BEHIND THE NUMBERS
Quality of Earnings Analysis

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Lancaster Colony Corporation (LANC)

Update on 3/22 results and 10-Q review

We are maintaining our earnings quality rating of LANC of 4+ (Acceptable)

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

Summary

While LANC's 3/22 quarter revenue slightly topped estimates, EPS came in at 71 cps after adjustments for 63 cps in impairment charges related to Bantam Bagels, 29 cps in Project Ascent charges, and a 4 cps benefit from contingent consideration adjustments. This was well short of analysts' expectations and the stock is down about 20% since reporting.

From a pure earnings quality standpoint, we see LANC as still being reasonable. The write-down of the Bantam Bagels' goodwill was certainly not a positive, but the company does not carry as large an intangibles balance as many food companies. This is not the first time Bantam has incurred a write-down but given the impairment test was triggered by the company's plan to explore selling the business, we do not expect further material charges from this source.

Nevertheless, LANC does face several headwinds in the next few quarters in the area of rising costs.

- Volume growth was a negative 2% in both segments while total revenue growth was 13% with dramatic price increases driving the difference. The company has taken sizeable price increases in the last two quarters with more on the way. We are concerned about how long demand will remain elastic. Inflation may be denting demand for dining out and we believe yesterday's sell-off in staples was at least partly due to TGT's results reminding investors that when push comes to shove, the big box retailers and grocers are the 800-pound gorilla.

- Gross margins fell by 840 basis points as the higher prices could not offset 30% raw materials inflation, higher costs from packaging, freight, warehousing, and labor, as well as higher costs from the increased use of co-manufacturers. We do note that the MD&A in the year-ago 10-Q contained the following statement regarding costs in the 3/21 quarter: *"Manufacturing costs in the current-year quarter continue to reflect the impacts*

of COVID-19, including hero pay for our front-line employees, increased expenditures for personal protective equipment and lower operating efficiencies. The absence of these items in the 3/22 quarter would seem to have been a material, unusual benefit but this was not mentioned in the 3/22 10-Q's MD&A.

- While management expects conditions to remain very difficult, we do see one bright spot: inventories rose in the quarter faster than raw materials inflation and now stand at a historically high level on a DSI basis. We believe the company's inventory accounting method may mean that the 3/22 quarter absorbed more of the brunt of higher costs than many of its peers.

How Far Can LANC Push Pricing?

This is the key question facing most companies today, including the consumer staples names. Even LANC's revenue growth was entirely dependent on pricing growth in the quarter. Total revenue rose by 13% in the period, yet volume *declined* with the balance coming from pricing. The volume growth was weak in both segments with Retail posing a 2% decline compared to 12% volume growth in the year-ago quarter. Retail volumes would have grown 5% after adjustment for discontinuing non-core product lines. Pricing added about 9% to Retail growth. Meanwhile, Foodservice sales volume also declined by 2% versus flat volume growth last year. However, pricing/mix of 22% resulted in net growth of 20%.

The company said that it is experiencing inflation of about 30% for raw materials as well as higher fuel, freight, and packaging costs which were all ahead of expectation going into the quarter. Unfortunately, management does not see this getting better soon and stated that pricing is its primary tool for fighting higher costs. The company increased prices by 6% in Retail in both the 12/21 and 3/22 quarters and anticipates another 8% in the 6/22 quarter. Foodservice prices increased by 13.3% in the 12/21 quarter, 20% in the 3/22 quarter, and will increase in the mid-20% range in the 6/22 quarter. Management said so far that it was not seeing a significant rejection of the price increases although it admitted it was seeing some trade down in certain categories.

We are most concerned with the Foodservice segment. Management saw a falloff in demand in the Foodservice segment in the latter half of the quarter which it attributed more to restaurants having trouble staffing than a reflection of declining consumer demand. Still, inflation takes its toll in other areas and gas prices are topping $5 a gallon. Stimulus checks are gone and increasing talk of recession can't be doing consumer sentiment any good. We are concerned about how long the demand for dining out will last in these conditions. The potential offset is consumers eating at home could shift sales to the higher-margin Retail segment.

We also believe that TGT's profit disappointment yesterday serves as a reminder that the company's retail customers are facing their own cost pressures and decades of retail consolidation have left the staples companies with much less bargaining power when it comes time to get serious about pricing.

Inventory Is a Possible Bright Spot

We have highlighted how lower inventories have put some consumer products companies in a tough spot going forward as they have had trouble rebuilding inventories. This may have artificially delayed the impact of higher costs from hitting the income statement depending on the accounting method they employ which could result in the impact of higher costs being magnified in upcoming quarters. However, it appears that in LANC's case, the most recent quarter may have absorbed a bigger portion of the blow from higher costs. The following table shows LANC's inventory components and their year-over-year growth rates for the last few quarters:

	3/31/2022	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020
Raw Materials	$61.17	$56.29	$48.08	$48.90	$40.60	$41.73
Finished Goods	$104.86	$98.87	$110.29	$72.98	$62.44	$67.32
Total Inventory	$166.02	$155.17	$158.37	$121.88	$103.05	$109.05
Raw Materials YOY Growth	50.6%	34.9%	16.4%	42.2%		
Finished Goods YOY Growth	67.9%	46.9%	59.2%	44.0%		
Total Inventory YOY Growth	61.1%	42.3%	43.2%	43.3%		

We can see that in the last two quarters, LANC's inventory growth has exceeded inflation which implies a buildup in inventory units. Take a look at components on a DSI basis:

	3/31/2022	12/31/2021	9/30/2021	6/30/2021
Raw Materials DSI	16.4	15.6	14.8	15.4
Finished Goods DSI	28.2	27.4	33.9	23.0
Total DSI	44.6	43.0	48.6	38.4

	3/31/2021	12/31/2020	9/30/2020	6/30/2020
Raw Materials DSI	13.7	14.3	14.8	13.5
Finished Goods DSI	21.1	23.1	24.8	19.9
Total DSI	34.8	37.4	39.6	33.4

	3/31/2020	12/31/2019	9/30/2019	6/30/2019
Raw Materials DSI	14.9	14.1	14.1	11.4
Finished Goods DSI	20.9	18.5	21.4	20.5
Total DSI	35.8	32.6	35.5	31.9

Both raw materials and finished goods inventories are now at historical highs. You will not catch us applauding historically high inventories very often, but in this case, we believe it is potentially a positive. Admittedly, some of this increase may be due to higher labor costs and costs from contracting with third parties to help with production being capitalized in inventory in addition to

raw materials inflation. However, the company specifically cited building out inventories to be prepared to meet demand as having a negative impact on cash flow in the quarter.

LANC states in its 10-K that it accounts for inventories under *"various methods that approximate actual cost on a first-in, first-out basis."* The average cost method is often referred to as approximating FIFO which makes us believe that LANC utilizes average cost or similar methods for much of its inventory. While average cost may approximate FIFO, the difference is that the cost of inventory purchased in the period will immediately impact cost of sales regardless of whether it is sold in the period or not. In times of rampant inflation, this can meaningfully impact results. While we have criticized several companies whose results appear to have benefitted from delaying raw materials purchases, LANC may have shifted more of the impact of higher costs into its 3/22 quarter and lessened the blow in the next couple of quarters which will allow it to keep more of the benefit of its price increases. We are not predicting a huge improvement in gross margin in the 6/22 quarter by any means, but simply note that the company appears to have less risk than some of its peers that have more inventory to purchase over the next couple of quarters.

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- 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 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 upcoming quarters. 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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