

The Core Research Series

GRAINS ARE GOING HIGHER, BUT IS IT REALLY THAT BAD FOR FOOD COMPANIES? A 'dirt-to-dinner' look at grain inflation

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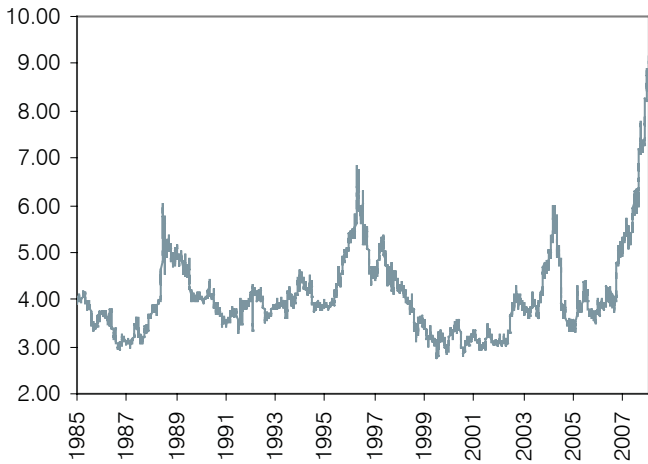
INTRODUCTION

'Food-for-fuel' energy policies continue to pressure the agricultural complex, setting the stage for what many believe will be a prolonged period of grain inflation. Conventional wisdom suggests this trend is good for grain processors but bad for food companies. Intuitively this makes sense; new end markets should help grain processors and rising input costs should hurt food companies. However, in this paper, we outline a contrarian case that shows the exact opposite result, demonstrating the negative impact grain inflation will have on processor returns while potentially unleashing a decade of pent-up pricing power and much needed capital discipline across the food industry.

GRAIN STOCKS ARE NOW AT 30-YEAR LOWS

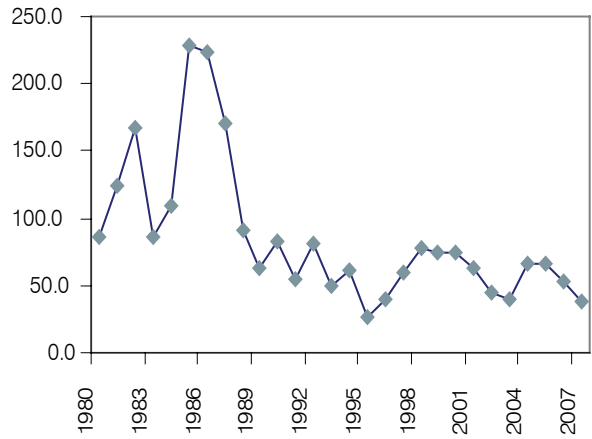
Over the past 30 years, there have been temporary grain spikes, mostly due to weather-related supply shocks. In each case, these periods were short-lived and prices ultimately returned to long-term averages with the following year's harvest. However, we believe this spike is different. Grain stocks are at dangerously low levels, yet key growth drivers – the step up in government-mandated bio fuel programs and strong demand from emerging markets – are likely to continue for the next 18 to 24 months. This combination of low-ending stocks and unprecedented demand growth suggests current elevated prices are sustainable in the intermediate term, perhaps longer.

All Grains (\$/bushel)



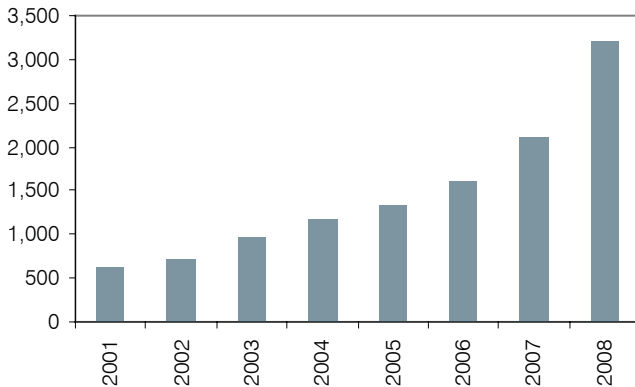
Source: FactSet

All Grains - US Days' Supply



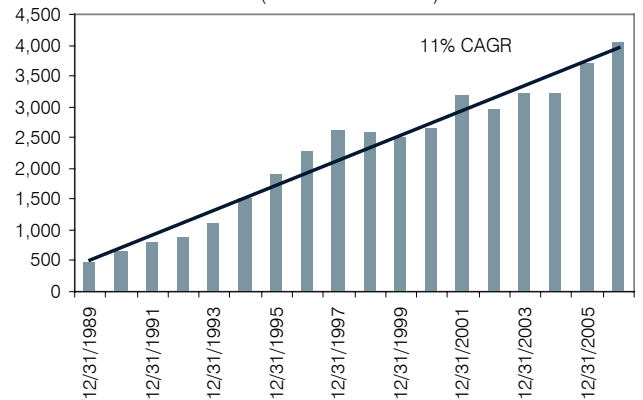
Source: USDA

Corn Used for Ethanol (Mil. Bushels)



Source: USDA

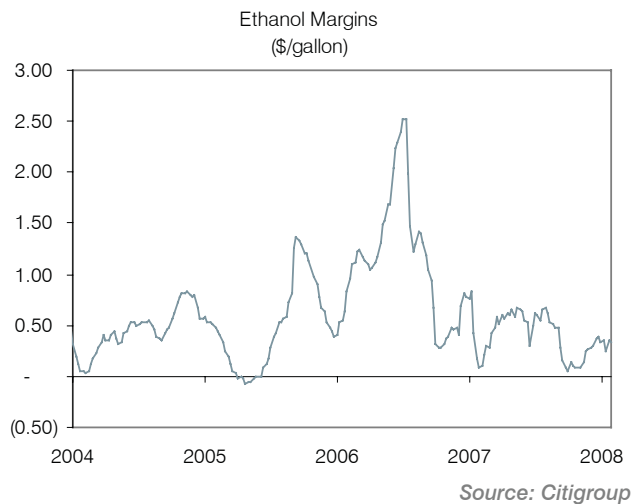
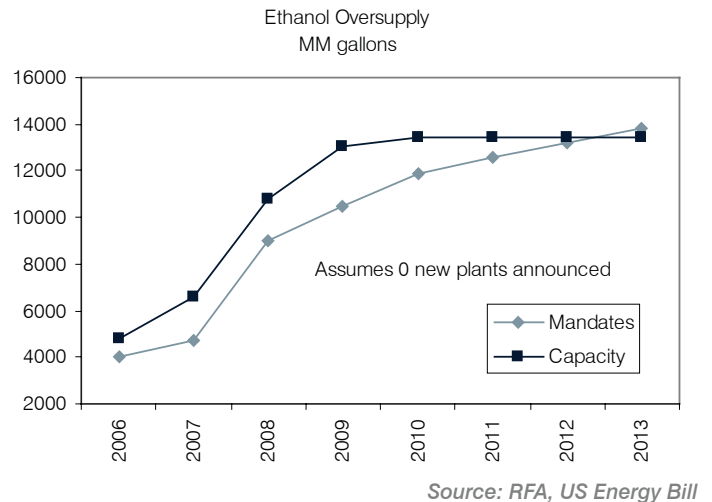
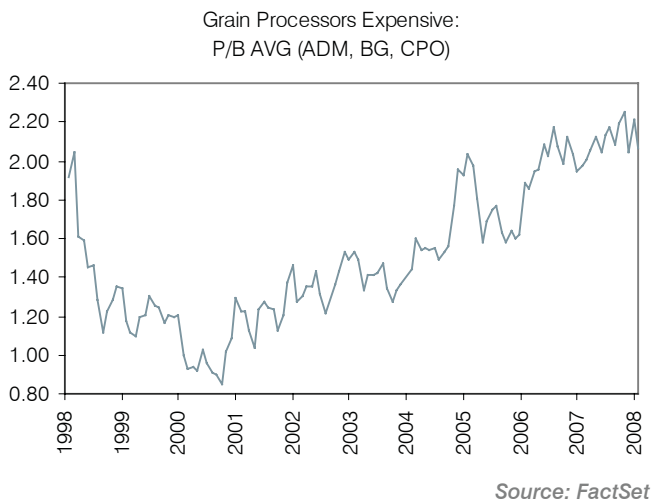
Meat/Poultry Exports to Emerging Mkts (thousand metric tons)



Source: USDA

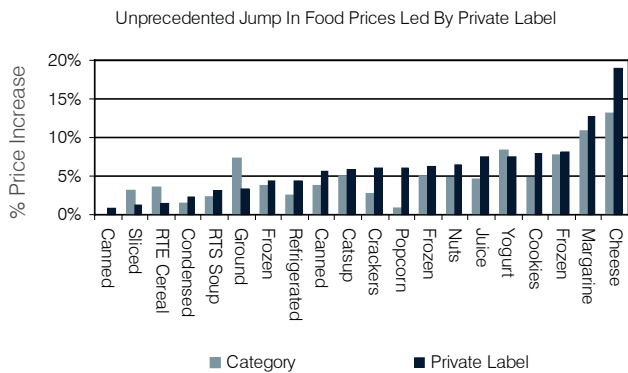
BIO FUELS, A DOUBLE EDGED SWORD FOR THE PROCESSORS

Decade-high valuations across the processor group suggest that the federal mandates for bio fuels may be a boon to grain processors. We disagree. Specifically, we question the sustainability of long-term returns given the unusual dynamic of a business whose selling price is driven by economic fundamentals, while the input price is driven by grain fundamentals (weather, acres, yields, etc.) and the products' very existence is dependent on government mandates. Factor in the substantial capacity additions against this market and we see a bad ending to this story. More importantly, the second-order impact of these 'food-for-fuel' programs, namely higher grain prices as discussed above, has pressured the processors' core milling business. A good example is the high fructose corn syrup business, a key sweetener ingredient used in soft drinks and packaged foods, which will experience significant margin compression in 2008 as higher cost corn flows through the income statement.

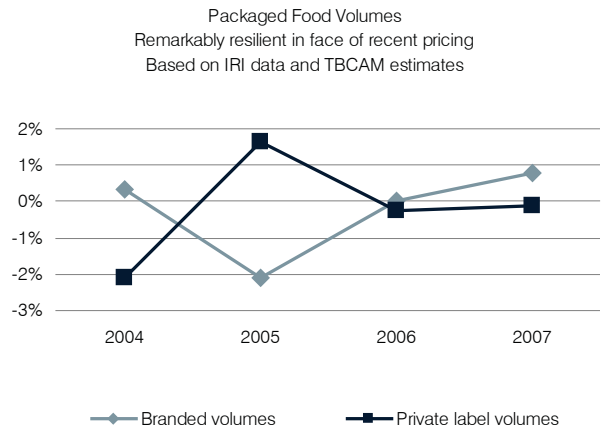


THE DEMISE OF FOOD PRICING HAS BEEN GREATLY EXAGGERATED

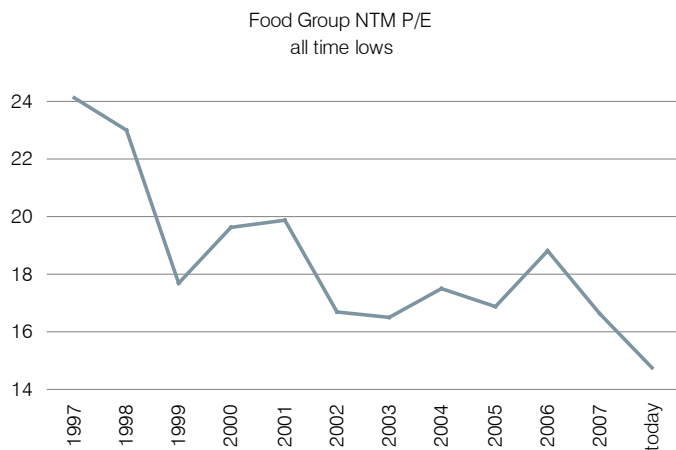
Contrary to our bearish outlook on the processors, we actually believe grain inflation is good for packaged food companies. Over the last decade, food margins have compressed significantly as the retail trade stubbornly refused the pass through of 'hidden' inflationary items such as rising media and health care costs. As a result, food stocks now discount little in the way of pricing power and investors are incorrectly extrapolating this experience to the current spike in grain costs. Unlike the 'hidden' inflation of the last decade, the recent move in grains is visible and more pronounced, making the cost recovery discussions with the trade much easier. Furthermore, after initial resistance, the trade has been pleasantly surprised by the muted consumption impact associated with higher selling prices and, therefore, it is no longer resistant to price hikes. In fact, trade-owned discount labels are actually leading the industry price-hikes, making branded pricing even easier to achieve. The net result is that food industry pricing is at an inflection point whereby prices will soon anticipate grain inflation rather than pass through on a six-month lag. This pricing change puts more visibility on group margins and should drive valuations, currently at decade lows, higher.



Source: Citigroup, Nielsen IRI



Source: Nielsen IRI



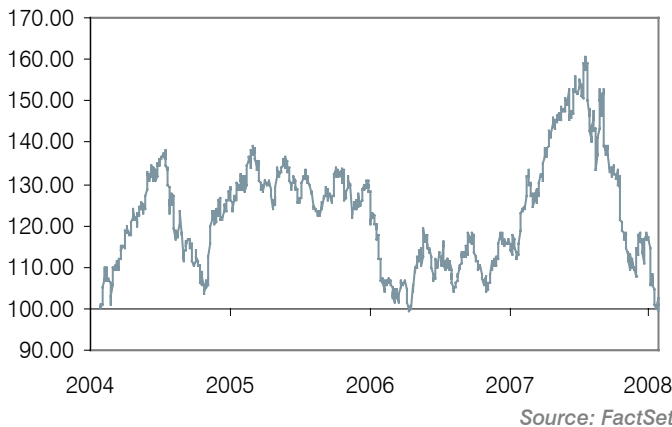
Source: FactSet, TBCAM estimates

A COW IS REALLY JUST EIGHT BUSHEL OF CORN, A HOG THREE BUSHEL, A CHICKEN TWO.....

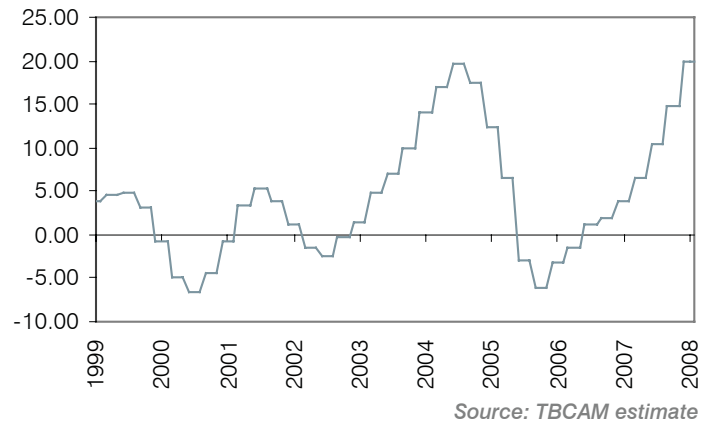
We take a similarly bullish and contrarian view toward the more commoditized protein industry. As evidenced by decade-low valuations, the Street has concluded grain inflation is bad for protein companies. The thinking is simply that because grains are the key livestock feed, higher prices will pressure margins. Again we disagree and, looking one step further down the road, see the higher grain prices forcing much needed production discipline in these commoditized markets and, actually having a positive impact on margins. The egg market, the shortest cycle agricultural product and the quickest to react to changes in the market, is a good example. Despite record high input costs, egg producers have cut back production significantly and, as a result, have generated record margins, four times that of their historical averages.

We see a similar phenomenon in the hog industry, which we believe is also poised for significant production cuts. Unlike the egg market, the production discipline has yet to flow through the longer-cycle hog market but we believe this is only a matter of time and we see significant upside to industry margins. Furthermore, we believe exports to China could represent a structural uptick to industry demand and margins. China consumes over half the world's pork, but their domestic supply has contracted meaningfully as blue ear disease has wiped out a substantial portion of their hog herd. As a result, we see US hog producers playing a much larger role in China food supply going forward.

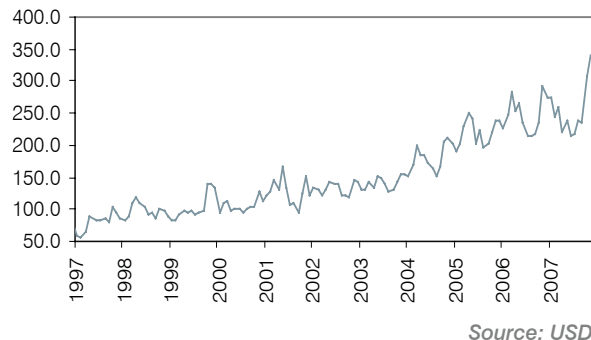
Protein Stocks at 4-Year Lows
Index (SFD, PPC, TSN)



Egg Industry Margin Despite Grains:
% EBIT



Pork's Explosive Export Growth
MM Pounds



CONCLUSION

Neither the markets nor the company managements fully understand the true economic implications of food inflation. We all grew up in a benign, even deflationary, input environment where zero pricing was the norm. As such, the knee-jerk reaction to the inflation cloud has been fear but we believe this fades over time and the focus will slowly move to silver linings outlined above.

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Prior to joining The Boston Company, David was a Senior Managing Analyst at Dreyfus, covering consumer staples. Prior to joining Dreyfus, David was a Senior Analyst at Dean Witter. Before that, he served as an Analyst in the corporate finance division of Banque Paribas.

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