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BTN Research

August 9, 2018 | www.btnresearch.com

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ConAgra Brands (CAG)-Sell

We see a high probability of disappointment with the Pinnacle Foods (PF) deal and the high debt load.

We recently looked at ConAgra (CAG) in an EQ-Review on July 26, 2018. We noted several headwinds such as cash flow growth has stalled despite cuts to advertising and stretching payables to suppliers with third-party lending arrangements. The company is covering its dividend at about 50% of free cash flow, but not its stock repurchasing that has been helping EPS growth:

Shares in mm	f2018	f2017	f2016	f2015
Avg Shares	407.4	436	438.5	431.3
EPS Growth from repo.	8.4%	0.1%	-1.7%	n/a

In fiscal 2018 (ending in May), CAG had a big surge in EPS growth from buying back shares. This will continue in f2019 at a slower rate as the ending share-count in May was 390.8 million shares or 4.1% lower than the average for the year of fiscal 2018.

However, as the merger with Pinnacle Foods is finalized in two quarters, CAG will issue about 77 million shares to Pinnacle shareholders and another 16 million shares issued for cash. This $10.9 billion purchase will boost Debt to EBITDA to 5.0x. The company has effectively said that the dividend will not grow this fiscal year (ending in June 2019). It also will devote free cash flow toward paying debt down until it reaches 3.5x EBITDA, which means little if any share repurchases combined with the new issuance of shares which should slow EPS growth.

The other issue comes from analyzing the deal. The price paid is key because there are three basic reasons to make an acquisition:

1) The price is so cheap, even if it performs poorly, it can still be attractive and produce solid return on capital.
2) There is so much fat to cut that earnings can be improved materially by picking low-hanging fruit and that will boost results – earnings/cash flow growth.
3) The target company is growing rapidly and can quickly grow into the value paid and produce a solid long-term return.

One can argue, other reasons may include acquiring a key breakthrough technology that helps the combined company even more. But, in the case of Pinnacle – we're talking about frozen green beans. Pinnacle was built using these rules in combination. Now, CAG is buying it for 15.8x EBITDA. Total debt will be about $11.5 billion and 5x EBITDA. To reach CAG's target of 3.5x EBITDA, it will need to pay down $3.5 billion, which is essentially 18 months' worth of EBITDA and they are not talking about fully digesting this deal and its benefits until 2022. Just a quick back of the envelope view makes this goal tough:

Pro forma EBITDA	$2,300
Taxes 21%	$200
Cap Ex	$350
Interest Exp	$575
Dividend	$410
Leftover	$765

This is a quick and simple look at the combined company operations and pro forma projections of trailing results. Capital spending is what the two companies have been spending, and interest expense assumes a 5% average rate. What is not in here is restructuring charges that will undoubtedly occur as the companies merge and pay severance, buy out contracts, redo computer systems, incur legal fees, etc. On the conference call, CAG expected to spend $355 million in cash to merge the companies and produce synergies $215 million by 2022. Also, working capital changes are not in here and higher prices alone for some raw materials may consume cash. The stated focus is also on investing more in the business. The company will argue there are some tax loss carry-forwards to mitigate some of this as well as asset sales that will be targeted. But, on the surface, paying down debt is going to take some substantial time.

Is there really much growth here? Both companies report that they are growing faster than the market – but this isn't a market growing at 20%. They are paying big multiples

for posting largely flat sales. Without acquisitions, Pinnacle would have been reporting almost no sales growth.

Hidden marketing fees are also penalizing sales. Pinnacle has noted that extensions of existing product lines, new recipes, and other new themed marketing ideas are key to maintaining sales. However, stores often require slotting fees, greater marketing support, coupons, and even discounts on new products to place them in the store. These are accounted for as reductions to gross sales and are likely why there is little positive pricing here.

CAG's goal is to cut expenses enough to improve margins at Pinnacle by 700bp. But, this is an acquisition of a roll-up situation. CAG is paying a higher multiple for Pinnacle, than Pinnacle paid to acquire the companies that built Pinnacle. Pinnacle had the same plan and already boosted margins by 800-1000bp. Now that rate of change has stalled, and CAG still expects to find 700bp more. This is one of the toughest types of acquisitions to succeed with.

Pinnacle did extensive work on restructuring. They have already closed surplus real estate, moved facilities closer to the raw materials, moved R&D, procurement, and sales teams to the same location to work more closely together. They have canceled external manufacturing and brought it house, cut the number of suppliers and types of materials used in packaging. Pinnacle is a company that has spent years accomplishing what CAG says it plans to do when it merges. We doubt there is much low-hanging fruit left – certainly not 700bp of fruit to pick.

Other minor headwinds include marketing, R&D, and amortization. CAG expects to invest more in the combined business, yet both CAG and Pinnacle cut advertising last year. Pinnacle also saw a drop in accruals for coupons and marketing. Pinnacle amortizes customer relationships over a much longer time than CAG – if combined on CAG's assumption schedule, the expense should rise. We see some potential for a one-time boost to earnings by using CAG's rate of return on Pinnacle's pensions and CAG's bad debt allowance assumptions.

Sales Growth - Defined as a Volume * Price

One of the big things in Pinnacle's results is they tout how sales are growing faster than the industry as a whole. That sounds like a great story, but it quickly becomes obvious that given actual sales results – the industry is not growing. One of the keys to the deal was Birds Eye frozen foods. Pinnacle bought it in late 2009 when it has $1.34 billion in sales. Here are the sales for this unit since then:

$ in mm	2017	2016	2015	2014	2013	2012	2011	2010
Birds Eye Sales	$1,299	$1,305	$1,227	$1,185	$1,097	$1,104	$1,101	$1,066

After the deal, Pinnacle eliminated some lower margin products and sold some minor things. But, after 7-8 years, sales are back to $1.3 billion. So, this must be big growth. Unfortunately, we found that sales growth defined as changes in volume and pricing was not the primary player here

Birds Eye	2017	2016	2015	2014	2013	2012	2011
Sales Growth	-0.40%	5.60%	10.00%	1.70%	0.50%	0.20%	3.30%
Pricing	0.00%	0.80%	1.40%	-1.20%	0.40%	1.70%	1.20%
Volume	-0.30%	2.90%	3.30%	2.30%	0.10%	-1.30%	2.10%
Acquisition	2.10%	2.10%	5.30%	0.60%	0.00%	0.00%	0.00%
Recalls	-2.30%	0.00%	0.00%	0.00%	0.00%	-0.20%	Data

Pricing has been a modest at best source of sales growth. The volume gains have come from initial stocking of new brand extensions and adding some new stores – in other words – initial stocking of inventory. In 2017, destocking at customers was the reason for negative volume results. In years, 2016, 2015, 2014, and 2011 – Pinnacle said Birds Eye sales were higher based on increased distribution and new product launches such as new sizes or Disney themed inventory. The rest of the sales growth has not been organic – it was bought via acquisitions, which are greater than all the volume gains.

Looking at total sales growth at Pinnacle – it looks even more pronounced that acquisitions are driving the bulk of growth:

Total PF	2017	2016	2015	2014	2013	2012	2011
Sales Growth	0.50%	17.80%	2.50%	5.20%	0.60%	0.40%	1.30%
Pricing	0.20%	0.20%	1.30%	-1.10%	0.20%	1.60%	2.00%
Volume	0.30%	0.00%	-0.70%	0.30%	-0.90%	-2.30%	-0.80%
Acquisition	0.00%	17.70%	2.30%	6.20%	1.60%	0.00%	0.00%

Lesser brands like Vlasic Pickles and Aunt Jemima have been drags on sales volumes and offset gains made by Birds Eye and the rest of the frozen products. Without acquisitions, this company really isn't showing any organic sales growth at all. Thus, if the goal is to buy Pinnacle Foods to achieve top-line growth – we think that is unrealistic.

The Hidden Drag on Sales

Grocery stores have limited space to sell products. In addition, they want those products to turn quickly to drive their own sales, limit their inventory investment, and generate profits for the store. In addition, it is generally known that stores tend to make more profit on store-brand (private label) products. Thus, branded food has even less space to fill and needs to convince stores that it's a profitable idea to carry these products. This is done basically by paying the store.

Pinnacle Foods defines sales as unit volumes x price – net of several other costs. Those other costs include cash discounts offered to stores, slotting fees (basically rent for shelf space), in-store marketing such as temporary price discounts, advertising in the store's weekly circular, and promotional displays, as well as coupons used by customers. There is not much of this that is fully quantified by Pinnacle Foods. Arguably much of it would come out of pricing, not volume and this would help explain why pricing growth is weak or negative much of the time.

Going into new stores as expansion would require this type of in-store spending. The store is replacing another product with Pinnacle's and the store wants to see the new inventory sell. Thus, it will insist on marketing support payments.

As important, extensions of current brands also require support, so customers know they exist. Pinnacle openly discusses how many new products it releases each year. Two things are key to remember, the new products are replacing something and that may be other Pinnacle items so there is often discussion about one product is growing and others beings

destocked or SKU elimination. Also, new products can mature very quickly – again this isn't a new iPhone. We're talking about rolling out a family-sized frozen dinner or adding a 4-cheese frozen pizza to the line-up. Thus, the discussion is often about how some products are growing, next year are not, and others are decaying. Discussions like this happen every year:

> 2017- Sales growth was driven by new Birds Eye Organics and Veggie Made Pastas offset by lower sales in frozen seafood and breakfasts. Duncan Hines 1-sized products boosted sales, while pie filling, Wish-Bone dressing fell.
>
> In 2015, Hungry-Man was falling. In 2016, new Hungry-Man Selects boosted sales. In 2017, Hungry-Man wasn't mentioned.

We won't write up every year here, but the lesson is clear – Pinnacle is maintaining essentially flat sales by eliminating some product and rolling out new product every year. The Annual Report continually touts its innovation philosophy in staying ahead of what customers want next. This goes back to even the public offering statements when the company cheered how 2011 saw 2.5% sales growth from new products. Total sales that year were up only 1.3%. So new product is a key part of what makes Pinnacle.

However, getting new product in the stores means they have to pay fees and marketing support to the stores and that comes out of pricing. New products also push existing ones out and thus cannibalize some of the volume. The net result is basically flat sales.

Cutting Costs – Boosting Cash Flow – That's CAG's Plan

If there has not been much if any sales growth, then CAG has two other options to make a deal work. Either pay a very low multiple or find many ways to cut costs. CAG cannot say it paid a low multiple. It paid a larger price for Pinnacle Foods at 15.8x EBITDA than Pinnacle paid for its major acquisitions:

Date	Purchase	Price	Sales	EBITDA	Price/Sales	Price/EBITDA	Margin
2009	Birds Eye	$1,340	$1,300	$142	1.0x	9.4x	10.6%
2013	Wish-Bone	$575	$190	$38	3.0x	15.1x	20.0%
2015	Boulder Brands	$975	$500	$62	2.0x	15.7x	12.4%
2018	Pinnacle Foods	$10,900	$3,154	$690	3.5x	15.8x	21.9%

The prices and sales figures were listed in announcements for the purchases. The EBITDA figures are estimated in most cases using partial year figures we found after the deals were completed and the Price/EBITDA figures were provided in some cases. The margin is EBITDA divided by sales.

It is obvious to us that CAG paid not only the highest multiples to buy essentially the same assets, but also Pinnacle Foods already cut costs significantly to boost profitability at these same operating companies given that it bought almost 60% of its current sales at margins of 10%-12% and now is almost at 22% for the full company.

The goal of CAG is to find $215 million in synergies at Pinnacle Foods where it can cut costs, do things more efficiently, and gain some savings by buying in greater bulk as it becomes part of a larger company. That's a 700bp increase in margin that is expected and is the figure used by CAG to forecast that the purchase price will only be 12.1x EBITDA after this is achieved in 2022.

Earlier, we pointed out the goal of CAG to pay down debt to 3.5x EBITDA. Without these forecasted synergies, that will require a $3.5 billion paydown. With these forecasts, it will mean retiring about $2.7 billion in debt. That amount of debt paydown is going to be quite a stretch for a company expecting about $500-$700 million in free cash flow after the dividend which also wants to spend $355 million to try to produce synergies.

Also working against this goal is Pinnacle's results have not been showing dramatic gains on some of these deals in a while. Let's look at Birds Eye, Wish-Bone, and Boulder:

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	$278.20	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%

In the case of Birds Eye, it has seen some sales growth as noted earlier due to some acquisitions after 2014. However, look at the margin. Pinnacle bought this in 2009 with a margin of under 11%. They drove it to basically 21% in two years and since then, it has been basically 21%-22% for years. We will discuss what Pinnacle did below to achieve this in addition to focusing and continual roll out of new products already discussed. However, we think CAG is buying a business that has already undergone a huge reorganization to

drive out costs and boost margin. The people at Pinnacle clearly had this focus and yet, they have been unable to pull out much more in the last 5-years. Now CAG plans to find another 700bp?

Wishbone we do not have great details about except this- Pinnacle bought it from Unilever and continued to have the production contracted to Unilever 18 months after the deal. Their goal was to move the production in-house after that time and be able to save enough in costs to essentially boost EBITDA to $65 million. That would require about $50 million in capital investment. So, they essentially paid about $625 million with the capital investment to buy $65 million in EBITDA or 9.6x EBITDA.

We do know that bringing the production in-house has happened and we believe EBITDA has increased since the purchase. However, we do not think Pinnacle has been successful in turning around sales at Wish-Bone. The company has cited lower sales at Wish-Bone in years 2015-18. The one exception was the 2nd half of 2016 when it said the launch Wish-Bone EVOO and Ristorante Italiano dressings offset some of the decay. By 2017, Pinnacle reduced SKUs at Wish-Bone and reworked some of the marketing and label design. Sales are still falling.

So, while this deal is too small for Pinnacle to break-out individually. Our best guess is that lower sales have hurt EBITDA while internal production has helped it. Perhaps the situation is sales in the $170 million range and EBITDA of $50 million. That would be below its own forecasts but still represent an improvement in cash flow vs. what was acquired. They have been working on this for over 4-years now. We're not sure how much more CAG can fix here.

Boulder may still be a work in progress, but it too is showing signs that it may have topped out in terms of margin gains in 2018. The company talked about some pricing pressure impacting results in 2018.

	1H18	2017	2016
Boulder Sales	$196.7	$403.4	$364.7
Adj. EBITDA	$38.1	$88.0	$59.7
Margin	19.4%	21.8%	16.4%

So again, Pinnacle Foods bought a company with a margin of about 12.4%, it improved it quickly and now seems to have leveled off at about 20%. It's early to make too many

conclusions here, but here's another business that is about 13% of the sales CAG just bought where it needs to find 700bp of cost savings after the previous experts already improved it by that amount and are not seeing further gains at this point.

In our opinion, this is a classic case of a roll-up of another roll-up story. We've seen this before – Newell buying Jarden leaps to mind and even CAG's purchase of Ralston. The previous company has already claimed much of the low-hanging fruit in terms of cost savings available and they bought the assets at a lower price with room for improvement. It sells to the next company at a premium price with the promise that tremendous synergy potential still exists. Is there 700bp of improvement left here that Pinnacle ignored? We seriously doubt that.

Look at the Level of Restructuring Pinnacle Has Already Done on These Assets

Give some kudos to Pinnacle – they do their work. Reading any of the annual reports in recent years is devoted to a recap of how they culled out poor performing SKUs, launched new products, found new ways to boost efficiency and save on costs. We talked about how they essentially added Wish-Bone and built their own production assets there rather than acquire Unilever's above. Here are some little things that they discussed in the 2017 annual report:

- Processing more grains in-house in the off-season in a plant they own and eliminating the need for additional third-party contract work
- Boosting conformity in pallets to optimize logistics
- Reducing the number of packing materials and cutting number of suppliers
- Redesigned production floor layouts at some plants to boost productivity
- New digital marketing and investing in e-commerce
- Consolidated 3 distribution centers into one in Pennsylvania and 3 refrigerated facilities into one in California and still added capacity
- Acquired a new Wisconsin plant that will allow more production brought in-house

We are particularly focused on something like reducing number of suppliers and materials needed for something like packaging. One of the biggest areas CAG expects to improve is better buying power by being a larger company. Even here, Pinnacle already did much of this and will mute CAG's efforts.

The heavy lifting of deals often involves optimizing real estate and employee locations. Pinnacle has done a ton of this and it shows in the margin improvements it has already seen on these assets. Here are some from the Birds Eye deal before Pinnacle went public:

> *"On May 15, 2012, we announced plans to relocate the Birds Eye research and development ("R&D") team from Green Bay, Wisconsin to our new facility at our Parsippany, New Jersey headquarters. We believe that the relocation will allow for seamless collaboration between marketing, sales, procurement and R&D that will drive superior brand innovation, marketing and productivity."*

> *"On April 15, 2011, we announced plans to consolidate the Birds Eye Frozen segment's Fulton, New York plant operations into our Darien, Wisconsin and Waseca, Minnesota facilities in order to locate vegetable processing closer to the crop-growing region and thus reduce the related freight costs"*

> *"On December 3, 2010, in an effort to improve our supply chain operations, we announced the closure of the Tacoma, Washington plant and the consolidation of production into our Ft. Madison, Iowa plant"*

Some Other Potential Headwinds/Tailwinds for CAG

Merging the two companies together may result in accounting assumptions at Pinnacle changing to the levels used by CAG. For example, CAG amortizes intangible assets like customer relationships and licensing agreements over an average of 14 years. Pinnacle is much higher than that:

Relationships	Years	Gross	Net
Distributors	34	$176.4	$116.7
Food Service	10	$11.4	$7.4
Private Label	7	$1.3	$0.0

Right now, Pinnacle is reporting $5.2 million in expense on amortizing distribution relationships. If that is moved to CAG's 14 years, it could jump to $12.6 million.

On pensions, Pinnacle uses a 6.0% rate of return assumption on assets, while CAG uses 7.5%. The discount rates are similar enough, but the 150bp higher return assumption would give lower Pinnacle pension costs by about $3 million.

Bad debt expense, here Pinnacle maintains a reserve of 3.4% of receivables. That has already come down slightly. However, CAG has almost no reserve at 0.3% of receivables. If CAG adopts its own estimates, it could free up about $10 million in income in the first year. After that, bad debt expense would likely rise again.

We see a few more costs that appear more likely to increase for Pinnacle going forward, especially with CAG reporting that it wants to invest more in the business. For example, CAG already cut is advertising last year and so did Pinnacle. R&D has been an area where Pinnacle has spent money – it cut there last year. Also, accruals for marketing items like coupons, broker commissions, and marketing costs all fell at Pinnacle in 2017:

Pinnacle #s	2017	2016	2015	2014
R&D expense	$16.1	$18.1	$13.0	$11.3
Advertising	$29.3	$33.0	$28.2	$35.9
Coupon Accrual	$2.4	$5.00	$2.0	$1.9
Broker Accrual	$7.0	$8.	$4.5	$3.5
Marketing Accrual	$39.0	$51.1	$46.2	$36.2

Conclusion:

We will congratulate the Pinnacle Foods team for some hard work reorganizing some businesses and boosting profitability via new products and aggressive cost-cutting. Even they were unable to boost sales very much and that reflects what they already know – people eat out more these days and cook at home less. Therefore, it is very difficult to grow the top line, especially when paying supermarkets fees and marketing stipends to support new product roll-outs.

However, we're not expecting a great match with ConAgra given the deal relies heavily on finding 700bp of additional margin gains from the Pinnacle assets. Margin gains have already stalled at Pinnacle and they are already at the point of using fewer pallet designs as a way to try to save more. We think the marrow is already gone from the restructuring bones and that sets up ConAgra for some disappointment after paying a premium multiple and taking on significant debt for this deal. Canned tomatoes and canned pasta seem unlikely to create big synergy opportunities with frozen vegetables and single-serving cake mixes. Stuff like Marie Calendar's should compete against the acquired Hungry-Man frozen

entrees. Perhaps SKUs can be reduced, but if Pinnacle has shown anything – success requires continual new product launch and retirement of older SKUs.

ConAgra has been rewarding its shareholders with share repurchases to drive EPS growth as well as a rising dividend. Both of those are on hold now as it digests Pinnacle and pays down debt rather than returning cash to shareholders. Even CAG is not promising all its synergies until 2022 and will be focusing on Debt/EBITDA ratios and funding cash restructuring charges for several years. Some lesser brands could be sold at much-reduced multiples than what CAG just paid and that will continue to highlight the high price of this deal and the potential for unrealized promises as shareholders wait for years to see results.

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