BEHIND THE NUMBERS
Quality of Earnings Analysis

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Lamb Weston Holdings, Inc. (LW) Earnings Quality Review

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are initiating earnings quality coverage of LW with a 5+ (Strong) rating.

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

Summary

Unlike most packaged food companies, LW has seen its sales and profits come under pressure due to the pandemic. While sales of its frozen potato products to retail customers have benefited from the surge in at-home dining, the bulk of its sales are to restaurants and commercial customers. Sales of french fries to customers with drive-throughs have held up reasonably well, but lower sales to customers dependent on sit-down dining and non-commercial customers such as hospitals and schools have more than offset this.

Overall, we do not see any significant problems with the company's accounting quality. We applaud it for not resorting to non-GAAP disclosures with add-backs of arguably operational expenses. While it does report a significant portion of profits through joint ventures, its disclosure is reasonable. It has incurred higher inventory and production-related costs which should improve, but like most companies, the reversal of recent cost cuts such as advertising expenses and lower trade promotional activity will likely offset some of the improvement ahead.

What is weak?

- The company conducts a large degree of business via three 50% joint ventures with a total carrying value of approximately $290 million. It accounts for these under the equity method and reports profits on an after-tax basis as a line item on the income statement. Profits from these JVs typically run about 10-15% of total company net income. The company does a reasonable job of discussing factors impacting results at the JVs. Still, the lack of visibility into operating results is a negative for earnings quality.

- LW has a meaningful degree of interest rate risk as $602 million of its $2.8 billion in debt is variable-rate. The company disclosed in its 10-Q that a 1% increase in interest rates would negatively impact net profits by $4.7 million or a little over 3 cps.

- In the 5/19 quarter, LW identified a material weakness in its internal controls relating to how long temporary access was allowed to IT systems involved in financial reporting. There were no negative impacts reported and the matter was considered resolved by the end of the 5/20 quarter. While problems with internal control are always serious, we do not attach a high degree of concern to the matter.

What is strong?

- We appreciate that LW does not present non-GAAP results littered with "one-time" adjustments. There are no ongoing restructuring charges and write-offs that the company asks investors to excuse. This is remarkable, especially considering it was spun out of Conagra, a company that hardly ever reports a quarter without a significant charge.

- LW has made some minor acquisitions, but it is not the product of an ongoing roll-up strategy. Accordingly, goodwill and intangibles account for less than 10% of total assets which is unusual in the food industry.

What to watch

- Inventory days of sales have risen by 5-7 days in each of the last three quarters as demand from the company's full-service restaurant customers plummeted with COVID-related shutdowns. The increase in DSI was driven more by a decline in COGS than a

rise in inventory. Inventory balances declined YOY in the 11/20 quarter. When viewed over a two-year period, inventory levels are not alarmingly high.

- In light of the decline in sales, the company elected to store the 2019 potato crop longer than normal as a way to manage inventory balances. This led to higher costs to process these older inventories due to storage costs, a lower yield, and the higher cost associated with processing older potatoes. These costs built up in inventory during the 8/20 quarter and were expensed in the 11/20 quarter, which contributed to the 310 bps decline in gross margin in the period. The company plans to process this year's crop in a normal time frame and does not anticipate these higher costs to continue.

- SG&A expense declined by about 20 bps as a percentage of sales after we adjusted out a $5 million expense related to the ERP rollout. However, the company received about 30 bps of tailwind from lower advertising expense which is likely to reverse as conditions normalize.

- While we applaud the company for not presenting its own non-GAAP results with endless charges added back in, this means that actual non-operating impacts such as one-time gains and losses are also included in the reported EPS numbers. This leaves it up to analysts to make their own adjustments. Adjustments that should be made every quarter include the mark-to-market impact of unrealized gains and losses on FX and commodity hedges which are reported both in the company's core operations as well as those reported under the joint ventures. Each of these sources regularly impacts EPS growth by 2-4 cps every quarter and should be taken into consideration when evaluating earnings beats and misses.

- LW emerged from the 2016 spin-off from Conagra with approximately $2.9 billion in debt which has remained fairly constant over time. This represents a little under 3 times net debt/EBITDA. This is on the high side, but the company regularly posts free cash flow after buyback north of $200 million annually. Also, it does not spend heavily on acquisitions to drive growth, does not spend heavily to buy back shares, and its dividend (1.3% yield) consumed only 40-50% of free cash flow before COVID.

Inventory Situation

The bulk of LW's inventory is made up of potatoes sourced via long-term and shorter annual contracts with growers. While COVID resulted in increased demand for the company's retail

products sold to the at-home market through supermarkets, this was more than offset by the weakness in its sales to full-service restaurants. This resulted in LW reporting sales declines of 12.1%, 11.9%, and 15.6% in the 11/20, 8/20, and 5/20 quarters, respectively. In preparation for lower demand, the company delayed purchases of new raw materials and stored last year's supplies longer than usual to manage its inventory levels. The following table shows the calculation of days of sales (DSIs) for each component of inventory for the last twelve quarters:

	11/29/2020	8/30/2020	5/31/2020	2/23/2020
Cost of Products Sold	$672.600	$657.700	$735.800	$686.900
Total Inventory	$630.500	$470.600	$486.700	$597.300
Raw Materials and Packaging DSI	28.2	9.3	14.1	19.8
Finished Goods DSI	51.8	50.3	45.2	54.3
Supplies and Other DSI	5.4	5.6	5.5	5.0
Total DSI	85.3	65.1	64.8	79.1

	11/24/2019	8/25/2019	5/26/2019	2/24/2019
Cost of Products Sold	$734.100	$740.400	$752.900	$653.400
Total Inventory	$636.000	$466.500	$498.300	$588.200
Raw Materials and Packaging DSI	26.5	7.3	11.3	21.7
Finished Goods DSI	47.9	45.8	44.9	55.5
Supplies and Other DSI	4.4	4.2	4.1	4.7
Total DSI	78.8	57.3	60.2	81.9

	11/25/2018	8/26/2018	5/27/2018	2/25/2018
Cost of Products Sold	$662.400	$684.300	$685.500	$621.100
Total Inventory	$628.200	$447.700	$549.700	$630.500
Raw Materials and Packaging DSI	30.1	6.5	11.6	
Finished Goods DSI	51.6	48.8	57.1	
Supplies and Other DSI	4.6	4.2	4.2	
Total DSI	86.3	59.5	73.0	92.4

While DSIs have risen YOY by 5-7 days in each of the last three quarters, they are not that out-of-line when compared to two years ago. Also, inventory levels declined YOY on an absolute basis in the 11/20 quarter with the DSI decline being driven by the greater decline in COGS. Therefore, we are not alarmed that the company has an unmanageable amount of inventory on hand.

We do note that the company incurred higher costs by storing last year's crop longer. There were higher than usual storage costs along with the fact that processing older potatoes yields less and costs more. This led to higher costs built into inventory during the 8/20 quarter which did not hit the income statement until the 11/20 quarter given the company's FIFO (first in-first out) inventory accounting method. This was a factor in the 310 bps decline in gross margin in the 11/20 period along with other unusual costs incurred due to COVID such as sanitation, safety

protocols, and plant shutdown costs. Management identified $47 million of specific COVID-related costs in the 5/20 quarter and $16 million in the 8/20 quarter, but it did not add these back as non-GAAP adjustments. It also stated in the 11/20 quarter conference call that it would no longer quantify such costs as it was difficult to separate them from ongoing operating costs at this point, which we applaud.

Going forward, LW plans to process the current crop in a more normal time frame and it does not anticipate a repeat of the production inefficiency costs that plagued the 11/20 quarter. However, it has warned that it expects to continue to incur COVID related costs through the end of fiscal 2021 (the 5/21 quarter).

Lower Advertising Costs

LW tracks “product contribution margin” as a key indicator for core performance. This measure is calculated as sales less cost of sales and advertising and promotional expense. However, advertising and promotional expense is recorded under “selling, general and administrative expenses” on the income statement.

While the company incurred higher costs from COVID and related production inefficiencies, it was able to cut some costs to help offset this. Advertising was a notable area of savings. The following table shows advertising spend as a percentage of revenue for the last eight quarters:

	11/29/2020	8/30/2020	5/31/2020	2/23/2020
Advertising and Promotional Expense	$2.500	$1.200	$5.600	$6.600
% of Revenue	0.28%	0.14%	0.66%	0.70%

	11/24/2019	8/25/2019	5/26/2019	2/24/2019
Advertising and Promotional Expense	$6.000	$4.800	$8.900	$11.000
% of Revenue	0.59%	0.49%	0.89%	1.19%

LW spends relatively little on advertising which makes sense given its high concentration of sales to restaurants and institutions. However, by more than halving advertising and promotional expense, the company was able to add a 30 bps tailwind to operating margins in the 11/20 quarter, a benefit that should turn to a headwind in upcoming quarters.

Despite the cuts, SG&A still increased by 40 bps as a percentage of revenue in the quarter. This was partly due to $5 million in spending on its IT upgrade project. Adjusting for this, SG&A

expense would have fallen by about 20 bps as a percentage of sales. Again, kudos to the company for not automatically adding the IT expense back as a non-GAAP adjustment.

Decline in Trade Promotion Accruals

In addition to advertising, LW promotes its products with trade promotion deals which include slotting fees at retailers, cooperative marketing programs, and temporary price reductions conducted by the company's retail customers. The ultimate cost of much of these amounts will not be known until products are actually sold by customers. Therefore, the company estimates the eventual cost and records it as a reduction to revenue and an accrual of a liability at the time it sells the product to its customers. The following table shows a calculation of the accrued promotional liability relative to retail segment sales. While there may be some accruals related to the company's restaurant customers, we believe that most of the trade promotional accruals are related to activity conducted by the company's retail customers.

	11/29/2020	8/30/2020	5/31/2020	2/23/2020
Retail Sales	$140.7	$153.9	$201.9	$132.2
Accrued Trade Promotions	$36.6	$36.7	$42.5	$53.7
Days of Sales	23.7	21.7	20.6	37.0

	11/24/2019	8/25/2019	5/26/2019	2/24/2019
Retail Sales	$132.1	$129.3	$129.2	$129.0
Accrued Trade Promotions	$54.3	$50.0	$48.6	$45.8
Days of Sales	37.4	35.2	34.2	32.3

Retail sales have been one of the bright spots in the company's operations as the pandemic has driven a surge in at-home dining. However, we can see that despite the increase in retail segment revenue, promotional accruals declined sharply sequentially in the 5/20 quarter and have remained depressed during the quarters impacted by the pandemic. This would ordinarily be a concern as it could indicate the company was inadequately accruing for promotional costs it would incur. However, in the current environment where its retail customers are struggling to keep the shelves stocked, we suspect the company was able to negotiate better terms for slotting fees and in-store promotional activity was not as necessary to drive sales in the unusual market conditions. This could have had a material benefit to sales and profit growth. For perspective, if accrued trade promotions had remained constant as a percentage of retail segment sales, it would have reduced total company sales and operating profits by over $20 million over the first nine months of the year. While we do not consider this aggressive accounting since there was a reasonable explanation for the decline, analysts must consider that this benefit will reverse as normal demand conditions return at the retail level. The reserve should rise by $20 million over time and every $5 million will hit EPS by about 3 cps.

Joint Ventures- Note Mark-to-Market Adjustments

LW maintains multiple joint ventures which include the following:

- 50% interest in Lamb-Weston/Meijer joint venture with Meijer Frozen Foods B.V. in the Netherlands which sells frozen potato products in Europe.
- 50% interest in Lamb-Weston/RDO Frozen, a potato processor in the US.
- 50% interest in Lamb Weston Alimentos Modernos S.A. joint venture with Sociedad Commercial del Plata in Argentina which sells frozen potato product in South America.

The combined carrying value of these three JVs was $291.4 million as of the end of the 11/20 quarter.

Results are accounted for under the equity method with after-tax profits shown on the income statement below the income tax line. The following table shows the after-tax profits of JVs relative to total company net income for the last eight quarters:

	11/29/2020	08/30/2020	05/31/2020	02/23/2020
T12 Net Income (Including JVs)	$296.000	$339.500	$365.900	$477.900
T12 After Tax Income from JVs	$34.800	$30.600	$29.300	$50.600
	11.8%	9.0%	8.0%	10.6%

	11/24/2019	08/25/2019	05/26/2019	02/24/2019
T12 Net Income (Including JVs)	$507.900	$491.500	$487.200	$479.600
T12 After Tax Income from JVs	$55.000	$50.200	$59.500	$69.400
	10.8%	10.2%	12.2%	14.5%

	11/25/2018	08/26/2018	05/27/2018	02/25/2018
T12 Net Income (Including JVs)	$497.800	$456.800	$433.700	$409.400
T12 After Tax Income from JVs	$81.600	$83.500	$83.600	$82.300
	16.4%	18.3%	19.3%	20.1%

Note that the decline in JV income in the 2019 periods was a result of the company acquiring the remaining 50% of the Lamb Weston BSW joint venture which resulted in the results of those operations no longer being reported with after-tax income from JVs.

Management does a reasonable job to discuss trends and operational factors in play at the JVs in its MD&A. We praised LW above for it not utilizing excessive non-GAAP earnings disclosures that can potentially distort the adjusted results in favor of the company. The downside of this is that it also does not include legitimate adjustments such as one-time gains or losses which leaves it to the analyst to look for such items in the commentary and footnotes. One source of such non-operational gains is the unrealized gains and losses associates with the mark-to-market impacts from currency and commodity hedging contracts in the JV's results which the company discloses in the "Equity Method Investment Earnings" section of the MD&A. Also, there was an unusual loss from the withdrawal from a multiemployer pension plan at one of the JVs in the 2/20 quarter.

The following table shows the impact of special factors affecting the reported results of the company's share of the JV results:

	11/29/2020	8/30/2020	5/31/2020	2/23/2020
GAAP After Tax Earnings from Joint Ventures	$19.200	$11.900	-$6.100	$9.800
Unrealized Gain/(Loss) from Mark-to-Market Adj.	-$0.100	$4.700	-$6.300	-$7.300
Loss Related to Multiemployer Pension Withdrawal	-	-	-	-$2.600
Adjusted After Tax Earnings from Joint Ventures	$19.300	$7.200	$0.200	$19.700
YOY Impact of Adjustments	$2.600	$3.600	-$3.700	-$6.400
EPS Impact	$0.014	$0.019	-$0.020	-$0.034

	11/24/2019	8/25/2019	5/26/2019	2/24/2019
GAAP After Tax Earnings from Joint Ventures	$15.000	$10.600	$15.200	$14.200
Unrealized Gain/(Loss) from Mark-to-Market Adj.	-$2.700	$1.100	-$2.600	-$0.900
Loss Related to Multiemployer Pension Withdrawal	-	-	-	-
Adjusted After Tax Earnings from Joint Ventures	$17.700	$9.500	$17.800	$15.100

Over the last eight quarters, the EPS impact of the YOY effect of one-time items ranged from a 1.9 cps gain to a 3.4 cps loss. This is a source of non-operational gain that should be taken into consideration and matched to the earnings performance versus expectations to help determine the quality of the beat or miss in a given period.

Another item of explanation related to joint ventures is the company's agreement with Lamb-Weston/Meijer to share the cost of upgrading the company's ERP system. The JV footnote in the 10-Q for the 2/20 quarter states:

> *"During the thirteen weeks ended February 23, 2020, we entered into an agreement with Lamb-Weston/Meijer, effective as of December 31, 2018, to share the costs of a single, global enterprise resource planning ("ERP") platform and related software and services.*

Under the terms of the agreement, Lamb-Weston/Meijer will pay us in five equal annual payments, plus interest, beginning in the period the system is deployed at Lamb-Weston/Meijer. In connection with this agreement, we recorded a $6.0 million receivable from Lamb-Weston/Meijer in "Other assets" on our Consolidated Balance Sheet as of February 23, 2020. We expect the receivable to increase as development and implementation of the ERP progresses over the next year."

The company also states in its MD&A section of the 5/20 10-K with regard to movement in SG&A expenses:

"SG&A expenses were $338.3 million, up $3.2 million, or 1%, in fiscal 2020 compared with fiscal 2019. The increase in SG&A was largely driven by approximately $11 million of net pandemic-related SG&A and other expenses described above, higher expenses related to our information technology services and infrastructure (including approximately $8 million of nonrecurring expenses, ***excluding expenses payable to us by Lamb-Weston/Meijer under the cost sharing agreement****, that primarily relates to consulting expenses associated with developing and implementing a new ERP system)…"*

LW books a receivable due from the JV as expenses related to the rollout of the ERP system are incurred. The receivable stood at $15.4 million as of the end of the 11/20 quarter and it will be paid when the system goes into service. The company's total spending on the EPR system is recorded in SG&A and the amount spent on behalf of the JV is offset by the booking of the receivable.

Mark-to-Market Adjustments in Other Segment Contribution Margin

In addition to unrealized gains and losses on FX and commodity hedges at JVs, the company records unrealized gains and losses in its core operations which it discloses in its segment disclosures under the "Other" segment results. The following table shows the unrealized losses at core operations for the last eight quarters:

	11/29/2020	8/30/2020	5/31/2020	2/23/2020
Mark to Market Gains/(Losses) in Other Segment Results	$4.300	$7.700	-$6.800	-$0.700
% of Sales	0.5%	0.9%	-0.8%	-0.1%
Impact from Change in Mark to Market Losses	$0.100	$4.600	-$0.900	-$7.300
EPS Impact from Change in Mark to Market Losses	$0.001	$0.025	-$0.005	-$0.039

	11/24/2019	8/25/2019	5/26/2019	2/24/2019
Mark to Market Gains/(Losses) in Other Segment Results	$4.200	$3.100	-$5.900	$6.600
% of Sales	0.4%	0.3%	-0.6%	0.7%

We can see again that the unrealized gains and losses can be a source of 2-4 cps non-operational benefit or penalty to growth in a particular quarter. As with the similar amounts in JV results, these should be taken into consideration when assessing the quality of an earnings beat or miss in each quarter.

Identification of a Material Weakness

It is worth noting that in the 5/19 quarter, LW identified a material weakness in internal control related to its information technology involved in the financial reporting process. The flaw revolved around how long temporary access to the systems was allowed. No negative effects were reported and the company considered the matter resolved as of 5/20. This appears to be a relatively minor matter and we do not attach a high degree of concern to the matter. For reference, below is the note from the 5/20 10-K discussion the matter:

> "As of May 26, 2019 the Company identified a material weakness in internal control over financial reporting related to ineffective information technology general controls (ITGCs) in the areas of user access over one of the Company's information technology (IT) systems that support the Company's financial reporting processes. Automated and manual business process controls that were dependent on the affected ITGCs were also deemed ineffective because they could have been adversely impacted. During a portion of the 53-week period ended May 31, 2020, the ITGCs were ineffective and the information or system generated reports produced by the affected financial reporting systems could not be relied upon without further testing.
>
> We identified the design and evaluation of the sufficiency of the incremental audit procedures over the financial information reliant on the impacted IT systems as a critical audit matter. Significant auditor judgment was required to design incremental audit procedures and assess the sufficiency of the procedures performed and evidence obtained due to ineffective controls and the complexity of the Company's IT environment.

The primary procedures we performed to address this critical audit matter included the following. We used our judgment to determine the nature and extent of incremental audit procedures to be performed over the information produced by the impacted IT systems. We modified the types of procedures that were performed, which included testing the underlying records of selected transaction data obtained from the impacted IT systems to support the use of the information in the conduct of the audit. In addition, we evaluated the overall sufficiency of audit evidence obtained related to the information produced by the impacted IT systems.

Also from the 10-K:

As disclosed in Part II. Item 9A. Controls and Procedures in our Form 10-K for the fiscal year ended May 26, 2019, during the fourth quarter of fiscal 2019 we identified a material weakness in internal control related to information technology general controls in the area of application support team access to an information technology system ("IT System") that supports process controls and information used in our financial reporting processes. During fiscal 2020, management implemented our previously disclosed remediation plan that included enhancing our communication of internal control responsibilities to ensure the timely termination of access to the IT System when granted on a temporary basis to authorized members of our application support team. During the fourth quarter of fiscal 2020, we completed our testing of the operating effectiveness of the implemented controls and found them to be effective. As a result, we have concluded the material weakness has been remediated as of May 31, 2020.

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.

Disclosure

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