

July 14, 2021

Conagra Brands, Inc. (CAG) Earnings Quality Update- 6/21 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 coverage of CAG at 2- (Weak).

We are also moving CAG to “On Deck Sell” status from “Top Sell” on the Focus List. This is a reflection of the price drop rather than quality improvement. Any significant recovery in price may result in a return to Top Sell status.

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

Summary

CAG reported adjusted EPS of only 54-cents in 4Q21 after guiding to 49-55 cents. Estimates had them at only 52-cents which illustrates that investors were already losing faith in CAG beating forecasts given that the company has been topping the high end of its guidance by a wide margin until 3Q21. In addition, the company gained 1.0 cents from a lower tax rate and management is forecasting the tax rate to be higher again going forward. It added 0.5 cents from rounding up EPS. More importantly, CAG again noted that its 2.7% higher pricing was helped by lower promotional activity which is netted against sales. Less promotional spending boosts sales, pricing, and EPS. It was also lower against the first period of Covid. It was not quantified and had been half the pricing gains of fiscal 2Q21 and 3Q21. If it was one-third of

pricing in 4Q, it added 3.2-cents to EPS. If it was half, it added 6.7-cents. Plus, its equity income investments added 2.2-cents.

We believe CAG effectively missed forecasts badly if these items cannot be maintained. The company cut guidance for fiscal 2022 with operating margin now expected at 16% vs. 18%-19% and EPS of \$2.50 vs. \$2.63-\$2.73. The only reason why they didn't cut the forecast further is CAG expects growth in pension income and equity income investments to offset more than half the inflationary problems.

What is strong?

- Equity Income Investments are primarily its stake in a JV called Ardent Mills. This is their former flour milling business. This is a lower-margin commodity business. One of our biggest criticisms of CAG's restructuring and margin-building prowess is almost all of its 400bp margin gain came from spinning off lower-margin businesses like flour milling, Ral-Corp, and Lamb Weston potatoes. Ardent has about a 10% gross margin and mid-4% net margin. We know it occasionally has a stronger year under favorable conditions of high demand like 2017-18 when gross margin jumped to 11.6%. We do not have the 10-K to judge Ardent's performance for fiscal 2021 yet, but the equity income to CAG has jumped in the last two quarters.

CAG Eq Income	4Q	3Q	2Q	1Q
fiscal 2021	\$33.4	\$21.5	\$23.0	\$6.5
fiscal 2020	\$22.9	\$10.4	\$27.6	\$12.3
fiscal 2019	\$9.2	\$12.7	\$37.7	\$16.2

We will do more work on this when we have the 10-K, but there have been gains, bad contracts, and restructurings within Ardent for years that produce big swings in results. There is obviously an easy comp for 1Q22 in this area. It's generally a fairly stable business looked at over time. But from the discussion on the call, this is a key area where CAG expects to pick up 10-20 cents in EPS for fiscal 2022 to offset 41-cents of inflation pressure. That would mean \$50-\$100 million in higher equity income y/y. It certainly helped 4Q21 by over \$10 million at over 2-cents in EPS. Ardent has moved into milling more grains than simply wheat such as chick-peas and quinoa, but the size of the improvement CAG is forecasting may be a stretch.

- Foodservice is returning. Historically, this was just over 10% of sales and fell to 9% in fiscal 2020 and only 7.5% last year. That was Covid-related and some of those lost sales were offset by the higher grocery business. For the 4Q, sales in this area jumped 31% compared to Covid's 4Q20. 1Q will give CAG a food service comp of -20% from the prior

year. We would expect to see some growth there. We do think investors should be concerned that foodservice margins are about half what CAG enjoys on retail sales. Moving these sales back to foodservice represents about a 5-cent headwind for EPS.

What is weak?

- CAG expects to take pricing under the current inflationary environment. However, they are guiding for it to take longer than anticipated setting up a very tough 1Q22. The problem we have is for years CAG talked about building its brands and conceding volume so they could take pricing. Yet with the exception of Covid – they really have not done this. Look at their two largest units on pricing changes by quarter:

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Grocery Pricing	4Q	3Q	2Q	1Q
fiscal 2021	0.8%	3.7%	1.7%	3.5%
fiscal 2020	2.4%	-1.9%	-1.2%	-0.7%
fiscal 2019	-1.4%	0.8%	0.3%	0.0%

Frozen Pricing	4Q	3Q	2Q	1Q
fiscal 2021	3.4%	4.3%	1.4%	6.2%
fiscal 2020	-0.2%	0.7%	1.9%	1.3%
fiscal 2019	0.9%	-1.1%	0.0%	0.9%

Grocery & Snacks 4Q21 should be a big red flag in our view. Inflation was already hitting, and while there was a tough comp from Covid, they picked up almost nothing. They still face competition from other branded and numerous private-label products. CAG has a horrible record of trying to boost prices more than the other competitors and saw it wipe out areas like Marie Callender's and Hunt's Tomatoes.

- CAG sees refreshing its product lineup as a key to success. Under normal times, that requires the shelves to be cleared with mark-downs so there is real estate in the grocery store to refill with new products. CAG was in the middle of a multiyear disaster of having to remake Pinnacle Foods line-up and losing pricing as it sought to introduce new products. Covid saved them. They not only didn't have to mark down product to get rid of it, anything they stocked was selling without promotions. CAG will need to live in the real world again where Mondelez, Del Monte, Pillsbury, Swanson's, Weight Watcher's, and numerous store brands want the shelf space too and grocers aren't out of inventory.

- Lower promotional spending was also a big part of the increase in pricing during Covid. Promotional spending is netted against sales. We know in 2Q and 3Q – half the pricing gains were due solely to lower y/y promotional spending and CAG said that helped 4Q too. That has been a major EPS contributor.

They have very tough comps in that area. CAG is guiding to the idea that it will continue to pay less on promotional spending forever and thus there won't be a headwind on pricing from a return of normal promotional activity. Imagine you're a grocery chain and you were collecting \$100 million in slotting fees, in-store signage, in-store tastings/demos, premiums for end-of-the-aisle product placement from CAG in 2019. Then it falls to \$40 million and CAG only wants to restore spending to \$50 million going forward. Meanwhile, Frito Lay and others call and want to maintain their inflated Covid volumes too. They were spending \$200 million before Covid, dropped to \$100 million during Covid, but now are willing to jump to \$250 million. Whose products will you stock more of? And your store brands are lower-priced than all the branded companies, your customers buy them, and you have a higher margin on those than the branded stuff – how much more CAG are you going to stock? We have already seen them try this with Marie Callender's pricing in fiscal 2019. A competitor offered product with lower prices to the stores than CAG and grabbed 20% of the frozen display cases for that product line.

- CAG is still not replacing the lower promotional spending with higher traditional advertising either. 4Q21 advertising came in at \$75.2 million, basically equal to 4Q19 (without Covid) and 3Q21. We have pointed out many times, that CAG was spending more on advertising in the time before it added Pinnacle Foods to the mix as a much smaller company. It's going to be difficult to claim premium prices and convince grocers to take your product and replace existing products with your new offerings as you spend less promoting and advertising.
- If CAG is so good at this, why do they continually take impairments on their brands? Could there have been a stronger period for sales in fiscal 2021? Yet, CAG took a \$95.5 million brand impairment. During fiscal 2020, the impairment was \$260 million, 2019 - \$94 million, 2018 - \$15 million, 2017 - \$343 million.

What to Watch?

- Looking at the bridge to fiscal 2022 earnings, CAG is expecting a 41-cent hit from inflation squeezing earnings. It expects to offset about 70% of that from continued expense cuts and higher income after the 3-years of growth, brand building, and focus on cost-cutting. CAG now expects 2022 adjusted operating margin of 16% vs. 15.4% in 2019. There is some mighty growth planned.
- The expense cuts are expected in the form of promotional spending, Covid actions, and better buying/synergies. We would be skeptical of some of this. We think competition will push CAG to spend more on promotional items – especially since it wants to keep rolling out new products and sees 20% remakes for its product line as a way of staying competitive. Higher promotional spending will reduce sales growth too. The problem with banking on Covid to boost profits is most of the Covid related cost came from giving employees higher wages. How will CAG cut pay? The labor market is tight and people are still getting paid higher unemployment checks. Also, Covid saved money as CAG didn't have travel costs. Those should return and were \$13 million for the first 3 quarters of fiscal 2021. We could see some buying and transportation costs being mitigated simply as supply chains normalize too – but have a tough time seeing how in year four, CAG is going to pick up tons of new cost savings from Pinnacle Foods integration like it claims.
- The income increases that are supposed to offset the inflation pressure are expected from Ardent Mills which we spoke of earlier and pension income growth. We need the 10-K to evaluate both. As noted before, Ardent has been a fairly consistent low-margin commodity business. CAG has restructured it some and added minor add-on acquisitions. Pension income growth likely would come from changes in assumptions. It's also non-cash income.
- CAG is also touting that it has cut its debt/EBITDA ratio to only 3.6x (actually down from 4.00x to 3.65x – CAG rounded down). It is taking credit for its prowess in improving the balance sheet. We would note that actual debt has not declined very much- \$9.2 billion to \$8.9 billion after a stellar year when EBITDA rose to \$2.45 billion from \$2.30 billion. That EBITDA was fueled by a 17.5% operating margin in 2021 vs. 16.5% in 2020. The forecast is for 16.0% in 2022. On the expected flat sales, the margin squeeze will drive EBITDA back to 2020 levels and the debt to EBITDA back to 3.92x. As far as paying down debt, cash from operations was \$1.47 billion in 2021 – that should be lower due to operating margins falling 150bp on flat sales, and it should be lower as inventory costs

more per unit and is a drain on working capital. Capital spending is expected to be \$475 million and the dividend is \$600 million. The cushion to retire more debt could be lower if CAG does not reduce Covid pay and hold the line on promotional spending as planned.

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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