BEHIND THE NUMBERS
Quality of Earnings Analysis
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General Mills, Inc. (GIS)
Earnings Quality Update- 11/21 Qtr.

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

We are reducing our earnings quality rating of GIS from 4+ to 3+ (Minor Concern).

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

Summary

We started following GIS over 3-years ago and noted that inventory was something to watch. GIS uses LIFO accounting for US inventories, carries its grain inventory at net realizable value, and non-grain inventories outside the US as FIFO. This compares to many of its peers who use FIFO or average cost. The higher inflation hitting many markets is taking a toll on GIS's results as it missed fiscal 2Q22 results by 6-cents. The company's guidance for annual EPS growth is only -2% to 1%, which is expected to be driven by it raising prices that should leverage some fixed costs.

Several other issues at GIS are still benign and the spread between GAAP and non-GAAP EPS is fairly small (only a 2-cent difference last quarter and 1-cent in the August 2021 quarter). It did add 1-cent to EPS from lower stock compensation. However, we are reducing the rating because we see some additional issues that may catch up with the inventories and hurt results further.

Shouldn’t Raw Materials in Inventory be Rising amid Heavy Inflation? – Grain Just Did

Inventory	11/28/2021	8/29/2021	5/30/2021	2/28/2021	11/29/20	8/30/20	5/31/2020	2/23/2020	11/24/2019
Raw Materials	$422.1	$425.1	$411.9	$420.4	$432.8	$436.3	$392.2	$387.1	$398.0
Grains	$206.4	$128.0	$111.2	$119.0	$113.3	$78.5	$93.6	$90.8	$99.2
Finished Goods	$1,457.4	$1,640.5	$1,506.9	$1,418.5	$1,360.4	$1,286.4	$1,142.6	$1,273.7	$1,433.6
FIFO over LIFO	-$288.6	-$258.4	-$209.5	-$199.1	-$194.0	-$196.1	-$202.1	-$209.5	-$211.3
Total Inventory	$1,797.3	$1,935.2	$1,820.5	$1,758.8	$1,712.5	$1,605.1	$1,426.3	$1,542.1	$1,719.5

- The FIFO over LIFO adjustment is showing that international inventories at FIFO would be valued $289 million higher under LIFO. That higher cost is crimping gross margin, and you can see that the difference has risen over 30% in the last two quarters from a fairly constant $200 million prior to that.

- Grain is carried at net realizable value and was running consistently at $100 million. In one quarter, it jumped to over $200 million.

- We know packaging materials, proteins, and other inputs are increasing in price – how are raw materials not rising? Plus, they are actually down compared to 12-months ago.

- Finished goods also declined sequentially and are worth watching now. They are essentially flat with pre-Covid times from 2019. ***It appears that GIS may have drawn down inventories in the 11/21 quarter and simply did not replace them. That may mean that the gross margin for the 11/21 quarter actually was helped by breaking into lower-cost LIFO layers***. However, as we will discuss in the next section, we are very skeptical that GIS can continue to work its way further into lower-cost inventory layers as inventories are already very low.

DSIs Are Already at Low Levels:

A key point is that GIS’s inventories are already at low levels. The following table shows inventory days for the last twelve quarters:

	11/28/2021	8/29/2021	5/30/2021	2/28/2021
DSI	48.2	59.8	56.3	54.0

	11/29/20	8/30/20	5/31/2020	2/23/2020
DSI	52.0	52.7	42.9	50.5

	11/24/2019	8/25/2019	5/26/2019	2/24/2019
DSI	54.9	59.2	52.5	51.0

	11/25/2018	8/26/2018	5/27/2018	2/25/2018
DSI	51.4	55.8	60.5	50.3

Note that raw materials are down to 11 days from a normal level of 13-14 days. Likewise, finished goods are down to 39 days from 51 the quarter before and they are normally 45-49 days.

What happens to gross margin when GIS cannot draw down existing stocks more? Finished goods inventory wouldn't last much more than a month coming into December and it seems unlikely, GIS would draw that down much more. When we look at fiscal 1Q and 2Q gross margins, there has clearly been significant cost pressure. With LIFO accounting, new higher-priced stocks will be sold first. Look at how much cost pressure there already was during this fiscal year:

y/y change	**11/28/21**	**8/29/21**
GAAP Sales	$304.6	$175.9
GAAP COGS	$394.5	$168.9
Adj GM change	-330bp	-150bp
Pricing gain	5%	2%
Volume gain	0%	0%

GIS came into fiscal 2022 expecting $800 million in commodity cost pressure. It just raised that forecast to $1.3 billion after fiscal 2Q22. It started the year expecting organic sales growth of -3% to -1%. It has now raised that forecast to 4%-5% based on taking more pricing than expected.

The problem seems to be that GIS already took higher pricing in the November quarter and still saw commodity inflation overwhelm it as COGS rose faster than sales. And, that happened as GIS was drawing down inventory levels, which could have meant it was selling inventory that was older and lower cost than what it will have to run through the income statement moving forward. It would seem to us that pricing could hold at the current levels and hit forecasts of 4%-5% organic growth. However, the cost pressure should intensify as GIS replaces inventory sold last quarter. Every $50 million of inventory pressure over what is expected is 6.4 cents of EPS, and it blew through that figure last quarter despite the higher pricing and selling lower-cost units.

Three Other Points to Consider on Pricing Power and Inflation

- GIS took higher pricing in Asia/Latin America in recent quarters as well as FX gains. This is not unique to GIS as we have seen this with several companies. Essentially before Covid, FX losses were common and companies took higher pricing in Latin America to offset that. During Covid, FX losses increased even more, and in the last few quarters that has recovered to be a tailwind along with price hikes. For GIS, this is clouded as Latin America is grouped with Asia and the total is only about 9% of sales. But, look at the swing in FX – the positive figure may end this quarter or next:

FX Asia/Lat. Am	11/28/2021	8/29/2021	5/30/2021	2/28/2021	11/29/20	8/30/20	5/31/2020	2/23/2020
FX	2%	5%	3%	-3%	-5%	-10%	-11%	-3%

- GIS should have seen pricing benefit from lower promotional spending during Covid that effectively boosted net pricing. With competition returning to normal, many companies are saying that promotional spending will continue to grow and offset some pricing gains. GIS said on its call that it believes it can be selective and "optimize" promotional spending. We shall see, but it does warn in its 10-K that if it does not match the promotional spending programs of competitors, it could lose market share and sales. If it does match, it may reduce sales too.

- Hedging should take out some highs and lows of commodity issues, but it is unlikely to stop the full impacts. GIS marks its grains to market value and it records the gain or loss on hedging positions in the income statement. These gains and losses eventually make their way to Cost of Goods Sold when the inventory related to those contracts is sold. Looking at the sizes of these items of late, GIS is certainly making some gains on its hedges:

Marks/Hedging	11/28/2021	08/29/2021
M-to-M Contracts	$16.6	$30.4
(G)/L on contracts	-$35.9	-$34.7
M-to-M grains	$31.4	$28.4
	$12.1	$24.1

GIS has seen gains of $35-$36 million the last two quarters on commodity contracts and marked up its grain inventories by almost the same amount. None of this is close to the $1.3 billion headwind being forecast for commodity inflation this fiscal year. Also, on non-GAAP EPS, GIS backs this line item out.

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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