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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Contents

Conagra Brands (CAG) 1Q'21 Update- Upgrade to NEUTRAL p. 1
The Kroger Company (KR) EQ Update- 7/20 Qtr. p.12
PepsiCo (PEP) EQ Update- 9/20 Qtr. p.19
General Mills (GIS) EQ Update- 8/20 Qtr. p. 23

Conagra Brands (CAG)– 1Q'21 Update
Upgrade to NEUTRAL from SELL

CAG is one of the stronger beneficiaries of COVID and the lockdowns. **When we last wrote about CAG, it was still cutting guidance for the third time on both sales and margins.** It further had too much inventory on hand. **Enter COVID and the mad scramble for anything in a grocery store, and CAG suddenly touts that its multi-year disappointment with the Pinnacle Foods acquisition is now a rousing success. We remain skeptical** of that and the fact that it was still taking impairments on acquired intangibles after COVID illustrates our concerns.

We are moving our rating on CAG to NEUTRAL based largely on COVID cleaning up the balance sheet. It beat EPS estimates by 13-cents by posting an adjusted 70-cents in 1Q21. **It wouldn't be Conagra if it didn't add back 4-cents from its continual restructuring. It picked up 7.3-cents from in-store advertising switching from a $30 million drag on sales last year to a $16 million credit in 1Q21.** Going forward, CAG expects in-store advertising to become a rising expense again. It gave amazingly low guidance in our view given seasonal tailwinds along with COVID issues. **ROI is only 11.9% giving CAG full credit all the COVID increased earnings and reversal of marketing. It falls to 10.5% with minor**

adjustments in those areas and assuming some of the cash on hand is used to rebuild working capital:

Items that deteriorated

- Guidance looks weak at 6%-8% organic sales growth for 2Q21 after stating that sales should stay elevated for a much longer period.
- Recent sales growth of 15% in 1Q21 was padded by retailers restocking inventory adding 600bp to growth.
- Retailers are still rebuilding inventories and 2Q also has a seasonal build-up. CAG could pick up another 600bp of sales growth simply from this source again – meaning adjusted sales may be back to pre-COVID growth rates already.
- Even with all these potential sales and high operating rates, CAG's guidance for margins is forecasting a sequential decline and a y/y gain of only about 100bp vs. about 400bp of gains during COVID.
- Some of its newest products that CAG had high hope for took an impairment charge in 4Q20 due to lower than expected sales and profit margins – this was during COVID.

Items that improved

- Net Debt is down $1.3 billion y/y in 1Q21. That is a combination of cash increasing and hefty debt repayments in 4Q20.
- Net Debt to EBITDA is down to 3.7x at this point.
- CAG has positive volume gains for the first time in years due to COVID and stores still need to restock further.
- Operating leverage drove large gains in operating margins and profits.

Ongoing Issues

- CAG's focus on raising prices to drive future sales growth runs counter to what retailers want as they want to reduce prices to consumers.
- Kroger store brands are taking market share and CAG has a history of disappointment when it boosts prices but other brands do not.

- In-store promotional spending is a drag on sales. By reversing an accrual in this area vs. a sizeable cost in 1Q20 – CAG picked up 7-cents in EPS last quarter. It simply didn't need to do much promotion in the worst of COVID. That is expected to become a rising drag on sales going forward. Guidance is CAG will see less operating leverage too and hurt operating margins going forward.
- Can CAG drive volume gains once restocking is complete?
- CAG's own inventory looks very low and should require rebuilding. The big debt paydown and cash build was the result of pulling almost $400 million in cash from inventory and payables. Those may reverse in 2Q to a much larger degree than even 1Q and boost net debt levels.

Sales Growth Was Poor Pre-COVID and Guidance is Very Poor in Our View

The goal at CAG is to drive organic growth with pricing even if that means some volume loss. That has been the trend for years:

Org. Growth	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19	4Q18	3Q18
Volume	-1.3%	1.0%	-2.5%	-1.2%	1.2%	-2.2%	0.0%	-0.1%	-2.8%
Price	-0.4%	1.8%	2.5%	0.7%	2.1%	1.1%	2.1%	2.1%	0.6%
Retail Inv.	n/a	-1.2%	-1.7%	-0.2%	-1.4%	-0.5%	-0.9%	n/a	n/a
Organic Growth	-1.7%	1.6%	-1.7%	0.5%	1.9%	-1.6%	1.2%	2.0%	-2.2%

- Coming into COVID – CAG had positive volume growth twice in 10-quarters and both times after horrendous quarters the year before.
- In 3Q20, CAG said retail investments to support products were a headwind – likely pricing was positive but became negative when netted against the marketing.
- Before and after 2Q20, guidance for the year was 1.0%-1.5% organic growth. During 3Q20, guidance was cut to 0.0-0.5% organic growth. After 3Q20, CAG simply said it expected to beat the 0.5% figure.

What happens with COVID? Volume suddenly takes off at unheard of rates. People are stuck at home. They panic buy what they can:

Org. Growth	1Q21	4Q20
Volume	10.9%	21.0%
Price	4.1%	0.5%
Retail Inv.	n/a	n/a
Organic Growth	15.0%	21.5%

- 4Q figures were extreme and retail investing dropping considerably. We did not see it quantified.
- **1Q21, it looks like the good times are still really good. But, according to the company, 600bp of volume was due to stores restocking inventory – not consumer sell-through. Also, retail investment accruals were reversed and added 70bp to pricing. That makes adjusted growth 8.3% in the quarter with the most COVID issues.**
- Guidance is even more puzzling – We know from Kroger that it still wants to build inventories higher and there is a seasonal build that happens in this quarter too. CAG says it sees the same thing – yet guidance for 2Q21 is for 6%-8% organic growth! If they pick up another 400-600bp in restocking demand – organic growth may already be declining back to pre-COVID levels for CAG.
- A further headwind will be marketing spend in the stores will return. This will net against pricing in organic growth. According to the earnings call, *"Relative to Q1 operating margin, we expect less operating leverage benefit and **we expect to increase our marketing support both above the line and below the line.**"*
- Some of the key sources of growth in 1Q21 – were brands with amazingly easy comps:
    - Wishbone up 16.9% in 1Q21 – we know Wishbone had negative sales growth in 2015, 2016, 2017. It then fell more than 20% in 2018, it fell 15%-20% in 2019 and was up slightly in 2020.
    - Hunt's up 14.7% in 1Q21 – In late 2019 and early 2020 – Hunt's was down 11% in 4Q19 and 9% in 1Q21.
    - Chef Boyardee up 5.6% in 1Q21 – after being down 6.7% in 4Q19 and 1Q20 triggering an impairment charge on these assets.
    - A year ago, Marie Calendar's fell 20% - it didn't make the list of growing brands in 1Q21.

Guidance for Adjusted 2Q21 Operating Margin Also Looks Weak

CAG is guiding to 18.0%-18.5% adjusted operating margin. That sounds very low in our view, given that 2Q is normally the highest margin period:

	1Q21	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19
Adj Op. Margin	20.2%	17.1%	15.7%	17.1%	15.7%	13.2%	16.3%	17.5%

- Even in 2018, 2Q was the highest level of operating margin, with the normal seasonality as holiday stocking began.
- The higher sales level expected – especially on volume, should leverage fixed costs and boost margin. Yet, CAG expects margins to fall by about 200bp sequentially.
- Not only do CAG customers need to build inventory, but CAG needs to boost its own inventory in what is seasonally the time for a build-up and it's starting 20 days below the year before due to heavy COVID demand:

	1Q21	4Q20	3Q20	2Q20
Inventory	$1,579.6	$1,377.9	$1,646.5	$1,770.4
Adj. COGS	$1,867.9	$2,165.3	$1,843.6	$1,530.4
DSI	77.2	58.1	81.5	105.6

	1Q20	4Q19	3Q19	2Q19
Inventory	$1,755.7	$1,563.3	$1,638.6	$1,729.7
Adj. COGS	$1,662.9	$1,837.8	$1,805.1	$1,594.0
DSI	96.3	77.6	82.8	99.0

- As we have shown in past reports, CAG's margin gains over time have much more to do with culling/divesting lower-margin units out of the results. The company has continued to do that in fiscal 2020 and fiscal 2019:
  - 3Q20 – sale of Lender's bagels for $32.2 million
  - 2Q20 – sale of Direct Store Delivery snacks for $137.5 million
  - 4Q19 – sale of Gelit frozen pizza for $80.1 million
  - 4Q19 – sale of Wesson oil for $168.3 million
  - 1Q19 – sale of Del Monte Canada for $32.2 million

- CAG also claims it exceeded synergy targets in fiscal 2020 and gained even more in 1Q21. It believes it has taken costs out of the supply chain as the biggest driver of these synergies.
- In 1Q21 they had supply constraints, they had short periods when production was shut-down due to Covid-Issues and ways to protect employees were created.

CAG has just seen operating margins rise y/y by almost 400bp for two quarters on the back of enormous operating leverage as volume growth hit record levels. It has seasonality in its favor, it has inventory building at customers, and its own inventory needs driving what should be the 3rd best volume quarter ever. Yet, the guidance is for operating margins to increase only about 100bp this quarter? What happens when production levels are at normal levels? What happens when more retail investment is needed and/or CAG has a tougher time taking pricing?

The Battle of Branded Goods at Higher Prices vs Store Brands Remains – CAG Still Taking Impairments

One of the issues we have had with CAG's operating model is it is difficult to take pricing because competitors get on the shelves by cutting prices. Also, the supermarkets have their own store brands, organic brands, and health-conscience brands too that typically sell for less than branded goods.

We talked about this issue many times in past reports where CAG was losing market share with Hunt's canned tomatoes to store brands and Chef Boyardee was losing share in prior quarters as well to the point that CAG took impairments against assets. The reason for the market share losses was CAG boosting prices while store brands didn't follow suit widening the price gap.

We saw Kroger's CEO Rodney McMullen announce that it is committed to investing its restructuring efforts into lower pricing for customers and its goal is to make it cheaper to shop at Kroger:

> *"**We've promoted throughout the pandemic**. Now we did change what we promoted, because obviously, you want to promote what you have, so we would have not promoted paper towels and toilet paper and certain meat items and things like that*

because just the availability of supply. But we've had promotions throughout the pandemic and it's really on the things that matter.

We continue to invest in price and we think it's really important *that we think customers will look at it reflectively that we've been there to support them throughout to help them stretch their budgets. So the –* ***as Gary mentioned, waiving the pickup fee, continuing to invest in promotions, continuing to invest in price, all of those are things that we believe will pay off. Our customers will reward us for what we're doing over time.***

On market share, I specifically talked about fresh, but ***we continue to gain share in the center store fresh and all areas of the store and our own brands continue to gain share as well.****"*

Gary Millerchip - Chief Financial Officer added:

"I think, as we've shared kind of consistently, our goal is really to be balanced in the business model and ***continue to balance the [price] investments we'll be making in supporting the customer which is certainly our continued intent with the savings that we achieved through sourcing benefits*** *and then of course alternative profit being accelerator of gross margin as well."*

The CEO also talked about its products gaining popularity and taking market share:

*"Our customers are eating more at home, and we are seeing some customer segments trade up to the larger pack sizes as well as more premium quality foods and natural and organic foods.****Our larger sized big pack platform is up well over 50%. Private Selection is up over 17% and Simple Truth is up over 20% in the second quarter. Our brands continue to tap into emerging trends and evolving customer needs,*** *delivering new flavors and innovative new items like the new plant-based Emerge grinds and patties, which launched in late 2019.*

A recent third-party industry study reconfirmed that Simple Truth is the most loved natural and organic brand in the U.S. Simple Truth significantly outperformed competitors on strength of brand, *which is a combination of awareness, willingness to recommend and strength as the driver of store selection. In continuing to exceed our customers' expectations of value and quality, while also consistently delivering*

innovative new items our customers love, our brands remain one of our most powerful competitive advantages."

Gardein is another case in point. This was an acquired brand for meatless products that CAG couldn't stop raving about the potential only a year ago. New products, appeals to health, a new source of growth off a low base…. Here is what CAG said about *Gardein* one year ago in 1Q20:

> *"Another brand in our portfolio with **significant growth opportunity is Gardein**, which we spoke about at length last quarter. **We're working hard to continue to build out the Gardein brand to capitalize on the explosive growth in the plant-based meat-alternative space**. The Gardein foodservice business grew an impressive 25% in the first quarter and continues to accelerate penetration across multiple Foodservice channels. As we shared with you last quarter, the brand is the second largest in the plant-based meat alternative space and has already quadrupled in size over the past four years.*
>
> ***In retail, we expect our Gardein to gain prominence in both frozen and refrigerated as we introduce more high-quality innovation. On-trend brand with modern attributes, Gardein is uniquely positioned to generate superior velocities** by leveraging Conagra's culinary capabilities, differentiated packaging techniques, and our diverse portfolio of power brands. And we are well-positioned to support Gardein's continued growth with new capacity coming online during Q2."*

In 4Q20, CAG took a $146.2 million impairment charge against intangible assets. The rationale was:

> *"**The more notable brands with impairments include Frontera®, Gardein®**, Glutino®, Hungry Man®, and Udi's®. While most of our recently acquired brands continue to remain on track with previous assumptions, **these brands have had lower than expected sales or profit margins** which have led to some revisions in our original assumptions (most notably declines in our assumed royalty rates)."*

Credit to CAG for Paying Down Debt with COVID Cash

In 4Q20, the rise in income and the release of cash from inventory and payables allowed CAG to retire debt and boost cash on hand to effectively lower net debt by over $700 million. Net debt fell by over $1.2 billion during the full year and was also helped by nearly $200 million in proceeds from divestitures:

	1Q21	4Q20	2020
Cash from Ops	$284.5	$936.1	$1,842.6
Cash from Inv/AP	-$182.0	$386.1	$11.8
Divestitures	0.0	3.2	194.6
Debt Paid	$133.4	$281.6	$947.5
Cash Increase	-$5.1	$444.3	$316.7
Chg. Net Debt	-$128.3	-$725.9	-$1,264.2

We are pleased to see the company accelerate debt reduction when income and cash flow are strong. The high debt level was one of our primary negative parts of the CAG story in the past. It seems likely that working capital will be a drag in 2Q and reclaim some of the cash on the balance sheet, but they have the liquidity to handle that.

However, if CAG's results drop from the amazing levels of the last two quarters and/or the cash balance falls to rebuild working capital - the net debt to EBITDA ratio of 3.7x may actually rise. Here is the current situation:

	1Q21
Financed Debt	$9,616.8
Cash on Hand	$438.2
Net Debt	$9,178.6
Adjusted EBITDA	$2,462.9
Net Debt/EBITDA	3.7

- If rebuilding working capital consumes $200-$300 million – the ratio increases to 3.8-3.9x
- We know that CAG had 70bp of sales come from reversing an accrual on in-store marketing in 1Q21. It had a 170bp drag on sales from the same item in 1Q20 that fell out of EBITDA – that's a positive $46.4 million swing and the company says in-store promotion is returning.

- We know that CAG offered employees a lump-sum settlement of pension payments in 2020 and booked an outsized expense of $42.9 million that was added back to adjusted EBITDA. We would argue that expense would have been recognized over time and not added back if dealt with under the original terms.
- Adjusting for these three items – the ratio rises to 4.0x.

The recent trailing four quarters of EBITDA have certainly been helped by rising sales and nearly 400bp of margin gains. Pre-COVID, adjusted EBITDA was running about $2.0-$2.1 billion:

	1Q21	4Q20	3Q20	2Q20	1Q20
Adj. TTM EBITDA	$2,462.9	$2,297.0	$2,065.4	$2,104.6	$2,015.0

Guidance is for the margin gain to be much more subdued in 2Q21 and for sales growth to be at best half of 1Q21's level. This is a bit crude, but what if organic sales growth had been 5% lower for both 1Q21 and 4Q20 and margins improved by only 200-350bp. What impact would that have on EBITDA:

- 1Q21 saw 15.0% organic sales growth and 450bp of adjusted operating margin gain. That resulted in y/y operating income growth of $165.8 million. That went into the new higher EBITDA figure.

- If 1Q21 had only 10.0% sales growth and only 350bp of margin gain, EBITDA would have grown by $119.3 million – lighter by $46.5 million. At a 250bp margin gain, EBITDA would have grown by $93.6 million - $72.5 million lighter.

- 4Q20 saw 21.5% organic sales growth and 390bp of margin gain. That added $218.4 million to EBITDA.

- If 4Q20 had only 16.5% sales growth and the 17.1% margin was 16.1% instead, operating income would have only grown by $135.1 million – a drop of $83.3 million. A margin of 15.1% would have resulted in EBITDA falling by $113.0 million.

The reason we are showing this is CAG is already giving guidance closer to this type of growth, with guidance of 6%-8% revenue growth, not 15%, and 100bp of margin gain, not

450bp. The company is forecasting that it holds some of the higher levels of sales for a longer period of time. Also, the huge growth figures are going to remain in trailing EBITDA for a year. But, if margins start coming in below 4Q20 and 1Q21 going forward, and sales don't top those +15% and +21% gains – CAG is going to report lower EBITDA in the future.

Our conclusion is it does not take much of the bloom off recent results to assume operating income growth may have seen $130 million that won't be sustained ($46.5 million in 1Q21 and $83.3 million in 4Q20). That would be a combination of lower volumes and pricing pressure due to more in-store advertising hurting sales and margins.

If we add that to the $46 million positive swing in 1Q21 on accruals that helped results and the pension cost of $43 million – It may be more realistic to view EBITDA as being closer to about $2.25 billion going forward. If we assume $200 million in cash rebuilds working capital, the debt to EBITDA ratio becomes 4.2x again ($9.4b in net debt over $2.25b of EBITDA).

Kroger (KR) EQ Update- 7/20 Qtr.

Current EQ Rating*	Previous EQ Rating
5+	5+

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 maintain our earnings quality rating on Kroger (KR) at 5+ (Strong).

The company beat forecasts handily with EPS of $0.73 vs. forecasts of $0.54. The effective tax rate falling 180bp helped by 2.4-cents. Also, the cents/gallon on fuel came in stronger y/y and fuel profits fell only $30 million y/y. KR had guided to fuel profits being down $50-$100 million for 2Q. **That incremental $20-$70 million in fuel profits helped by 2-7 cents in the quarter. Thus, KR still had a solid beat.**

What we still like is adjustments to EPS are minimal and largely related to gains/losses. For a company that has invested $300 million more in wages than forecast in the Restock Plan, spent heavily on COVID mitigation policies, and continues to invest in pricing for customers – it isn't removing any of that in adjusted results. The only adjustment in 2Q was for $21 million in costs related to store closings and some third-party consulting fees.

We like KR's efforts to improve longer-term cash flow and its balance sheet by funneling some of the higher cash flow into resolving more of the multi-employer pension plans. This has been a continual use of cash for several years. It announced that it expects to sign a deal in 3Q20 to withdraw from the UFCW union plan for a contribution of $962 million to be paid in three installments. These multi-employer plans have been the one negative we found when we started to follow Kroger. The company also repaid its credit revolver and all its commercial paper. All of these actions should help Kroger's future results.

Items that deteriorated

- Inventory declined significantly in 1Q20 and produced cash flow. However, that was not intentional. KR grew DSIs back in 2Q but not completely.
- We expect inventories to rise for seasonal reasons in 3Q and to adjust back to pre-COVID levels on DSIs. That could be a $500 million cash drain, offset partially with higher payables.
- Capital spending should also be higher in 2H20 than in 1H20 and could be another $500 million higher cash outflow.

Items that improved

- Liquidity was up considerably with KR paying off its revolver, all its commercial paper, and still holding $2.8 billion in cash (up $2.4 billion since year-end).
- Net debt to EBITDA is at 1.7x vs. goals of 2.3-2.5x. Even assuming inventory build, KR should remain below its target and may return more cash to shareholders.
- Its share of obligations under multi-employer pension plans fell to $2.3 billion from $3.1 billion
- Adjustments to EPS from GAAP are benign. KR only added back 3-cents related to third-party legal expenses and some store closings. It has not added back COVID costs for new training, overtime nor has it added back its restructuring charges or new investments in lower prices.

Ongoing Items

- KR expects to sign a deal to withdraw from more of the multi-employer pensions in 3Q. This should cost $962 million spread over 3-years.
- Multi-employer plans have consumed considerable cash flow in recent years but repeated withdraw actions should transition KR to a smaller expense and cash drain going forward.

History of Multi-Employer Plans for Kroger – It Is Improving

These plans are often set up by unions for various employees. Because the employees of each union may work for one of several companies, these pension plans have multiple companies making cash payments to the pension plans to support the benefits.

Several years ago, many of these plans were underfunded by a significant amount and ERISA and others started to step in to develop plans to cure the funding shortfalls. As we noted in our original report, KR has been making sizeable contributions to these plans and the number of plans with weak funding has dropped from six to two. Like many other pension plans, the long-term drop in interest rates continued to drive up the obligations and even with significant cash payments to the plans, the underfunding levels were remaining largely flat. This is why we anticipated that Kroger would continue to see large cash payments to some of these plans in the future.

Multi-Employer Plans	2019	2018	2017	2016	2015
KR Contribution	$461	$358	$964	$289	$426
KR Underfunding Share	$2,300	$3,100	$2,300	$3,000	$2,900
plans under 60% funded	2	2	2	5	6
plans over 80% funded	6	7	8	7	7

The share of the underfunding is not a direct liability to Kroger. However, we took it as an indication that large cash contributions would likely continue. What Kroger has started to do is withdraw from some of these pensions. The plan can work up an estimated cost for any party to leave – if they agree to pay the pension plan to ensure the funding is there. In 2017, Kroger reached a withdrawal payment with its Central States Pension plan for $550 million.

During these years, Kroger has made the following payments related to withdrawing from certain plans:

	2Q20	1Q20	2019	2018	2017	2016	2015
Withdraw fees	$0	$0	$135	$155	$467	$28	$0
Other payments	$0	$236	$326	$203	$497	$261	$426

- In 2016 – withdraw fees of $111 million were expensed with a cash payment of $28 million in 2016 and the rest in future years.
- In 2017, withdraw fees of $550 million were expensed with a cash payment of $467 made and the rest in future years.

In the 2Q20, Kroger announced it has reached a withdrawal plan for the UFCW International Union Pension Fund. It expects to pay $962 million to the fund plus a $27 million transition reserve. These payments would be funded over three years.

It is not clear if this impacts all the various UFCW plans – Kroger lists five plans related to that union. UFCW has been where much of the recent cash spending from Kroger has gone in recent years:

	2019	2018	2017
So. CA UFCW	$75	$71	$66
Desert Sts. UFCW	$19	$19	$18
Rocky Mtn UFCW	$23	$20	$19
Retail Food UFCW	$10	$10	$10
UFCW Cons Plan	$174	$55	$201
Total UFCW	$301	$175	$314
Total Multi- Spend	$461	$358	$954

In our view, this is a positive move. Cash flow is up at Kroger with COVID and the Kroger Restock program. This agreement should reduce a sizeable amount of future cash payments to the multi-employer pension plans in return for cash upfront in 2020-2022. While the $2.3 billion of underfunding representing Kroger's share at the end of 2019, it may be able to cut $900 million off that total.

Kroger Did Rebuild Inventory in 2Q on DSIs- Not Much in Dollars

In 1Q20, KR had enormous cash flow due to higher earnings. However, it also picked up over $1.5 billion from seeing inventory decline and payables increase. The company noted that COVID demand was outstripping the logistics to get products into stores during 1Q and it wanted to return inventory levels to pre-COVID levels. It saw DSIs increase sequentially, which is normal. Actual levels may still be lower than optimal and this could be a mild headwind going forward:

	2Q20	1Q20	4Q19	3Q19
DSIs	30.1	22.4	34.3	36.3

	2Q19	1Q19	4Q18	3Q18
DSIs	32.5	25.2	33.8	35.2

Adding another 2-3 days of inventory would mean about $500-$700 more of additional inventory. Also, 3Q is normally a period of time of higher inventory given holiday

purchases beginning. **Looking at the sequential change in dollar terms, inventory fell $756 million in 1Q and only grew by $70 million in 2Q. Thus, we still think there is a headwind coming for cash flow.**

On payables, the DSPs reached a more normalized level in 2Q and consumed $261 million in cash in the quarter from 1Q.

	2Q20	1Q20	4Q19	3Q19
DSPs	26.6	20.7	25.7	28.5

	2Q19	1Q19	4Q18	3Q18
DSPs	26.0	20.2	25.2	27.4

Looking at 1Q and 2Q key cash flow components and reported cash from operations, cash flow gains have been huge in 2020 so far – history shows higher inventory may be matched against higher payables for 3Q:

	3Q19	2Q20	2Q19	1Q20	1Q19
Net Inc. less gains	$45	$457	$232	$778	$424
Dep/Amort	$772	$760	$740	$1,018	$976
Inventory Chg.	-$362	-$71	$150	$756	$124
Payables Chg.	$599	-$261	-$155	$783	$364
Reported CFO	$771	$1,160	$1,009	$4,245	$2,268

- 2Q20 was helped by deferring the employer's share of Social Security taxes under CARES Act for $329 million.
- 1Q19 was helped by a $295 contribution from a contract payment on selling a business.

Cash and Debt Have Improved

Cash is up to $2.8 billion at the end of 2Q20 from $400 million at the end of 4Q19. It is also worth pointing out that KR has repaid all of its commercial paper. It also drew down $1 billion on the credit line in March but repaid that in full during May. With all the cash on hand, the net debt figure has dropped by nearly $3 billion in the last 6-months. At the same time, trailing 4Q's EBITDA has been increasing:

	2Q20	1Q20	4Q19
Debt net of cash	$11,034	$11,170	$13,945
Adj. EBITDA	$6,492	$6,183	$5,629
Debt/EBITDA	1.70	1.81	2.48

There are several points to make here:

- KR's goal is to have a Debt/EBITDA ratio of 2.3-2.5x
- Even if we add in the $2.3 billion of its share of multi-employer pensions, the ratio would be 2.05x now
- Therefore, we think paying the $962 million over three years – will improve the ratio adjusted for that as debt as EBITDA has only been elevated for two quarters at this point.
- According to management, their data are showing more people wanting to eat healthier and cook more at home. This has KR believing recent COVID gains will hold in 2020 and 2021 will exceed pre-COVID levels.
- **The trailing 12-months EBITDA of $6.5 billion is not adjusted for everything under the sun. There are $80 million of severance charges and $119 million in charges for store closures and 3rd party consulting. That's only 3% of the adjusted EBITDA.**
- Having inventory increase by $500 million without having payables increase – would only add 0.08 turns to the debt/EBITDA.
- Capital spending will be a larger head-wind in 2H20 as guidance still calls for $3.0-$3.4 billion in investments for the year with only $1.34 billion spent in the 1H20.
- When we look at all the cash, the rising cash flow, we believe Kroger is in very good shape going forward to remain below its debt ratio targets.
- The company noted it will continue to allocate investments to digital sales and higher productivity. It also expects to grow its dividend and return additional cash via share repurchases as well.

Adjustments to EPS Look Benign to Us

The company continues with its policy of not adding back its Restock Kroger costs. That's still a very nice sight given how many companies we review who add back every nickel of expected costs related to restructuring, integration, and acquisitions in adjusted earnings. KR is not even adding back COVID-related costs.

The company's investment in Ocado – related to its logistical infrastructure has continued to perform well and GAAP has KR marking this to market every quarter. KR's adjusted results are penalized by subtracting the gain. Its investment in Home Chef has also performed well since the acquisition. It came with some contingent payment obligations if it beat expectations, which has happened. So those payments are considered one-time and added back. Finally, part of Restock involved some third-party consulting fees and some store closing costs. Those are added back but do not appear that material to us.

Adjusted 2Q20	Income	EPS
GAAP	$819	$1.03
MTM Ocado	-$278	-$0.35
Home Chef	$19	$0.02
Transformation	$21	$0.03
Adjusted income	$581	$0.73

As noted earlier, KR beat by 19-cents. It did pick-up just over 2-cents from a lower tax rate and it's expected headwind for lower fuel profits came in at -$30 million rather than -$50 to -$100 million. That added at least 2-cents more. The minor transformation cost related to some real estate and third-party fees of 3-cents being added back did not make a difference in KR beating forecasts.

PepsiCo (PEP) EQ Update

Current EQ Rating*	Previous EQ Rating
3+	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

PEP beats EPS expectations by 17 cps in the 9/20 quarter. We are raising our earnings quality rating to 3+ (Minor Concern) reflecting the improvement in receivables. However, overhangs remain that prevent us from raising the rating to a 4 (Acceptable) at this time.

Changes of note in the quarter:

What got worse at PEP?

- A lower tax rate added 4 cps. While we doubt it was anticipated in many models, we are not concerned given the much larger earnings beat. Concern level- LOW
- Lower pension costs added about 1.7 cps to EPS growth in the 9/20 quarter. Concern level- LOW

What got better at PEP?

- The growth in accounts receivable DSOs fell to just half a day from the 1.5 to 3.0-day pace of the last few quarters. This is only one quarter after several meaningful acquisitions and a period which is still likely seeing delayed collections as a result of COVID. This reduces our concern level and prompted us to upgrade the earnings quality rating.

Overhangs that remain

- Cash flow remains tight although the company has cut capex forecasts by $1 billion for the full year. The dividend and buyback will still exceed free cash flow. Concern level- MEDIUM
- PEP has made several sizeable acquisitions so far this year and net debt to EBITDA has risen to 2.7. Concern level- MEDIUM
- Non-GAAP earnings add back the company's ongoing restructuring charges. These charges have averaged about 3% of non-GAAP net income per quarter for the last 6 quarters. Concern level- MEDIUM

Other Items

- PEP identified approximately $150 million in costs in the quarter related to COVID in the form of employee protection and compensation costs, inventory write-downs, an increase to bad debt provision and other costs. PEP expects some of these costs may be recurring, but we would expect these to begin dropping off over the next few quarters.

Lower Tax Rate Added 4 cps

(Concern level: LOW)

PEP's adjusted tax rate fell to 18.9% from 20.8% in the year-ago quarter. This added about 4 cps to EPS growth. The company's guidance is for a full-year core effective tax rate of 21%, so we doubt many analysts' models were expecting the lower rate. We are not overly concerned as the company would have still beaten earnings by a wide margin without the unexpected boost.

Lower Pension Expense Added 1.7 cps

(Concern level: LOW)

Lower pension costs added about 1.7 cps to EPS growth in the 9/20 quarter. Expense benefitted from recognized gains on fixed income in plan assets, increased plan contributions, and a decline in settlement costs which was partially offset by a decrease in discount rates. While we would consider this a low-quality source of income growth, as with

the tax rate above, we are not overly concerned given the much higher earnings beat in the period.

The Trend of Rising DSOs Improved

In past reviews, we noted that PEP's DSOs had been rising 1.5 to 3 days for the last few quarters. However, as the following table shows, the YOY increase fell to just 0.5 days in the 9/20 quarter.

	9/05/2020	6/13/2020	3/21/2020	12/28/2019
Sales	$18,091	$15,945	$13,881	$20,640
Accounts Receivable	$9,295	$8,780	$8,477	$7,822
DSOs	43.2	46.3	51.3	42.4

	9/07/2019	6/15/2019	3/23/2019	12/29/2018
Sales	$17,188	$16,449	$12,884	$19,524
Accounts Receivables	$8,735	$8,502	$7,604	$7,142
DSOs	42.7	43.4	49.6	41.0

Given the large acquisitions in the 6/20 quarter and the likelihood that the company is still seeing delayed collections pertaining to COVID, we are not concerned by the mild increase.

Ongoing Concerns

- Cash flow remains tight. The company reduced its full-year outlook for capex to $4 billion from the previous $5 billion and kept its full-year free cash flow outlook for $6 billion. Cash return to shareholders in the form of dividends and buybacks was left at $7.5 billion. The dividend was raised by 7% in June. The buyback is adding about 1.2% to EPS growth which itself is running the mid single-digits.
  Concern level- MEDIUM

- PEP made several acquisitions in the 6/20 quarter totaling over $8 billion. This followed the $3.3 billion SodaStream deal at the end of 2018. In that timeframe, the buyback and acquisition spending have driven net debt to EBTIDA from 1.6 to 2.7. To its credit, PEP has split the amount of the purchase price over tangible assets

acquired roughly half between goodwill and acquired intangibles and it is not adding the amortization of acquired intangibles back to non-GAAP results. Nevertheless, an acquisition habit that drives up debt is always a concern.
Concern level- MEDIUM

- Non-GAAP earnings add back the company's ongoing restructuring charges. These charges have averaged about 3% of non-GAAP net income per quarter for the last 6 quarters. This is not alarmingly large, but it lowers the perceived quality of adjusted earnings and we will consider it more of a concern if the 2019 plan is expanded or new plans announced.
  Concern level- LOW

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	Description
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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