BEHIND
THE NUMBERS
Quality of Earnings Analysis

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# Treehouse Foods, Inc. (THS)
# Earnings Quality Update- 3/21 Qtr.

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

*We are cutting our earnings quality rating of THS to 2- (Weak) from 3- (Minor Concern).*

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

## Summary

THS beat non-GAAP EPS by 3-cents for 1Q21. That included adding back 4-cents in charges related to responding to shareholder activism (the first time we've ever seen that BTW). THS also added back 2-cents from the remaining inventory mark-up for the Riviana deal in 1Q.

The company also added back another huge 16-cents from COVID, which the company said came in below expectations. We are very skeptical of this as THS has now spent 75-cents of EPS on COVID – the company only earns about $2.50 pre-COVID and their COVID cost figures are rising from 9-cents in 3Q20? We are not seeing other companies reporting that percentage of earnings going to COVID planning. THS is now starting its 4th series of restructuring in just over 3-years. It added back 35-cents in "one-time" items here in 1Q.

After all the prior work of boosting prices, realigning its plants, culling SKUs, COVID demand… THS is reporting that gross margin was essentially flat and said it gained 9-cents from the "timing of lower expenses" – which sounds to us like saving on travel costs and lower marketing. Also, if there are lower marketing costs such as trade discounts and store incentives – that effectively raises the revenue figure and should help gross margin.

Note that the company is currently an On-Deck Sell on the BTN Focus List. This quarter would prompt us to move this to a Top Sell were it not for the smaller market cap and making this a potential buyout target and some investors pushing the company to sell out to a new management team.

## What is weak?

- What else is in the COVID Costs? THS reported another 16-cents in COVID-related costs for 1Q21 – which, of course, it added back to adjusted EPS. That is now 75-cents that THS has added back related to COVID – which is 25%-30% of their annual adjusted EPS figure. We looked to see what they did that others are not – we aren't seeing anything different. THS built a program to talk to employees more often, office employees worked at home, they cleaned more and offered masks, and employees in the production and warehouse operations received a bonus.

  It is also worth remembering that a COVID meant THS saved money on travel and entertainment. It likely benefited from making higher sales with less marketing and advertising overall too. As noted above, THS claims it picked up 9-cents from timing issues helping it reduce costs in 1Q21.

- Another restructuring? Strategic Growth Initiatives began in 1Q21 and are expected to cost $130 million largely consisting of consulting and professional fees along with new technology to help marketing and value-engineer the supply chain. There were other restructurings to implement the IT system and exit some facilities in 1Q21. This follows Treehouse 2020 that cost $300 million, started in 3Q17, and just ended. That was designed to optimize the supply chain, cut employees, and optimize the manufacturing operation. Treehouse 2020 was already followed by Structure to Win in 1Q18. That cost $93 million and sought to cut administrative costs and fix and centralize the supply chain. Since 2017, THS has added back $8 to EPS for restructuring charges.

  We have been asking what is there to show for this?
    - Gross Margin is down 300bp since 2017
    - General and Administrative costs are down 20-30bp since 2017
    - Organic Growth was 0.7% in 2017, then -1.0%, then -5.0%, 2.7% with COVID, and now down -5.0% to start 2021.

- What else can help gross margin? THS culled lower margin SKUs in the last three years that were worth about 14% of total sales. COVID meant the shelves at the stores were cleared, and then fully restocked at full price and there should have been fewer marketing discounts, incentives, promotions required that lower net sales. THS was able to manufacture at full capacity to not only restock shelves, but also rebuild its own inventory. That should have spread fixed costs over more volume and helped gross margin. THS had a $40 million jump in volume in 4Q20 and it is now back to 68 days on its own inventory level. That is about normal of around 70 days and up from 58 days in 4Q20. With all of that, THS just posted a flat gross margin of 18.1% y/y.

  Against that, THS has higher wages and higher raw material costs. It is also spending more on shipping. THS guided to 20-30 cents of adjusted EPS in 2Q due to these pressures vs. the 36-cents in 1Q. They hope to take more pricing going forward and THS does use FIFO accounting. Their inventory turns about 6x year so they could get some recovery there, but it sounds like gross margin will weaken further before then. It may have been easier to take pricing before restocking the retailer shelves. THS has not been successful in getting price hikes since 2018, yet it noted other years like 2017-19 when commodity inflation pressured results and they did not fully recover those costs.

- Cash flow is under pressure too with inventory rising and the company benefited from selling more receivables y/y along with a greater dollar figure related to slow paying the banks who are due the cash after THS receives the payment on receivables it sold to the banks:

| | 1Q21 | 4Q20 | 3Q20 | 2Q20 | 1Q20 | 4Q19 | 3Q19 | 2Q19 | 1Q19 |
|---|---|---|---|---|---|---|---|---|---|
| A/R Sold | $246.7 | $284.3 | $226.7 | $200.1 | $229.8 | $243.0 | $196.2 | $184.5 | $148.7 |
| Payables on Collections | $128.8 | $202.8 | $123.6 | $131.3 | $106.7 | $158.3 | $136.6 | $70.5 | $97.5 |

Cash from operations was -$5.5 million for 1Q21 vs. $68.5 million for 1Q20. For 1Q21, THS benefited from selling more receivables and holding more cash from the banks, that represents a potential headwind for cash flow going forward.

# 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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