BEHIND THE NUMBERS
Quality of Earnings Analysis
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BTN Thursday Thoughts

Updates and New Developments on Active BTN Ideas

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General Mills, Inc. (GIS)- Review of 4Q22

We are maintaining our earnings quality rating of GIS at 3+ (Minor Concern).

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

Summary

GIS reported non-GAAP EPS of $1.12 beating forecasts by 11 cents. Share repurchases added 1.2 cents and rounding added 0.4 cents. It has a minor headwind on taxes.

The biggest driver here was an 18% price increase for the company, which contributed to volumes falling 9%. We believe that pricing largely falls to the bottom line. Losing 1% of the price hike would have cost GIS about 6.5 cents of EPS. Thus, we don't consider this a sustainable or high-quality earnings beat. And the company's guidance would seem to confirm that, calling for sales growth of 4%-5%, operating profit change of -2% to +1%, and EPS growth of only 0%-3%.

- Guidance calls for 4%-5% organic growth with 14% inflation – that would seem to indicate another round of very high price hikes and lost volume. This leads us to multiple potential

problems. The first of which is their big customers such as Walmart and Kroger are saying on their conference calls that they expect to keep pricing on food items as low as possible and expect their suppliers to help out in that area too. Also, they are highlighting that consumers are switching away from branded items toward cheaper store-brand substitutes and the stores are getting faster growth in that area. As noted above, if customers push back even just a little on price hikes – every 1% GIS doesn't pull through is about 7 cents per quarter in EPS.

- GIS is still not growing its inventory at rates that correspond to 14% inflation. Total inventory was $1.87 billion at the end of May vs. $1.82 billion the year before. Raw materials are up 29% and grains are up 48% within that total, but total DSIs were down by two days y/y. GIS said after the 3Q and now after 4Q that it didn't expect to rebuild inventories or to see it build in customer stocks either. They were correct on that. But, adjusted gross margin still fell 70 bps y/y for 4Q and 3Q saw a decline of 160 bps y/y. GIS blamed inflation and supply chain deleveraging. How does this get better in the near term? Lower volumes should deleverage supply chains more and higher-cost raw materials and grains are working their way into finished goods. We have speculated that gross margins may have been helped already by liquidating LIFO layers and tapping older inventory at lower price points. That may be harder to continue.

- Higher prices are leveraging operating costs. However, GIS also cut some expenses in dollar terms too which gives an added boost to cost leverage. Advertising and promotion look like areas that could become headwinds as GIS is guiding to spending more in fiscal 2023:

	f22	**f21**	**f20**
Advertising	$690.1	$736.3	$691.8
Accrued Trade Promotion	$474.4	$580.9	$550.9

Lower promotional spending boosts revenue and lower advertising against higher revenue boosts margin. Just looking at lower advertising in fiscal 2022 against higher sales gave GIS 43bp of better margin. Now GIS is guiding to flat operating profit in dollar terms.

- We don't expect the JVs to add much to earnings growth like they did in 3Q and 4Q:

JV Income	4Q	3Q	2Q	1Q
fiscal 2022	$29.7	$29.9	$33.0	$29.1
fiscal 2021	$25.7	$11.8	$36.4	$41.3

- There could be a tailwind from the pension plans. GIS raised its expected rate of return for 2023 to 6.75% from 5.85%. Its sensitivity analysis shows that 100 bp change helps income by $66 million, so 90 bps may be about $60 million. It also raised the interest rates for the pension assumptions by more than 100 bps for 2021 and every $100bp change is worth $49 million. Together, this could be a 10 to 15-cent tailwind for EPS. That's enough to produce the 0%-3% EPS growth GIS is forecasting. It probably offsets higher marketing at least.

- GIS has $11.6 billion in debt. Higher interest rates may take a toll sooner than later with $811 million in commercial paper and banklines, $768 million due in the fall of 2022 with rates of 0% and 2.6%, and $1.94 billion due in 2023 with some at 1% and others floating rate. We don't think GIS will have a problem rolling this debt over, but 30% of their debt rolls over within 17 months and may well happen at a higher rate. Every 100bp is $35 million or 5 cents of EPS headwind.

Patterson Companies, Inc. (PDCO)- Review of 4Q22

We are maintaining our earnings quality rating of PDCO at 2- (Weak).

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

Summary

PDCO trounced guidance of 56 cents and posted 71 cents of adjusted EPS for 4Q22 (ending in April). Last quarter we noted that everything set up for a good 4Q and couldn't figure out what PDCO was afraid of as it held guidance so low. We speculated the fear may have been another large LIFO adjustment coming in 4Q, but that did not happen.

The beat was solid although we think at least half the beat may be questioned. However, one quarter doesn't make a trend and PDCO has a history of seeing many write-offs, one-time items, and temporary expense cuts to make EPS forecasts – so we'd like to see more than one period that looks fairly clean before raising our rating. We still see some headwinds that may arise and here are the areas that we check:

- **LIFO adjustment of $10.2 million vs $21.0 million in 4Q21**. Last year, PDCO told investors to add back $12 million of the $21 million LIFO adjustment as one-time in nature. A $9 million LIFO charge would have been in line with fiscal 2020 and 2019. **It could be argued that $10.2 million was about $1 million higher than forecast and this was a headwind of 0.8 cents.**

- **We did notice that the inventory obsolescence charge came in much lower than normal in fiscal 2022.** The charge was $61.6 million, but PDCO identified $49.2 million of that as one-time in nature in 1Q22 when it donated excess Covid protection products which it added back to non-GAAP earnings. In 4Q21, it wrote down $11 million of Covid protection products and called that out as a one-time event (even though it repeated in a huge way only a month later). In 2021, the total charge was $45.8 million. If we adjust for these two charges, it becomes obvious that PDCO actually had an earnings boost from an abnormally low inventory charge:

	f22	f21	f20	f19	f18
Inv. Obsolescence Chg	$61.6	$45.8	$27.4	$31.0	$22.9
One-Time write-off	$49.2	$11.0	-	-	-
Net adjusted income	$12.4	$34.8	$27.4	$31.0	$22.9

We believe 4Q21 picked up somewhere between $10-$20 million in earnings from having the amount of the charge going into adjusted EPS come in so light. **The resulting easy comparison for 4Q22 represents 7.8-15.6 cents in EPS vs. the reported 15-cent beat.**

- The loss on selling equipment contracts rose considerably in 4Q22 to -$9.95 million from -$1.85 million in 4Q21 due to higher interest rates. That shows up as a reduction to sales. However, offsetting that are gains on interest hedges which almost matched this completely at $10.03 million vs. $1.79 million, and those are reported in “other income”. We’ll agree there was no EPS impact here but it did lower gross margin by about 50bp by reducing the sales figure much more.

- Losses on securitization of receivables were a small tailwind, declining from $1.26 million to $0.97 million. This goes into operating expenses and was a 0.2-cent tailwind, but that seems immaterial to us.

- PDCO is talking about its sales team making bigger efforts for fiscal 2023 to drive revenues even though guidance is only for 3% growth at the midpoint of forecasts. We think PDCO may need to spend more on marketing and share compensation than it has in recent years. These have been big drivers of EPS growth:

	f22	f21	f20	f19	f18
Advertising	$1.5	$0.1	$5.7	$8.4	$6.9
Non-Cash Compensation	$23.8	$30.5	$37.4	$38.4	$38.7

In 4Q22, stock compensation was flat y/y at $5.4 million vs. $5.3 million, but the EPS tailwind may be over. If PDCO just returned to spending $5 million on advertising and $30 million on stock compensation, it would be a 7.5-cent headwind in fiscal 2023.

- The effective tax rate rose from 21.0% to 23.1% in 4Q22, which cost PDCO 1.9 cents. We think this may have come from PDCO boosting its valuation allowance

on deferred tax assets by $2.66 million even though the gross account rose only $1 million. This is worth watching if it declines and becomes a source of EPS 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.

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