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## **COMPANY SUMMARY**

### **Monday, January 23, 2006**

**Speaker: Bob Cummins**

#### **Food Industry Comment:**

**ConAgra Foods** (CAG-\$20.85) lost 34% of its market value between January 21 (\$30.24) and December 12, 2005 (\$19.99), as a result of disappointing earnings and concerns about likely changes under the new management. Since then, the share price has stabilized in a narrow \$20-\$21 range, on increased volume. We take that as an encouraging sign that investors recognize that prospects for CAG's core businesses are improving, both in the absolute and relative to poor results in the second half of F2005, and that CEO Gary Rodkin's approach to strengthening the company and upgrading its performance is likely to be a gradual one, rather than a radical housecleaning that would drive the stock to a new low. As discussed in our Company Summary of December 13, the risk/reward ratio at this price appears unusually attractive, as does the long-term potential for the company under its new leadership. We reiterate our "1" (Strong Buy) rating, and our 12-24 month target price of \$28-\$30.

Since joining the company on October 1, 2005, Mr. Rodkin has already made some important changes. On December 1, the company named Robert Sharpe, formerly Senior Vice President and General Counsel at PepsiCo, Mr. Rodkin's alma mater, to the newly created position of Executive Vice President for Legal and Regulatory Affairs. On December 20, it announced a major realignment of the corporate structure and management organization that, among other things, will result in Dennis O'Brien, President of Retail Products, and Allan Lutz, President of Foodservice, leaving the company. The number of business segments will be reduced from three to two, as Foodservice will be combined with Food Ingredients to form ConAgra Foods Commercial, to be headed by Greg Heckman, formerly President of Ingredients. The Retail segment will be headed by Mr. O'Brien's former second in command, Dean Hollis, but the responsibilities of that job will change. Doug Knudsen, already the head of retail sales, will remain in that position but will now report directly to Mr. Rodkin, as will a new Chief Marketing Officer, to be recruited from outside. In addition, Jim Hardy, CAG's Senior Vice President, Manufacturing, will have broader responsibilities as Executive Vice President, Manufacturing and Supply Chain.

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**See pages 5 to 7 of report for Analyst's Certification and important disclosures.**

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In the December 22 news release, which discussed the company's results in the second quarter ended November, Mr. Rodkin stated that "The current quarter profit shortfall indicates that our fundamentals need to be much stronger. Strengthening the fundamentals will be aggressively pursued but will take a fair amount of time; however, there are opportunities for short-term improvement through better execution, and we will not hesitate to take actions that have clear benefits."

He further said that "We are thoroughly reviewing the components of our product portfolio and how we participate in the marketplace, along with our operating, organizational, and capital structure initiatives so that we have realistic, holistic plans for improvement. When we host our investor event in March, we will comment on all the major elements needed to realize ConAgra Foods' potential. This will include our brand and product portfolio strategy, our plans for more efficient operations, the right levels of brand investment, and our progress toward optimizing our organizational structure. We will articulate how all of those factors relate to our capital allocation discipline, which will be designed to appropriately invest behind our brands, continually strengthen our balance sheet, and give us financial flexibility. Our goal is to implement the strategies that fundamentally strengthen this company and enable it to build sustainable profitable growth consistently."

Mr. Rodkin's public comments since his appointment as CEO on August 31 provide some insights regarding his overview of the company, its long-term potential, and the steps that must be taken to achieve it, subjects that will be discussed in greater detail at the investor meeting in New York on March 16. Some of his comments may be summarized as follows:

- A great deal has already been done by the previous management to strengthen CAG's performance, and the new team will build on that foundation. The emphasis will be on strengthening top-line growth while increasing efficiency, thereby achieving significantly higher profit margins. That process will take time, but the opportunities are "huge," and the company is on the right track.
- There is no intention of "lowering the bar," i.e. taking steps that would depress near-term earnings in order to enhance the long-term performance. The company will take a responsible approach, and in fact, the goal for the second half of F2006 is to deliver the best earnings possible, in contrast to last year's poor results.
- No firm decision has been made on divesting any of CAG's businesses, but management will carefully review the portfolio to determine what actions may be appropriate. The commodity trading operation, whose earnings have been volatile, nevertheless is considered a valuable business that provides significant benefits to the company, but some changes may be made to reduce its volatility.

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- CAG has some unusually attractive brands, examples of which are Healthy Choice, Chef Boyardee, Egg Beaters, Hunt's tomato products, Orville Redenbacher, PAM, and a number of strong regional brands. Many of its brands have been underleveraged. The company's frozen food lines and those focused on health and wellness are considered particularly well positioned for growth.
- The company needs to spend more on marketing, and will do so as its profit margins improve. The expenditures will be highly focused, with the most promising brands getting a disproportionate share, and others being cut back. A detailed analysis is under way to determine the priorities. Concentrating marketing dollars on the most attractive brands should enhance both sales and earnings growth materially.
- The balance sheet and cash flow are strong. After the early repayment of \$500 million of debt this month, there will be no significant payments due for the next five years. The new \$1.5 billion credit facility was arranged strictly for the sake of flexibility, and does not imply any plans for acquisitions. Capital expenditures in F2006 are estimated at \$400 million (down from \$453 million last year), while depreciation and amortization should be in the \$360 million range. The company is also generating cash by managing working capital effectively. At the end of November, cash and equivalents of \$687 million were \$334 million higher than a year ago, while receivables and inventories, at \$4.2 billion, were \$193 million lower. Total debt was just under \$4.4 billion, \$591 million below the level of November, 2004.
- Management recognizes that the current \$1.09 annual dividend, which represents an above-average 5.3% yield, is highly valued by CAG investors, and the company can afford to continue paying it if it chooses to do so. Future dividend payments will be determined by the Board of Directors based on an analysis of all aspects of the company's financial situation.

In F1Q-06 (August), EPS showed a better than expected 14% increase, thanks to large profits from commodity trading and a lower tax rate. That trend reversed in the November period, as a result of disappointing sales in Retail Products, increased costs for fuel and energy, transportation, warehousing, steel, and other packaging, and a decline in trading profits versus higher than normal prior-year results. Thus, EPS from operations fell 19% to \$0.38 from \$0.47 a year ago, with the commodity area accounting for \$0.03 of the decline.

We are assuming that trading profits remain at the recent more normal rate in the second half, but EPS comparisons nevertheless are expected to turn positive, since earnings last year in both Retail and Foodservice were depressed, largely due to problems in the packaged meats business, which is now recovering. Management is not providing specific earnings guidance for the year. We have shaded our estimate from \$1.48 to \$1.44 (versus \$1.35 in F2005), but that implies year-to-year growth of 15% for F3Q and 35% for F4Q, reversing last year's declines of 19% and 37%, respectively.

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There is clearly substantial upside earnings potential for ConAgra Foods if management can achieve its goals of accelerating sales growth and expanding profit margins. With annual sales of \$14.5 billion, or \$28 per share, this is one of the few large food companies that sells at less than one times sales. Apart from the depressed stock price, that reflects a below-average EBIT margin of 9.4%, compared with 15%-19% for other large packaged foods companies. CAG's overall margin is held down by the 41% of sales attributable to the Foodservice and Ingredients businesses, which have a combined segment margin of about 9%, before corporate expenses. It also reflects eroding margins in Retail, whose segment margin in F2006 is estimated at 13.7%, up from last year's 13.3%, but still below the recent high of 15.4% earned in F2003. Without allowing for any growth in sales, we calculate that every 100 basis point improvement in the EBIT margin (i.e., to 10.4%, 11.4%, etc.) would add \$0.19 to EPS, or 13%.

While we are bullish on the CAG shares at this price, there are several uncertainties in the near-term picture that should be noted:

- (1) Divestitures. It is normal for a new CEO to review a company's businesses to determine which may be candidates for sale. On the other hand, we have never seen a divestiture that was not dilutive to earnings, since interest income on the after-tax proceeds seldom if ever fully offsets the lost operating profits. A few small asset sales would have little impact, but if the strategic plan laid out at the meeting in March includes the divestiture of businesses that contribute a significant portion of earnings, it could have a negative impact on the stock.
- (2) Capital Expenditures. CAG over the past several years has been investing in plant modernization and consolidation to increase efficiency. Undoubtedly Mr. Rodkin will continue those efforts, but if he decided to accelerate the program by increasing spending materially, that in turn might well lead to a reduction of the dividend in order to conserve cash.
- (3) Marketing Expenditures. The company's emphasis thus far seems to be more on redirecting marketing dollars to achieve the optimum results than on a major increase in the overall budget. However, it seems possible that instead management may decide it must "jump-start" the company with a major infusion of marketing dollars. If so, this too could threaten the dividend, not to mention depressing earnings for a while.
- (4) Writeoffs. It would not be surprising if the March presentation included an announcement of writedowns for plant closings, impairment charges, workforce reductions or other purposes. As a one-time charge, this should have little impact on the stock price, although the initial announcement could be taken by some investors as a sign that the company is in worse condition than they realized.

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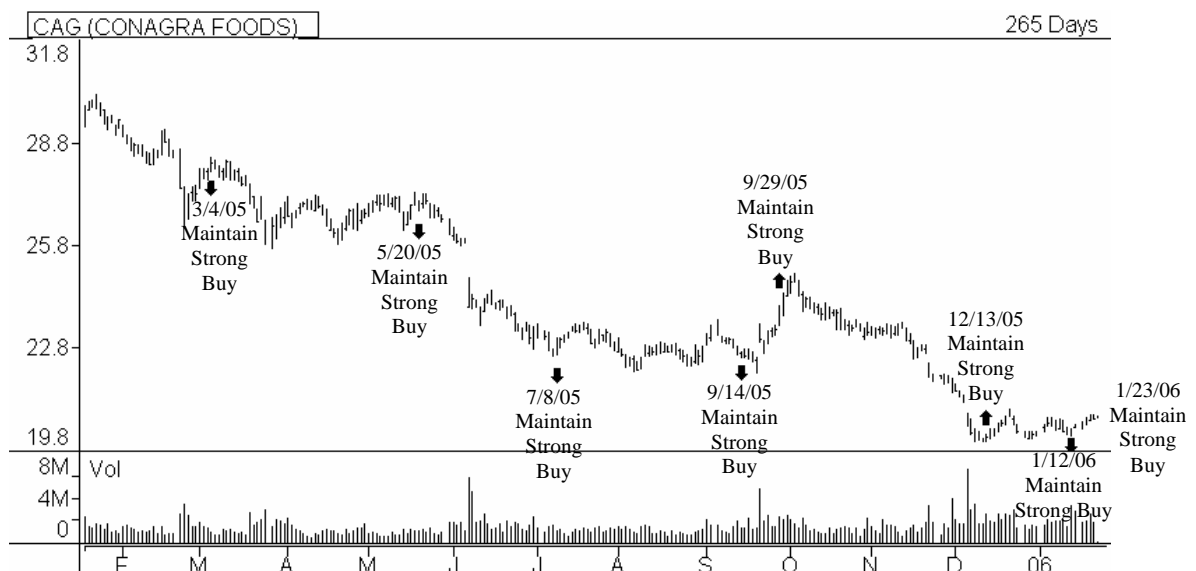
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