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Treehouse Foods (THS) EQ Update- 9/20 Qtr.

Current EQ Rating*	Previous EQ Rating
3-	3-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

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

We are maintaining our earnings quality rating of 3- (Minor Concern)

THS picked up one of the smallest bumps from COVID that we have seen among food/consumer product companies and it's now largely gone with sales up only 0.7% in 3Q. To be fair, it lost some restaurant sales – but that is a much smaller part of the business. The company missed its sales forecast for 3Q but beat on EPS by 10-cents. We would argue the EPS beat is of lower quality as THS added back 6-cents for COVID costs that exceeded what it earned in incremental gross profit from COVID demand. It also added back 23-cents in taxes on 28-cents of adjustment items. Much of this is COVID-related too from the CARES Act. Even with COVID demand and some margin gains – ROI is still only 8.2%. We think margin gains may disappear as well. When we look at what improved at THS, much of it looks temporary.

What improved?

- Debt to adjusted EBITDA fell from 4.0x at the start of the year to 3.7x after 3Q20 (we are not adding back stock compensation.). Debt is not down much, only $53 million, but higher EBITDA helped the ratio.

- Favorable mix drove gross margin up 120 and 160bp in the last two quarters. This is due to fewer lower-margin restaurant sales and more retail sales with COVID. Adjusted EPS rose from 55-cents to 71-cents, and the 160bp of margin added 23-cents.

What deteriorated?

- The COVID sales bump looks gone already. Volume rose $32 million in 1Q20 and $39 million for 2Q20. It only rose $4 million in 3Q20. And, in 3Q THS started to benefit from restocking channel inventories.

- Sales growth of 0.7% looks even worse when compared to another easy comp of -4.4% from 3Q19. Guidance is calling for basically flat sales in 4Q with more channel stocking and another easy comp.

- Capital spending is still running below initial guidance of $135 million, which was already projected as a reduction from $147 million in 2019.

- Cash flow improved by $119 million through 3-quarters. However, $23 million is due to less of a working capital drag and $81 million from a change in deferred taxes. Plus, THS is benefitting by $20-$25 million by deferring payroll taxes.

What to Watch?

- Gross margin gains are due largely to lost restaurant sales which are lower margin. Going forward, some of those sales should recover and pressure margin.

- Sales growth is being helped in 3Q and 4Q by restocking the retail channel. That should mean sales growth may slow more and THS isn't seeing much growth at all now.

- Selling and Distribution costs are flat as a percentage of sales. That is with lower fuel costs pushing down freight costs. We believe THS may have also reduced marketing further during COVID which would help Selling costs.

- Other G&A costs are also not leveraging even with COVID helping sales in 1Q and 2Q.

- Cash flow may not get as much help from declining inventories from 3Q to 4Q as normal. Inventories are starting at a lower level to end 3Q and the company is working to build channel inventories.

- Cash flow will be helped in 4Q by a $73.5 million income tax refund from the CARES Act.

- THS will purchase another pasta company in 4Q or 1Q. Will this set off more restructuring?

Sales Growth Is Still Very Poor

For a food company that primarily sells through retail stores – THS had one of the poorest COVID bumps we have seen. The company attributes this to losing some sales to the Food-Away-From-Home market (restaurants). To us that looks like a fairly small part of total sales. In the 3Q presentation, THS noted that source of demand was down 22%, but it was a smaller part of sales change than retail demand being about 3x larger for net pricing change and only grew at 7%. On top of that, THS has had amazingly easy comps this year:

Sales Trends	3Q20	2Q20	1Q20
Volume	$4.2	$38.7	$32.3
Price	$2.7	-$1.7	-$5.5
Organic Growth	$6.9	$37.0	$26.8
Growth Rate	0.7%	3.6%	2.6%
2019 Organic growth	-4.4%	-6.7%	-6.1%

- 3Q20 Meal Prep down 2.0% as they couldn't offset food-away-from-home declines
- 3Q20 Snacks/Bev. Up 5.2% helped by pricing and COVID demand
- 2Q20 Meal Prep up 1.8% with COVID demand, higher retail demand, offsetting restaurants
- 2Q20 Snacks/Bev. Up 7.0% due to COVID
- 1Q20 Meal Prep up 0.5% with COVID demand
- 1Q20 Snacks/Bev. Up 6.0% with COVID

They had negative comps to grow against all year and still didn't post much with COVID tailwinds in our view. Guidance for 4Q has several issues to watch:

- Guidance is for $1.11-$1.17 billion in sales against $1.14b last year – a range of -2.6% to 2.6%.
- The comp is another easy one -3.8% from 4Q19.
- THS expects to benefit from retail stocking of many SKUs in the quarter also.

Here is what the CEO said on the conference call about SKUs:

> "***In April, responding to sharp increases in demand, we worked with our customers to simplify and prioritize certain SKUs.*** *This had two important impacts: first, it allowed us to better serve our customers' needs and keep their shelves stocked with private label basics; second, this simplification enabled us to run more physical cases through our plants, driving profitability and cash flow. The trade-off of these benefits*

*was a temporary decline in private label share in measured channels of about 200 basis points in the second quarter. You'll also recall that on our last call, **<u>we detailed our efforts to return those deprioritized SKUs into production and that we would be shipping about 80% of those SKUs by the end of August.</u>** That process has played out expected, and unit share is beginning to recover as we thought. In fact, the most recent shared data shows that private label penetration has returned to May levels, which means private label share for our categories has risen by 150 basis points. **<u>We anticipate this trend will continue."</u>***

We have seen several other companies talking about similar plans. Retail shelves were emptied early in the COVID process and in 3Q, there was finally a chance to start building inventories in the channel again. THS started this process late in 3Q and should see it continue in 4Q. It will get listed as organic growth, but we are not going to consider it sustainable. Eventually, the stocks will be rebuilt and organic growth will more closely resemble what is actually sold to consumers.

We also think investors should note that some of this should have helped 3Q sales but look at volume up only $4.2 million. It looks to us that the COVID bump is already gone here.

Gross Margin Improved but Can It Last?

As we noted in the original report, gross margin has been falling for years despite all the restructuring at THS. In 2020, there are still several one-time items that hurt gross profit. COVID is the largest one. It is worth noting that COVID costs exceed their COVID bump. As noted above, THS added a net $32 million and $39 million in sales volume in 1Q and 2Q. At a 19% gross margin that is only $6-$7 million in incremental gross profit. THS is spending over $26 million on COVID expenses and calling $17 million a one-time expense. If just $7-10 million more of that spending is permanent for wage increases, cleaning procedures, and supplies – that is 70-100bp of gross margin at risk.

Gross Margins	3Q20	3Q19	2Q20	2Q19	1Q20	1Q19
COVID	$17.3	$0.0	$17.8	$0.0	$0.9	$0.0
Restructuring	$0.2	$0.6	$0.0	$0.2	$0.7	$3.0
Chg. Regulations	$0.0	$4.0	$0.4	$0.0	-$0.1	$0.0
Withdrawal from Multi-Emp. Plans	$0.0	$0.0	$0.0	$4.1	$0.0	$0.0
Depreciation Adj.	$0.2	$0.1	$0.0	$0.2	$0.0	$1.4
One-time Items	$17.7	$4.7	$18.2	$4.5	$1.5	$4.4
Adjusted Gross Margin	19.7%	18.1%	20.1%	18.9%	18.1%	18.8%

The other reasons we do not believe gross margin gains will hold are the company's explanations for the improvement. In both 2Q and 3Q, THS said that it benefited from favorable mix of sales – meaning they had more retail sales and less to restaurants where margins are lower. At some point, that should swing back and give the company more low-margin sales. THS also said that its margins benefitted from higher volume leveraging fixed costs for manufacturing and distribution as well. But, it is also known that THS is selling more volume now to restock the channel – that will likely end in 4Q. We should also point out that in 2Q and 3Q, as THS worked with retailers to focus on producing more volume of only about 20% of its SKUs – that should have helped make manufacturing more efficient as well. Now, the other 80% of SKUs are being made again.

In 1Q when the bulk of the quarter did not have COVID demand, margins were down. THS said that was due to unfavorable pricing and unfavorable mix as it had more lower-margin business. It appears to us that is an area that should bounce back and pressure margins again.

Margins Are Not Being Helped by Selling and G&A Costs – It's all Gross Margin

The company has cut Selling and Distribution costs along with G&A costs as part of its restructuring. Selling used to be about 7% of sales and dropped to 6%. G&A was 5.5% and fell to 5.1% in recent years. However, the change has stalled:

Other Costs	3Q20	3Q19	2Q20	2Q19	1Q20	1Q19
Selling & Dist. Adj.	$59.8	$60.0	$62.7	$59.8	$64.4	$70.2
S&D % Sales	5.7%	5.7%	6.0%	5.8%	5.9%	6.6%
G&A Adjusted	$50.1	$50.9	$61.9	$59.4	$63.0	$60.6
G&A % Sales	4.8%	4.8%	5.9%	5.8%	5.8%	5.7%

These are adjusted to add back items like COVID, restructuring, litigation, etc. We are surprised that with higher sales, there isn't some more leveraging of costs. Instead, costs have remained flat to even slightly up as a percentage of sales. The company reported that freight rates fell and that helped selling and distribution. In 1Q20, it had a larger change by moving away from spot market freight deals y/y and that change was already in place for other 2019 quarters. THS says that it has watched costs very closely as the reason G&A is largely flat as a percentage of sales – but again, if they could not leverage the cost base with higher COVID demand – when can they?

The company only discloses information on marketing and R&D in the 10-K. We know that THS was cutting its allowance for marketing in recent years and it flows through selling and distribution costs.

	2019	2018	2017
Marketing Allowance	$32.9	$45.7	$56.9
% Sales	0.8%	1.0%	1.2%

From 2017-2019, they cut this allowance by 40bp. We know that many other food companies have been able to cut marketing during COVID. If THS was able to do the same, we would argue that freight costs may actually be up on a permanent basis as we expect marketing to return. Also, lower freight costs are likely partially tied to fuel costs being lower in 2020 vs. 2019. So again, if selling and distribution is flat as a percentage of sales – there are three potential headwinds for this cost going forward: higher marketing, higher fuel costs, and loss of COVID-driven sales.

Research and Development spending had already dropped by $9 million from 2017 to 2019 and added 13bp to margin. This could be a headwind for G&A also along with losing some of the COVID sales.

Cash Flow from Drawing Down Working Capital Appears Over

As we pointed out in the original report, THS produced over $350 million in cash flow by pulling down working capital from 2017-19. A big part of this was selling receivables. We did not believe it could continue pulling cash out of working capital. So far in 2020, it has been a sizeable drag:

Working Cap.	3Q20	2Q20	1Q20
Receivables	-$2.2	$28.8	-$24.0
Inventory	-$35.3	-$85.5	$1.1
Prepaid Exp.	-$27.8	$0.7	-$60.4
Payables	-$8.6	$18.4	$39.7
Accrued Exp.	-$11.1	$43.0	-$11.1
Cash from W/C	-$85.0	$5.4	-$54.7
Cash from Ops	$1.2	$54.8	$68.5
Cap Exp.	$18.3	$3.0	$27.3
Software	$4.3	$3.8	$3.8
Free Cash Flow	-$21.4	$29.3	$37.4

Seasonally, inventories normally drop in 4Q. DSIs are 71 now coming out of 3Q, which is low historically. They usually fall as much as 20 days. We are not sure that will happen this year as THS is rebuilding channel inventories and the drop in DSI is to 55-60 days and they are starting at a lower level. We estimate that a drop to 55-60 days would mean inventories would fall to $555-$605 million from the current $664 million. That is not going to offset the drag working capital has already been this year of -$134 million:

Inventory	4Q	3Q	2Q	1Q
DSIs 2020		70.7	67.5	55.1
DSIs 2019	54.3	73.6	73.1	89.5
DSIs 2018	59.6	78.2	70.6	68.7

Additional points to consider about cash flow and sustainability:

- Capital spending is coming in light from forecasts of $135 million for 2020. So far only $79 million has been spent. Historically, capital spending is above $150 million so this may be a headwind for free cash flow in 2021.

- Cash flow looks better this year through three quarters at $124.5 million vs. $5.8 million in 2019. Of that, working capital was less of a drag by $22.9 million and there was a positive swing in cash flow of $80.7 million 2020 for deferred taxes.

- Cash flow in 2020 is benefitting from deferring payroll taxes of $20-$25 million from the CARES Act. That will become a headwind in 2021 and 2022 when that deferred amount is repaid.

- The CARES Act also helped THS realize a tax refund of $73.5 million – which has largely hit in the 4Q. Through 3Q, total COVID spending has been $36 million at THS and it has realized $25 million in tax benefits in that area.

- THS continues to benefit from slow-paying banks on collected receivables that have been sold. This balance finally dipped y/y in 3Q dropping from 70% of the total to 55%.

	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
Receivables Sold	$226.7	$200.1	$229.8	$243.0	$196.2	$184.5	$148.7
Payable Due on Sold A/R Collected	$123.6	$131.3	$106.7	$158.3	$136.6	$70.5	$97.5
% Owed	54.5%	65.6%	46.4%	65.1%	69.6%	38.2%	65.6%

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 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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