

Lamb Weston Holdings (LW) Earnings Quality Review of 8/21 Qtr.

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

We are raising our earnings quality rating back to 5+ (Strong) and adding to our On Deck Buy list.

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

Summary

LW's 8/21 quarter earnings of \$0.20 per share missed consensus targets by 18 cps. The company is seeing a return to away-from-home dining which helped drive an 11% increase in volume against relatively easy comps last year. Pricing rose by 2%. Management admitted the Delta variant weakened away-from-home demand in August. However, absent significant shutdown orders this winter, the top line should not be a problem especially as difficult retail comps normalize going forward. It is worth noting though, that management was somewhat worried about the possibility of delayed shipping and container availability having the potential to stunt volume growth.

The stock is down about 10% since the 8/21 quarterly earnings release. The bulk of the disappointment was centered around the company's higher-than-expected costs with management placing most of the blame on what it deemed the worst potato crop in its history along with a doubling in the price of edible oils. Also cited were labor challenges and production disruptions driving up unit costs. Prior to the August quarter, the company was anticipating gross margins would climb back to pre-pandemic levels of 25-26% by the end of the fiscal year. Now

it is calling for pressure to continue throughout the remainder and margins to be 5-8 percentage points below that level for the fiscal year.

We have several observations regarding LW:

- Our 5+ (Strong) rating reflects the fact that the company's earnings appear clean. Non-GAAP adjustments are practically non-existent. The major adjustment to earnings to be made is the unrealized gains/losses from hedging-related mark-to-market activity. This adjustment actually turned against the company in the 8/21 quarter as a decline in the size of unrealized gains relative to last year shaved 3 cps off of the reported earnings growth.
- The company essentially makes one thing- french fries. Over 10% of sales are to McDonald's. The french fry market is controlled by LW and two other companies and the industry is not impaired by cutthroat pricing. This makes the demand for the company's product very predictable and stable over time. The downside is the company is exposed to a weak potato crop both in terms of pricing and in terms of quality as a poor-quality crop results in higher production costs. We suspect that concerns over climate change are amplifying the recent focus on the bad potato crop. Management anticipates meaningful insight over the next two months into the full financial impact of this year's crop on FY '22 results.
- Keep in mind that this is the second year that the company has experienced higher than normal potato costs. In response to the pandemic in fiscal 2020, the company held on to last year's potato crop longer than normal to save cash. As we discussed in past reviews, these older potatoes increased processing costs which built up in inventory and resulted in substantial hits to margins in the 8/20 and 11/20 quarters. Gross margin adjusted for unrealized hedging gains/losses fell to 19.5% for the trailing 12-month period ended 8/21 compared to 23.7% for the same period ended 8/20. Before that, gross margins typically ran in the 25-26% range. As the inventory situation clears itself and restaurant sales pick back up and leverage costs, a return to the 26% level over the next 12-18 months is, in our mind, a reasonable expectation.
- The company is implementing price increases to combat rising costs but is admittedly behind the curve. Price increases will benefit the second quarter, but the real benefit will not be seen until contracts roll over in the third quarter.
- Debt is manageable at just over 2x a normalized EBITDA of \$900 million. When new capacity comes online, it should allow the company to boost EBITDA to over \$1 billion and put the company in a position to retire around \$300 million in debt annually. We could

easily see 5% annual stock price appreciation just from shifting value from the debt to the equity holders even if the multiple remains flat.

- Valuing LW is a challenge as it does not have any direct public comparisons. Looking at the recent past as a guide, normalized EBITDA is around \$900 million implying an EV/EBITDA of around 10x. Comparing that to Kellogg's EV/pre-pandemic EBITDA of over 13 makes LW seem relatively cheap.
- Market sentiment has clearly turned against LW and there could be more downside if management comes back with discouraging news about the potato crop in a couple of months. This is the key reason we are not making LW a Top Buy at this point. However, we believe it is a good bet that next year's potato crop will be much closer to normal, price increases will kick in, and dining out will pick at least by next summer. We don't think it will take the market a year to come to the same conclusion.

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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