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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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General Mills (GIS) EQ Update 11/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3-	3-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

*For a more detailed explanation of the EQ Review Rating scale, please refer to the end of this report

We are maintaining our earnings quality rating to 3- (Minor Concern)

GIS reported adjusted EPS of $0.95 in the11/19 quarter which was 7 cps ahead of the consensus.

- Inventories continued to rise, climbing 3.5 days over the year-ago quarter with essentially all the increase in finished goods. Management noted the following regarding the increase in the conference call: *"We built inventory in the second quarter to protect service while we worked through labor contract negotiations.* ***With those negotiations now successfully concluded, we expect inventory levels to normalize which will result in unfavorable de-leveraged in the back half of the year."*** We are less concerned about the increase in inventory given the specific explanation. Management noted that the manufacturing leverage and the timing of s shipping in pet food added about $25 million to gross profit in the period. Even with this adjusted out, gross margin rose over 20 bps. However, the reversal of these items in the second half is expected to mute margin growth for the remainder of the year. Management has been very open about the benefit of the inventory build on profits in the period.

Nevertheless, profits clearly received an artificial boost in the quarter, prompting us to maintain our 3- (Minor Concern) rating.

- GIS's adjusted tax rate was 21.9% in the 11/19 quarter versus 23.8% a year ago which the company attributed to "favorable changes in earnings mix by jurisdiction." The decline in the adjusted effective rate would have added a little more than 2 cps to earnings growth. However, the 21.9% rate was in-line with the company's forecasted rate for the full year. We suspect analysts incorporated a rate well below the 23.8% year in their models meaning the rate likely played a minimal role in the earnings upside.

- Cash flow continues to benefit from the rise in accounts payable which jumped 9 days over the year-ago level to almost 98. This trend is common in the packaged food industry but at 90 days, we are skeptical the company may be limited in how much it can continue to boost cash flow growth with further stretching.

- Higher pension income added about 1.3 cps to EPS growth in the quarter. We view this as a marginally material non-operational source of growth that could continue to benefit comparisons in the next couple of quarters.

- Capital spending in the quarter declined to $88 million in the quarter from $141 million last year. Trailing 12-month capex as a percentage of sales is now down to 2.6% from 3.8% a year ago. This source of free cash flow growth will likely reverse in upcoming quarters.

- Management noted in the call that organic sales will be boosted in the back half of the fiscal year in part due to it realigning its Pet segment to its fiscal calendar which will have the effect of including an additional month of Pet sales in the fourth fiscal quarter. Note that there will also be a 53rd week in fiscal 2020. However, the company also plans to spend more on brand investments in the back half and there will also be the above-discussed reversal of the benefits of production leverage from the inventory build which will be loaded more into the third fiscal quarter. Current consensus estimates call for a 7% decline in adjusted EPS in the 2/20 quarter followed by a 6% growth in the 5/20 quarter.

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 Concerns"	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 may 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 the next quarter. 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.

Disclosure

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