BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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General Mills (GIS) EQ Update

Current EQ Rating*	Previous EQ Rating
4+	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 an explanation of the EQ Review Rating scale, please refer to the end of this report

We are raising our earnings quality rating to 4+ (Acceptable) from 3+ (Minor Concern)

GIS beat EPS estimates by 13 cps in the 8/20 quarter. We note no material non-operating earnings benefits. Inventories continued to improve as COVID-driven demand has given the company a chance to wipe the slate clean. While minor concerns remain, the inventory improvement prompts us to raise the earnings quality rating.

Changes of note in the quarter:

Items that deteriorated

- Accounts payable days continued to rise. The percentage of suppliers using third party financing appeared to level off. The increase in payables drove about 40% of the increase in cash flow for the trailing 12-month period so a reversal would have a significant impact on future growth. *Concern level- MEDIUM*
- Strong sales growth at the company's CPW joint venture drove JV profits to almost 7% of total profits from 4.5% a year ago. *Concern level- LOW*

Items that improved

- The improvement in inventory continued in the 8/20 quarter, with DSIs falling to below 53 versus 59 in the year-ago period. This is the primary reason for our upgrade in earnings quality rating.
- GIS has worked net debt back down to 3x EBITDA. It raised the dividend for the first time in years and resumption of the share buyback appears likely which will offset current dilution from share plans.

Ongoing Issues

- Impairment testing has shown that over $1 billion in intangibles remain thinly covered and the company warned that while the Pillsbury brand intangibles are well-covered, they are at risk of decreasing coverage. COVID-related demand likely reduces the near-term risk of a write-down.
  Concern level- LOW

Payable Days Continue to Rise

We have noted in the past that like many packaged food companies, GIS is stretching payables to drive cash flow growth. The following table showed that this continued into the 6/20 quarter:

	8/30/2020	5/31/2020	2/23/2020	11/24/2019
COGS	$2,774	$3,255	$2,777	$2,852
Accounts Payable	$3,184	$3,248	$2,932	$3,063
DSI	104.5	97.8	96.1	97.7
% of Payables Utilizing 3rd Prty Financing	42.0%	40.9%	43.3%	41.8%

	8/25/2019	5/26/2019	2/24/2019	11/25/2018
COGS	$2,613	$2,700	$2,755	$2,902
Accounts Payable	$2,787	$2,854	$2,751	$2,824
DSI	97.0	96.2	90.8	88.6
% of Payables Utilizing 3rd Prty Financing	39.3%	36.8%	37.0%	36.6%

Payable days rose to over 104 in the 8/20 quarter from 97 in the year-ago period and 98 in the previous quarter. The percentage of suppliers using third-party financing rose to 42% in the 8/20 quarter versus 39.3% last year and 40.9% the quarter before. We do note that the number was already elevated prior to COVID and the fact that sequential growth has leveled out makes us wonder if access to these 3rd party arrangements has peaked.

We see above that payables at the end of the 8/20 quarter rose by $397 million versus the year-ago period which compares to a $916 million reported increase in trailing 12-month cash flow in the same time frame. Clearly, a reversal in payable growth would be a drain on cash flow in future quarters.

Joint Ventures Providing Disproportionate Growth

As we have documented before, GIS has sizeable unconsolidated joint ventures that are material to results. It owns a 50% interest in Cereal Partners Worldwide (CPW) which sells ready-to-eat cereals and cereal bars in international markets. The company also has a 50% interest in Haagen-Dazs Japan (HDJ). GIS's share of after-tax earnings for joint ventures is reported on the income statement. The following table shows the contribution of JVs as a percentage of total net income and the JVs' share of reported income growth for the last eight quarters:

	8/30/2020	5/31/2020	2/23/2020	11/24/2019
After Tax Earnings from Joint Ventures	$41.3	$33.6	$10.8	$24.9
Adjusted net earnings attributable to GIS	$623.5	$673.1	$474.9	$579.9
JV % of Net income including JVs	6.6%	5.0%	2.3%	4.3%
% of Growth Generated by JVs	14.0%	8.2%	3.3%	3.6%

	8/25/2019	5/26/2019	2/24/2019	11/25/2018
After Tax Earnings from Joint Ventures	$21.8	$20.0	$11.8	$22.5
Adjusted net earnings attributable to GIS	$484.5	$507.4	$505.4	$512.4
JV % of Net income including JVs	4.5%	3.9%	2.3%	4.4%
% of Growth Generated by JVs	7.2%	-1.6%	-10.7%	-3.4%

The overall contribution from JVs is significant at almost 7% of total profits in the 8/20 quarter. Also, JV profits are growing faster than the company's consolidated operations, causing the growth from JVs to provide a disproportionate share of the growth rate in the last two quarters. While disproportionate growth from a JV is ordinarily a point of concern,

we are not especially alarmed given that COVID-related demand has driven strong growth in the cereal segment, providing a plausible explanation for the sudden growth. Also, we note the company provides strong disclosures in this area, showing an itemized breakout of revenue growth for CPW and HDJ on a quarterly basis and a streamlined income statement on an annual basis.

Inventory DSIs Continue to Improve

We raised our rating from 3- (Minor Concern) to 3+ (Minor Concern) in our last review as inventory DSI's fell by 10 days YOY in the 5/20 quarter:

	8/30/2020	5/31/2020	2/23/2020	11/24/2019
COGS	$2,774	$3,255	$2,777	$2,852
Inventories	$1,605	$1,426	$1,542	$1,720
DSI	52.7	42.9	50.5	54.9

	8/25/2019	5/26/2019	2/24/2019	11/25/2018
COGS	$2,613	$2,700	$2,755	$2,902
Inventories	$1,700	$1,559	$1,545	$1,639
DSI	59.2	52.5	51.0	51.4

This improvement continued in the 8/20 quarter, with DSIs falling to below 53 versus 59 in the year-ago period. GIS had previously warned that inventories would have to come down in the back half of FY 2021 (5/20 and 2/20 quarters) and that gross margin would suffer. However, the COVID-induced boost in demand for at-home food gave the company a chance to clean the slate with inventory. This is the primary reason for our upgrade in earnings quality rating.

Ongoing Issues

- Impairment testing has shown that the $672.6 million of Europe and Australia reporting group intangible assets exceed fair value by 14% and the $330 million *Progresso* brand intangible assets exceed fair value by only 5%. The company has also warned that while the *Pillsbury* brand intangibles are well-covered, they are at

risk of decreasing coverage. We would expect the boost from COVID demand will help keep these asset values higher in the short-run, if the company is unable to sustain growth in these areas it may again become risks as a source of possible intangible impairment charges.

Concern level- LOW

Explanation of EQ Rating Scale

Rating	Explanation
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.

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