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**JULY 20, 2005**

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## **COMPANY SUMMARY**

### **Wednesday, July 20, 2005**

**Speaker: Bob Cummins**

**Food Industry Comment:**

**Del Monte Foods** (DLM-\$11.20) since the December 2002 acquisition of Heinz's U.S. tuna fish, pet products, infant feeding and soup businesses has successfully integrated those operations, achieved cost synergies, strengthened its management team, marketed its products effectively, and substantially reduced its debt. However, its earnings have clearly been disappointing, reflecting the inflationary cost pressures that have affected the whole food industry. EPS of \$0.75, before nonrecurring charges, in the April 2005 fiscal year were not only 16% below those of F2004, but lower than the \$0.80 earned in F2002, before the HNZ deal. Similarly, the share price, which reached a high of \$12.20 in 2002 on the news of the deal, has not seen that level since then.

On the other hand, we sense that the tide now may have turned, and that the benefits of the 2002 transaction, which doubled the size of the company, may start to be reflected more fully in both earnings and market performance. We base that judgment, among other factors, on the soundness of DLM's businesses; on management's determination to continue seeking price increases to offset rising costs; on a newly announced strategic plan that aims to reduce annual costs by \$50 million (\$0.15 per share) in F2006, and by \$100 million (\$0.30) over the next three years; and on the beneficial EPS impact of the recent repurchase of 12 million shares, more than 5% of the total outstanding. Management's initial F2006 earnings guidance of \$0.75-\$0.80 is understandably cautious, in view of continued cost increases for packaging, energy and transportation. Nevertheless, we look for gradually accelerating momentum over the course of the year, leading to increased confidence among investors. We continue to view Del Monte Foods as one of the most interesting mid-size companies in the food industry, and reemphasize our Strong Buy ("1") rating and our 12-month target price of \$13-\$14, which would be 14-15 times estimated EPS of \$0.90 for calendar year 2006.

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

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Del Monte achieved sales growth of 4% in F2005, adjusted for an extra week in the prior year, with Consumer Foods up just over 2%, and Pet Foods an impressive 9%. However, cost pressures led to a 4% decline in gross profits on the same basis, as the gross margin narrowed by 190 basis points, to 25.2% of sales. Higher SG&A expense, partly driven by a 20%+ rise in marketing expenditures, was fully offset by lower interest expense, reflecting debt reduction and refinancing. Nevertheless, negative operating leverage led to a double-digit decline in EPS for the year, as mentioned.

Margin pressure was at its peak in the fourth fiscal quarter. Based on a comparable number of weeks, both revenues and SG&A costs were in line with the prior year, and interest expense declined sharply, but gross profits were 21% below a year earlier, as the margin narrowed by 390 basis points, to a record low of only 23.7%. As a result, EPS from operations fell to only \$0.23, down from \$0.32 reported (\$0.30 adjusted) a year ago.

Although outside pressures caused F2005 to be a disappointing year, Del Monte had a number of positive accomplishments, and took several important strategic steps aimed at strengthening its performance in the future:

- The rise in Pet Products sales, resulting from new product additions and effective marketing, was particularly gratifying, since the business was declining under Heinz's ownership, and continued to do so in its first full year as part of DLM. Despite a narrowing of its profit margin in the past year, it remains highly profitable, earning 16.6% on sales, compared with 10.7% for the other broad segment, Consumer Products. Thus, although it contributes only 26% of total sales, it accounts for 36% of segment profits, while also offering superior growth potential.
- Several Consumer Products lines also showed favorable volume and market share trends in the past year, notably Del Monte brand fruit products, College Inn broth, StarKist pouch and other specialty items, and private label soups, which gained market share at the expense of the branded competitors.
- While rising costs obviously took their toll on profits, we give management full credit for taking prompt steps to raise prices on virtually all of its product lines, thus easing the impact. We expect continued pricing actions going forward, both to cover further cost increases and to restore profit margins to normal levels. We also note that management in the past year avoided the temptation to cut back on marketing expenditures, but instead continued to support its brands aggressively, which we applaud.

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- The company also continued to pay down debt in F2005, using cash flow from operations as well as the net proceeds from the sale of a noncore pet food business at an attractive price. Net borrowings declined by \$179 million, to \$1.16 billion, down from \$1.72 billion in January, 2003, immediately after the Heinz transaction. DLM also reduced its interest costs in February, 2005, by tendering for \$300 million of 9 ¼% notes, due in 2011, and replacing them with a new issue of \$250 million of 6 ¾% notes, maturing in 2015. Interest expense in F4Q (April), excluding the one-time refinancing penalty, was only \$21.0 million, 38% below the \$34.1 million a year earlier, adjusted for a comparable number of weeks.
- In September, 2004, Texas Pacific Group, which formerly controlled Del Monte, sold its last remaining stock, amounting to 12.3 million shares, or 5.9% of the total, in an underwritten public offering. In June, 2005, in an unrelated transaction, DLM used about \$125 million of available cash to repurchase 12 million of its own shares, or 5.2%, through an accelerated stock buyback (ASB) arrangement. The price was \$10.42 per share, before commissions, and subject to adjustment based on the average price of the stock over the next 16 months, as the investment banker purchases shares to cover its short position. The structuring of this transaction enables DLM to reflect the full benefit of the reduction of outstanding shares in calculating EPS beginning July 1, with a meaningful impact on reported results over the final three quarters of F2006.
- The company took a number of important steps to strengthen its management team over the course of F2005. The July, 2004, retirement of DLM's long-time Chief Operating Officer, Wesley Smith, led to several top-level changes. Todd Lachman, age 41, who joined the company via the Heinz acquisition, and previously was with Procter & Gamble, was promoted from Managing Director, Del Monte Pet Products, to Executive Vice President of the corporation, with responsibility for all three business units, including Del Monte Brands and StarKist Brands in addition to pet foods. His rapid rise in the organization is indicative of the high regard in which he is held by CEO Rick Wolford.
- At the same time, Nils Lommerin, age 39, who joined DLM in 2003 as Executive Vice President, Human Resources, was given the broader title of Executive Vice President, Operations, with additional responsibility for manufacturing, engineering and other functions. His previous experience was at Oxford Health Plans, PepsiCo, and Kraft. Donald Binotto, age 49, another Heinz alumnus, was promoted from Managing Director of StarKist Brands to Senior Vice President, Operations and Supply Chain, reporting to Mr. Lommerin. In September, 2004, DLM hired Tim Cole, a 25-year veteran of Quaker Oats, now a unit of PepsiCo, for the newly created

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position of Executive Vice President, Sales. Finally, in March, 2005, the company announced the appointment of a new member of the Board of Directors, Victor Lund, age 57, who spent 25 years as a senior executive of two leading supermarket chains, American Stores and Albertson's.

- Last but not least, in conjunction with its yearend earnings release last month, Del Monte announced a new strategic plan designed to enhance both top-line growth and profitability. In addition to the cost-reduction steps mentioned above, it includes an increased emphasis on the company's brand-name businesses and on leveraging their potential, as well as an assessment of all of its operations to identify possible candidates for divestiture. Those presumably would include activities that are underperforming and have limited prospects for improvement, especially those that have little or no brand equity.

Del Monte's first quarter ending in July is always the low point of the year, and in F2005 accounted for less than 20% of annual sales, and 8% of EPS from operations. Management estimates F1Q sales growth at 2%-4%, and EPS in the \$0.03-\$0.07 range, compared with \$0.06 before one-time items last year. That wide range, we believe, reflects the difficulty of predicting earnings with precision given the marginal nature of the quarter. The company is not providing any quarterly guidance for the rest of the year, but we would note that last year, despite margin erosion, earnings were relatively flat in the October period, began to weaken materially in the January quarter, and were down sharply in April, as discussed above.

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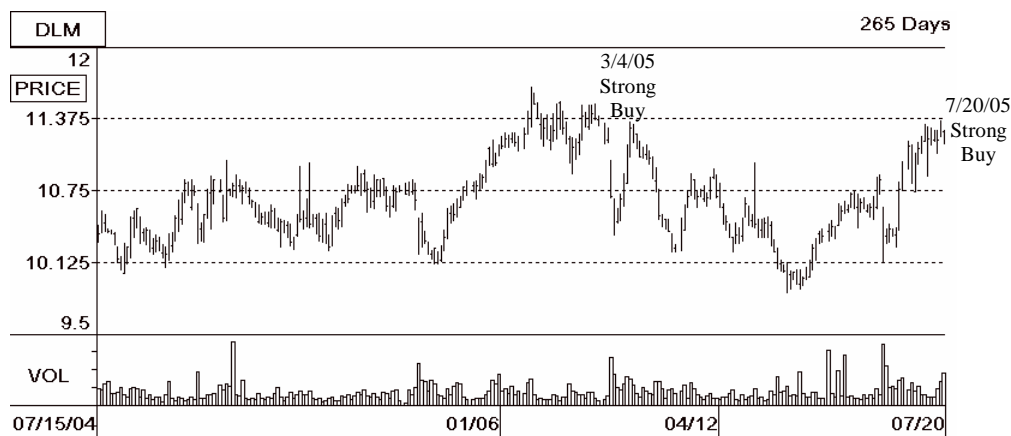
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