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## COMPANY SUMMARY

### Tuesday, November 9, 2004

**Speaker: Bob Cummins**

**Food Industry Comment: .**

**Dean Foods** (DF-\$32.50) Since reaching their 2004 low of \$28.25 on October 26<sup>th</sup>, the DF shares have rallied 15% on management's confirmation that it expects a resumption of earnings growth in 4Q, after two down quarters, with EPS up 13%-18% to \$0.63-\$0.66. Raw milk costs have receded to more normal levels, sales of the company's high-margin branded products continue to grow at impressive rates, its remaining problem areas are being addressed effectively, and the company has taken advantage of its depressed price to repurchase nearly 6% of its shares since July 1. Thus, after a flat year for EPS in 2004, management projects 8%-13% growth to a new high of \$2.20-\$2.30 in 2005. The multiple of 14 times the midpoint of that range in our view is reasonable for a company that we consider one of the most dynamic in the food industry. Moreover, after a difficult 2004, we believe management is taking a cautious approach to 2005 earnings guidance, and upside surprises are possible. We reiterate our Strong Buy ("1") rating, and are raising our 12-month target price slightly from \$37-\$38 to \$38-\$39.

Dean on November 3<sup>rd</sup> reported 3Q (September) sales of \$2.8 billion, up 20%, largely reflecting the pass-through of higher costs for milk, butterfat, packaging materials, and fuel, as well as the impact of strategic acquisitions. EPS from operations were \$0.46, at the high end of management's most recent guidance of \$0.44-\$0.46, but 12% below last year's \$0.52. The weakness reflected lower profits in the Dairy Group, due to higher costs and competition, in the Specialty Foods Group, as a result of disruptions in two of its major businesses, and in Dean's dairy operations in Spain, partly offset by strong earnings improvement in the Branded Products Group, the company's principal growth engine. We calculate that the \$0.06 EPS decline reflected a \$0.13 benefit from Branded Products, offset by earnings declines of about \$0.07 for Dairy and \$0.06 for Specialty Foods, a \$0.05 penalty attributable to Spain and corporate expenses, and a \$0.01 reduction from a higher tax rate.

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See last page of report for important disclosures and Analyst's Certification.

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The Dairy Group, which accounts for about 80% of sales and segment operating income, reported 17% sales growth for 3Q. Most of that increase reflected cost inflation, but the company also gained market share, as fluid milk volume rose 2.6%, compared with a 4% decline for the overall category, as measured by IRI. Operating income declined 10%, compared with a prior-year period when both dollar profits and the profit margin were at all-time highs. This year's margin of 6.7% of sales, although 200 basis points below that of 3Q-03, is believed to be well above those of most other milk processors, reflecting Dean's efficient operations and economies of scale. In addition to cost pressures and competitive activity, the hurricanes in Florida are estimated to have accounted for about \$1.5 million of the \$17 million profit decline. Although milk costs have receded, other costs including fuel and packaging remain high, while competition remains high. The 4Q comparison is another difficult one, and profits for the segment are expected to show another decline. Management's earnings guidance for 2005 assumes flat results for Dairy, although we sense that that may prove conservative. The difficulties of 2004 could prove to be a long-term plus for Dean, since the combination of dramatic cost increases and lower volume has put severe pressure on its weaker competitors, many of whom are struggling to survive.

By contrast, 3Q results for the Branded Products Group were outstanding. Management's strategy has been to use Dairy profits to finance the growth of the promising brands in this segment, but having gained critical mass, Branded Products is now reporting significant profit improvement while continuing to spend aggressively on advertising and promotion. In 3Q, the segment's sales increased 73%, with about half of the \$128 million increase attributable to the January 2004 acquisition of Horizon Organic. Strong double-digit unit volume increases were achieved by the Horizon (+28%), Silk (+29%), International Delight (+29%) and Land O'Lakes (+14%) brands, and segment profits rose dramatically for the third consecutive quarter, despite higher marketing expenditures, reaching \$33 million, or 10.8% of sales, versus a small loss a year ago. Sales of this segment will reach \$1.1 billion in 2004. Management expects continued strong sales and earnings momentum in 4Q and throughout 2005.

The Specialty Foods Group produces a variety of food products for both retail and foodservice markets. It typically has been a dependable and highly profitable although relatively mature segment, but has suffered setbacks this year, with profits down 17% in 1Q, 26% in 2Q, and 61% (including some one-time charges) in 3Q. Its pickle division, which is the leading supplier of private label products in that category, suffered from delays in harvesting and processing this year's crop, as well as reduced consumer demand due to the cool, wet summer. Another division, which produced and packaged nutritional drinks for several beverage marketers, lost significant volume as a result of a shift to alternative packaging, and has now been shut down. Dean recently brought back the retired President of Specialty Foods to assist in restoring it to its historical profit levels. The absence of the drinks business will be a plus for 2005, since it lost money this year.

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In addition to its U.S. dairy operations, Dean is also one of the leading dairy products marketers in Spain and Portugal, under the Leche Celta brand. This business is growing rapidly, with milk volume up 10% in 3Q, but like its domestic counterpart, its profits have suffered this year due to inflated commodity prices.

Management's earnings forecast for 2005 assumes 4.5%-7% growth in operating income, reflecting flat earnings in Dairy, strong growth in Branded Products, and a partial recovery for Specialty Foods and Leche Celta, as well as the benefit of lower shares outstanding. The contribution from buybacks could well exceed the \$0.06 figure mentioned, inasmuch as that reflects only the shares purchased to date, and does not include any benefit from the additional \$100 million expenditure authorized last week, which based on the current price could reduce the share count by another 2%.

In summary, we consider Dean Foods an unusually well managed and successful company that encountered some unusual challenges this year, but has dealt with them effectively, and is now positioned not only to pull out of its slump, but to reassert itself as one of the most promising companies in the food industry.

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**Strong Buy ("1").** The stock's total return is expected to exceed significantly the average total return of the analyst's industry coverage universe over the next 12 months.

**Buy ("2").** The stock's total return is expected to exceed the average total return of the analyst's industry coverage universe over the next 12 months.

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**Sell ("4").** The stock's total return is expected to be below the average total return of the analyst's industry coverage universe over the next 12 months.

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