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Cat and Dog Food, Inc.

Evan Lorenz writes:

Extraordinarily overvalued markets rarely correct to being merely expensive. Yet, after last year's selloff, the S&P 500 trades at 28.7 times its cyclically adjusted price-earnings ratio, a premium to the 50-year average of 21 times. And despite widespread expectations for a recession this year, the Street estimates that earnings for the blue-chip gauge will rise—not fall—by 4.8% in 2023. Where to turn for a nice, safe equity return?

Not necessarily to the trusty consumer-staples stocks. Yes, canned soup and frozen pizza may appear to be cycle-proof, but food stocks are expensive, consumers may opt for cheap store brands instead of name ones and margin-crimping promotional spending might roar back. In preview, *Grant's* is bearish on General Mills, Inc. (GIS on the New York Stock Exchange).

Recession, yea or nay, is the first item on the analytical agenda. Evidence in support of a slump includes the deeply inverted yield curve, the business-cycle survey responses of "most economists" and the latest reading of the Institute for Supply Management's Manufacturing PMI, which declined to 48.4 in December (lowest since May 2020) from 49 in November of last year. "Regarding the overall economy," ISM chair Timothy Fiore said in the accompanying press release last week, "this figure indicates contraction after 30 straight months of expansion."

Perhaps, some will allow, but you don't see it yet in wages and employment. According to the December labor report, the United States added 223,000 non-farm jobs while the unemployment rate fell to 3.5% from 3.6% in November and average hourly earnings rose by 4.6%.

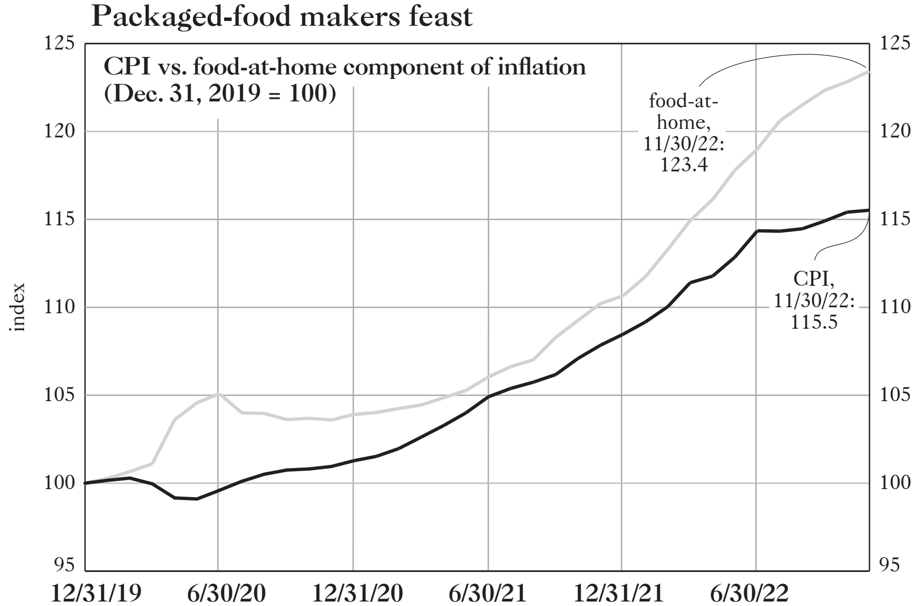
The wise Marty Whitman exhorted the analysts of corporate financial statements not to settle for what the numbers said but to probe for what they meant. Analysts of the government's macroeconomic reports may similarly strive, although what those data say is sometimes a little cloudy.

The obsessively watched monthly non-farm payrolls data of the Bureau of Labor Statistics present a case in point. The jobs numbers derive from business surveys and an econometric birth-death estimate to allow for business formations and failures. A more comprehensive, alternative source of survey information, also by the BLS, the Quarterly Census of Employment and Wages (QCEW), appears with a five-month lag and provides the basis of annual revisions of the payroll data.

Comparing the second-quarter 2022 QCEW to the corresponding monthly jobs numbers yields a striking result: According to the Federal Reserve Bank of Philadelphia, which did the digging and released its findings last month, the United States added a mere 10,500 net new jobs in the three months ended June, not the 1,047,000 attributed by the BLS's monthly numbers.

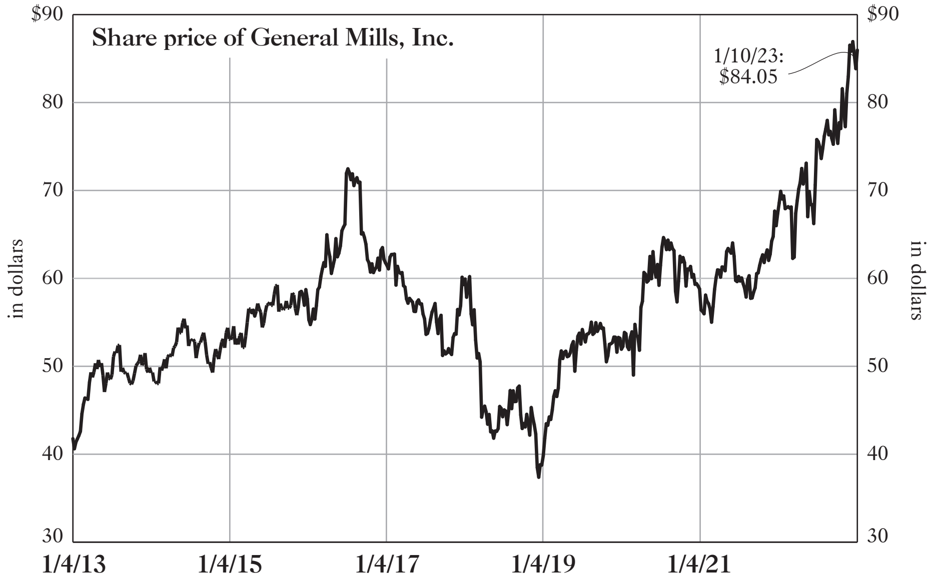
Maybe the consumer can arbitrate between the two. Walmart, Inc., on its

Packaged-food makers feast



source: Bureau of Labor Statistics

Cheerio!



source: The Bloomberg

Nov. 15, 2022 earnings call, reported that shoppers are buying smaller quantities with greater frequency, a behavior typical of hard times. Furthermore, Walmart greeters are saying howdy to the kinds of affluent consumers who, when the economy is humming, mainly shop elsewhere. "[N]early three-quarters of share gains [are] coming from those exceeding $100,000 in annual income," CFO John David Rainey told dialers-in on the call. "This quarter, our private-brand penetration in food categories increased about 130 basis points, reflecting customers' increased focus on quality products at value prices."

On Nov. 16, Target Corp. reported a similar lurch towards frugality, "and these trends only became more pronounced towards the end of the third quarter, when spending patterns changed dramatically," executive vice president and chief growth officer Christina Hennington told analysts.

To maintain Covid-era spending habits, consumers are running up debt or drawing down stimmie-enhanced savings. The savings rate as a percentage of disposable income dropped to 2.4% in November 2022 from 7.1% a full year ago. Credit-card balances jumped by 15% year over year in the third quarter of 2022, up from growth of 12.7%, 9.2% and 4.5% in the prior three quarters. A comparable rise in credit-card borrowings preceded the Great Recession.

Different today are the big price jumps that the packaged-food companies continue to push through. "For the period ended Dec. 25, 2022, four-week food pricing is up 15% year over year," Jonathan Feeney, who rates General Mills a hold for Consumer Edge Research, LLC, tells me. "That's on top of a 10% increase in the same period a year ago. You are talking about a 25% increase" over the past two years.

However, as prices have risen, units have fallen: In the latest available quarter, after adjusting for acquisitions, volumes declined by 2.3% at Kellogg Co., 3.8% at Kraft Heinz Co. and 6% at General Mills. Listen to any packaged-foods earnings call, and the question of price elasticities comes up. So far, so good, the industry is reporting: Consumers have cut purchases less in response to price hikes than they did before Covid-19 arrived.

Even so, major brands are losing market share to private labels. General Mills, for instance, maintained or expanded share in only 37% of its product categories over the past two quarters. You'd expect that Big Food would step up promotional activity in response—but they haven't. "The percentage of total food sales in U.S.-measured channels currently sold on 'deal' is 24.4%, well below the 31.0% seen in 2019," Bernstein Research finds. "This has likely been a tailwind to pricing, since promotional spend[ing] is deducted above the net revenue line."

However, this happy circumstance is owing to the downbeat fact of virus-related production snarls. "Within food, there are no major categories with in-stock levels north of 95% [of retail shelf space] and some, like frozen food, including baked goods and meat, along with snacks, candy, refrigerated baked goods, meals and dough, are all still sub-90%," a team of Goldman Sachs Group, Inc. analysts led by Jason English observe. Food manufacturers have scant incentive to discount and promote when they can't keep grocers' shelves full.

At the end of the day, packaged-food makers would rather raise prices by a dollar than sell an additional dollar's worth of food. In the case of a price hike, that incremental dollar falls directly into operating income. To sell an extra box of Totino's pizza rolls, General Mills must incur the cost to procure the ingredients, make the food and ship the product to a retailer. All in all, General Mills's operating margin in the 12 months ended Nov. 27, 2022 amounted to 15.9% of sales, which means that selling an extra dollar's worth of food generates an extra $0.16 of operating income.

. . .

General Mills, born the Minneapolis Milling Co. in 1856, set out to transform raw ingredients into packaged food, such as wheat into a bag of flour. The modern Mills continues in that fundamental vein, after experimenting with such miscellany as high-altitude balloons in the 1940s and a deepwater research submersible, the *Alvin*, in 1964. It's also dabbled in restaurants (Red Lobster and Olive Garden), apparel (Talbots and Eddie Bauer) and toys (Parker Brothers).

The extracurriculars are history today as Mills concentrates on food for people and their animals. Four units comprise the corporate whole: North American retail (63% of trailing sales), international (14%), pet (12%) and North American foodservice (7%). Key product categories include snacks (21.8% of sales; brands such as Bugles and Fruit by the Foot), cereal (16.3%; Lucky Charms, Trix and Chex), convenient meals (15.3%; Totino's, Annie's and Pillsbury) and pet food (Blue Buffalo). More than 100 Mills brands are offered for sale in more than 100 countries, but the 50 states contributed 77% of the top line in the fiscal year ended May 29, 2022.

Also of note: Mills has a 50% stake in a joint venture to sell cereal outside of North America with Nestle S.A. and a 50% joint venture to sell Häagen-Dazs ice cream in Japan. In the 12 months ended Nov. 27, 2022, Mills's share of the joint ventures' after-tax income amounted to $94.8 million, versus $2.8 billion in after-tax income from the wholly owned businesses.

In the latest quarter, General Mills hiked prices across its portfolio by an average of 17%. Historically, consumer-staples manufacturers do not cut prices after inflationary surges reverse. As the mid-20th-century Fed chairman William McChesney Martin was approximately wont to observe, "the purchasing power lost to inflation is never regained." Neither, necessarily, do businesses relinquish their inflation-fattened margins. "Input costs on a spot basis peaked in June and are roughly down 20% off their peak," Feeney tells me. "How are companies going to guide for 2023? Because, at the moment, everything I described to you would suggest that gross-margin outlook should be much better."

Pets have to eat, too—and not just any old thing out of a can. Bulls don't forget to mention Mills's move into premium pet food via its $8 billion, 2018 acquisition of Blue Buffalo Pet Products. In calendar 2017, Blue Buffalo generated $1.3 billion of pet-division sales—at the time, it was *the* pet division. Thanks to organic growth and a series of tuck-in acquisitions, Mills's pet sales reached $2.4 billion in the 12 months ended Nov. 27, 2022.

Pet food is outgrowing the overall packaged-foods industry for three reasons. No. 1, "premiumization," a shift towards the high end. No. 2, "humanization," the psycho-economic phenomenon whereby products like Pawsecco, a sparkling beverage for teetotaling, day-drinking dogs, come into being. (On that point, no less than 34% of respondents to a 2019 survey by the pet-food maker I and Love and You said that their pet is their favorite child, while 41% said they spend more money on that favorite child's food than on their own.) No. 3, the secular tailwind brought about by the pet-adoption wave in the lonely days of 2020. While the pet boom has subsided, the increase in the number of households hosting little furry friends will boost pet-food sales for the next decade or so.

General Mills at a glance
all figures in $ millions except per share data

	TTM*	FY '22**	FY '21	FY '20	FY '19
revenue	$19,367.2	$18,992.8	$18,127.0	$17,626.6	$16,865.2
operating income	3,716.8	3,475.8	3,144.8	2,953.9	2,515.9
net income	2,909.0	2,707.3	2,339.8	2,181.2	1,752.7
EPS	4.79	4.42	3.78	3.56	2.90
shares outstanding	607.3	612.6	619.1	613.3	605.4
cash	644.1	569.4	1,505.2	1,677.8	450.0
debt	10,586.8	10,809.0	12,250.7	13,260.5	13,021.3
total assets	31,319.8	31,090.1	31,841.9	30,806.7	30,111.2

* For the 12 months ended Nov. 27, 2022.

** Fiscal year ends in May.

source: company reports

Certainly, Mr. Market is not unaware of these facts. Last year, General Mills's stock generated a 28.1% total return including reinvested dividends versus an 18% loss for the S&P 500. As a result, GIS trades at 20 times trailing earnings, a premium to the S&P 500 multiple of 19 times and to the 18.4 times that Big Cereal averaged in the five years ended 2019.

The bond market likewise smiles on Mills. Rated Baa2/triple-B, the company's senior unsecured 4.2s of 2028 change hands at $98.25, a price to yield 4.6%, or a premium of just 86 basis points over Treasurys. It's a yield spread more in keeping with double-A-rated corporate bonds (76 basis points) than with the triple-B-rated subset (170 basis points). As of Nov. 27, 2022, the General Mills balance sheet showed net debt equivalent to three times trailing Ebitda.

Out of the 20 analysts who cover Mills, 3 say buy and 4 say sell and 13 say neither one nor the other. The C-suite, at least, stands united: Over the past 12 months, insiders have dumped 373,071 shares for proceeds of $28.2 million with exactly no purchases. Short interest amounts to 3% of the equity float.

"If you look at their margins in the North America retail division, they are at a decade high," English tells me, "which is stunning. . . . They've realized that price-cost surplus far faster than anyone else, which is great for them. But, as we think about going forward, if the whole narrative in the industry becomes, 'Who is going to recover margins?' then Mills doesn't have the same potential."

Covid-era production problems are the source of the bullish coincidence of robust pricing and anemic promotions. As noted, Mills has little incentive to discount boxes of Lucky Charms when it can't meet demand. Fortunately for consumers, if not for investors, manufacturers are recovering. What happens when supply chains unsnarl, I asked David Schneidman, a director of Alvarez & Marsal Consumer Retail Group. "That's when you'll see deep discounts," came the reply.

Private-label products are already deeply discounted. In the categories in which TreeHouse Foods, Inc. competes, national brands were priced at a 21%–24% premium to store brands prior to 2020. Today that price gap has widened to 27%. "This combination of high shelf prices and wide price gaps translates into a basket of private-label goods that represents significant savings for the consumer," TreeHouse CEO Steven Oakland pointed out on the Nov. 7 earnings call.

In a November survey conducted by Coresight Research, a specialist in retail and technology, 78.5% of respondents said, yes, they noticed that retail prices were rising. (The other 21.5% must be mooching off their parents.) Within that observant majority, 50% said they plan to switch to cheaper brands, a 10 percentage-point increase from a similar canvass in October.

SNAP, the Supplemental Nutrition Assistance Program formerly known as food stamps, got a Covid boost; states could issue additional funds to low-income families so long as a public-health emergency remained in force. Sixteen states opted out of the emergency allotments last year and if, at some point, the government declares an end to Covid, household purchasing power may suffer another setback.

While consumers do, indeed, dine out less frequently during business-cycle downturns than in flush times, branded food sales do not enjoy a reciprocal lift. "In previous recessions," Alexia Howard, who rates GIS a sell for Bernstein, pointed out in July, "there has been a trade in from food eaten in restaurants to food eaten at home—or at the very least a slowdown in the ongoing long-term shift in favor of eating out. We saw this during the financial crisis and again back in the recession of the early 2000s. And during the financial crisis, the 'trade-in' from restaurants was simply offset by the 'trade-down' to private label, leaving the volumes for the branded companies pretty much business as usual."

Meanwhile, retailers are making common cause with consumers for lower prices. According to a Nov. 12, 2022 *Wall Street Journal* report, Walmart's CEO delivered such a diktat to the nonfood suppliers of its Sam's Club chain in October. "Inside a hotel auditorium, he said Walmart would be pushing back against suppliers' efforts to raise prices, according to people familiar with the situation," the *Journal* noted. "Its rivals—from Target Corp. to Amazon.com, Inc.—are adopting a similar posture. Large retailers are canceling orders, resisting price increases and in some cases asking suppliers to provide discounts."

Though Blue Buffalo's revenues have almost doubled since Mills acquired it in April 2018, the pet division reported an 11% decline in volumes in the latest quarter, excluding the impact of acquisitions. Management attributed the disappointment to destocking by several large retailers, though even after adjusting for that bump, it appears that sales fell by 3%. This is the second consecutive quarter of year-over-year organic volume declines.

And here comes the competition. Blue Buffalo is not the only brand to ride the wave of premiumization in pet food and the Covid pet boom. According to a PetFoodIndustry.com dispatch in September, at least 37 new pet-food manufacturing facilities popped up or were expanded in North America last year.

Peers such as Kraft Heinz Co. and Conagra Brands, Inc., which lack rapidly growing divisions on the same scale as Blue Buffalo, trade at an average of 15.1 times trailing earnings. All in all, we judge, Mills's 20 multiple stands out like a finely manicured sore thumb.

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