BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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"'I will never forget his spot-on advice when I worried aloud that we weren't unwinding our policy of zero interest rates and reducing our balance sheet quickly enough,' Fisher said. 'Richard, he said, you can't go from Wild Turkey to cold turkey overnight.'"

-Dallas Fed President Richard Fisher remembering advice from Herb Kelleher who he referred to as a "civic titan" and "wise counselor."

Random Interesting Thoughts for 2019

One of the recharging features of Christmas break is we catch up on some reading and podcasts that have gone into the "to-do" pile for some time. There are of course many things that are somewhat outdated at this point – but we still found some trends and thoughts that may be of interest to you as well. We have added links to PDFs provided by companies if you would like to read the entire document too.

- Byron Wien's top predictions for 2019 on the economy, trade, politics
- Byron Wien's research notes that the US has never had a recession when corporate profits are rising
- Starwood Property Trust's Investor Day presentation shows $3.3 trillion in annual infrastructure spending through 2030
- The housing ownership rate has returned to normal
- Stephen Moore's view that new trade deals effectively cut US export prices more than foreign import prices – which can be a new catalyst for the US economy
- Steve Schwarzman questions why 3.5% growth is bad after being told 1.8% was good
- Ares Capital Corp's Investor Day presentation showing just how much the banks have disappeared from the leveraged loan market – falling from 71% to 7%
- AT&T and 5G roll-out potentially driving a rebound in Apple and Samsung's new phones as the 5G speeds are game-changing
- Daimler still citing strength in China and confirming that it is set up to grow volumes faster than the market at a good profit level over time
- The new Prison Reform Act is releasing more inmates, shortening sentences and requiring inmates be held within 500 miles of home – does this make many prisons obsolete?

A good New Year's read is Byron Wien's top predictions for the next year

He has been doing this for years and here is the 2019 edition. We agree that the FED will not be raising rates very aggressively. However, we would also point out that the market is taking care of this regardless of FED activity. With large trading partners such as Germany having a 10-year bond at 20bp and Japan at 2bp – the US market is attracting buyers and holding our 10-year bond yield down. In 2013, there was the taper tantrum and US 10-year

rose above 3% momentarily on fears that we would soon be at 5%-6%. That turned out to be completely false and here we sit in 2019 at 2.7% after numerous FED hikes. We also agree with Mr. Wien's prediction for heavy focus on infrastructure spending.

Another piece from Mr. Wien we found interesting was from October when he takes on recession fears. He does not believe there is one coming before 2020 at the earliest pointing toward solid growth figures:

> *"**the U.S. has never experienced a recession when corporate profits have been increasing,** and this is the current trend that is expected to continue in 2019. S&P 500 earnings are projected to be up 20% in 2018 and 7% in 2019. Also, there has never been a recession in the U.S. when the leading indicators have been rising, as they are now. Even when they turn down, there is usually a lead-time of a year or more before the economic decline starts."*

Starwood backs up the infrastructure theme

We have seen considerable investing in the pipeline sector, data centers, telecom, airports. Starwood Property Trust has started investing in some infrastructure – primarily power plants. The company had an investor day in December with a 129 page presentation. STWD likes to invest in real estate areas where there is growing demand such as medical related buildings, affordable housing, and now power production. On pages 70-83, they discuss the increasing spending hitting infrastructure and the strong return potential.

Some key points listed are the world needs to invest $3.3 trillion per year in infrastructure through 2030 and low natural gas prices in the US continue to drive more power plant construction using gas. It also highlights the need for more logistics infrastructure.

We note an interesting housing graph in the Starwood presentation on page 86

Long-time readers know we focused considerably on some warning signs in housing during 2004-2008. One of the biggest signs of the mania was the US homeownership rate had been 64-65% for basically 50 years. Suddenly it was rising to 69% rapidly and then started to decline in 2006 before collapsing in 2008-09. The graph on page 86 shows the ownership

rate bottomed in 2016 has now recovered to the long-term rate of 64%. The information is from the Federal Reserve Economic Data.

Stephen Moore says new trade deals can be a new catalyst for the US economy

Stephen Moore who is currently one of Trump's economic advisors and has been a member of the Wall Street Journal's editorial board and a leader of the Club for Growth, did an interview last fall talking about the economy, taxes, and the new trade deals. The standard points of lower taxes help the economy grow as do lower tariffs were discussed – that's not too earth-shaking. **However, he called out the new European trade agreement because part of that deal is a focus to continue working toward a 0% tariff rate for both the US and Europe. What he noted is the lower rates and a drive toward 0% is huge because the US export goods are starting from a much higher tariff rate than the European imports.** Thus, this could be another trigger for US economic growth because US exports should enjoy a larger price cut due to high tariff rates coming down and sell more volume than European imports where the price cut will not be as significant starting from a lower tariff rate.

An interview with Steve Schwarzman the CEO of Blackstone also puts the economy in perspective.

His view is we're growing at rates people said were impossible a year ago – why is that bad?

> *"In terms of 2019, we see a pretty good momentum with our companies. In real estate, we have and other exposures, it's slowing a bit, which should not be unnatural. I mean, **you were at 4.2% for economic growth two quarters ago. Gee whizz, so we were like a huge developed economy. That's pretty out there on the curve. And last quarter it was 3.5%,** and it'll be -- nobody ever knows what next year will be. But consumer confidence is really high and business confidence is high, markets are in high. But you'd expect to be somewhere around 3% next year. **And people forget that for eight years we averaged 1.8% and we kept being told that was good.** And so I don't see the feds, particularly trying to induce an economic slowdown that's certainly not what Jay was saying as I happened to be at the speech that he gave last week at the Economic Club here in New York. So we look forward to a reasonably good year. But*

a year whether it's sort of mid-to-upper single digits for growth, that kind of approach for companies."

Ares Capital presentation showing banks have fallen from 71% to 7% of leveraged loan market

Ares Capital Corp. (ARCC) is another company that we follow. They also had a large investor day presentation in November. They outline their growth potential with the rising leverage factor now allowed for BDCs. **What is often touted by finance companies like ARCC and STWD is with all the new banking rules and Basil requirements – the banks have really left a vacuum behind as they exit many areas of the market.** On page 41, ARCC had the best stats we have ever seen on this subject. They show the leveraged loan market in the US broken down by banks and non-banks such as hedge funds, finance companies, REITs, BDCs. **In 1994, the banks had 71% of the leveraged loan market and that fell to 45% by 2000. In 2018, it was down to 7%!** That's a strong tailwind for these companies to pick up share of a growing market.

AT&T and the 5G rollout could potentially drive rebound in new Apple and Samsung phones

Like most people in the last few weeks, we have seen the weakness in sales of the new iPhone from Apple and some of the Samsung phones as well. Much of this seems to be customers extending the time before they upgrade as many of the new features are not compelling enough to cause people to spend $1,000. This is not a full review of Apple or Samsung by any means but reading some interviews from AT&T management talking about 5G – there may be a catalyst to drive phone sales in 2019-20. AT&T is selling 5G and is touting some speeds that may be game-changing to many people. However, to get those speeds, a customer needs a newer phone – an iPhone 8, Samsung 8 or higher. The speeds being discussed are 400mb/second to 1gb/second.

Scott Mair of AT&T described the 5G Evolution in December:

"*The capability we're putting up on the tower is really one that leverages LTE advanced capabilities. And what that means is carrier aggregation, improved*

modulation techniques and 4x4 MIMO. All yield a much better experience for our customers. In fact, ***those towers will support 400 megabit-per-second peak speeds. And I always like to say, kind of rule of thumb, 10% to 20% of that is what an average customer will see, so 40 to 80 megabits per second is the experience. And that -- right now, we'll have that complete in 400 markets by the end of this year, over 175 million people. And we'll be nationwide next year, by the middle of the year in 500-plus markets.***

And so between end of June to what will now be end of this year, right, December this year (2018), we're finally going to see commercial. ***We've said we'd be first in the market with a mobility 5G solution in small parts of 12 cities, going to 19 cities in the first half of '19.*** *That commercial interval of six months, to me, is absolutely amazing, from standards being built and finalized six months later. In an infrastructure business, having -- getting that out in six months is amazing. So our product that we're going to be using -- that device ecosystem is pretty important. So the product we're using is a MiFi product. It's the Netgear Nighthawk 5G mobile hotspot. That will be an entry device. And the device ecosystem is really what drives adoption, obviously. You got to have something to use it. And the way the time lines are shaping up, there's news this week, right, on what we'll see in the first half '19.* ***So we'll begin to see some 5G-capable devices in the first half of '19. And I think in the second half of '19 and early first half 2020, we start to see that ramp.*** *We start to see the scale devices come into play. We see scaling of networks in '19 and '20. And so what we're starting now is important. The ecosystem is developing very nicely, and it's coming together. And so you'll see '19 ramp into 2020 in terms of 5G rollout."*

CEO Randall Stephenson agreed in December:

"***I'm probably about as energized about 5G as any technology innovation that we've ever deployed. It's such a radical game changer to have the kind of capacity, performance of a network with – I'm going to exaggerate, but no latency. It's effectively a no-latency network. So, the always-on conductivity is really, really important.*** *Between here and there, you're going to see an evolution. I think you used that term. In fact, we have a technology term, we're calling it 5G Evolution. As we go through the last part of this year and 2019, we will be deploying 5GE, 5G Evolution, which means all this spectrum I told you about that we're hanging up, there's a technology called carrier aggregation that allows us to kind of make that spectrum – I'm going to oversimplify it, but like a single channel of spectrum. You get that kind of throughput. You get that kind of performance. We're deploying that technology and*

*some other technology, MIMO and 256 QAM, the punchline of all that, all that means is, **if you have an iPhone 8 or an iPhone X or a Samsung 8 or later, as we deploy this, 400 markets by the time we exit this year will have 400 meg theoretical speeds on this network.***

Now, you load it up, you're not going to get 400 meg, but this is step change improvement in speeds. So, 400 markets, by end of this year, they will roll this out through 2019.

*And so, you're going to see between now and just deployment of 5G in the millimeter wave spectrum some rather **radical increases in the performance of these networks, of our network, and a huge amount of our customers that have, like I said, iPhone 8 or newer or Samsung 8 or newer handsets will experience these speeds.** And so, we're rolling that out right now as we're doing all this other work at the cell site and so forth."*

Daimler is still citing strength in China and confirms it is set to grow faster than the market

Daimler is a stock that has been slaughtered based on China, tariffs, and software concerning emissions. The company had 50,000 cars in inventory that should have been delivered in 4Q that would help rectify some of this. We saw their 3Q18 call where they still listed China as a strong market for them:

"*Let's come to the outlook for the fourth quarter and full year 2018. At Mercedes-Benz Cars, we plan for unit sales in full year 2018 in the magnitude of last year. **While we are benefiting from a very attractive product portfolio and unchanged strong demand in China,** at the same time, our unit sales are, to a certain extent, influenced by delivery delays and drive cycle effects of certain model series, such as the new A-Class and the model upgrade of the C-Class."*

What really caught our eye though was they had a great Q&A about if you remove some of this short-term noise – is this company on path to consistently hit expected profitability figures and sales forecasts:

Arndt Ellinghorst of Evercore:

"One question on the more medium-term outlook, Bodo, really. Given where the stock is trading, I think we shouldn't spend too much time on the nitty-gritty quarterly stuff here. Can you ensure investors that there is growth in Mercedes cars that you can keep the level of profitability at 8% to 10% for the, say, coming two years to three years? Can the Group generate €4 billion to €5 billion of free cash flow ballpark? Could you, as much as you can, I don't – I know you don't want to give us a guidance for the next year, but can you give us a bit of a framework for the next two years to three years really because some of your long-term investors or the potential investors here? I think that's incredibly important at this point.

Bodo Uebber

"Arndt, thank you for your very good question. And let me outline a little bit in this direction. I do think we have given you a frame for the strategic direction of Mercedes cars. When I go back to the last Capital Market day and the things we have shown at this day, and these are – I do think I can refer nicely to your question. ***I do think in the long run, we do have possibility to grow the Mercedes car group volume because of strong product on the one hand of our core product, but also the upcoming electric product.*** *So there's a – as you know, our 10 models, of course, we are investing a lot in this direction.*

So I'm fine with the product portfolio to accelerate growth in the long run over and above the market volume. *You can see in passenger cars. On the one hand,* ***we have outlined our strategy to stick to the 8% to 10% bandwidth of profitability. That includes, of course, the higher investments, on the one hand, as we have mentioned, but also the Fit for Leadership program, which addresses the optimization of the total business model****, as it was also outlined. So we will accelerate in these directions also on the cost side, as I have mentioned, over the €4 billion program to make sure that we achieve the bandwidth. We have to consider some certain rules, of course, which I need to tell you.*

We had some discussions, as you know, about customs and other stuff, which might have some short-term impacts, which I can't exclude, but I do think we have, again, finally, also the answers on this kind of questions, finally. So nothing has changed in the direction. We need to accelerate. We need to be disciplined in terms of spending, and so on and so forth. But other than this, there is no change of the strategic directions. The market for premium is still better than for volume, from my point of

view. We have always in-depth discussion about this development. ***When you look at China, for example, and other markets, I do think we are in the right segment for accelerating growth.*** *And I even do believe that, for electric products and for elements out of case, that the premium manufacturer is well positioned in this area of digitalization and electrification."*

Does the Prison Reform Act render many prisons obsolete?

A final area we would throw out is the prison reform bill signed into law in December. Not only will this shorten prison terms and release many people early, we noticed the new law requires prisoners be held closer to their families – no more than 500 miles - and gives judges more leeway in dealing with mandatory sentencing laws. We have not explored this much yet, but we did considerable work on the prison companies in the past – The Geo Group - GEO and CoreCivic -CXW. The private prison business was driven by two things – mandatory sentencing and outsourcing.

Many prisons were built in low population areas in smaller population states like Oklahoma, Arizona, Colorado, etc. Those states are not supplying all the inmates. States with large populations would contract to have their prisoners held in these facilities. Even a small state like Hawaii had a huge number of prisoners being held in Arizona in private facilities. When you consider that a state like Colorado is surrounded by Wyoming, Nebraska, Utah for example – how many prisoner families live within 500 miles? Oklahoma is more than 500 miles from big areas like Chicago, Minneapolis, and Illinois.

We would need to look at this more closely – but, this could make some existing prisons obsolete. **One of the risks we always pointed to for these companies is their real estate has very little terminal value.** People value them like other REITs owning apartments in Charlotte or office space in Boston where replacing tenants or remodeling are possible. In reality, prisons are not going to become multi-use and have half the property converted to a hotel. Moreover, they tend to be in the middle of nowhere – with directions that include steps such as, "turn off the paved road then go another 25 miles." **At this point, we are going to throw this out as a possible new risk factor for the prison companies and have not seen any other comments on it.**

ConAgra (CAG) Move to NEUTRAL from SELL (but problems remain)

With the stock down over 40% since our August warning, we are going neutral but continue to see several troubling signs for the company

Wow! – That didn't take long for CAG to post weak results after paying a premium for Pinnacle Foods. What is more disappointing is CAG's surprise that Pinnacle has a growth problem. They don't think it's the whole company, just roughly half the sales focusing on Birds Eye, Wish-Bone, and Duncan Hines. They are blaming it on only having public information to review before the bid, but we certainly saw it. Birds Eye growth was coming exclusively from acquisitions with pricing and volume metrics falling for years. Pinnacle talked about falling sales at Wish-Bone from 2015-18 in its public documents even after pulling older SKUs and launching new products. Duncan Hines had just rolled out new products, which often mean initial stocking to boost sales growth, but quickly fades. CAG is now expecting Pinnacle sales to come in 5% below forecasts.

We still believe investors should be concerned about several items – especially achieving synergies and holding market share. On top of that, higher interest rates and weaker results at Pinnacle are not a good combination to sustain the value of the new $10.5 billion in intangible assets following the acquisition:

- **Growth with new products hurts sales of existing products.** There is not a surge in additional people suddenly eating more frozen food – CAG and PF tout sales of new products but are vague on why total sales growth lags. The reason is new products take limited shelf/freezer space away from older products, which are discounted and replaced.

- **CAG has admitted that PF is not just a cost cutting exercise at this point – they have to rebuild brands, products, and retake shelf space.** They also admit they need to rework pricing too. Further, CAG noted that customers have switched to more store-brand product in some cases and competitors have taken more market share too.

- **Getting back on the shelves and freezers should require more pricing investments, more marketing, and more store support with displays and free samples.** That

sounds like net prices will fall more at PF before they rise and costs will be increasing. We expect more disappointments in digesting the acquisition.

- **We remain very skeptical of finding $215 million in synergies or 700bp of margin at PF.** So far, the only areas of lower costs are incentive pay because the stock has fallen and options are not being exercised and cuts in advertising. CAG has not spelled out any plans beyond "applying the ConAgra Playbook." They are touting the strength and success of legacy CAG and expect gross margins of 30% and operating margins of 15%. With the disappointments at PF, it expects gross margins of 27%-28% and operating margins of just under 15%. Where is the room for 700bp of improvement at PF?

- **The balance sheet is a focus for CAG.** It expects to pull more working capital out of PF. We have noted that CAG has essentially stretched its payable to suppliers and will focus on doing the same with PF. It also sold Wesson Oil for $180 million and will likely retire debt. That will reduce sales about 2% and cost the company earnings and cash flow too – about 5-cents per share annually. The dividend at a 4% yield and only about 50% of cash flow doesn't look that suspect on the surface – but CAG has cut it in 2006 and 2016 to do restructurings and has already said no increases this year. That may be another source of cash to retire debt at 5x EBITDA if results don't materialize as forecast.

Nuggets of Growth Are Not Moving the Total Top-Line

ConAgra continues to tout that it has significant growth and points to some new items. However, the total top-line growth remains far below the rates being touted. The fiscal 2Q19 results were typical:

	2Q19	1Q19	4Q18	3Q18
Frozen Single Serve Meals	11.3%	10.0%	13.0%	13.2%

The company talks glowingly about huge growth and taking market share. However, it focuses on only one area of the business. In this case, it was frozen single-serve meals. Not in the discussion in 2Q19 is that the growth rate has already slowed from 15%-20% the year before as many of these products rolled out. Also, what gets left behind is discussion that ConAgra sales remain very weak despite the boom in frozen single-serve meals:

	2Q19	1Q19	4Q18	3Q18
CAG Legacy Sales Growth	1.3%	1.7%	3.1%	2.2%

In fiscal 2018, total CAG sales growth was negative at about -1%-2% which followed -5% growth in fiscal 2017. After two poor years, CAG saw total sales growth of low-single digit against years of easy comps and already that growth if vanishing.

There are two things going on here. First, older products are being replaced and therefore get marked down and not reordered. While not frozen food, a personal example of this illustrates the issue. My old electric toothbrush was dying and it finally occurred to me to buy a new one last weekend while in the toothpaste section. There were three models available – and I grabbed the 1000 model for $40 instead of the 3000 or 5000 for $75 or $89. The 1000 model said it was a close-out. When I checked out, the price turned out to be $10 – it was marked down an additional $30 or 75%. The stores simply do not suddenly have more shelf space and new products take shelf space from older ones. The growth rates for the older products become negative and offset sales of newer placements.

The other point to consider is new products can be a risk for the stores because they have to remove something else to place a new item. They may charge higher fees to manufacturers to get these new items on the shelves. Also, they may insist on the manufacturer provide more marketing support such as discounted prices, in store displays, or customer samples. The manufacturer wants to prove the new product is in demand and growing so it sacrifices price for market share. CAG reports that it raised prices this year on the new frozen single serving meals and also continues to sell products on promotion. The rate of promotions fell noticeably in 1Q19 but bounced back in 2Q19.

This is why organic growth at CAG before the PF deal is negative. In the 2Q19, Grocery & Snacks were 42% of sales and had volume growth of -2.2%. Foodservice at 12% of sales had volume losses of -12.9%. Offsetting this was the highly touted Frozen & Refrigerated division at 36% of sales grew volumes at 0.5% and International at 10% of sales grew volumes at 0.6%. The company is giving guidance for 1%-2% organic growth for the year – that already looks suspect to us.

The PF Deal Is Not Just About Cost Cutting Anymore – Revenue Is a Problem

When this deal was laid out – we were very skeptical that CAG could hit its targets because it required cutting 700bp of costs out of Performance Foods. CAG laid out zero revenue synergies and on the 2Q19 call – continued to say revenue synergies are still not being forecast. According to the CFO, Dave Marberger:

> *"The synergies we say in the upside, these are the cost synergies right. So, the $215 (million) were cost synergies. We did not build any revenue synergies into our model. Now obviously the business is down relative to what we had modeled, so we have to do all the things we discussed to bring that business back. But when you talk about upside going out long-term, we believe that there could be a side on revenue synergies. That's not in the updated cost synergy number that we will have."*

We were skeptical of CAG achieving that much cost cutting because PF was built via acquisition and rationalizing costs. PF already closed excess capacities to achieve better margins running the remaining facilities at higher utilization rates. It already reworked logistics, achieved scale in purchasing, rebuilt product lines. PF already had margins roughly equal to CAG. It is difficult to buy a company from another cost cutter and magically find a ton of fat to slash. See our August 2018 report for more details on this.

Now, CAG admits that PF has revenue problems and product line problems and are expecting PF sales to come in 5% below guidance. CEO Sean Connolly:

> *"On sales, we now estimate the Pinnacle portfolio will land calendar year '18 at roughly $3 billion, which is about $160 million or 5% below Pinnacle's target. Approximately $30 million of this miss is driven by our post close decisions to exit some year-end promotions that we saw as extremely low ROI. At adjusted gross margin, we now estimate Pinnacle would have closed out calendar year '18 at approximately 28%, which is roughly 230 basis points below its internal targets."*

In CAG's view, there are a myriad of issues to address. They believe Pinnacle chased low margin business and hurt pricing power. They also believe the pipeline at Pinnacle is weak and CAG is pulling many of the products and plans to remake the inventory lines. That means these problems will take time to resolve and boosting price again may be difficult:

> *"With regards to execution, Pinnacle over-extended new items in the same demand pool, favored high margins over high quality and highly competitive products, and missed some major consumer trends. These missteps ultimately undermined brand*

> *strength and pricing power, while gross productivity was insufficient to make up for operational offsets like a major product recall.*
>
> *Instead of improving the products more subpar SKU entered the market, which led to even more inefficient SKU proliferation. And then to try to jumpstart volume, low ROI trade was infused behind price promotion; compounding this unenviable situation with acute cost inflation, particularly in transportation and better innovation from the competition; and as you'd expect the side effect of disappointed customers. When Birdseye, Duncan Hines and Wishbone delve further into the virtue led cycle and brand performance stalled, customers reduced distribution. Since then, each brand has lost share with competition. Given these dynamics, the Pinnacle business will unfortunately under-deliver its pretty close internal standalone targets."*

This is not a one-quarter problem. CAG is seeing problems at PF that will last over a year even though they hope to get some new product ready before then,

> *"because of the weakness of the Pinnacle innovation, we have sprung into action to stop further proliferation of similar types of SKUs. But we've also sprung in action in terms of rebuilding a new innovation pipeline with the Pinnacle team and the ConAgra team working arm and arm to do that, but that's going to take some time. It's not going to be all at the exact same window, so it won't all be the beginning of the second half of 2020. Whatever we can get into the marketplace faster, we will get in."*

PF has conditioned customers to expect lower prices is what we are reading and its products are not what customer want. Both of those situations should make it difficult to raise prices which should pressure revenues and margins at PF. That's a far cry from the picture CAG laid out a few months ago. Moreover, competitors have taken share from PF. Displacing competition likely means lower pricing and/or lower margins due to more support for the retailer. CAG is going to be asking them to make two decisions – eliminate an entrenched product from the shelves that apparently is selling and replace it with an unknown new product:

> *"Birds Eye is an extraordinary brand. It is number one in the veggie and veggie-based meal space. And good things are still happening within the franchise like the Veggie Meal. But the brand architecture has become too fragmented in this finalized space*

within vegetables with flat out passed over for being too low margin. <u>And when the consumer is hyper passionate about our space as they are about spiralized, you just can't opt out. You've got to give the consumer what they want and figure the margin challenge out as you go. If you opt out, the competitor will fill the vacuum and that's exactly what happened.</u>

So, the way that we think about this here at ConAgra is we think of Duncan Hines as a sweet treat brand not as a cake mix. We view perfect size for one not as a portion control cake, but as a convenient warm sweet treat. And as the frame of reference being different, the product design would've been different. And frankly, it would've been more appealing. And <u>unfortunately, the competition figured this out and has been stealing share, so we've got work to do. And then the third one that we pointed to was Wish-Bone. Now this is a big category. It's also a great brand. But frankly it has not benefited from enough disruptive innovation. What has been launched hasn't resonated</u>, for example the - yellow line and that will change."

CAG will also need to displace some private label products. Generally, those are higher margin for the retailer and sell at a lower price for the consumer. CAG was asked about this on the call too:

<u>"How much of that Birds Eye loss destruction is a result of shelf loss at one major retailer that happen to introduce retailers branded SKUs and if that's a fairly local big reason why we're seeing the loss shelf and pain here.</u> Have we seen the biggest impact from that in the consumption data or might the year-over-year in the data look even worse from now?"

"That is a piece of it, Rob. I think another significant piece that I already talk -- big piece of this whole spiralized space has been a very, very big opportunity and a competitor has really taken that business at major customers. With respect to private label in frozen over time, here's how I think about that. <u>As we've said before, private label make sense in highly commoditized subcategories but it really has never made sense for work historically in finished meals, side dishes, enhancers, appetizers and things like that. Every few years that I've been around the frozen space, you will have a retailer give it a go but it has never taken hold and it probably will happen again from time to time.</u> It's happening a little bit now in vegetables, but the outcome is unlikely to be any different in these more -- these less commoditized subcategories. Ultimately, when customers see that their store brand advocacy is resulting in declining category sale, there is the there will be the exact same reversal we've seen

before. So that's the dynamic that I've seen over and over again, and it plays out the same way almost every single time."

We don't know how CAG will take back shelf space in that scenario without cutting prices and/or ramping up promotional spending. We don't know how it launches new products that it doesn't even have yet without discounting. We don't know how CAG will beat back entrenched branded competitors without offering the stores a better deal. None of this sounds like a short-term issue. All of it sounds like a revenue and gross margin problem for the PF deal.

Where is the Cost Cutting?

One of our greatest pet peeves is when companies blow their guidance and then announce – "don't worry, we have magically found more restructuring opportunity to offset the problems." CAG rang this red flag and indeed is promising even greater savings with minimal details.

"As Sean mentioned, we are pleased with the progress we've made in identifying synergies <u>and we expect to deliver more than the $215 million in total cost synergies we previously disclosed.</u> As a reminder, our synergy estimates are net of additional reinvestments, and we expect this net synergy estimate to benefit the P&L between fiscal year 2019 and fiscal year 2022. <u>We expect to over deliver on our synergy targets without incurring any cash costs to achieve above the estimated $355 million. We estimate that we will deliver approximately $20 million in synergy savings or about 10% of the originally disclosed amount for full year fiscal 2019. As for the sources of upside, we see incremental savings primarily in the areas of SG&A and procurement. We are still working the details</u> but intend to deliver these higher savings as quickly as possible."

As we addressed above, PF has some significant revenue and margin pressures to deal with over many quarters. That alone is likely to offset some of any realized cost savings. We also think it is important to note that this is not a case of PF being a similar company with margins of 6% and CAG at 15% where it should be easy to understand where cost savings will emerge. These are both companies that have already cut costs for years and both already have essentially the same margins. Adjusted for one-time items such as restructuring costs and acquisition items, PF's operating margin in 2Q was 22%. CAG's 2Q

margin was 17.1% or 19.3% before corporate expenses. CAG's guidance is that its own operations will post a 30% gross margin and 15% operating margin for fiscal 2019. It expects a lower gross margin of 27%-28% for PF but an operating margin of 14.6-14.9%.

Already, CAG has called out the new expenses for amortizing intangibles at PF as largely offsetting estimated cost savings plus some of the PF expenses will hurt CAG margins:

> *"We are estimating all-in Pinnacle adjusted operating margins of 14.6% to 14.9%. The Pinnacle reporting segment is being impacted by both the intangible asset amortization expense estimated at $17 million for the period and an estimate of $20 million in cost reduction synergies. Also included in those estimates are Pinnacle related expenses that will ultimately be recorded in total ConAgra corporate expense and not the segment for fiscal year 2019."*

The place where expenses are falling is advertising. 1Q19 was lower than 1Q18 and even adding PF to the mix for one month in 2Q19, the 2Q19 spending was below 2Q18.

	2Q19	2Q18	1Q19	1Q18
Advertising	$69.4	$86.0	$42.7	$54.9

Does this sound sustainable? If CAG plans to retake market share and restore PF sales, it will require advertising and promotion. Remember, it has to displace both branded competitors who have taken that market share and lower priced private label products the filled the shelves also. As we noted in the August report, PF was already cutting items like this including R&D, coupons, advertising, and marketing accruals:

Pinnacle	2017	2016	2015	2014
R&D exp.	$16.1	$18.1	$13.0	$11.3
Advertising	$29.3	$33.0	$28.2	$35.9
Coupon Accrual	$2.4	$5.0	$2.0	$1.9
Broker Accrual	$7.0	$8.0	$4.5	$3.5
Market Accrual	$39.0	$51.1	$46.2	$36.2

ConAgra and PF teams are expected to work "arm in arm" rebuilding the product pipeline. That doesn't sound like R&D costs are coming down for PF either. Now the company is starting in the hole from what CAG said it was buying. On the call, CAG talked about over 200bp of margin compression. It now has to rebuild and launch new products in a bigger

way and plans to do extensive relaunches on about half of PF's sales (Birds Eye, Duncan Hines, and Wishbone). It won't achieve all this in a year and all of that costs money and/or margin as they have to find ways to get back on the shelves.

The other area being cut is incentive pay which is tied to the stock price of CAG that has dropped significantly.

> *"Adjusted SG&A for the quarter was down 4.4% compared to the prior year and was 9.1% of net sales. The decrease was primarily driven by lower incentive base compensation in the legacy ConAgra business. This included lower stock-based compensation expense due to the lower share price, which was partially offset by the addition of expenses related to the Pinnacle Business."*

The Balance Sheet Goals Could Impact the Dividend

The current debt load at CAG is 5.0x EBITDA and stands at $11.1 billion net of cash (implying forward EBITDA of $2.2 billion). In 2.5 years, CAG expects to be at 3.5x EBITDA. Thus, EBITDA either needs to grow to $3.2 billion or as much as $3.4 billion of debt needs to be retired. On top of that, we have seen no change in the $355 million cash costs of merging the company and implementing restructurings. In fact, we'd argue that figure has increased as CAG now sets about trying to rebuild product lines and sales at PF.

The company has already announced an asset sale of $180 million to sell Wesson Oil – which will reduce that $2.2 billion figure. It also has highlighted that it wants to pull cash out of PF's working capital. We highlighted in July that CAG has helped its trade creditors factor receivables, which has enabled CAG to stretch its payables to as much as 60 days. However, in the last two years, PF was already over 50-days on its payables, which also illustrates again that PF was already run by financial people looking to maximize cash generation before CAG came along. Going to 60 days would only free up about $30 million in cash. Thus, we cannot see asset sales and working capital as areas to produce significant amounts of cash. Those areas are unlikely to even cover the restructuring costs.

From $2.2 billion in EBITDA before losing Wesson Oil, CAG has guided to $390 million in interest expense, capital spending of about $350 million, a tax rate of 25% is going to result in tax expense of about $325 million, and the dividend is $400 million. That leaves $735 million to retire debt per year before paying restructuring costs.

That's $1.8 billion in reduced debt over 2.5 years if CAG applies all the remaining cash flow in that manner. That still leaves the $9.3 billion in debt to EBITDA at 4.25x unless EBITDA rises by $460 million. We consider that a very big question-mark considering:

- We think the chances of finding $215 million in cost savings at PF are low given that's a 700bp increase in margin there and PF and CAG margins are roughly equal now
- CAG would still need recover the lost sales and margin at PF, then all the $215 million in synergies and still grow EBITDA another $245 million
- The company is not forecasting any revenue synergies and currently revenue is coming in below target and they sold 2% of their sales with Wesson Oil
- Cuts in advertising have already occurred and now CAG needs to create and rollout new products – marketing support costs seem more likely to rise
- Both companies have already gone through years of restructuring
- PF will be fighting to maintain revenues and margins for some time as it develops new products and tries to win back shelf space – which could hurt cash flow

Over 2.5 years, the company will pay out $1.0 billion in dividends. It can probably make its leverage target if it diverts some of the dividend payment toward debt reduction. If $500 million reduced the debt figure to $8.8 billion, CAG would still need a $300 million increase in EBITDA via synergies and growth by then to reach a 3.5x leverage ratio. The company has already cut its dividend twice in recent years 2006 and 2016 – both times after having too many weakening divisions leading to big asset sales/spin-offs, wholesale restructuring, and efforts to ramp up marketing.

We continue to believe that CAG bought and overpaid for a low/no growth company that was already run by financial engineers for years who already slashed costs. By ballooning the debt and disappointing in the first month after closing the deal, we think CAG has a tough road ahead. Any write-downs in asset values due to impairments or any delays in showing some improvements seem likely to weigh on this stock and even CAG says improvements will take time. CAG added $10.5 billion in intangible assets that will have to be tested against weaker cash flows and likely a higher hurdle rate reflecting a weaker

risk profile. Impairment charges may highlight the need to retire debt even faster – that could put pressure on the dividend. However, at 10x EPS, it's tough to be overwhelming negative on something the market is already focused on.

Ocean Yield (OCY NO) January 10, 2018 update

As we discussed in a recent report, Ocean Yield's customer Solstad has been looking to boost liquidity with creditors during the seasonally slower winter season. Ocean Yield has agreed to defer its charter payments for 6-months along with bond-holders at Solstad.

The company has been forecasting a turnaround in the offshore market and was still early. However, more contracts are being signed now for new charters of offshore rigs and support vessels. We were anticipating as much as a year of charter deferral for Ocean Yield and its two vessels and so this outcome is only half as long and should result in $4.4 million in lower EBITDA for Ocean Yield against a full company total of about $300 million. Also, this $4.4 million will occur in the first half of the year. We do not anticipate a problem with the dividend based on this outcome.

Roper Technologies (ROP) 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 ROP with a rating of 4+ (Acceptable)

ROP reported adjusted EPS of $3.09 in the 9/18 quarter, a full 15 cps ahead of the consensus target. The effective tax rate for the 9/18 quarter was 21.5%. Management stated in the conference call that the tax rate was "a little bit lower than we expected coming into the quarter." The effective rate in the 6/18 quarter was 23.1% and the company expects an effective rate of 23% in the 12/18 quarter. If we use 23% as a proxy for the expected rate going into the 9/18 quarter, we estimate that the lower than expected tax rate added about 6 cps to earnings which still implies a strong earnings beat for the period. Management also increased its range of forecasted EPS for 2018 to $11.69-11.76 from the previous $11.40-11.56.

Overall, ROP's recent earnings quality appears high and we note following observations on the quarter:

- Accounts receivable and unbilled receivable days of sales have declined slightly. This takes into consideration the impact of acquisitions, the reclassification of Gatan assets as held for sale, and the impact of the adoption of ASC 606.

- Deferred revenue days have been tracking roughly in-line. Like the declining receivables balance, this bodes well for the quality of recent reported revenue growth.

We note that the main factor keeping us from giving ROP a rating of 5 (Strong) is the high degree of deferred revenue and resulting estimates utilized in its accounting for revenue.

Revenue Recognition Metrics Are Solid

ROP's software business as well as its project-based businesses result in significant amounts of revenue being recognized over time as service are performed. This makes the ongoing monitoring of receivables, unbilled receivables and deferred revenue particularly important. The following table shows the calculation of ROP's accounts receivable and unbilled receivables days of sales (DSO) for the last eight quarters:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Sales	$1,318.70	$1,293.70	$1,202.50	$1,226.57
Accounts Receivable	$671.70	$669.30	$631.20	$641.70
Unbilled Receivables	$176.10	$180.00	$157.60	$143.60
Total Receivables	$847.80	$849.30	$788.80	$785.30
Accounts Receivable DSOs	46.5	47.2	47.9	47.7
Unbilled Receivables DSO	12.2	12.7	12.0	10.7
Total Receivable DSO	58.7	59.9	59.9	58.4

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Sales	$1,159.90	$1,134.70	$1,086.31	$1,010.80
Accounts Receivable	$603.87	$576.36	$549.84	$619.85
Unbilled Receivables	$157.85	$146.94	$143.59	$129.97
Total Receivables	$761.70	$723.30	$693.40	$749.80
Accounts Receivable DSOs	47.5	46.3	46.2	56.0
Unbilled Receivables DSOs	12.4	11.8	12.1	11.7
Total Receivable DSOs	59.9	58.2	58.2	67.7

We see that both accounts receivables days of sales and unbilled receivables days of sales declined sequentially and year-over year in the 9/18 quarter. In addition, the company disclosed that its adoption of ASC 606 beginning in the first quarter of 2018 had the impact of accelerating the recognition of certain revenues related to multiple-element software deals. This had the effect of increasing unbilled receivables by almost $3 million as of 1/1/18 compared to the balance calculated under the old method on 12/31/17. This implies that the 9/18 unbilled receivables balance would have been lifted by the accounting change compared to the 9/17 balance which was calculated under the old method. In addition, the receivables balances were likely boosted by the June 2018 acquisitions of PowerPlan and ConceptShare and the July 2018 acquisitions of BillBlast. However, some of this was likely offset by the reclassification of the Gatan assets to "held for sale" status in the 6/18 quarter.

Meanwhile, deferred revenue days of sales continue to trend roughly in-line:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Sales	$1,318.70	$1,293.70	$1,202.50	$1,226.57
ST Deferred Revenue	$613.80	$620.00	$584.70	$566.40
Sales YOY growth	13.7%	14.0%	10.7%	21.3%
Deferred Revenue Days	42.5	43.7	44.4	42.1

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Sales	$1,159.90	$1,134.70	$1,086.31	$1,010.80
ST Deferred Revenue	$534.56	$516.36	$513.82	$488.40
Sales YOY growth	22.7%	21.8%	20.4%	7.1%
Deferred Revenue Days	42.1	41.5	43.2	44.1

While deferred revenue days fell by a little more than 1 day sequentially, it increased compared to the year-ago quarter.

Under ASC 606, ROP began reporting a current and non-current contract liability account which is available for the last four quarters. This account consists mostly of deferred revenue plus billings in excess of revenues, and customer deposits. ROP disclosed in its 9/18 10-Q that acquisitions added $26 million to its net contract liabilities, which was offset by $12.8 million from the reclassification of Gatan's assets and liabilities as "held for sale." Therefore, the net impact was likely immaterial to the trend in short-term deferred revenue.

In addition, as with unbilled receivables which was discussed above, the adoption of ASC 606 in the first quarter of 2018 resulted in a $13.5 million reduction of deferred revenue on 1/1/18 as compared to deferred revenue under the old method on 12/31/2017. This implies a reducing effect on the 9/18 deferred revenue relative to the 9/17 balance which is calculated under the old method.

All things considered, the quality of ROP's revenue growth appears to be high, and we will continue to monitor the trends in these accounts going forward.

Charles River Laboratories (CRL) EQ Update- 9/18 Quarter

Current EQ Rating*	Previous EQ Rating
4+	4+

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

We are maintaining our rating on CRL at 4+ (Acceptable)

CRL reported adjusted EPS of $1.53 which was 15 cps ahead of the consensus estimate. This included 8 cps in gains from venture capital investments. Management is forecasting a 10 cps loss from its venture capital investments for the fourth quarter so this benefit will essentially reverse itself before the end of the year.

- Overall, we consider the earnings quality of the quarter to be strong. Revenue recognition trends remain healthy as client receivable and unbilled receivable days of sales declined from year-ago levels.

- Likewise, short-term deferred revenue days of sales increased slightly over last year. Long-term deferred revenue rose sequentially.

Revenue Recognition Trends Remain Healthy

As the following table shows, both client receivables and unbilled receivables on a days-of-sales basis continued the downward trend started in the 6/18 quarter. Short-term deferred revenue days also showed a slight uptick on a year-over-year basis:

.	9/29/2018	6/30/2018	3/31/2018	12/30/2017
Client Receivables	$376.30	$372.36	$343.55	$335.84
Unbilled Receivables	$113.31	$108.58	$98.80	$96.30
Total Receivables	$489.61	$480.94	$442.35	$432.14
Short-Term Deferred Revenue	$140.76	$130.39	$98.47	$117.57
Customer Contract Deposits	$44.59	$37.54	$23.57	$0.00
Client Receivable DSOs	58.7	58.1	63.5	64.0
Unbilled Receivables DSOs	17.7	16.9	18.3	18.4
Total Receivable DSOs	76.3	75.0	81.7	82.4
Short Term Deferred Revenue Days	21.9	20.3	18.2	22.4
Receivables DSOs less S/T Def. Rev. Days	54.4	54.7	63.5	60.0

	9/30/2017	6/30/2017	4/01/2017	12/31/2016
Client Receivables	$321.47	$306.24	$301.25	$284.00
Unbilled Receivables	$103.39	$94.52	$84.84	$82.20
Total Receivables	$424.86	$400.75	$386.09	$366.20
Short-Term Deferred Revenue	$108.98	$119.34	$127.59	$127.73
Customer Contract Deposits	NA	NA	NA	NA
Client Receivable DSOs	63.2	59.6	61.7	55.5
Unbilled Receivables DSOs	20.3	18.4	17.4	16.1
Total Receivable DSOs	83.5	78.0	79.0	71.6
Short Term Deferred Revenue Days	21.4	23.2	26.1	25.0
Receivables DSOs less S/T Def. Rev. Days	62.1	54.7	52.9	46.6

In addition, long-term deferred revenue continued to increase:

	9/29/2018	6/30/2018	3/31/2018	12/30/2017
Sales	$585.30	$585.30	$493.97	$478.48
Long-Term Deferred Revenue	$178.33	$141.72	$108.79	$125.88
Days of Sales	27.8	22.1	20.1	24.0

Note that the company only recently began disclosing the long-term portion of deferred revenue under ASC 606. Year-over-year trends will be more informative when available in 2019.

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 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.

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