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"Inflation is when you pay fifteen dollars for the ten-dollar haircut you used to get for five dollars when you had hair."

-Sam Ewing

Some Thoughts on Chile and Argentina

I have been traveling to South America for many years to go fishing, dove shooting, find some new wines, and eat great steaks. Last week was another trip with most of the time spent in Argentina. Every time, there is a currency story to tell. My first trip was in 2002 after the Peso devalued from 1 to 1 against the US dollar to 4 to 1. With it at 40 to 1 now and moving like a car odometer – it was an interesting trip.

A short story of the movement happened over about 3-weeks. One of my Argentine friends, who works for the outfitter we use wanted me to bring him an iPhone X. He was fine with a used one for $700 or a new one for $1,000. I didn't want to hassle with finding a used one. I went to the Apple store which had pulled the older phones for the September 21 launch of the latest X-S model, so I had to wait for that day. When he contacted me, about September 8th or 9th, the X model would have cost him the equivalent of about $1,500 in Argentina. I bought the X-S model for $1,000 in the US on the 21st, and it would have been over $2,000

down there that day. By the time I gave it to him on Saturday, it would have cost $2,500 in Argentina.

There is massive inflation there, but only if you use Pesos. In 2002 and 2003, everything in Argentina was very cheap from a Dollar perspective because of devaluation. People took Pesos or Dollars, but airfare, hotels, and meals were 20%-25% of the prior price in Dollars. From about 2005-2015, there was steady inflation for both Pesos and Dollars. At that time, many people were playing the currency black market because the real-world exchange rate was much different than the official rate. You could buy about 40% more Pesos than Dollars in many years, but if you charged anything, it was going to happen at the official rate in the range of 4-8 to 1. So suddenly, hotel and airline rates were rising 20%-30% per trip because the official exchange rate reflected the inflation rate for both currencies. This really reached a crescendo in 2015 when we found that even the currency exchange at the airport wouldn't buy back Pesos.

The Peso has been floating for a few years now which takes out the black market. People want Dollars, primarily as a store of value, but they accept Pesos and Dollars again. There is actually some serious devaluation down there from a Dollar perspective. A 14 oz Veal T-bone at a nice steakhouse in Mendoza is $10, a bottle of wine that is $35 in the US at a store is $8 down there in a restaurant. Many places will discount bills if you pay with Dollars. We went fishing for a day and the price was 20% lower paying in cash with Dollars.

The country is still a financial disaster as the IMF gets involved and there are minimal foreign reserves and heavy debt loads again. It is being discussed daily in the *WSJ*. Another default or debt restructuring seems likely as the move from 18 to 40 Pesos to the Dollar just this year demonstrates. But, there are some other things going on that point to a better future, in my view, and I'm not seeing much discussion on some the positives I saw in the *WSJ*.

Keep in mind that Argentina is essentially two countries – half the population lives in Buenos Aires and the rest live in the other 90% of the country. For many years, the country was run for the benefit of the big city. Farmers and ranchers could not export crops and beef because keeping it in Argentina would allow the price of food in the city to remain low. Oil and gas prices were artificially kept low as well for the same reason. I spend much more time away from Buenos Aires and there were mass protests by farmers and ranchers going on. Several times, we have seen them refuse to ship crops and block roads, making it tough to move traffic. That was not the case at all this time. The government unions instead had

a one-day strike for buses and airports to protest inflation in the city but even unions outside Buenos Aires didn't really participate.

The past government officials in Argentina looted the place. If a road project would cost $2 million, they would authorize $8 million and the road would never be built, and the money would vanish. It was almost shocking to see how much actual infrastructure and construction has been completed and continues. The farm belt includes towns like Jesus Maria and Cordoba. The primary road between the two was two lanes. There was an abandoned railroad track to the side. We didn't see the train run still, but the road is now a divided 4-lane highway for part of the way and construction continues. Driving on Mendoza roads has been like riding a horse for many years with all the bumps and potholes. That city is repaving areas and making upgrades to its city parks and water infrastructure.

Airports are seeing night and day improvements. We flew via Santiago, Chile because there are two airports in Buenos Aires and it is a hassle to switch between the two. Santiago is building a completely new terminal for International travel and will refurbish the current terminal – which already looks very modern. They have added more restaurants already and there were about 20 construction cranes working on the new building. Cordoba used to be the equivalent of flying into Lubbock, Texas – four gates and a store selling cheap souvenirs. That has expanded and added more restaurant/bar facilities. American Airlines is adding international routes from the US to Cordoba.

We didn't see idle people anywhere. Everyone is working and ignoring Buenos Aires. Homes in many areas in the farming areas have been fixed up and look very nice with yards and fresh paint. The Chinese are buying crops and beef from them, so they seem to be expanding operations again. Service at restaurants was very quick – in other years, places would be understaffed. Many people seem to be enjoying life and no one was complaining about the government 24/7. We used to be greeted with "OMG – you won't believe what we have to do now." Our best episode of that was about 4-years ago I think when we met the German-born manager of the Hyatt in Santiago watching a World Cup game. He asked what else we were doing and said we were going to the Hyatt in Mendoza on the trip also. He shook his head and laughed about how his friend who runs that one was just pulling his hair out over all the turmoil in the economy, currency, and government.

One of the biggest hassles of traveling down there was it was 1952. That has changed considerably on this last trip. It used to be that to go anywhere, you had to connect through Santiago or Buenos Aires and there might only be one flight per day or even only 4x per week. So, if you wanted to fly from Mendoza to Cordoba – which is about 450 miles away

and two decent sized cities, you'd have to fly to Buenos Aires or Santiago, perhaps stay the night or wait foris held
4-hours in the airport, then 500 miles back to Cordoba. Now it's more like Southwest Airlines, there are direct flights every day between several more cities and it takes much less time. Airfares have also come down. There have been times when the Dallas to Santiago or Buenos Aires flight was $1,000-$1,200 and then it was $800 to fly a couple 1-hour segments within the country. The planes looked fuller as well. It is even possible to check-in online and there are electronic kiosks in even the Cordoba airport to print a boarding pass if you want a paper one. I know that sounds really weird to point out, but only 18-months ago, every passenger had to wait in line at the ticket counter to check in for a flight there.

Both countries have eliminated entry fees that often had to be paid in cash – and very crisp clean bills of US currency. That was always a fun experience, having to go through seven $100 bills hearing "oh that one has a small tear, no – that one has a crease, no- that one is worn…" until you found one acceptable for the customs agent.

My basic conclusion is for 16-years, there has been a collapsing currency in Argentina and a huge amount of malaise there with considerable corruption. Now, there is a collapsing currency and many signs of progress in productivity and increased work going on. If nothing else, after the latest collapse there is more infrastructure to build off of for a more solid recovery. In the meantime, do yourself a favor and enjoy a few days living like a king for 20-cents on the dollar. Everyone is friendly and the answer to any question is YES.

Given the rate of inflation in Pesos, we have already seen some companies moving Argentina to a Hyper-Inflationary status and it could have some negative impacts on results. People smoke *Marlboros* there and Philip Morris has already called out Argentina as a headwind. *Budweiser* beer is now available there. Monsanto (now Bayer) and Deere have a big presence there too. At some point, a company like Latam – the airline in Chile that has operations in Argentina, Brazil, and Peru may be a way to play that area more heavily for a recovery.

The Hershey Company (HSY) EQ Review

Current EQ Rating*	Previous EQ Rating
4+	NA

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

We initiate coverage of The Hershey Company (HSY) with a 4+ (Acceptable) rating.

- Accounts receivable days of sales (DSO) rose by 3 days over the year-ago period. We see this as largely due to an unusually low receivables balance in last year's comparable quarter more than an elevated level in the current quarter. While the company stated in the 2Q18 conference call that the increase was due to the 1/31/18 acquisition of Amplify, we do not see that the acquisition added materially to the DSO increase. This is more an item of curiosity than concern.

- Despite the Amplify acquisition, inventory levels have been declining both on a days of cost of sales basis and an absolute basis with the decline more focused in raw materials. HSY utilizes the LIFO (last-in, first-out) method of accounting for 60% of its inventories. Ordinarily, a decline in inventory for a company utilizing LIFO is a red flag that it is artificially benefitting from a "LIFO liquidation." However, the conditions are not present for this to happen. Instead, we believe the company's cash inventory spend is starting to benefit as unprofitable commodity hedges have expired, allowing HSY to enjoy the currently lower prices of some of its key raw materials. The company's adjusted profit numbers will also likely start to benefit as the cumulative losses being recognized in adjusted results are now running out.

DSO Jumped By 3 Days in the 6/18 Quarter

HSY's accounts receivable days (DSO) in the 6/18 quarter rose by 3 days over the year-ago period, as seen in the following table:

	7/1/2018	4/1/2018	12/31/2017	10/01/2017
Sales	$1,752	$1,972	$1,940	$2,033
Accounts Receivable	$502	$614	$588	$743
Sales YOY growth	5.3%	4.9%	-1.6%	1.5%
Accounts Receivable YOY growth	20.2%	3.1%	1.2%	-2.2%
Accounts Receivable DSOs	26.1	28.4	27.7	33.3

	7/2/2017	4/2/2017	12/31/2016	10/02/2016
Sales	$1,663	$1,880	$1,970	$2,003
Accounts Receivable	$417	$596	$581	$760
Sales YOY growth	1.5%	2.8%	3.2%	2.2%
Accounts Receivable YOY growth	-13.7%	9.5%	-3.0%	-0.2%
Accounts Receivable DSOs	22.9	28.9	26.9	34.6

The initial issue that jumps out at us when looking at the table is that receivables in the 7/02/17 quarter were unusually low. This is most likely due to the timing of sales in the first half of 2017. Consider the following from the company's 10-Q filing for the 4/2/2017 quarter:

> *"…$69.4 million decrease in cash generated by accounts receivable, primarily attributed to the timing of sales during the quarter.* ***U.S. sales were measurably higher in the last 15 days of the first quarter of 2017 versus the first quarter of 2016 due to timing of shipments, which drove a higher investment in accounts receivable as of the 2017 quarter-end."***

This thought was refined in 2017's first quarter conference call:

> *"At the end of the first quarter, net trading capital increased versus last year -- last year's first quarter by $14 million.* ***Accounts receivable were higher by $52 million due to higher Easter sales."***

Easter, a huge selling season for HSY, fell on April 16th in 2017 compared to March 27th in 2016 which was likely a contributing factor to the later timing of sales in 1Q17. Sales growth was weaker in 2Q17 which could have also been partially impacted by the timing of Easter. Regardless, it is obvious that receivables and DSOs were unusually low in 2Q17 which makes the year-over-year increase in DSOs in 2Q18 much less concerning.

We are therefore somewhat puzzled by management's explanation of the receivables increase in the 2Q18 conference call:

"So, the biggest reason for the changes in receivables was clearly the Amplify acquisition as we acquired their receivables. So, that drove that increase."

The Amplify acquisition was finalized on 1/31/18 and we know that the fair value assigned to Amplify's receivables was $41.2 million. We also know that the company attributed 3.4% of the sales growth in 1Q18 to the two months of Amplify's sales during the period. This would have amounted to about $64 million. If we simply scale that up to 3 months, we get a rough estimate of Amplify's first-quarter sales of about $96 million. Using these figures, we estimate that Amplify was carrying about 39 days of receivables at the time of the acquisition. While certainly higher than HSY's DSOs in the high 20s, this is not enough of a difference to meaningfully impact our calculation for 2Q18 as our calculation of DSO for that period would have included a full second-quarter of sales from Amplify. For another rough estimate, if we take out our estimate of Amplify's receivables and sales from the first quarter from HSY's second quarter sales and receivables figures, we calculate an adjusted DSO for the second quarter of 25.4, only about a half of a day less than the reported DSO. The actual impact was likely less than this as HSY has had several months to improve upon Amplify's collectability. Given that we are not concerned about the increase in DSO due to the unusually low level in last year's second quarter, we may have "chased a rabbit" somewhat in this paragraph. However, we are a little curious about management's comment on the receivables increase and will be skeptical if it is used again in the next two quarters to explain another increase in receivables.

Inventory Is Declining

HSY's inventory levels have been noticeably declining in the last two quarters as seen in the following table:

	7/1/2018	4/1/2018	12/31/2017	10/01/2017
COGS	$958	$998	$1,111	$1,093
Inventory	$916	$782	$753	$938
COGS YOY growth	6.8%	2.8%	-9.6%	-5.2%
Inventory YOY growth	-2.1%	-1.6%	1.0%	11.2%
Inventory DSIs	***87.3***	***71.5***	***61.9***	***78.3***

	7/2/2017	4/2/2017	12/31/2016	10/02/2016
COGS	$897	$970	$1,228	$1,153
Inventory	$936	$795	$746	$844
COGS YOY growth	0.8%	-4.1%	16.4%	7.8%
Inventory YOY growth	7.5%	3.2%	-0.7%	3.7%
Inventory DSIs	***95.2***	***74.8***	***55.4***	***66.8***

As noted above, the company finalized the Amplify acquisition on 1/31/18. HSY does not disclose the specific fair value of inventory acquired but does quantify "other current assets" (not including accounts receivable) at $35.5 million. Despite the inclusion of the Amplify inventory at the end of the first quarter with only two months of Amplify cost of sales, the company's DSIs fell by over 3 days year-over-year in 1Q18. **Importantly, not only did the DSI decline, but the inventory balance itself has declined year-over-year for the last two quarters.** To examine the movements in inventory more closely, we show the percentage makeup of inventory components for the last 8 quarters in the table below:

	7/01/2018	4/01/2018	12/31/2017	10/01/2017
Raw Materials % of Inventory	24.6%	27.0%	24.1%	26.2%
Goods in Process % of Inventory	12.7%	13.2%	10.0%	9.1%
Finished Goods % of Inventory	62.8%	59.8%	65.9%	64.7%
Inventory at FIFO % of Inventory	100.0%	100.0%	100.0%	100.0%
Adjustments to LIFO as % of Total FIFO	15.6%	17.8%	19.4%	16.2%

	7/02/2017	4/02/2017	12/31/2016	10/02/2016
Raw Materials % of Inventory	27.1%	30.6%	33.8%	31.2%
Goods in Process % of Inventory	11.0%	11.8%	9.5%	9.7%
Finished Goods % of Inventory	61.8%	57.6%	56.7%	59.2%
Inventory at FIFO % of Inventory	100.0%	100.0%	100.0%	100.0%
Adjustments to LIFO as % of Total FIFO	16.3%	18.6%	20.0%	18.3%

We can see that the decline in inventory was more focused in raw materials. HSY's main raw materials include cocoa, sugar, dairy products, and nuts. Prices for cocoa were higher in the first half of 2018 versus 2017 while prices for milk and sugar were notably lower in the first half of 2018. (Prices for these three commodities for the last three years are shown

in the below exhibits from Tradingeconomics.com.) The company cited unfavorable price realization of 1.5% penalizing sales for the first six months of 2018 which is likely in part due to benign raw materials prices.

We also know the following about the company's inventory accounting policy from its 10-K:

> ***"As of December 31, 2017, approximately 59% of our inventories, representing the majority of our U.S. inventories, were valued under the last-in, first-out ("LIFO") method. The remainder of our inventories in the U.S. and inventories for our international businesses are valued at the lower of first-in, first-out ("FIFO") cost or market.*** *LIFO cost of inventories valued using the LIFO method was $443,492 as of December 31, 2017 and $402,919 as of December 31, 2016. The adjustment to LIFO, as shown in Note 16, approximates the excess of replacement cost over the stated LIFO inventory value. The net impact of LIFO acquisitions and liquidations was not material to 2017, 2016 or 2015."*

HSY does not designate its commodity derivatives as hedging instruments, so inventories are not impacted by mark-to-market adjustments. Instead, commodity derivatives are marked to market every period with the gains and losses recognized in cost of sales as described by the company in its SEC filings:

> *"Derivatives used to manage commodity price risk are not designated for hedge accounting treatment. Therefore, the changes in fair value of these derivatives are recorded as incurred within cost of sales. As discussed in Note 11, we define our segment income to exclude gains and losses on commodity derivatives until the related inventory is sold, at which time the related gains and losses are reflected within segment income. This enables us to continue to align the derivative gains and losses with the underlying economic exposure being hedged and thereby eliminate the mark-to-market volatility within our reported segment income."*

For example, the mark-to-market impact for 2Q18 was a $183,000 gain compared to a $32.5 million loss in the year-ago quarter. Looking at the tables above, we can speculate that the spike in cocoa prices in the second quarter of 2018 drove up the value of contracts hedging future inventory purchases, leading to the lower losses on outstanding contracts. Note that in its adjusted and segment results, HSY adjusts out the mark-to-market impact and includes only the amount of gains or losses associated with inventory sold during the period. The following table shows information disclosed by the company about its commodity derivates positions. We recommend reading the table in conjunction with the detailed explanation of line items shown below it:

	7/01/2018	4/01/2018	12/31/2017	10/01/2017
Net (Gains)/Losses on Mark-to-Market- (In COGS)	-$0.183	-$66.590	$15.234	$2.445
Net Losses Reclassified from Unallocated to Segment Income	$20.648	$29.660	$23.040	$24.399
Unallocated (Gains)/Losses to Adjust Segment to Reported Income	-$20.831	-$96.250	-$7.806	-$21.954
Cumulative (Gains)/Losses Recognized in COGS but Unallocated	$10.865	$31.696	$127.946	$135.538
(Gains)/Losses Expected to Be Reclassified to Segment over 12 Months	$41.445	$77.411	$94.449	$93.814

	7/02/2017	4/02/2017	12/31/2016	10/02/2016
Net (Gains)/Losses on Mark-to-Market- (In COGS)	$32.519	$5.536	$134.577	$37.246
Net Losses Reclassified from Unallocated to Segment Income	$20.963	$22.624	$2.190	$1.455
Unallocated (Gains)/Losses to Adjust Segment to Reported Income	$11.556	-$17.088	$132.387	$35.791
Cumulative (Gains)/Losses Recognized in COGS but Unallocated	$157.492	$145.937		
(Gains)/Losses Expected to Be Reclassified to Segment over 12 Months	$91.119	$88.675		

Net (Gains)/Losses on mark-to-market- (In COGS)- The mark-to-market gains and losses on outstanding commodity derivative contracts that are recognized in COGS for each period.

Net Losses Reclassified from Unallocated to Segment Income - The gains and losses from commodity contracts related to inventory sold during the period. This is the amount reflected in both segment results and the company's adjusted income figures.

Unallocated (Gains)/Losses to Adjust Segment to Reported Income- The adjustment used to reconcile segment earnings to reported income.

Cumulative (Gains)/Losses Recognized in COGS but Unallocated- The cumulate gains and losses which have been realized in COGS but have not been recognized in either segment results or adjusted earnings as the related inventory has not been sold yet.

(Gains)/Losses Expected to Be Reclassified to Segment over 12 Months- The amounts expected to be reclassified from the "Cumulative (Gains)/Losses Recognized in COGS but Unallocated" account (explained above) to being recognized in segment and adjusted income figures based on the company's current forecasts.

We can see that the company's reported gross profit for the last couple of quarters has benefitted from a huge shift from mark-to-market losses to gains which is most likely due to both the rise in cocoa prices and the expiration of unprofitable contracts written prior to the decline in prices seen in key raw materials. HSY's cash inventory purchases in 2017 likely did not benefit from the lower raw materials prices due to contracts struck when the prices were higher. The losses on these contracts which built up during late 2016 and 2017 have essentially been "amortized" into HSY's adjusted profits as the inventories associated with the contracts were sold. However, we see from the decline in the "Cumulative (Gains)/Losses Recognized in COGS but Unallocated" line that these cumulative losses are running out implying lower losses recognized in adjusted results in upcoming quarters.

So, with all this in mind, we have the following observations about the company's inventory balances:

- Ordinarily, a decline in inventory from a company utilizing LIFO accounting raises a red flag due to the possibility it is benefitting from matching older, lower-cost inventories against current sales in what is known as a "LIFO liquidation."

- However, for a company to benefit from a LIFO liquidation, raw materials prices must be rising, and the company must be realizing higher sales prices. Neither is currently the case for HSY.

- Instead, the decline in inventories with the focus in raw materials likely reflects the company beginning to realize lower costs on acquiring new raw materials as its older, less favorable hedges have expired.

- In addition, the reduction in overall inventory levels in the last two quarters may also simply indicate the company is becoming more efficient in its inventory management.

- The company only includes gains and losses on contracts related to inventory that is sold in the period in its segment and adjusted results. The amount of cumulative deferred losses to be recognized in adjusted results is close to running out which may benefit adjusted profit figures in upcoming quarters.

- In short, we are not concerned that HSY's inventory balances contain any hidden problems at this point.

General Mills (GIS) EQ Review

Current EQ Rating*	Previous EQ Rating
4-	NA

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

We initiate coverage of General Mills (GIS) with a 4- (Acceptable) rating.

Overall, we have no major concerns with the quality of GIS's results. We note the following trends that should be monitored in upcoming quarters:

- GIS's inventory DSIs have been declining for the last few quarters. The decline appears to be centered in raw materials, although the Blue Buffalo acquisition makes it difficult to make a hard conclusion. The company utilizes the last-in, first-out (LIFO) method of accounting for about half its inventories. Declining inventories for a LIFO company can indicate the company is benefitting from matching older, lower-cost inventories against current sales. However, we are not currently concerned about this given the decline in prices for some of the company's key raw materials. We will be monitoring this trend in the upcoming quarters.

- Accounts payable days (DSPs) have been increasing rapidly in recent quarters as the company extends terms with its suppliers. This is consistent with most of the other food companies we have reviewed. It is also expanding the extension of third-party financing to its suppliers with the amount of payables subject to such arrangements almost doubling since the end of 2016. These arrangements likely allow the company to still enjoy early pay discounts while still taking longer to pay its suppliers. This is a very real boost to cash flow growth, but the rate of increase in DSPs is slowing and the benefit to cash flow from rising payables is declining.

- GIS recently took almost $100 million in impairment charges to write down the carrying value of intangibles associated with several brands. It has also noted that the spread between the fair value and carrying value of intangibles assets associated with several other brands and reporting units are thin and may narrow further indicating there is a risk of more writedowns in the future.

- Sodiaal has the right to put all or part of its interests in joint ventures to GIS. The current carrying value of this redeemable interest is $771 million. While debt is high after the Blue Buffalo deal, cash flow and borrowing capacity should be sufficient to cover a redemption should it arise.

Inventory DSIs Declining

GIS's inventory DSIs have been declining for the last few quarters, as seen in the following table.

	8/26/2018	5/27/2018	2/25/2018	11/26/2017
COGS	$2,751	$2,474	$2,627	$2,756
Inventory	$1,686	$1,642	$1,453	$1,517
DSI	55.9	60.6	50.5	50.2

	8/27/2017	5/28/2017	2/26/2017	11/27/2016
COGS	$2,456	$2,487	$2,486	$2,593
Inventory	$1,595	$1,484	$1,461	$1,526
DSI	59.3	54.4	53.6	53.7

GIS acquired Blue Buffalo Pet Products on 4/24/18, in the last month of its fiscal year ended 5/28/17. The company reports Blue Buffalo results on a 1-month lag which resulted in Blue Buffalo's balance sheet being consolidated at the end of the fourth fiscal quarter, but there was no corresponding activity recorded on the income statement or cash flow statement for the period. This makes it very easy to adjust working capital accounts for the 5/18 quarter for the acquisition. If we simply take out the Blue Buffalo inventory balance at the time of the acquisition as disclosed in GIS's 10-K, we get an adjusted DSI figure for the 5/18 quarter of 54.1, or slightly below the year-ago figure.

The DSI figures in the table above are calculated on a quarterly basis, meaning the incremental inventory from Blue Buffalo is matched against a full quarter of cost of sales. This means the only impact on the comparison with the year-ago DSI would be the degree to which Blue Buffalo's DSI is different from that of the GIS base business. We do not believe that this would have had a significant impact on the overall DSI, so the downward trend in inventories relative to cost of sales likely remained in place in the quarter.

GIS describes its inventory accounting policy in its 10-K as follows:

"All inventories in the United States other than grain are valued at the lower of cost, using the last-in, first-out (LIFO) method, or market. Grain inventories are valued at net realizable value, and all related cash contracts and derivatives are valued at fair value, with all net changes in value recorded in earnings currently.

Inventories outside of the United States are generally valued at the lower of cost, using the first-in, first-out (FIFO) method, or net realizable value."

About half of the company's inventories are accounted for under LIFO.

The following table shows the breakdown of inventory components as a percentage of FIFO inventory.

	8/26/2018	5/27/2018	2/25/2018	11/26/2017
Raw Materials % of inventory	20.8%	21.6%	23.6%	23.1%
Finished Goods % of inventory	74.3%	73.5%	70.3%	70.0%
Grain % of inventory	4.8%	4.9%	6.1%	6.9%
Excess FIFO over LIFO % of FIFO inventory	11.5%	11.5%	12.7%	12.4%

	8/27/2017	5/28/2017	2/26/2017	11/27/2016
Raw Materials % of inventory	21.9%	23.4%	22.3%	22.3%
Finished Goods % of inventory	73.7%	72.3%	72.0%	71.8%
Grain % of inventory	4.4%	4.3%	5.6%	5.9%
Excess FIFO over LIFO % of FIFO inventory	11.9%	12.4%	11.7%	11.6%

Raw materials (other than grain) was the only inventory component that fell as a percentage of sales. We are aware that the trends in these components could have been impacted by the Blue Buffalo acquisition and note that the year-over-year decline in raw materials percentage did begin the quarter its inventories were consolidated. Given the increase in grain prices, we are not surprised to see the relative increase in the grain component of inventory. The following table from tradingeconomics.com shows wheat prices for the last three years:

Other major raw materials for the company include dairy products, sugar, vegetable oils, meats, nuts, and vegetables. Dairy and sugar prices are both generally lower than they were last year, although dairy prices are currently on a run as seen in the following two graphs.

We pay close attention when a company that utilizes LIFO inventory begins to show a declining trend in its inventory balances as the possibility exists that the company is benefitting from matching older, lower-cost inventories against current sales. The benefit is most pronounced in an environment of rapidly rising raw materials costs which allows the company to push through price increases on its customers. However, the benefit will quickly turn on the company when it is eventually forced to replenish inventories at the higher cost level, possibly at a time when it is no longer able to push through price increases.

Currently, we are not concerned that this is happening with GIS for a few reasons. First, while DSIs have been on a downward trend, they are not alarmingly low compared when looking back over 2-3 years of data where DSIs have been as low as the high 40s. In addition, the company has seen lower prices for some key inputs versus a year ago, which likely contributed to the decline in the raw materials component of inventories. Finally, the Blue Buffalo acquisition somewhat clouds visibility over the last two quarters. Regardless, this is a trend to be monitoring in upcoming quarters.

Accounts Payable Is Increasing

Like most of the food companies we have looked at, GIS has been boosting its cash flow by extending its payment terms with suppliers. The following table shows the calculation of accounts payable days (DSPs) for the last 8 quarters.

	8/26/2018	5/27/2018	2/25/2018	11/26/2017
COGS	$2,751	$2,474	$2,627	$2,756
Accounts payable	$2,724	$2,746	$2,506	$2,467
DSP	90.3	101.3	87.0	81.7

	8/27/2017	5/28/2017	2/26/2017	11/27/2016
COGS	$2,456	$2,487	$2,486	$2,593
Accounts payable	$2,173	$2,120	$1,855	$1,938
DSP	80.7	77.8	68.1	68.2

As noted earlier, Blue Buffalo's balance sheet was consolidated at the end of the 5/18 quarter, but the income statement and cash flow statements were not impacted. If we adjust out the accounts payable balance at Blue Buffalo at the time of acquisition (4/28/18), we get an adjusted DSP of over 99, still a huge increase over the 5/17 quarter amount.

GIS also maintains a payables financing program available to some of its customers as described in its SEC filings:

> "We offer certain suppliers access to third party services that allow them to view our scheduled payments online. The third party services also allow suppliers to finance advances on our scheduled payments at the sole discretion of the supplier and the third party. We have no economic interest in these financing arrangements and no direct relationship with the suppliers, the third parties, or any financial institutions concerning these services. All of our accounts payable remain as obligations to our suppliers as stated in our supplier agreements. As of August 26, 2018, $1,010.1 million of our total accounts payable were payable to suppliers who utilize these third party services."

The following table shows the amount a payables from customers utilizing these third party payables financing arraignments as a percentage of total payables:

	8/26/2018	5/27/2018	2/25/2018	11/26/2017
Payables to suppliers utilizing third party financing	$1,010	$937	$927	$874
% of Total Payables	37.1%	34.1%	37.0%	35.4%

	8/27/2017	5/28/2017	2/26/2017	11/27/2016
Payables to suppliers utilizing third party financing	$725	$639	$563	$560
% of Total Payables	33.4%	30.1%	30.3%	28.9%

Since these suppliers can get their money up front with these financing arrangements, we assume that they are allowing GIS to extend the time it is taking to pay while still reaping at least some of the benefits of early pay discounts. As such, we believe the rising use of the programs is a key factor in the increase in payables balances.

Clearly, delaying payment time is a very real boost to cash flow. However, the company can only lean on its supplier so hard and for so long before they push back. The rate of increase in DSPs has already started to slow, and the benefit to cash flow in the three months ended 8/18 was down to $18 million compared to $79 million in the comparable period a year ago.

Impairments

At the end of fiscal 2018, GIS lowered its future sales and profitability forecasts for its *Yoki*, *Mountain High,* and *Immaculate Baking* brands which led to a $96.9 million impairment charge to write down the value of intangibles associated with those brands. The carrying values of *Yoki* and *Mountain High* were essentially cut in half while *Immaculate Baking*

was reduced to zero. In addition, the company noted while the coverage of its *Food Should Taste Good* and *Green Giant* brands and its US Yogurt reporting unit was "significant," they all had a "risk of decreasing coverage." We also note that the fair value of its *Progresso* brand was only 6% above its $462 million carrying value while the Latin American reporting unit's fair value was 21% above its $272 million carrying value. Thus, there is a reasonable risk of more writedowns occurring from any of these sources.

Redeemable Interests

GIS has a 51% controlling interest in Yoplait SAS and a 50% interest in Yoplait Marques SWNC and Liberte Marques Sarl. The remaining interests in both groups are held by Sodiaal International which has the right to put all or part of its share to GIS at fair value once per year up to 3 times before December of 2024. The redemption value is presented as a redeemable interest on the balance sheet and is currently valued at $771.6 million. GIS has net debt of about $15 million courtesy of the Blue Buffalo acquisition. The company has currently suspended the buyback which leaves about $1 billion in free cash after the dividend and this should rise with Blue Buffalo results going forward. Therefore, we don't see the Sodiaal put as a significant threat to the dividend at this point.

Conagra Brands (CAG)- EQ Review Update

Conagra released 1Q19 results last week where it missed on EPS by 2-cents and revenues by $20 million. What is even more surprising about that is we highlighted falling advertising expense as an area that has driven past earnings and could become a headwind. Yet, advertising fell another $12.2 million in the quarter y/y, which added 2.3-cents to EPS and the company still missed by 2-cents. We are updating the July 26, 2018 report on CAG in this report.

We were concerned with the following items:

Cash Flow Declining. This happened again in the 8/18 quarter with Cash flow dropping from $136 million to $95 million and capital spending doubling from $43 million to $86 million. The company made no repurchases in the quarter. On a trailing 12-month basis, cash flow after repurchases continues to be negative and dividend coverage is tighter:

TTM	18-Aug	18-May	17-May
Cash Ops	$879	$920	$1,141
CapX	$296	$252	$242
Free Cash Flow	$583	$668	$899
Dividend	$342	$342	$415
Dividend % FCF	59%	51%	46%
Repurchases	$667	$967	$1,000
Cash Flow after Repurchases	-$426	-$642	-$516

Accounts Payable Continue to Rise as Seen by DSPs. This happened again and reached 67 days in the 8/18 quarter.

	18-Aug	18-May	18-Feb	17-Nov
A/P - DSPs	67	60	57	53

	17-Aug	17-May	17-Feb	16-Nov
A/P - DSPs	60	53	46	50

These jumped by 7 days last quarter y/y, which is following a jump y/y jump for several quarters now. Stretching payables is becoming more common in the food industry to help cash flow. We still think there are limits as to how much this can grow and think investors should be concerned that it is not helping CAG's cash flow.

We also noted in the July 26 report, CAG has set up a third-party system whereby suppliers can get advances against the payables that CAG owes them. The amount advanced was flat from 5/18 to 8/18 at $103 million. This may be a signal that suppliers may not be willing to go much longer on payment terms with CAG and it may not be able to stretch payables the same rate going forward.

	18-Aug	18-May	18-Feb	17-Nov	17-Aug
Accts Pay	$984	$915	$870	$887	$846
Utilized 3rd Party Advances	$103	$103	$81	$69	$59
% of total Payables	10.5%	11.3%	9.3%	7.7%	7.0%

The Pension Benefit to Income Did Decline. We noted that CAG was very clear that after paying into its pension in recent years, changing the terms for salaried and non-qualified employees, and changing its investment focus that after booking pension income of $56 million and $21 million in fiscal 2018 and 2017 it would decline. CAG's forecast is a $46 million drop for fiscal 2019. In the 8/18 quarter, the drop was $5.9 million in pension benefit. This is an area where EPS probably came in 1 cent ahead of expectations and CAG still missed forecasts.

Advertising Expenses Declined Again. We were concerned that CAG would see a headwind to earnings as advertising and promotional costs would need to rise again in the future. They declined by another $12.2 million y/y in the 8/18 quarter and continued to help EPS by 2-cents.

TTM	18-Aug	18-May	17-May	16-May
Sales	$7,968	$7,938	$7,827	$8,664
Utilized 3rd Party Advances	$267	$279	$328	$347
% of total Payables	3.3%	3.5%	4.2%	4.0%

Pinnacle Foods Deal Expected to Close Ahead of Schedule. We addressed many of the problems we have with this acquisition including the price paid, the debt involved, and forecasted synergies being unlikely in our August 9, 2018 issue. We do not think paying a premium price for assets that have already seen extensive cost-cutting will have an abundance of low-hanging fruit to pick in another wave of restructuring.

Essentially, CAG will issue more shares and considerable debt to buy Pinnacle. It does not intend to resume share repurchases until debt is at 3.5x EBITDA. That could take over 4 years for a company projecting about $500-$700 million in free cash flow. Also, the dividend where coverage is getting tighter is not expected to grow in this fiscal year.

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 recent 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.

Disclosure

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