SHIELDS & COMPANY
MEMBER NEW YORK STOCK EXCHANGE
140 BROADWAY NEW YORK, NY 10005

ROBERT J. CUMMINS, CFA
(212) 651-0815

TRADING DESK
(212) 320-3001

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COMPANY SUMMARY

Friday, July 2, 2004

Speaker: Bob Cummins

Food Industry Comment:

Del Monte Foods (DLM- $10) on June 24th reported strong F4Q (April) results. EPS from continuing operations increased 52% (38% excluding an extra week in this year's quarter), reaching the high end of management's forecast range, as sales rose 20%, margins expanded meaningfully, and interest expense declined as a result of deleveraging. This was the first quarter to demonstrate conclusively the success of the December 2002 acquisition of Heinz's North American seafood, pet products, soup and infant feeding businesses. Nevertheless, the stock declined on the announcement as a result of management's caution that gross margins over the next two quarters are likely to be under pressure due to inflation in ingredient, packaging and energy costs, and that despite improvement in F2H as price increases take effect, EPS for F2005 may be about flat. We remain confident of DLM's future prospects and the likelihood that it will see an expansion of its modest 11 times P/E multiple, as its evolution continues and the company gains greater recognition. Thus, we view the recent selloff as an attractive buying opportunity, and reemphasize our "1" (Strong Buy) rating and our 12-month target price range of $14-$15.

The Heinz transaction 18 months ago was a significant step for Del Monte, more than doubling its annual sales, and increasing its operating income and shares outstanding three-fold and four-fold, respectively, while broadening its product range to include a wide variety of items in entirely new categories, under such well-known brands as StarKist, Nature's Goodness, College Inn, 9Lives, Kibbles 'n Bits, Pup-Peroni, Snausages, and NawSomes, as well as private label soups, where it is the leading supplier to retailers. Since then, management has concentrated on integrating the two companies and achieving the synergies inherent in such a large merger, while also developing and implementing strategies for optimizing the performance of the new businesses. In both respects, the results have been gratifying. The combination appears to have been carried out with a minimum of disruption, and cost savings are exceeding expectations. Meanwhile, management has continued to build the high-margin StarKist pouch line aggressively; enhanced the product mix in pet products by emphasizing the key brands and selected private label customers, and cutting back where profits were unsatisfactory; relaunching Nature's Goodness baby food with the Del Monte logo; and significantly increasing private label soup sales by introducing new products and gaining new customers and more shelf space.

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Earnings at the end of the first nine months of F2004 were 9% below the pro forma results of a year earlier, due to weakness in F1Q, but management forecast strong sales and earnings progress in the seasonally important April quarter, based on new product introductions, a stronger product mix, stepped-up marketing programs, a price increase on pet foods, and cost savings from merger synergies. That in fact proved to be the case, as discussed above. Both business segments, Consumer Products (75% of annual sales, 63% of profits) and Pet Products (25% and 37%) had a strong F4Q, with Consumer recording growth of 19% in sales and 50% in operating inome, and Pet up 22% and 43%, respectively. For the company as a whole, gross profits increased in line with sales, but a 1% decline in SG&A expense led to 42% growth in operating income, as the margin on sales rose 240 basis points to a healthy 15.6%. EPS from continuing operations for F4Q were $0.32 (including $0.03 from the extra week), versus $0.21, in both cases excluding one-time items.

For the full year, compared with pro forma figures for F2003, sales increased 4%, to $3.1 billion, while operating income rose 6% (10% for Consumer Products, 4% for Pet Products), and EPS were $0.89 versus $0.83, up 7%. One of DLM's most important achievements in F2004 was a larger than expected $264 million (16%) reduction of net borrowings, from about $1.6 to $1.3 billion, which not only strengthens its financial condition but also should add to earnings in the year ahead, through lower interest costs. The establishment of a quarterly dividend is also possible.

We expect that DLM's success over the past year in achieving merger synergies and revitalizing its newly-added product lines will produce ongoing benefits to earnings in F2005 and beyond. On the other hand, like the entire food industry, the company is experiencing the highest rate of cost inflation seen in many years, reflecting agricultural influences, a strong economy, and international uncertainties. Management estimates that higher costs will cost the company $50 million, or $0.15 per share, in the coming year, including $20-$25 million for cans, $15-$20 million for grains and meats, and $12-$15 million for energy. The company is moving aggressively to pass these costs along through higher prices, but there is always a lag before the full benefit is seen. As mentioned, pet food prices were raised early in calendar 2004, and further increases are likely. Higher prices have also been announced for tunafish, canned vegetables, and tomato products. In soup, as a private label manufacturer, DLM's pricing depends on action by the brand-name competitors, but General Mills has already raised prices, and we believe Campbell will eventually follow suit.

Despite prompt action on pricing, DLM expects its gross margin to narrow, year-to-year, in the seasonally low July quarter, and most likely in the October period as well. In the meantime, despite inflation pressures, the company intends to maintain a strong marketing program to support its brands, with total marketing expenditures estimated to increase more than 20% in F2005. As a result, management looks for F1Q earnings, excluding integration expense, in the $0.04-$0.06 range, down from $0.09 last year, and we suspect that F2Q may fall short of last year's $0.21 as well. Results are expected to strengthen in the second half, and for the year as a whole the gross margin is expected to match the 27.1% of F2004. Nevertheless, the company's

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initial EPS guidance, before integration expense, is a disappointing $0.87-$0.92, indicating little or no improvement on the past year's $0.89, versus our previous expectation of a solid double-digit increase, despite the absence of F2004's 53rd week. (We note, however, that assuming F2Q EPS of $0.19, that forecast implies a resumption of double-digit growth in the second half, with F2H EPS in the $0.63-$0.68 range, up 13%-21% based on a comparable number of weeks.)

We consider the current inflationary pressures a temporary issue that will soon be corrected through pricing action, and eventually some decline in commodity costs. It should not distract investors' attention from management's success to date, or from Del Monte's potential for further meaningful progress over the next several years.

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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.
Neutral ("3"). The stock's total return is expected to equal the average total return of the analyst's industry coverage universe over the next 12 months.
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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