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BEHIND THE NUMBERS
Quality of Earnings Analysis

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TreeHouse Foods, Inc. (THS) Earnings Quality Update 12/20 Qtr.

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

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

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

Summary

THS hit forecasts for 4Q20 of $1.07. It gained 3-cents in the Riviana acquisition as THS marked up the value of the acquired inventory by $3.1 million, and then expensed $2.1 million of that mark-up in 4Q20. On adjusted results, they added back the $2.1 million. THS also reversed a $6.2 million tax valuation allowance into earnings for 2020. That added 12-cents to EPS, it's just not clear if all of it hit in 4Q.

The company guided to more restocking of the channel in the quarter and that is what happened. Volume growth that practically disappeared in 3Q with COVID demand normalizing – rose from $4.2 million to $40.3 million in 4Q. Every $10 million of sales that is likely one-time in nature added over 1-cent to EPS. As we noted after 3Q, we think THS had the shortest-lived COVID bump of the various food companies we follow:

Organic Growth	4Q20	3Q20	2Q20	1Q20
Volume	$40.3	$4.2	$38.7	$32.3
Price	$4.8	$2.7	-$1.7	-$5.5
Organic Growth	$45.1	$6.9	$37.0	$26.8
Growth rate	3.9%	0.7%	3.6%	2.6%

That weak growth came against negative comps of -4% to -6% in 2019. Guidance is for sales of $4.4-$4.6 billion after hitting $4.4 billion in 2020 with COVID. And most importantly, the Riviana deal that closed in December is expected to add $170-$180 million in sales. Adjusted EPS for 2020 was $2.73 and THS sees Riviana adding 20-30 cents to 2021's total and expects EPS of $2.80-$3.20. This guidance also seems to rely on taking pricing to offset higher freight, employee, and raw material costs. THS is saying they hope to see some higher pricing help by the 2H21, but they have not been able to take much pricing. In 2018, they had pricing 1.4%, then 0.6% in 2019, and 0.0% in 2020.

What is weak?

- We still consider gross margin growth to be amazingly poor. Keep in mind, THS has been culling lower margin SKUs for years now. For a company with $4.4 billion in sales, it removed over $600 million in SKUs from 2018-2020. That should have helped gross margin. Also in 2020, COVID meant smaller restaurant sales, which are lower margin too and THS replaced that with higher margin sales to retailers. Yet, adjusted gross margin is still lower than when this all started. In 4Q, adjusted gross margin was up only 11bp y/y. We think that indicates huge pressure from retailers to reduce their costs and pushing on THS's margins:

	2020	2019	2018	2017
Adj. Gross Margin	19.7%	19.1%	20.0%	21.2%

  Going forward, lower margin restaurant sales should return and retailers won't need as much inventory stocking and they can push back more. As noted in the summary, THS is planning to boost prices in 2021 and have those kick in for the second half of the year. Pricing gains were only 1.4% in 2018, 0.6% in 2019, and 0.0% for 2020.

  It is also worth considering that THS's own inventory has been rebuilt at this point. DSI's were 58.5 days in 4Q20, which compares well with 54.3 days the year before and 59.6 days after 4Q19. To the extent that rebuilding its own inventories from Qs 1-3 in 2020 helped it leverage some fixed costs and boost margin – that tailwind may be gone too.

- THS is not seeing margin gains from cutting Selling & Distribution costs or G&A costs. Thus, its growth relies on gross margin gains holding and as noted in the prior section, 2020's gross margin improvement looks short-lived.

Adj. Other Costs	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
Selling & Dist.	$73.5	$59.8	$62.7	$64.4	$64.1	$60.0	$59.8	$70.2
% of Sales	6.2%	5.7%	6.0%	5.9%	5.6%	5.7%	5.8%	6.6%
G&A costs	$53.5	$50.1	$61.9	$63.0	$50.1	$50.9	$59.4	$60.6
% of Sales	4.5%	4.8%	5.9%	5.8%	4.4%	4.8%	5.8%	5.7%

THS is already saying it expects $100-$110 million in raw material cost headwinds to impact gross margin in 2021. It also noted that freight and employee wages are rising too which should hit distribution and G&A costs too. We are also going to note that THS cut R&D costs again in 2020 – down to $16.6 million from $18.8 million in 2019. And its marketing allowance remains very low at $39.6 million but used to be almost $57 million. COVID allowed many companies to cut marketing – but going forward those costs may return.

- THS did come in light on capital spending. Forecasts for $135 million for 2020 only hit $106 million. Forecasts are for $140 million of spending in 2021 so this is a cash flow headwind going forward.

- The Riviana deal is broken out. Of the $239 million spent, 24% will be allocated to goodwill and not amortized. 28% will be allocated to customer relationships and amortized over a whopping 20 years. As an aside – shouldn't investors believe that THS already had relationships with some of the same retailers? Tradenames are 18% of the allocated price and will also be amortized over 20 years. Inventory was a mere 8% and PP&E only 20%. It is worth noting that THS marked up the inventory by $3.1 million and then expensed $2.1 million in 4Q20 but then added back that expense to adjusted EPS. That was worth 3-cents in EPS.

- Some cash flow headwinds for 2021 still remain.

    - THS continued to sell receivables and slow its payment to the banks as it collected the funds. This facility allows a max $300 million of receivables to be sold and it was at $284 million in 4Q. Plus, the amount of money collected but not sent to the banks was $203 million – that is the highest we have seen it and it produces cashflow for THS:

	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
A/R Sold	$284.3	$226.7	$200.1	$229.8	$243.0	$196.2	$184.5	$148.7
Payables on Collections	$202.8	$123.6	$131.3	$106.7	$158.3	$136.6	$70.5	$97.5

- We also noted that THS benefited by claiming a tax refund of $71.4 million in the 4Q and intends to file for another $14.1 million refund on 2020 taxes for 2021.
- THS will need to deal with repaying the CARES Act payroll deferrals in 2021 and 2022 – about a $10-$12 million headwind in each year.
- It also sounds that if raw material costs increase – inventories could consume cash in 2021.

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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