BEHIND THE NUMBERS

EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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General Mills (GIS) EQ Update-8/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3-	3-

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

We are maintaining our earnings quality rating of 3- (Minor Concern)

GIS's adjusted EPS of $0.79 topped the Street consensus by 2 cps. Nevertheless, we continue to see red flags pertaining to the company's earnings quality.

- Cash from operations for the three months ended 8/19 fell by 6%, or $35 million. The change in current assets and liabilities was a $99 million drag on growth which the company blamed largely on an increase in inventory. However, we estimate about half this impact was offset by a rise in payables as the company continues to drive up payment terms on suppliers. Cash flow growth was further impeded by a $66 million change in deferred income taxes due to a net benefit related to the reorganization of wholly owned subsidiaries.

- Capital spending on a trailing 12-month basis fell by $124 million, or roughly 20%. As a percentage of sales, capex is now running at 2.9% versus the 4.0%-4.5% range seen in the 2017-2018 time period. This is providing a likely temporary boost to free cash flow growth.

- Inventories rose noticeably with DSIs jumping to 59.4 from 55.9 in the year-ago quarter. Remember that the company utilizes LIFO for its US inventories which limits the potential of rising costs being delayed from hitting the income statement. We are not overly concerned by the DSI increase but will be alarmed if it does not reverse in the next quarter.

- Also as noted above, payables have been rising. GIS began to push for longer payment times on suppliers a couple of years ago and in that time, days payable have steadily risen to over 97, up from 90, 81, and 71 in the 8/18, 8/17 and 8/16 quarters, respectively. That has not only been a boost to cash flow growth, but also more than offset the rise in DSOs from 34 to 39 during the same time frame. It appears that the company has essentially pressured its suppliers to help finance its customers. With the company taking more than three months to pay the average supplier, we are skeptical this can continue much longer. We note that the company offers certain suppliers access to third-party financing which allows them to monetize the balances owed to them by GIS. The balance of payables due to suppliers utilizing these arrangements has remained essentially flat over the last year.

- Total pension and postretirement benefit expense in the 8/19 quarter swung to a $2.5 million income from a $7.1 million expense in the year-ago period. This was largely due to a decline in interest cost which we suspect resulted from a decline in the rate used for the calculation. This added a little more than a penny per share to EPS growth.

- We note that gross profit growth received a $53 million boost from last year's first quarter purchase accounting charge related to the Blue Buffalo acquisition. To the company's credit, it did not add the purchase accounting adjustment back to non-GAAP earnings in the 8/18 quarter. However, it also did not remove this year's beneficial impact from its adjusted results either. The company pointed out in its MD&A section that margin improvement received a 130 bps boost due to last year's charge. Investors will simply have to be careful to not extrapolate the improvement going forward.

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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