BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Lancaster Colony (LANC) EQ Update-6/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3-	3+

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

We are lowering our earnings quality rating to 3- (Minor Concern) from 3+ (Minor Concern).

LANC reported EPS of $1.20 in the 6/19 quarter versus the consensus estimate of $1.30. However, results were inflated by a 21 cps share non-operational gain from the write down of the remainder of the estimated value of contingent consideration from the Angelic acquisition. This was partially offset by 5 cps from spending on its EPR initiative and 5 cps from a restructuring and impairment charge related to the closure of a frozen bread facility. This gives us an adjusted EPS number of $1.09 which was 21 cps below the consensus target.

The deterioration in our rating largely reflects the non-operating gain from the reduction of Angelic contingent consideration and the associated increase in risk of a future write-down of goodwill and intangibles related to the business.

- LANC wrote off the entire balance of the contingent consideration liability stemming from the Angelic acquisition. When LANC acquired Angelic for $35.5 million in November of 2016, the purchase price did not include contingent consideration that was contractually based on a pre-determined multiple of Angelic's 2021 EBITDA. LANC has been estimating the value of the contingent consideration liability since then and posts losses to reflect increases in the estimated liability and gains to reflect declines in the liability. The initial estimated value of the contingent liability was $13.9 million. This rose until it peaked at $17.1 million at the end of fiscal 2018. As we noted in previous reviews, that time period experienced non-operating losses to reflect the increase in the value of the liability. However, deteriorating results at Angelic led to declines in the expected earn-out payments which led to cuts to the

liability and non-operating gains during fiscal 2019. In the 6/19 quarter, LANC wrote off the remaining $6.7 million of contingent liability which provided a $0.21 per share non-operating boost to reported EPS in the period.

Management stated the following in the conference call with regard to the sources of problems at Angelic:

> *"I guess I would say ascribe it to a couple of things. One is the perimeter of the grocery store is probably a little bit tougher a category we've learned and I would also point to -- the flat out acquisition as a case in point in that I would say that's a contributor. The other thing that really has probably resulted in the biggest impact in the write-down is we had a pretty significant piece of the business that was tied to private label when we acquired the business. And we made a decision to begin to wean ourselves on that private label as we have worked to ramp-up our branded business in loaf bread, but also our branded business in wraps and crust and other products. And essentially what's happened as we have taken out the private label pounds, it's made that factory run less efficiently.*
>
> *So, the other parts of the business tend to be growing, but not as rapidly as we want. So, our expectation on this is, is not that the game is over. It's just taking us longer to get this business where we want it to go. And as you can appreciate Frank with the mark-to-markets on an earn out that's a relatively short duration you just have to square right into it and let the accounting numbers tumble where they fall."*

Of the original consideration of $49.4 million ($35.5 million purchase price plus $13.9 million contingent consideration), LANC recorded $24.4 million as goodwill and $18.8 million as other intangible assets. There have been no impairment charges taken against these amounts and management's description above seems to indicate it believes it can turn things around at the acquired business. Should conditions continue to deteriorate at Angelic, we believe there is a strong possibility that LANC will have to recognize an impairment. We also note that management has indicated that it has invested significant cash in expanding and automating production at acquired Angelic operations. While this will not technically impact the calculations to determine impairment, it does weaken any argument for synergies provided by the acquired operations if it took more investment to bring them up to necessary size.

- Cash from operations rose by 23% in fiscal 2019 with a huge boost from lower working capital. Inventory DSI fell by almost 4 days in the 6/19 quarter versus a year ago while payable days jumped by almost 6. About 30% of the increase in payables was due to an increase in capex-related payables which will eventually cycle through investment cash spending rather than operating cash spending. Still, the rise in trade-related payables was a significant boost to cash from operations. We note that the company's days payable of under 30 indicates that it is far from over-pressuring its suppliers unlike some other packaged food companies we have reviewed. Nevertheless, such a large cash flow jump from working capital can't continue at this pace. We do not view this as a large concern for cash flow health, however, as cash flow growth adjusted for working capital impacts still topped 12%.

- Capital spending skyrocketed in the fiscal year ended 6/19 to $71 million from $31 million a year ago. This is being driven by investments in capacity expansion projects in a dinner roll production facility which is expected to be complete by mid-fiscal year 2020, a recently-completed R&D facility, as well as investments in capacity and automation in its acquired Angelic operations. The high level of spending is expected to continue in fiscal 2020 with management estimating $80-100 million in spending for the full period. Even with the increased level of spending, free cash flow of $127 million was more than sufficient to cover the dividend ($70 million), the buyback ($7 million) and the acquisition spending ($55 million).

Explanation of EQ Rating Scale

Rating	Description
6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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