

U.S. Pet Food Industry Update

Continued Growth Amid Difficult Economy

EXECUTIVE SUMMARY

Sales in the United States pet food industry reached an all time high last year and should continue to experience solid growth into the future. Private equity interest has also surged within the industry during the past couple years. Private label and premium brands are driving much of the growth in the industry, and the dog treat segment is the fastest expanding sector in the entire pet food industry. The industry proved itself to be relatively recession proof but it could not avoid all of the financial woes facing the economy. Soaring food commodity prices have led to high inflation within the industry and are poised to trigger a round of consolidation-based M&A activity.

INDUSTRY TRENDS

- Dog treats are currently the fastest growing segment of the entire pet food market as manufacturers attempt to tap into owners' increasing desire to spoil their dogs. The dog treat market reached an all time high of \$2.1 billion in sales during 2010 and is expected to grow by roughly 26% through 2015. Since 2005, there have been 3,331 dog food-related product launches and 63% or 2,108 of them have been dog treats.⁽¹⁾ Many dog food companies are scrambling to enter the dog treat business to take advantage of this booming sector. Consequently dog treat manufacturers are prime targets for acquisition pressure from large dog food manufacturers and have represented many of the M&A transactions we have seen recently. This trend will continue into the future as more companies seek to offer retailers a complete line of dog food products.

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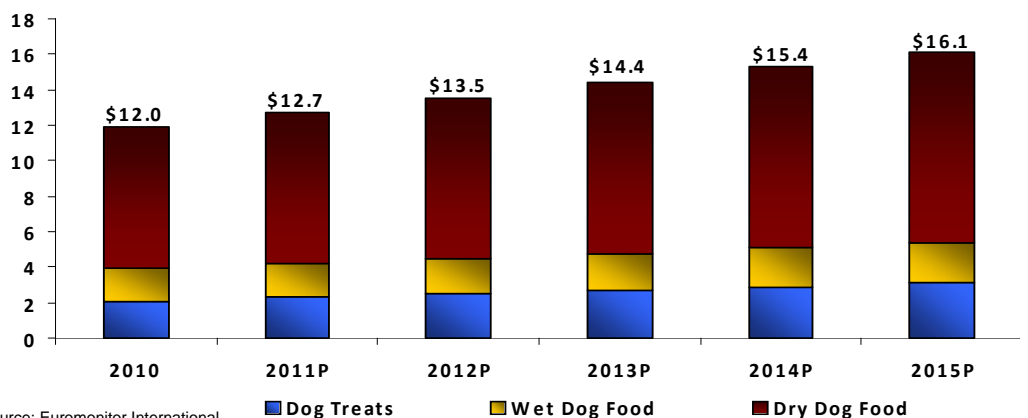
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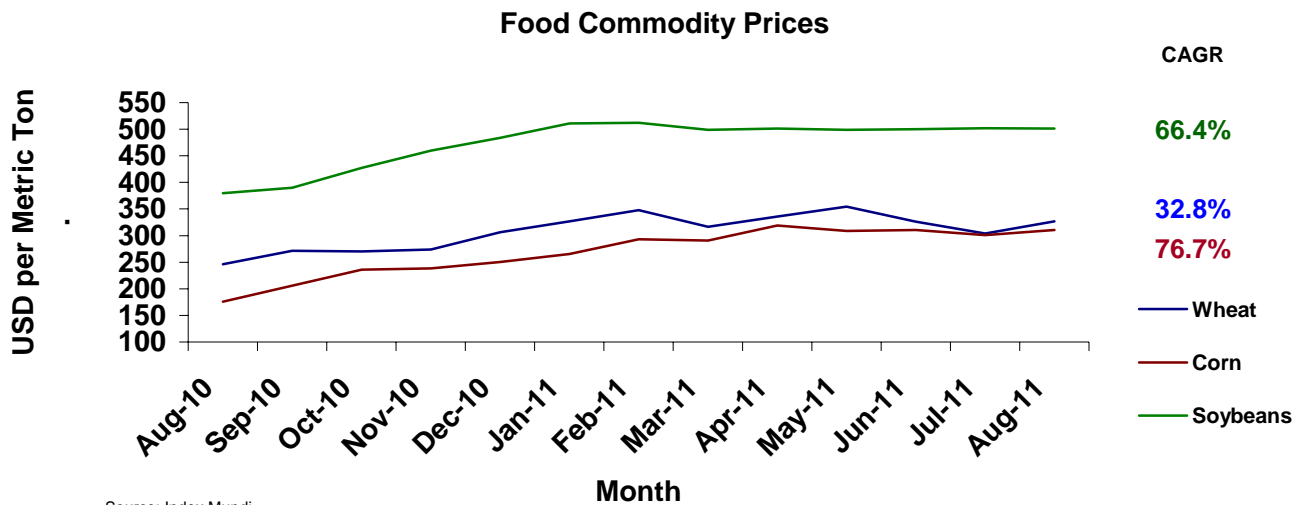
Projected US Sales of Dog Food (Billions USD)



Source: Euromonitor International

- There has been a recent rise in the percentage that dry dog food represents of total dog food sales. This has mostly been attributed to the massive pet food recalls in 2007 that by some reports killed over 8,000 dogs worldwide. Most of these deaths were traced to contaminated ingredients found in wet dog food. These product contaminations were traced to China where companies were purposely adding ingredients such as melamine to artificially increase the appearance of protein content. China has not been cooperating fully with FDA inspectors leading many to recommend avoiding Chinese protein sources. Consequently demand for dog food made in the United States has grown dramatically since 2007 enabling many smaller local manufacturers to thrive.

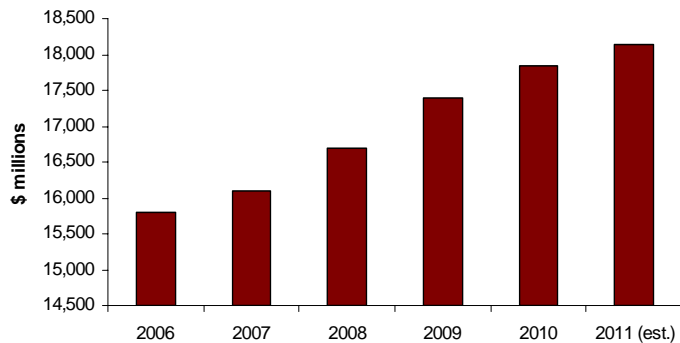
- Commodity price spikes have hit the pet food industry hard causing retail prices to rise across the board. The price increases in essential raw materials such as corn, soybeans, and wheat have mostly been attributed to increased demand from developing BRIC countries. This has also led to an increase in the price of most protein sources which are fed by these essential food commodities. Corn prices have soared to \$310.34 per metric ton, a 77% increase in the past year alone.⁽²⁾ Other food commodities have seen similar price spikes as shown in the graphs below. Dog food inflation was over 10% in 2010, much higher than the 2% CPI inflation, and is expected to remain high in the coming years as rising commodity costs are expected to diminish profit margins for many pet food producers. The shrinking margins have put pressure on the industry to consolidate in order to reduce costs and stay competitive. This should lead to higher M&A activity within the pet food sector in the near future as stronger companies buy up struggling competitors.



- Just as in the human food category, there is a growing preference for healthier dog food. In 2006, Nestle Purina introduced Beneful as a healthy choice dog food which jumpstarted this trend. Many other brands soon followed with their own healthy product lines and massive marketing campaigns. Most companies now promote organic, natural, or weight control product varieties. These products are especially targeted towards older owners as they are very conscious of their own health, and this mindset translates into the food they purchase for their pets. Premium brands, usually considered healthier, are driving much of the growth in the dog food market as consumers are becoming increasingly concerned with many of the controversial and low quality ingredients used by the largest brands.

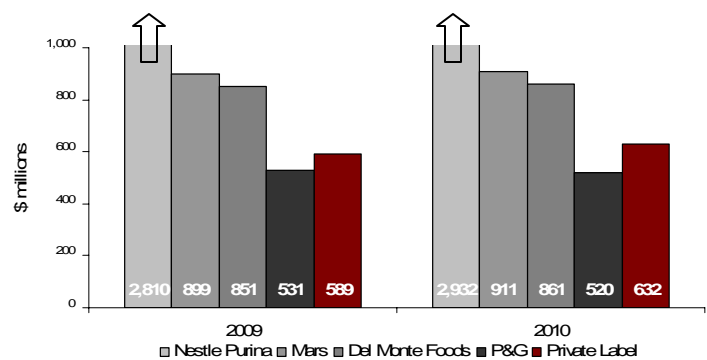
➤ Private label plays an important role in total pet food sales, which as a sector has continued to show positive growth throughout the recession. In 2010, when compared to the major pet food manufacturers, private label had the highest sales growth at 6.6%. This growth reversed the dip private label sales experienced during the 2007 pet food recalls associated with product contaminations. To distance themselves from customer perceptions of lower quality store brands, recently stores have begun to brand their private label products such as Walmart's Ol' Roy. Despite private label still commanding only a relatively small share of the growing pet food market, we expect private label sales to drive much of the growth in the near future as consumers continue to seek ways to save money. Private label sales in many western European countries account for close to 30% of dog food sales, evidence that there is still plenty of room for expansion in the US market.⁽³⁾ Private label products are generally priced 20% to 30% lower than their branded equivalents and these savings can be significant especially for larger dog owners.

Total US Pet Food Sales



Source: Mintel

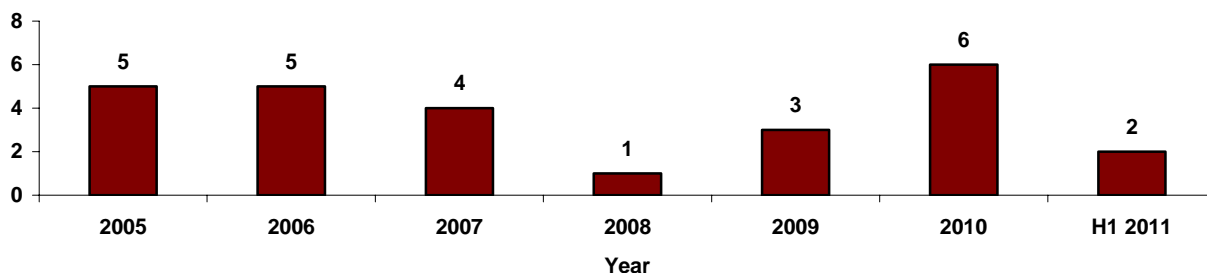
FDMx Sales of Leading Pet Food Companies



M&A TRANSACTIONS

In light of its recent growth and consistency of cash flow generation many private equity firms have become interested in the pet food industry. Historically the pet food industry has been somewhat underrepresented in the portfolios of private equity firms but this trend has reversed itself in the past few years. Of note was KKR's blockbuster buyout of Del Monte Foods, the largest dog treat manufacturer by sales with brands that include: Milk-Bone®, Kibbles n' Bits®, and Meow Mix®, in 2010 for \$5.5 billion. Private equity companies are sitting on about \$450 billion of dry powder which needs to be invested before the funds expire. Many pet food companies are also interested in consolidating due to the previously mentioned pressures of rising commodity prices. As the financial industry and credit markets recover from the currently weak U.S. economic period, we expect a return to a pre-recession number of transactions per year in the industry.

Number of M&A Transactions in US Pet Food Industry



Source: Capital IQ, Tully & Holland analysis

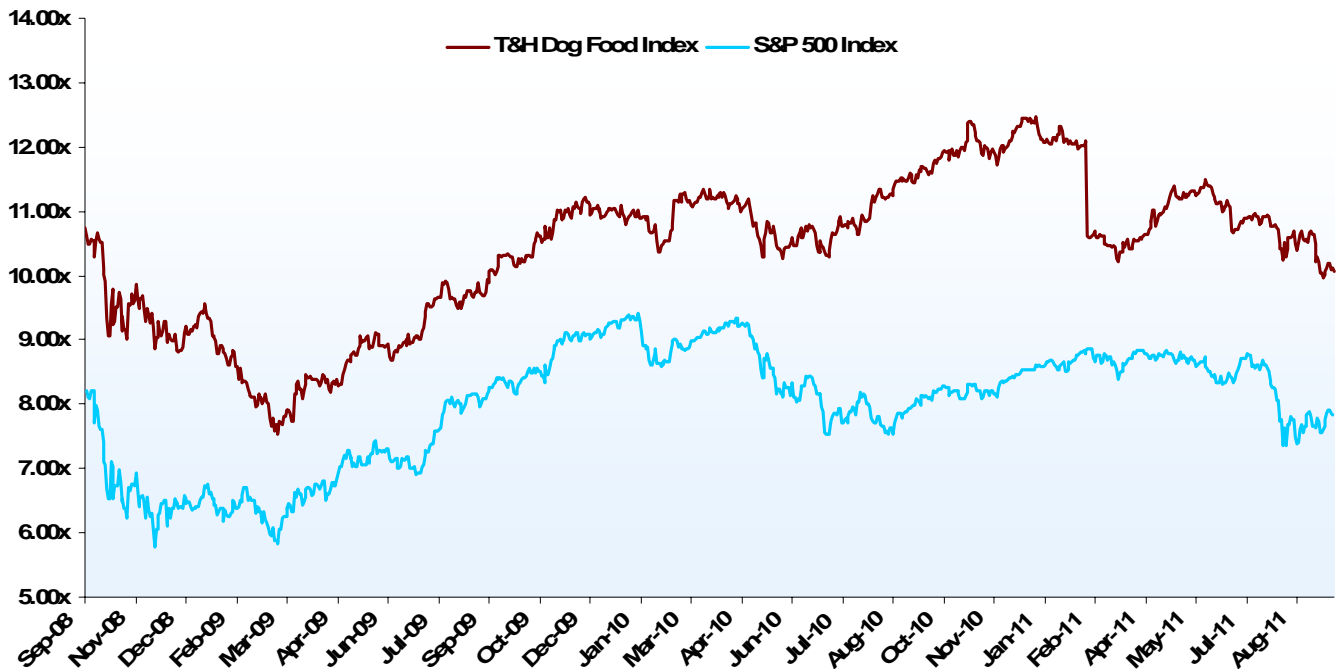
The chart below shows the latest pet food M&A transactions since 2009.

Date	Target	Transaction Value (\$USDmm)	Acquiror
07/19/2011	Prestige Pet Products, Inc.	-	Archer Daniels Midland Company (NYSE:ADM)
01/06/2011	Pro-Pet, L.L.C.	-	For The Earth Corp.
11/24/2010	Del Monte Foods Company	5482.03	Kohlberg Kravis Roberts & Co. (NYSE:KKR)
10/01/2010	Super Dog Pet Food Co., Inc.	-	Supply Chain Equity Partners
09/10/2010	Waggin' Train LLC	460.00	Nestle Purina PetCare Company
05/12/2010	Petra Pet, Inc. and Petra Vet, LLC	-	Imperial Capital Corporation
05/05/2010	Natura Pet Products, Inc.	-	Procter & Gamble Co. (NYSE:PG)
02/01/2010	Arkat Animal Nutrition LLC	-	DAD'S Products Company, Inc.
12/31/2009	Premium Pet Health, LLC	38.90	John Morrell & Co.
12/31/2009	Crest Flavor Company	-	Premium Ingredients International (US), LLC
02/12/2009	CH PET, Inc.	-	Sergeant's Pet Care Products, Inc.

Source: Capital IQ

PUBLIC COMPARABLES

The following graph shows the valuation of the companies within the Tully & Holland Dog Food Index which consists of ten actively traded dog food manufacturers. Using a weighted average based on market cap, these companies are currently trading at an EV/EBITDA multiple of 10.12x. This is significantly higher than the S&P 500 Index which is trading at a multiple of 7.84x. Over the past three years the dog food industry has consistently outperformed the S&P 500 Index and we predict that this trend will continue into the future.



Source: Capital IQ, Tully & Holland analysis as of 9/21/11
 EV / EBITDA multiple represents the quotient of the summation of EVs and EBITDAs for each component over LTM
 Tully & Holland Food Index Components: BRF, FWU, MIP, MABR, NESN, PG, MARS, DLM, HNZ, SPB

VALUATION ANALYSIS

Over the past few years we have seen a modest number of precedent transactions within the pet food industry. The majority of valuation metrics have not been publicized, as most of these deals have been private. The most recent disclosed deal was KKR's acquisition of Del Monte Foods for an 8.97x EBITDA multiple. Due to the limited number of disclosed deals, an alternate gauge of valuation is the public equity markets where the Tully & Holland Dog Food Index is currently trading at a mean enterprise value of 10.12x EBITDA. Because these are large publicly traded companies we would apply size and liquidity discounts to derive a private company comparable estimation of value. A 30% discount results in an enterprise value in the range of 7.0x to 8.0x EBITDA.

T&H CONCLUSIONS

The pet food industry performed strongly during the recession and is poised for sustained growth as the pet population in the US continues to grow. Pet ownership is also at an all time high with 62% of households owning at least one pet and this rate continues to rise.⁽⁴⁾ However, high inflation in the industry is becoming a problem for consumers as prices rose sharply in the past year due to skyrocketing commodity prices. The dog treat sector has great growth prospects as owners increasingly want to reward their dogs and many companies are rushing to get into the business. Premium and healthy as well as private label brands are going to drive much of the growth in the industry going forward. Large dog food companies will seek to acquire strategically complementary companies in these areas to better align their product offerings with what consumers demand, leading to increased M&A activity. This healthy industry has also drawn the interest of many private equity firms and we expect LBO activity to rise in the near future as well.

ABOUT TULLY & HOLLAND

INVESTMENT BANKING SOLUTIONS FOR CONSUMER PRODUCT COMPANIES

Founded in 1992, Tully & Holland, Inc. is a leading US investment bank that provides merger & acquisition advisory services and private placements to consumer companies with special emphasis on food companies, multi-channel marketers, consumer product manufacturers/distributors, and retailers. Tully & Holland's Managing Directors have a combination of deep industry knowledge and sophisticated financial experience enabling them to craft innovative solutions for each client's needs.

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Footnotes

- ¹ *Mintel*
² *Index Mundi*
³ *PetFood Industry*

⁴ *Datamonitor*