **The lower volumes quickly hurt margins too. Grocery & Snacks saw margins fall 220bp in 4Q and Refrigerated fell 100bp. CAG may have a tough time winning back customers too if it is not only higher priced than private-label brands but other name-brand competitors too. They posted negative growth all 3 brands and it looks like *Chef Boyardee* volume fell at double digits. *Marie Calendar's* looked very hard hit by competitors' pricing actions.**
- **CAG believes discount pricing is temporary and its way of operating will win out in the long run. It touted that these brands continue to be big cash cows and iconic brands.**
- **However, it also took an impairment charge against *Chef Boyardee*, which indicates to us that the future cash flows are not facing temporary pressure.**
- **We still think the debt and margin goals are unrealistic. Looking at free cash flow and the dividend, it appears debt could fall about \$1.2 billion in the next two years. To reach the 3.5x EBITDA target, the EBITDA would require a 20% operating margin. The company is only forecasting mid-16% in the next year and a long-term target of 18%-19%. Plus, marketing and R&D likely needs to rise after underinvestment and the need to remake product lines and roll out new products.**
- **Margin goals rely heavily on realizing synergies which we still consider optimistic – especially the increased synergy target after Pinnacle Food disappointed. The company just saw margins decline in fiscal 2019 even with some realized synergies and lower marketing costs as negative volume offset pricing. It will require more than just the just synergies, which means taking more pricing and we're watching that plan not work so well right now. Moreover, looking at the 4-years of remaking legacy CAG – margins were only up about 40bp from 2015-18, and they fell in fiscal 2019.**

Kroger and Wal-Mart confirmed that Food Stamps Were a Headwind Last Quarter

Whenever something that normally doesn't grow suddenly has a nice quarter – we look for explanations. CAG's fiscal 3Q19 had a surge in volume, which was out of line with past trends. The company attributed the increase to its brand-building plans and changing the labels of various products. We were skeptical as noted in our 3Q update and pointed out that winter storms that impacted nearly the full country for periods of time caused more people to eat at home and stock up in case of power outages or closed roads during those times and thus shopped more at grocery stores. Also, with the federal government shut down, Food Stamp payments were accelerated with many people getting four payments in the last quarter vs three.

According to Kroger, the food stamp issue added 44bp to its sales comp and Walmart gained 40bp. Due to the timing of their quarter ends, they effectively had 2 months of this period in their fiscal 3Qs and 1 month in fiscal 4Q. The results are in and Kroger saw the Food Stamp issue as a 15bp headwind and Walmart said it was about 40bp for it in the most prior quarter:

| Comp Sales | 1Q19 | 4Q18 | 3Q18 | 2Q18 | 1Q18 | 4Q17 |
|------------|------|------|------|------|------|------|
| Kroger | 1.5% | 1.9% | 1.6% | 1.6% | 1.9% | 1.5% |
| Wal-Mart | 3.4% | 4.2% | 3.4% | 4.5% | 2.1% | 2.6% |

ConAgra's legacy business returned to the normal trend of weak volume and trying to hold some pricing and ended up with negative sales growth after enjoying the full impact of Food Stamps and winter storms in its last quarter:

| CAG Grocery | 4Q19 | 3Q19 | 2Q19 | 1Q19 | 4Q18 | 3Q18 |
|--------------|--------------|-------------|-------------|-------------|-------------|--------------|
| Volume | -1.1% | 2.1% | -2.2% | 0.1% | -0.3% | -4.1% |
| Price | <u>-1.4%</u> | <u>0.8%</u> | <u>0.3%</u> | <u>0.0%</u> | <u>1.4%</u> | <u>-2.2%</u> |
| Total growth | -2.5% | 2.9% | -1.9% | 0.1% | 1.1% | -6.3% |

| CAG Refrigerated | 4Q19 | 3Q19 | 2Q19 | 1Q19 | 4Q18 | 3Q18 |
|------------------|-------------|--------------|-------------|-------------|-------------|-------------|
| Volume | -1.5% | 3.5% | 0.5% | 0.5% | 2.9% | 1.8% |
| Price | <u>0.9%</u> | <u>-1.1%</u> | <u>0.0%</u> | <u>0.9%</u> | <u>2.3%</u> | <u>0.8%</u> |
| Total growth | -0.6% | 2.4% | 0.5% | 1.4% | 5.2% | 2.6% |

CAG had the best of that in its third quarter and the worst of it last quarter. We continue to believe that the last two quarters aside, CAG is simply not a growth company.

Just Keep Boosting Prices – But Don't Marketing Investments Need to Continue?

CAG repeatedly says it does not want to focus on market share and is more concerned value over volume. Higher profits on smaller volume. As a result, its plan is to follow what P&G and Coke did for years – unsuccessfully btw. Keep raising prices and sacrifice volume. Private label goods have a place too and they can have the lower margin sales. In the prior section, it is already clear that taking pricing at the grocery and refrigerated divisions is becoming more problematic to maintain. For the total legacy part of CAG, it simply isn't growing the top line.

| Org. CAG Growth | 4Q19 | 3Q19 | 2Q19 | 1Q19 | 4Q18 | 3Q18 |
|-----------------|--------------|--------------|--------------|--------------|-------------|-------------|
| Legacy Vol | -1.2% | 1.2% | -2.2% | 0.0% | -0.1% | -2.8% |
| Legacy Price | 0.7% | 2.1% | 1.1% | 2.1% | 2.1% | 0.6% |
| Brand Building | <u>-0.2%</u> | <u>-1.4%</u> | <u>-0.5%</u> | <u>-0.9%</u> | <u>0.0%</u> | <u>0.0%</u> |
| Growth | -0.7% | 1.9% | -1.6% | 1.2% | 2.0% | -2.2% |

We want to point out three things here. First, with the exception of the 3Q19 when storms and Food Stamps helped demand, Legacy CAG is generally posting negative volume continually. Moreover, the pricing gains are not that strong either and appear to be slowing. The recent trends in volume follow several years of negative volume as CAG has been working to take pricing for four years now. So even with easy comps, CAG's base business is not growing.

Second, taking price against cheaper competition requires marketing and brand support. Recently, some of this spending has been reallocated as a reduction to sales rather than an expense. That is the line on brand building in the table above. After a heavy investment in 3Q19 to roll out some new products – this area of spending was cut significantly in 4Q19. That is a key point too. CAG missed on revenue forecasts even though the contra-account charge to sales almost disappeared completely last quarter. In effect, that cut in marketing boosted net sales – and CAG still missed.

Brand building investments and marketing were supposed to be very necessary to roll out all the new innovations like changing the name of *Wish-Bone* ranch dressing to *Wish-Bone RANCH DRESSING*. Yet, it continues to slash spending:

| Marketing | 4Q19 | 3Q19 | 2Q19 | 1Q19 |
|----------------|--------|--------|--------|--------|
| Advertising | \$73.9 | \$67.4 | \$69.4 | \$42.7 |
| Brand Building | \$3.7 | \$28.0 | \$10.5 | \$16.2 |
| Total | \$77.6 | \$95.4 | \$79.9 | \$58.9 |

We estimated the brand-building in dollar terms by using the basis points allocated as a drag on sales in the various quarterly presentations. Pinnacle Foods was acquired in the 2Q of last year. Historically, Pinnacle spent about \$30 million per year on marketing along with some unquantified slotting fees. For the fiscal year of 2019, CAG spent \$312 million. Assuming a full year of Pinnacle, it would likely have been about \$320 million.

The problem is stand-alone CAG used to spend \$330-\$350 million per year. With Pinnacle at roughly \$30 million and the company highlighting how much support spending it will be making – we’re surprised to see the combined company coming in below \$360 million. **Simply having brand building come \$10 million light added 2-cents to EPS in the 4Q19 results.**

The third thing we want to point to is CAG’s calling out of some new innovations for growth in a handful of products is not always sustainable nor is it driving positive sales for all of legacy CAG. We’ve talked about this in prior reports but the playbook often looks like this: discontinue a current product/packaging by investing in mark-downs of previously shipped product and clearing shelf space in the stores, then against those ugly comps, roll-out the new version and packaging with some marketing and enjoy the initial stocking of the shelves again. As sales equal customer consumption and not shelf stocking, the growth rate declines. For individual areas in the product line-up, growth can pop – but because people do not necessarily eat more food – they may not buy another product in the company’s portfolio creating negative growth elsewhere as they try the new version of something else. Thus, the total growth of the company does not increase:

| Sales Growth | 4Q19 | 3Q19 | 2Q19 | 1Q19 | 4Q18 | 3Q18 |
|---------------------|-------|------|-------|-------|-------|-------|
| Frozen Single Meals | 5.7% | 8.3% | 11.3% | 10.0% | 13.0% | 13.2% |
| Snack Foods | 6.5% | 7.5% | 6.4% | 3.2% | 5.8% | 5.7% |
| Total Legacy CAG | -0.7% | 1.9% | -1.6% | 1.2% | 2.0% | -2.2% |

The company doesn't break down frozen single-serve meals and snacks into volume and price, but it is clear that the growth phase for frozen single meals is slipping. The company blames some of that on competitors offering lower prices than Marie Calendar items. Someone wants the market share more.

What is interesting in this dynamic is some of the Pinnacle divisions - that are not in the numbers above - received enormous attention in 3Q19 and Investor Day. Sales at *Duncan Hines* and *Wish-Bone* have been declining at double-digit rates for some time. Investors were told, the new product is starting to roll-out, the innovation teams at CAG are fixing this. There were multiple slides for each in various presentations. **Did anyone else notice that neither were mentioned in the 4Q presentation at all? In fact, the only mention of them on the call was "they are moving toward stabilization."** That sounds like sales trends are still negative even with the new label designs. Pinnacle sales at retail are still showing accelerating declines:

| PF Retail | 4Q19 | 3Q19 | 2Q19 | 1Q19 | 4Q18 | 3Q18 |
|--------------|-------|-------|-------|-------|------|------|
| Sales Change | -5.6% | -4.6% | -3.0% | -1.4% | 1.1% | 2.1% |

The company has already warned that a turnaround for Pinnacle Foods will probably not start for 6-10 months. What's the plan? They are going to repackage products and raise prices in an attempt to boost total sales and margins. We'll talk about this more below, but we're skeptical that if customers aren't buying cake mix and salad dressing now – what will make them buy more at higher prices? Maybe higher marketing and brand investments – which again looks like a headwind for future results.

Chef Boyardee, Hunt's Tomatoes, Marie Calendar's Show the Fine Line of Price Hikes and Material Volume Declines

During the quarter, CAG noted that the price of steel cans had risen and therefore they raised prices for *Hunt's Tomatoes* and *Chef Boyardee* canned pasta. In *Hunt's* they raised prices by 5.1%, more than any other branded companies while many private-label tomatoes took much less pricing and many held flat. They did not quantify how much volume CAG lost, but CEO Sean Connolly noted, "*what we did not anticipate is that private label would stay flat and, in some instances, actually decrease price. By the end of the quarter, price gaps were simply too wide for consumers to ignore and we lost volume.*"

Anecdotally, we noticed this week that *Hunt's Tomatoes* were selling for a 100% premium to the store brand. Across the aisle, Kraft macaroni and cheese was selling for \$1/box versus \$0.89/box for the store brand. Both companies are getting a premium price, but has CAG already pushed the pricing gap too far?

Chef Boyardee saw sales fall by 8.9%. Now remember, they raised prices. So, if sales fell 8.9%, the volume decline was likely greater than 10%-12%. Going back to our red flag above, that the company also cut back on marketing, this probably hurt sales even more. Here's what Sean Connolly said on that:

“Similarly, on Chef Boyardee, we took price increases throughout the year. In Q4, the elasticity impacts of these increases were exacerbated by a decrease in merchandising support that was beyond our expectations. Each of these brands, Marie Calendar's, Hunt's and Chef Boyardee has a leadership role in its respective category. When on-shelf price gaps grow too wide or merchandising becomes uncompetitive, volume can be impacted quickly and significantly in the short-term windows and that was the case in Q4.”

Leaving aside the odd comment that CAG's marketing spending was lower than they expected as though the company had no control on that matter, we think this captures the problem that branded companies have been dealing with for 40 years. They don't operate in a vacuum anymore. There are other big players in food and supermarkets have huge private label offerings on the same shelves. Raising prices is not a pain-free way to grow – It cost their iconic brand over 10% volume decay in one quarter. Marketing has to be ramped up to try to limit volume decay and that is a sales/margin headwind too.

Marie Calendar's saw sales fall 3.3% despite all the new product remakes. CAG is blaming promotional pricing by competitors taking market share:

“Slide 14 highlights one example, where our competitor's product was discounted to drive significant incremental or promoted growth. As we moved through the fourth quarter, our competition became more aggressive on price and displaced some of the very valuable merchandising support that we had anticipated for Marie Calendar's. We don't believe that the short-term renting of our market share is a sustainable way to compete.”

CAG is still pushing its plan as better – raise prices and take more profit. Its view is other players cannot survive with big volume gains at lower prices (incremental sales growth of

competitor's products vs. *Marie Calendar's* was +75% vs -20%. We would note two things. The first is **shoppers stock up on products that are on sale. It is called pantry inventory** (or in this case freezer inventory). If meals are normally \$5 and suddenly only cost \$3, people buy thirty of them instead of four. **It takes longer to work off supply at home. Also, they become conditioned to wait for a sale before they buy again** – there's no hurry to buy more given the supply at home. This was seen when shoppers were conditioned in the early 2000s to see that pricing changes and thus, they were conditioned to stock up on shampoo or laundry detergent anytime they were on sale. When the recession hit and people stopped spending, Procter & Gamble and Clorox found that even lowering prices didn't get people to start buying again because they still had 7 bottles of soap at home. Also, it's rare that the cheaper brand doesn't stay cheaper at all times. The gap may narrow, but it still offers a lower price than CAG. Thus, once market share is lost, it's tougher to get it back.

The second problem in our view is when CAG loses volume or has only modest gains – its margins tend to fall. This is key to the whole plan, give up low-profit volume, boost price and enjoy higher margins:

| CAG Grocery | 4Q19 | 3Q19 | 2Q19 | 1Q19 | 4Q18 | 3Q18 |
|---------------|--------|--------|-------|--------|--------|--------|
| Vol. Change | -1.1% | 2.1% | -2.2% | 0.1% | -0.3% | -4.1% |
| Price Change | -1.4% | 0.8% | 0.3% | 0.0% | 1.4% | -2.2% |
| Margin Change | -220bp | +142bp | -2bp | -129bp | +121bp | -257bp |

| CAG Refrigerated | 4Q19 | 3Q19 | 2Q19 | 1Q19 | 4Q18 | 3Q18 |
|------------------|--------|-------|--------|--------|--------|-------|
| Vol. Change | -1.5% | 3.5% | 0.5% | 0.5% | 2.9% | 1.8% |
| Price Change | 0.9% | -1.1% | 0.0% | 0.9% | 2.3% | 0.8% |
| Margin Change | -100bp | +17bp | +100bp | -162bp | +109bp | -58bp |

In talking about *Hunt's* and *Chef Boyardee*, CAG's CEO was clear to point out how strong those brands are and how much cash flow they generate. They have seen temporary pricing issues from competitors before, they expect those products to remain very strong:

“We have a variety of canned food businesses that have quite frankly been very reliable contributors over the last several years, Hunt's is a good example of one of those businesses as has Chef. It is quite possible that from time to time for all the reasons we've discussed quite a bit today that we can see kind of this non-economic behavior by competition. That will happen from time to time.”

But, it doesn't tend to happen often and it does tend to be transitory. So, to label a reliable contributor as no longer reliably contributing is if that the perpetual notion is a bit of an overreaction. But I'm not going to say that we don't evaluate these kinds of things all the time. I don't think you'll find a company in our space that's been as active as we have over the last five years in reshaping the portfolio. And that includes divesting things that are kind of chronic drag on what we're trying to accomplish. So, we're always looking at that. We did more of that this quarter. I just wouldn't want you to paint -- to label canned foods as not reliably contributing as a perpetual notion when that's just not been what we experienced. In fact, what we've experienced is, historically it's been a high cash flow business and it's thrown off a lot of cash, a lot of fuels for growth elsewhere in the portfolio like frozen."

The question has to become – why did they take an \$89.6 million impairment charge against *Chef Boyardee* last quarter? If all this is temporary, the long-term cash flow should not be impaired. We also question how such a strong brand can get hit for a double-digit volume decline so quickly.

Are Debt and Margin Goals Realistic?

CAG expects to pay down its debt to 3.5x EBITDA by FY2021. That's two full years. Currently, the company is giving guidance for \$1 billion in free cash flow for 2020 and the dividend consumes just over \$400 million. The company also expects to spend over \$300 million to merge the companies and develop synergies. Let's keep it simple and assume the \$300 million in cost is in free cash flow guidance and forecast the company can retire \$600 million in debt each of the next two years. That would drop debt from the current \$10.4 billion to \$9.2 billion. **If the ratio is going to be 3.5x, EBITDA needs to be above \$2.6 billion.**

What is the starting point? Legacy CAG just did \$1.17 billion in adjusted operating profit for 2019, which was down \$18.8 million from fiscal 2018 with \$31 million of synergies achieved. Pinnacle Foods did \$3.15 billion in sales and \$690 million in EBITDA for fiscal 2018. We only have a partial year to look at for 2019, but we know the sales are down about 4%, and the operating margin was 15.3%. Also, depreciation is running about \$100 million for the total group per quarter. We are going to break that down as \$70 million to Legacy CAG and \$30 million to Pinnacle. **We estimate the starting point is basically \$2.0 billion in EBITDA**

| Starting EBITDA | |
|----------------------|---------|
| CAG Legacy EBIT 2019 | \$1,172 |
| PF est. EBIT | \$463 |
| Annual Dep/Amt | \$400 |
| Est. EBITDA | \$2,035 |

CAG believes it will find \$285 million in synergies by the end of fiscal 2022. The 2019 results already include \$31 million. If we give them credit for finding another \$200 million by the end of fiscal 2021, that would be 80% the target and get EBITDA to \$2.2-\$2.25 billion. **We've already addressed many times that we do not think that forecast is realistic. Pinnacle had been restructured extensively by the prior owners and CAG was forecasting \$215 million in synergy which was 700bp of margin from Pinnacle when it first acquired it.** After Pinnacle disappointed and CAG announced it would need to rebuild the product line and support mechanisms, it magically boosted the synergy forecast to \$285 million. **With Pinnacle results continuing to fall, we remain skeptical about the full level of synergy will be realized.**

Sales growth is expected to be about 1%, so getting EBITDA above \$2.6 billion is not going to come from the top line. That would only contribute about \$30 million to the \$350-\$400 million shortfall. The only way this can happen is if CAG picks up about 300bp of margin on top of all the cost synergies! If revenues rise by 1% and 1%, they would top \$11 billion in FY21. That would require a 20% operating margin to reach \$2.2 billion in EBITDA and \$2.6 billion in EBITDA. CAG isn't forecasting a margin that high.

We know their marketing and brand support needs to increase – that's a headwind for margins. In fact, marketing was lower in 2019 than in recent years for just CAG without Pinnacle. A \$50 million increase in this area would be a 45bp headwind on margins. We also know they are remaking many products which means R&D should be rising, which is also a headwind for margins. Combining computer systems, buying in bulk, shipping on the same truck – all those types of margin increases are part of the synergies the company expects to find and we already added that into the total. CAG has to achieve those synergies – then likely double it with other margin-boosting means. Let's also not forget, even CAG expects Pinnacle to be digging its hole deeper in early fiscal 2020 until they can fully apply their plan.

As we pointed out after the Investor Day presentation, CAG is touting how it grew margins by 400bp from fiscal 2015-18. However, the bulk of that involved selling a lower margin

potato business and spinning off a money-losing RalCorp. Looking at what CAG was operating now and in 2015 – basically the legacy grocery business – margins only grew by 40bp as a result of 4-years of remaking the business. And as we’ve pointed out, they gave back margin last year at the two biggest units:

| Legacy Margins | f-2019 | f-2018 |
|--------------------|--------|--------|
| Grocery 50% EBIT | 22.5% | 22.9% |
| Refrig 33% of EBIT | 17.2% | 17.4% |

Even the company’s forecasts do not seem to call for much more than simply the \$285 million in synergies to materialize by FY22. Sales are under \$11 billion and should rise slightly over that by FY22. That makes \$285 million in synergies worth 260bp by then. Operating margins in 2019 were 15.4%, the forecast is for those to rise to 16.2%-16.8% this year that’s basically \$90-\$150 million increase in EBIT so there’s synergy kicking in. Then the goal is 18-19% margins after the integration is complete in FY22. That’s 260bp-360bp of margin gain. They would still be shy of reaching \$2.6 billion in EBITDA too. \$11.1 billion * 18% is \$2 billion of EBIT and add in \$400 million of depreciation = \$2.4 billion for EBITDA. That would be another year out too.

Disclosure

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