BEHIND THE NUMBERS

Quality of Earnings Analysis

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General Mills, Inc. (GIS)
Earnings Quality Update- 2/22 Qtr.

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

We are maintaining our earnings quality rating of GIS at 3+ (Minor Concern).

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

Summary

GIS beat adjusted EPS estimates by 6 cents for 3Q22, but rose y/y by only 2 cents. On some of the obvious differences, the beat looks real. GIS gained 3.0 cents from JV income rising significantly y/y, its stock compensation increased and cost it 1.4 cents vs. being a 1-cent tailwind in 2Q, and it picked up 1.8 cents from lower share count and lower tax rate. There was also a purchase accounting adjustment of moving $2.9 million to goodwill – that added as much as 0.4 cents. There is not much detail on that, but we would consider it likely the $2.9 million was in an area such as intangibles being amortized, or another asset being expensed. All that combined is 3.8 cents vs. the 6-cent beat.

We still believe inventory issues provided more EPS than that as GIS continued to let inventory levels decline and it has no intention of rebuilding them in 4Q either. Gross margin fell by 160 bps vs. the 330 bp decline in the 2Q. We believe this is not a sustainable situation and GIS is postponing some of the inevitable margin squeeze. 100 bp of gross margin is equal to 6 cents in EPS, which is their entire beat.

The market cheered GIS boosting guidance solely on plans to raise prices further – moving organic growth for the fiscal year from 4%-5% to 5% and adjusted operating profit from a range of -4% to -1% to a new range of -2% to 0%. This may help the next quarter, but at some point, GIS will need to raise inventory too and more of the inflation should hit margins.

- Looking at inventory, the gap between FIFO and LIFO inventory continues to jump, finished goods declined in dollar terms as did grains, and only raw materials saw a sequential increase:

Inventory	2/27/2022	11/28/2021	8/29/2021	5/30/2021	2/28/2021	11/29/20
Raw Materials	$458.2	$422.1	$425.1	$411.9	$420.4	$432.8
Grains	$163.3	$206.4	$128.0	$111.2	$119.0	$113.3
Finished Goods	$1,408.5	$1,457.4	$1,640.5	$1,506.9	$1,418.5	$1,360.4
FIFO over LIFO	-$325.2	-$288.6	-$258.4	-$209.5	-$199.1	-$194.0
Total Inventory	$1710.0	$1,797.3	$1,935.2	$1,820.5	$1,758.8	$1,712.5

We believe that GIS is seeing some gross margin help from liquidating older LIFO layers and that is boosting gross margin. The company admitted that letting inventory decline is part of the reason it boosted guidance and it will not draw down inventories on retailer shelves. According to Jon Nudi the President of North American Retail:

> *"We don't expect shipments to lag sales in Q4. We also don't expect to rebuild inventories in Q4, and that's really reflected in our guidance. If we can do a bit better and service levels improve, we might be able to rebuild a bit, but likely will push into fiscal '23, where hopefully, we can get back to more historical inventory levels."*

The CEO also noted at while this will help Q4 in May, in fiscal 2023, GIS will see significant inflation:

> *"And what our hedging does is, it mostly buys us time, and we'll have inflation in fiscal '22. Though we'll have a significant inflation in fiscal '23, it just won't be at the level of spot prices at least in the calendar year you're seeing now in the market."*

- GIS uses LIFO for US sales – about 84% of the total in 3Q22 and FIFO for international. It sure sounds like they expect to pay the piper on the inflation front after May. How much longer can they wait? DSIs for finished goods was 41 days, down from 43 y/y and normally it is 45-49 days. Raw materials are back above 13 days which is normal. Wheat is still

50% higher than last year, oats are double, corn and soybeans are amazingly flat after a spike last spring, we know fertilizer and fuel needed to grow, and transport grains are up.

- Gross margin's slide was noticeably better in 3Q22, but it came with a huge surge in pricing and negative volume growth, which helped allow inventories to decline:

y/y change	2/27/22	11/28/21	8/29/21
Adj. Gross Margin change	-160bp	-330bp	-150bp
Pricing	7%	5%	2%
Volume	-4%	0%	0%

- Also helping was SG&A declines as adjusted gross margin was down 90bp vs. offset some of the -160bp from gross margin. GIS sees this as its cost savings programs but did admit on the call that some of that came from lower marketing – but it expects marketing costs to increase.

- We wouldn't count on a huge tailwind from JV income going forward. 3Q22 had an easy comp, and this was where GIS added 3 cents in EPS:

	4Q	3Q	2Q	1Q
fiscal 2022		$29.9	$33.0	$29.1
fiscal 2021	$25.7	$11.8	$36.4	$41.3

There is not much pricing power from the components of the JVs and 3Q22 saw a 9 point surge in volume from ice cream in Japan y/y. 4Q21 looks like a potential easy comp, but maybe 1 cent in EPS growth.

- **We also want to note that GIS used to report Latin America combined with Asia. Now it is combined into all International.** We were noting that we saw signs of GIS benefitting from higher pricing from hyperinflation in Latin America and also gaining positive FX movements in fiscal 2022 after a horrible fiscal 2021 for FX.

	2Q22	1Q22	4Q21
Asia/Lat Am Pricing	1%	4%	10%
Asia/Lat Am FX	2%	5%	3%
Asia/Lat Am Vol.	4%	1%	12%

For organic growth, GIS ignores FX. However, as we have seen with several other companies like Mondelez and Sealed Air – it's the FX drag that allows the above-normal pricing gains. **For all of International in 3Q22, pricing was 2%, volume -3%, and FX was -2% offsetting all the pricing.**

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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