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
3-	4-

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

We lower our earnings quality rating to 3- (Minor Concern) from 4- (Acceptable).

GIS reported adjusted EPS of $0.83, 7 cps ahead of the estimate. The rating reduction reflects the increase in prepaid expenses and the decline in trade and promotional accrual. While we don't see egregious signs of earnings quality problems, we note that for five straight quarters, GIS has handily beat earnings estimates while missing the top-line target which increases our skepticism.

- The company breaks out the composition of "prepaid expenses and other current assets" in its 10-K filings. The "prepaid expense" components increased from $174.4 million at the end of FY 18 to $250.2 million in FY 2019 which represents an increase of 1.4 days on a days of sales basis. Essentially, cash has been spent but not yet recognized on the income statement. While the exact composition of the account is unknown, the increase indicates that the company could have essentially capitalized operating expenses to delay recognition.

- The company accrues for trade and consumer promotional activity at the time of sale. As with the prepaid expense details, it only discloses accrued trade and consumer promotions on an annual basis in the footnotes of its 10-K. In 2019, the accrual fell from $499.6 million at the end of FY 2018 to $484.4 million at the end of FY 2019. This was about 1.1 days on a days of sales basis. Interestingly, the company cited higher promotional spend as having a negative impact on price/mix in the 5/19 quarter. The accrual account represents the company's estimate of how much of its current sales it will have to eventually pay to retailers in the form of in-store, sales-based promotions. A decline in the account indicates that the company could be under reserving to the benefit of current results.

- During the second quarter (11/18) of fiscal 2019, GIS wrote off $193 million in intangible assets related to its *Progresso, Food Should Taste Good*, and *Mountain High* brands. In addition, the company disclosed that the fair values of its Latin American reporting unit and its *Yoki* brand intangible assets exceeded carrying value by only 7% and 10%, respectively. Finally, while the coverage of its *Pillsbury* and US Yogurt intangibles was "significant" GIS warned that they were at risk of decreasing coverage.

- We remind clients that Sodiaal has the right to put its half of the Danone joint ventures to GIS which currently stands at $552 million.

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.

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