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COMPANY SUMMARY
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Speaker: Bob Cummins

Food Industry Comment: .

Del Monte Foods (DLM-$10.40) two years ago took a dramatic strategic step when it acquired four major businesses from Heinz for cash and stock, and thus not only increased its annual sales by 2 ½ times (to $3.1 billion), but also expanded its profit margins, strengthened its balance sheet, and enhanced both its stature in the grocery industry and its potential for long-term growth in sales, earnings and cash flow. Since then, management has done a commendable job of integrating the acquired operations, as well as implementing strategies to strengthen and build the newly-acquired product lines. However, the success of these efforts has been somewhat overshadowed by the above-average cost inflation for ingredients, packaging, energy and transportation that has affected the entire food industry. Like its peers, DLM has taken selective price increases where appropriate, but the pressures persist, as evidenced by management's latest downgrade of earnings expectations, indicating EPS from operations for the April 2005 fiscal year of $0.82-$0.87, 2%-8% below last year's $0.89, despite healthy sales growth. While disappointing, that does not change our view that this is an attractive emerging company in the food industry that will achieve healthy earnings growth and gain increasing recognition over time. The shares appear attractive for purchase here, selling at the same price as before the announcement of the Heinz deal, 11% below their 12-month high, and at only 12 times current earnings, one of the lowest multiples in the industry. Rated "1"(Strong Buy), 12-month target price $13-$14, down from $14-$15 previously.

Sales in F2Q (October) showed a strong 7% increase, reflecting new product introductions, price increases, and volume growth as a result of effective marketing efforts. EPS of $0.21 before integration expense were near the high end of management's $0.19-$0.22 guidance, but were only even with a year ago, as inflationary cost pressures held down margins. Nevertheless, that was an improvement on the seasonally low July quarter, when EPS were down 33%. Gross profit increased just 5% in the latest period, and operating income only 3%, resulting in an operating margin of 11.1% of sales, down from 11.6%. The positive effect of a 16% decline in interest expense was more than offset by a negative swing in other income and expense, a higher tax rate, and an increase in shares outstanding, resulting in flat EPS.

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Across-the-board cost increases for agricultural products, packaging (especially cans) and energy have plagued DLM throughout this calendar year, after years of relatively stable input costs. Price increases have been implemented successfully, albeit with a delayed impact, and have now effectively offset higher ingredient and packaging costs, with a further positive effect in F3Q. However, energy and logistics costs have been escalating as a result of high oil prices and tight capacity in the trucking industry, influences that have led to rising fuel surcharges and higher shipping rates. These transportation-related costs led to management's $0.05 reduction of F2005 EPS. With all of the food companies similarly affected, these costs also are likely to be passed along in higher selling prices unless the pressures ease.

This year's cost pressures should not obscure management's success in building the company's businesses, including both the traditional Del Monte brands and those acquired from Heinz. In F2Q, the **Consumer Products** segment, which accounts for 75% of annual sales and 61% of segment operating income, achieved growth of 5% in sales and 10% in profits, widening its operating margin by 60 basis points to 11.8%. Within the segment, Del Monte Brands, the largest single unit, accounting for about two-thirds of Consumer Products' sales, achieved 7% sales growth, with both vegetable and fruit products performing well, partly reflecting a change in the timing of some merchandising programs. Its tomato products, which include both the Del Monte and the Contadina brands, experienced market share erosion, an issue that management will focus on in the second half. Nature's Goodness baby food, a former Heinz brand, gained distribution with additional retailers, but the impact was offset by a decision to terminate a relationship with one customer based on pricing issues.

StarKist Seafood had flat sales for the quarter by design, as DLM chose not to match discounting of commodity tuna by its competitors, preferring to concentrate instead on the higher-margin sizes and products, including its proprietary pouch line, which now accounts for nearly 25% of its tuna sales, and registered a 5% gain in unit volume for the quarter despite a difficult comparison. With the cost of both fish and cans well above a year ago, StarKist is one of the areas experiencing the most cost pressure this year. Private Label Soup, whose sales are now being broken out for the first time, reported strong growth of 7%, as the company expanded its offerings of ready-to-serve soups and gained additional distribution in non-grocery channels, such as club stores, while category growth benefited from promotional spending by the brand-name competitors. Soup accounts for only about 10% of Consumer Foods sales, but it is believed to be one of DLM's most profitable product areas.

Pet Products, the company's other segment, which was part of the Heinz acquisition, accounts for 25% of annual sales, but 39% of segment profits, reflecting its superior margins. In F2Q, its sales increased by an impressive 13%, reflecting successful new product rollouts and effective marketing programs. On the other hand, profits declined 7%, as a result of increased advertising and promotional expenditures and a change in product mix, although ingredient, packaging and freight costs were also a factor, despite price increases. The margin narrowed from 17.5% of

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sales last year to just 14.5%. The company gained market share in every pet category where it competes, with a particularly positive impact from the introduction of Kibbles 'n Bits canned dog food, the restaging of 9 Lives cat foods with the return of Morris the Cat to advertising, and the addition of a new Meaty Bone snack item. As in its other product areas, DLM's strong relationships with the leading mass merchandise and club store operators are resulting in strong growth for its pet food and snack products in those channels. Marketing expenditures for Pet Products will remain high in the second half, but spending is expected to ease somewhat compared with the first half.

It is indicative of DLM's stature in the food industry that 62% of its total sales are derived from products that hold the number one or two market shares in their categories. It ranks number one in tuna (42.0% share), fruit (31.2%), dog snacks (23.5%), vegetables (22.7%), solid tomatoes, and private label soup. It has number two market shares in canned cat food (20.9%), cat snacks, and broth (College Inn). In the past 52 weeks, it has gained share in businesses representing over 75% of its sales base.

The company expects operating cash flow, net of capital expenditures, of \$185-\$200 million, or \$0.87-\$0.94 per share, in F2005. As in the past, these funds are likely to be used for debt retirement, although DLM will also consider product line acquisitions as other food companies continue to divest businesses. In addition, management stated on the conference call that it is giving serious consideration to establishing a cash dividend and a share repurchase program.

In view of the continuing cost issues, we have not yet established an EPS estimate for F2006, although we strongly believe the company will see a resumption of growth. Based on rising sales, declining debt, and an eventual recovery to normal profit margins, Del Monte clearly has a potential earning power well in excess of \$1.00 per share, and as positive comparisons resume the price/earnings ratio is likely to expand as well, in our opinion.

Analyst's Certification: I Robert J. Cummins certify that the views expressed in this research report accurately reflect my personal views about the subject companies and their securities. I also certify that I have not been and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendations in this report. I have a position in the shares of Del Monte Foods. Other reports issued by me are: ConAgra Foods ($26) 9/24/04-Strong Buy; General Mills ($44.80) 10/8/04-Strong Buy; SYSCO Corporation ($35) 11/5/04-Strong Buy; Sara Lee ($23) 10/29/04-Strong Buy; Sensient Technologies ($21.40) 10/22/04-Buy; Performance Food Group ($26.20) 11/12/04-Strong Buy; Dean Foods ($32.50) 11/9/04-Strong Buy; Heinz ($37) 11/30/04-Strong Buy; J.M. Smucker ($44) 11/23/04-Strong Buy; Del Monte Foods ($10.40) 12/3/04-Strong Buy; PepsiCo ($49) 10/1/04-Strong Buy.

Guide to Investment Ratings:

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.
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