BEHIND
THE NUMBERS
Quality of Earnings Analysis

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

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

We are lowering our earnings quality rating on LW to 5- (Strong)

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

Summary

LW reported earnings of $0.45 per share in the 3/21 quarter which missed consensus estimates by 6 cps despite beating the top-line targets by $80 million. Sales continued to be pressured by weakness in sit-down dining traffic and costs were increased by COVID's disruption to supply chain activity plus incurring repair and maintenance costs that had been deferred since the beginning of the pandemic.

We continue to see LW's earnings as solid quality given the lack of regular non-GAAP games played by most other companies we follow. Still, we note several cents of benefits to reported earnings in the quarter that were likely unexpected by analysts' models without which the earnings miss would have been wider. This prompts us to downgrade our rating to 5- (Strong) to reflect these non-operational benefits.

- LW does not adjust out the impact of mark-to-market of currency and commodity hedges. The impact of the change in these amounts in both the company's consolidated results and the earnings of its equity affiliates added about 9 cps to earnings in the quarter.

- The effective tax rate fell to 19.8% in the 3/21 quarter from 24.3% in the year-ago period due to "discrete items". This added about 2.5 cps to the quarter.

- The year-ago $2.6 million loss from a pension withdrawal included in equity earnings results added another 1.5 cps to earnings growth in the quarter. The company discloses this well so we would not consider this an unusual benefit to earnings in the period.

- Inventory DSIs fell by 5 days from the year-ago level. Remember that the company held on to last year's potato crop longer than normal to save cash which resulted in higher costs to process the inventory that drove up cost of sales in the previous quarter. While he company is working towards more efficient inventory management in the future, it warned in the quarter that it continues to see significant supply chain disruption, some of which is already baked into inventories and will hit the income statement in the 5/21 quarter. Management stated on the call:

  "With respect to costs, in the fourth quarter, we expect to incur a similar level of incremental pandemic-related manufacturing and distribution costs as we did in the third quarter. We experienced significant disruption in our production facilities, transportation, and warehousing networks in January and February, and this continued into March. We will realize some of the costs related to these disruptions in the fourth quarter as we ship finished goods' inventory produced during these months."

- Note that the company increased its percentage ownership in its Russian JV in December from 36% to 75% which resulted in these results being consolidated rather than reported as equity earnings. While the company does not quantify the impact, it likely contributed to the adjusted decline in equity results.

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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