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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

General Mills (GIS) EQ Review

Current EQ Rating*	Previous EQ Rating
4-	NA

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

We initiate coverage of General Mills (GIS) with a 4- (Acceptable) rating.

Overall, we have no major concerns with the quality of GIS's results. We note the following trends that should be monitored in upcoming quarters:

- GIS's inventory DSIs have been declining for the last few quarters. The decline appears to be centered in raw materials, although the Blue Buffalo acquisition makes it difficult to make a hard conclusion. The company utilizes the last-in, first-out (LIFO) method of accounting for about half its inventories. Declining inventories for a LIFO company can indicate the company is benefitting from matching older, lower-cost inventories against current sales. However, we are not currently concerned about this given the decline in prices for some of the company's key raw materials. We will be monitoring this trend in the upcoming quarters.

- Accounts payable days (DSPs) have been increasing rapidly in recent quarters as the company extends terms with its suppliers. This is consistent with most of the other food companies we have reviewed. It is also expanding the extension of third-party financing to its suppliers with the amount of payables subject to such arrangements almost doubling since the end of 2016. These arrangements likely allow the company to still enjoy early pay discounts while still taking longer to pay its suppliers. This is a very real boost to cash flow growth, but the rate of increase in DSPs is slowing and the benefit to cash flow from rising payables is declining.

- GIS recently took almost $100 million in impairment charges to write down the carrying value of intangibles associated with several brands. It has also noted that the spread between the fair value and carrying value of intangibles assets associated with several other brands and reporting units are thin and may narrow further indicating there is a risk of more writedowns in the future.

- Sodiaal has the right to put all or part of its interests in joint ventures to GIS. The current carrying value of this redeemable interest is $771 million. While debt is high after the Blue Buffalo deal, cash flow and borrowing capacity should be sufficient to cover a redemption should it arise.

Inventory DSIs Declining

GIS's inventory DSIs have been declining for the last few quarters, as seen in the following table.

	8/26/2018	5/27/2018	2/25/2018	11/26/2017
COGS	$2,751	$2,474	$2,627	$2,756
Inventory	$1,686	$1,642	$1,453	$1,517
DSI	55.9	60.6	50.5	50.2

	8/27/2017	5/28/2017	2/26/2017	11/27/2016
COGS	$2,456	$2,487	$2,486	$2,593
Inventory	$1,595	$1,484	$1,461	$1,526
DSI	59.3	54.4	53.6	53.7

GIS acquired Blue Buffalo Pet Products on 4/24/18, in the last month of its fiscal year ended 5/28/17. The company reports Blue Buffalo results on a 1-month lag which resulted in Blue Buffalo's balance sheet being consolidated at the end of the fourth fiscal quarter, but there was no corresponding activity recorded on the income statement or cash flow statement for the period. This makes it very easy to adjust working capital accounts for the 5/18 quarter for the acquisition. If we simply take out the Blue Buffalo inventory balance at the time of the acquisition as disclosed in GIS's 10-K, we get an adjusted DSI figure for the 5/18 quarter of 54.1, or slightly below the year-ago figure.

The DSI figures in the table above are calculated on a quarterly basis, meaning the incremental inventory from Blue Buffalo is matched against a full quarter of cost of sales. This means the only impact on the comparison with the year-ago DSI would be the degree to which Blue Buffalo's DSI is different from that of the GIS base business. We do not believe that this would have had a significant impact on the overall DSI, so the downward trend in inventories relative to cost of sales likely remained in place in the quarter.

GIS describes its inventory accounting policy in its 10-K as follows:

> *"All inventories in the United States other than grain are valued at the lower of cost, using the last-in, first-out (LIFO) method, or market. Grain inventories are valued at net realizable value, and all related cash contracts and derivatives are valued at fair value, with all net changes in value recorded in earnings currently.*
>
> *Inventories outside of the United States are generally valued at the lower of cost, using the first-in, first-out (FIFO) method, or net realizable value."*

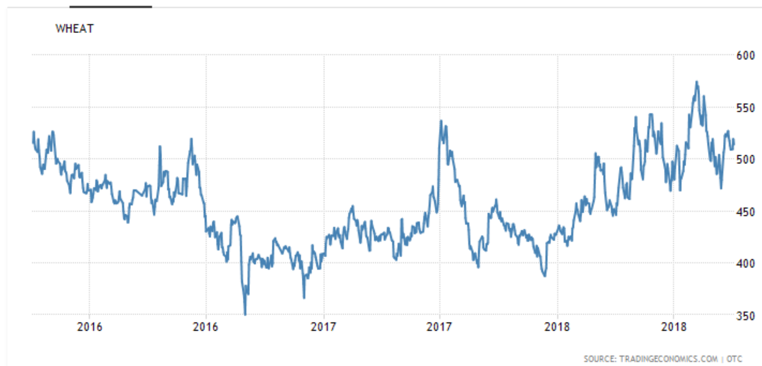
About half of the company's inventories are accounted for under LIFO.

The following table shows the breakdown of inventory components as a percentage of FIFO inventory.

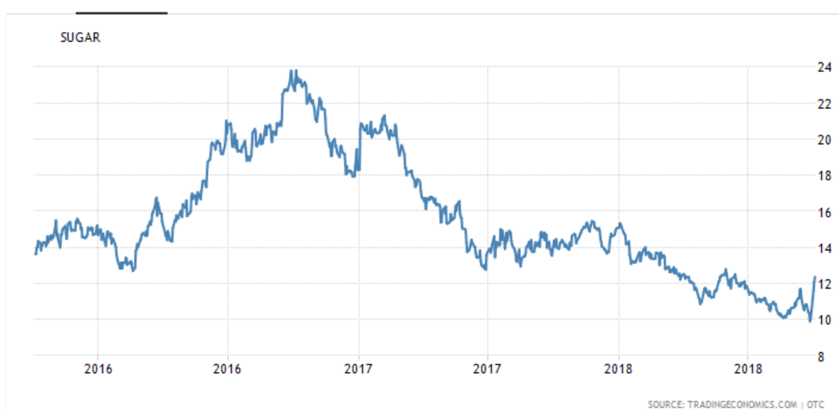
	8/26/2018	5/27/2018	2/25/2018	11/26/2017
Raw Materials % of inventory	20.8%	21.6%	23.6%	23.1%
Finished Goods % of inventory	74.3%	73.5%	70.3%	70.0%
Grain % of inventory	4.8%	4.9%	6.1%	6.9%
Excess FIFO over LIFO % of FIFO inventory	11.5%	11.5%	12.7%	12.4%

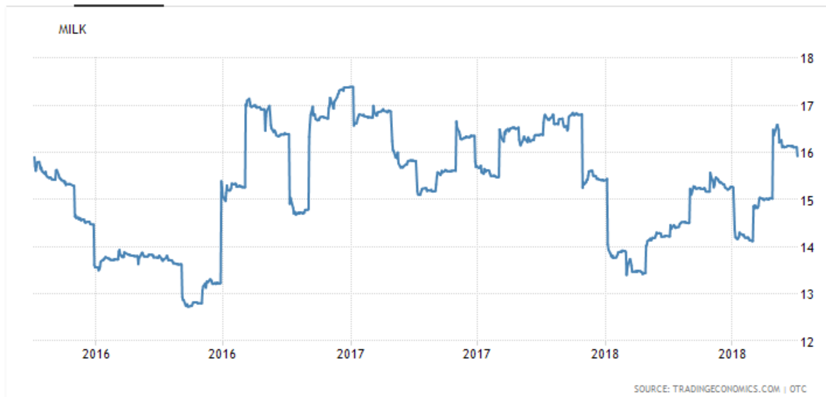
	8/27/2017	5/28/2017	2/26/2017	11/27/2016
Raw Materials % of inventory	21.9%	23.4%	22.3%	22.3%
Finished Goods % of inventory	73.7%	72.3%	72.0%	71.8%
Grain % of inventory	4.4%	4.3%	5.6%	5.9%
Excess FIFO over LIFO % of FIFO inventory	11.9%	12.4%	11.7%	11.6%

Raw materials (other than grain) was the only inventory component that fell as a percentage of sales. We are aware that the trends in these components could have been impacted by the Blue Buffalo acquisition and note that the year-over-year decline in raw materials percentage did begin the quarter its inventories were consolidated. Given the increase in grain prices, we are not surprised to see the relative increase in the grain component of inventory. The following table from tradingeconomics.com shows wheat prices for the last three years:



Other major raw materials for the company include dairy products, sugar, vegetable oils, meats, nuts, and vegetables. Dairy and sugar prices are both generally lower than they were last year, although dairy prices are currently on a run as seen in the following two graphs.





We pay close attention when a company that utilizes LIFO inventory begins to show a declining trend in its inventory balances as the possibility exists that the company is benefitting from matching older, lower-cost inventories against current sales. The benefit is most pronounced in an environment of rapidly rising raw materials costs which allows the company to push through price increases on its customers. However, the benefit will quickly turn on the company when it is eventually forced to replenish inventories at the higher cost level, possibly at a time when it is no longer able to push through price increases.

Currently, we are not concerned that this is happening with GIS for a few reasons. First, while DSIs have been on a downward trend, they are not alarmingly low compared when looking back over 2-3 years of data where DSIs have been as low as the high 40s. In addition, the company has seen lower prices for some key inputs versus a year ago, which likely contributed to the decline in the raw materials component of inventories. Finally, the Blue Buffalo acquisition somewhat clouds visibility over the last two quarters. Regardless, this is a trend to be monitoring in upcoming quarters.

Accounts Payable Is Increasing

Like most of the food companies we have looked at, GIS has been boosting its cash flow by extending its payment terms with suppliers. The following table shows the calculation of accounts payable days (DSPs) for the last 8 quarters.

	8/26/2018	5/27/2018	2/25/2018	11/26/2017
COGS	$2,751	$2,474	$2,627	$2,756
Accounts payable	$2,724	$2,746	$2,506	$2,467
DSP	90.3	101.3	87.0	81.7

	8/27/2017	5/28/2017	2/26/2017	11/27/2016
COGS	$2,456	$2,487	$2,486	$2,593
Accounts payable	$2,173	$2,120	$1,855	$1,938
DSP	80.7	77.8	68.1	68.2

As noted earlier, Blue Buffalo's balance sheet was consolidated at the end of the 5/18 quarter, but the income statement and cash flow statements were not impacted. If we adjust out the accounts payable balance at Blue Buffalo at the time of acquisition (4/28/18), we get an adjusted DSP of over 99, still a huge increase over the 5/17 quarter amount.

GIS also maintains a payables financing program available to some of its customers as described in its SEC filings:

> "We offer certain suppliers access to third party services that allow them to view our scheduled payments online. The third party services also allow suppliers to finance advances on our scheduled payments at the sole discretion of the supplier and the third party. We have no economic interest in these financing arrangements and no direct relationship with the suppliers, the third parties, or any financial institutions concerning these services. All of our accounts payable remain as obligations to our suppliers as stated in our supplier agreements. As of August 26, 2018, $1,010.1 million of our total accounts payable were payable to suppliers who utilize these third party services."

The following table shows the amount a payables from customers utilizing these third party payables financing arraignments as a percentage of total payables:

	8/26/2018	5/27/2018	2/25/2018	11/26/2017
Payables to suppliers utilizing third party financing	$1,010	$937	$927	$874
% of Total Payables	37.1%	34.1%	37.0%	35.4%

	8/27/2017	5/28/2017	2/26/2017	11/27/2016
Payables to suppliers utilizing third party financing	$725	$639	$563	$560
% of Total Payables	33.4%	30.1%	30.3%	28.9%

Since these suppliers can get their money up front with these financing arrangements, we assume that they are allowing GIS to extend the time it is taking to pay while still reaping at least some of the benefits of early pay discounts. As such, we believe the rising use of the programs is a key factor in the increase in payables balances.

Clearly, delaying payment time is a very real boost to cash flow. However, the company can only lean on its supplier so hard and for so long before they push back. The rate of increase in DSPs has already started to slow, and the benefit to cash flow in the three months ended 8/18 was down to $18 million compared to $79 million in the comparable period a year ago.

Impairments

At the end of fiscal 2018, GIS lowered its future sales and profitability forecasts for its *Yoki*, *Mountain High,* and *Immaculate Baking* brands which led to a $96.9 million impairment charge to write down the value of intangibles associated with those brands. The carrying values of *Yoki* and *Mountain High* were essentially cut in half while *Immaculate Baking* was reduced to zero. In addition, the company noted while the coverage of its *Food Should Taste Good* and *Green Giant* brands and its US Yogurt reporting unit was "significant," they all had a "risk of decreasing coverage." We also note that the fair value of its *Progresso* brand was only 6% above its $462 million carrying value while the Latin American reporting unit's fair value was 21% above its $272 million carrying value. Thus, there is a reasonable risk of more writedowns occurring from any of these sources.

Redeemable Interests

GIS has a 51% controlling interest in Yoplait SAS and a 50% interest in Yoplait Marques SWNC and Liberte Marques Sarl. The remaining interests in both groups are held by Sodiaal International which has the right to put all or part of its share to GIS at fair value once per year up to 3 times before December of 2024. The redemption value is presented as a redeemable interest on the balance sheet and is currently valued at $771.6 million. GIS has net debt of about $15 million courtesy of the Blue Buffalo acquisition. The company has currently suspended the buyback which leaves about $1 billion in free cash after the dividend and this should rise with Blue Buffalo results going forward. Therefore, we don't see the Sodiaal put as a significant threat to the dividend at this point.

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 recent 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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