

U.S. Food Industry Update

Politics, Prices and Performance

EXECUTIVE SUMMARY

The United States Food Industry continues its resilient growth despite the uncertain economic environment and rising commodity costs. As stated in our summer update, the rise in consumer discretionary spending and US exports will continue to drive top line expansion. However, margins are increasingly under pressure thanks to drought conditions in the central US affecting feeder crops, and the increase of regulatory pressures from Washington. With the impending US elections, a discussion on these regulations and food policies has re-emerged. Obesity and food safety remain major concerns in the US—a trend that companies can capitalize upon by developing products for more health conscious consumers and increasing their information technology capabilities. The companies that make up the Tully & Holland Food Index have consistently traded at a higher multiple than the S&P 500 and Dow Jones Industrial Average (DJIA) due to their steady cash flows and relatively recession-proof nature as a consumer staple. Finally, the first-half of 2012 mergers and acquisitions in the food industry were the highest of the past four years, a trend that correlates to rising commodity costs and pressured margins driving industry consolidation as companies pursue economies of scale.

KEY INDUSTRY TRENDS

➤ Food Policy and the Election

With the elections now weeks away, federal food policy is again coming into focus. The United Fresh Produce Association recently surveyed both candidates on their positions on food and agricultural policy. On agricultural regulation, Governor Romney promised more certainty and predictability when it comes to new and existing regulation promulgated by the EPA, with greater input from the agricultural sector. President Obama cited his administration's historic trade agreements and his continuing efforts to create smart, sustainable policies that will also reduce agricultural producer's regulatory burden. On nutrition, President Obama restated his strong support for the USDA's school nutrition programs and for private/public efforts in food education, regional food hubs and increased grocery stores in underserved neighborhoods. Governor Romney stated that the federal government should not dictate what every American eats, but instead concentrate on improved education on healthy eating. Both candidates supported the goals of the 2008 Farm Bill, with Romney linking reduced farm subsidies to the reduction of

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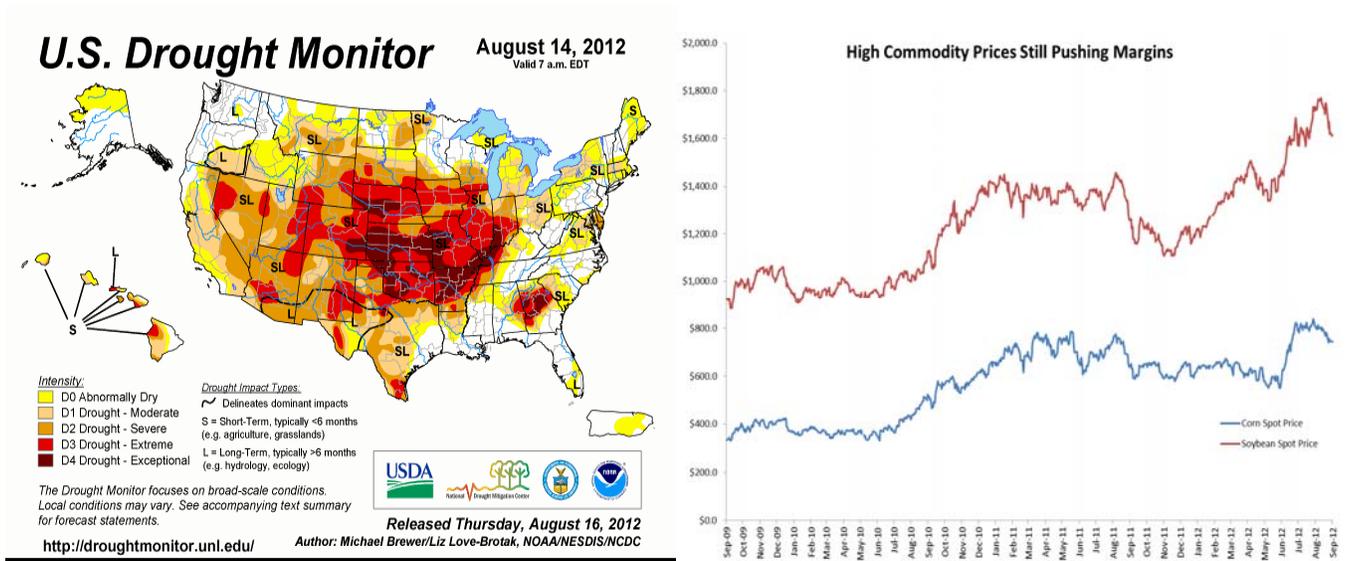
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trade barriers, and Obama encouraging more agricultural diversity through the National School Lunch and Breakfast programs. Suffice it to say, governmental regulation is expected to have a growing influence in food company operations.

➤ **Drought Hammers the Central US**

Economists predict that food prices may grow as much as 4% percent next year as drought conditions in the US are expected to inflate the cost of everything from pork to cereal. Extreme drought conditions in several US Midwest states are causing corn and soybean crops to wither, and analysts say the effects will ripple through the food chain. Both corn and soybean futures remain 20-30% higher over last years price on the CBOT. Corn prices reached record \$8.49 a bushel on August 10th and soybeans an all-time high of \$17.89 a bushel on September 4th. The USDA predicts US food costs could rise as much as 3.5% by year-end, and up to 4% in 2013. Unlike the food price rises of 2008 which primarily affected consumer staple products of wheat and rice, the current drought will most heavily impact the “feeder” inputs for beef, chicken, and pork. These increases will continue to pressure margins for food companies that cannot pass these prices on to the consumer.



Source: Thomson Reuters

➤ **Obesity Sparks Government Action**

Mayor Bloomberg’s initiative on soda sizes aside, there is increased government focus on US obesity rates. Studies from the mid-2000s, show that 33.3 % of US men are obese (A body mass index of 30 or more), as were 35.3% of women. In the healthcare act of 2012, the Federal government enacted a requirement that all restaurant chains with 20 or more restaurants post calorie counts for all menu and buffet items. At the municipal level, a number of cities are imposing requirements on both restaurants and retailers for more label disclosure and reductions of fat, sodium and portion size in food products. Food companies are responding to these actions by proactively reducing some portions and setting new, healthier targets for their formulations. For example, ConAgra Foods has pledged to reduce sodium by 20% by 2015, while

Wal-Mart announced a five-year plan for reductions of sodium up to 25% in its “Great Value” house brand. Regardless of the outcome of the election in November, the Food Industry will continue to experience more health-related regulatory focus and action.

➤ **Organic Food Sales Push Growth—especially for Dairy**

The US organic industry grew by 9.5% overall in 2011 reaching a record \$31.5 billion in sales. The growth compared favorably to conventional food, which experienced 4.6% growth. Organic food sales now represent 4.2% of US food sales, up from 4% in 2010. The Organic Trade Association’s (OTA) 2012 industry survey indicates that organic food sales will continue to sustain growth levels of 9% through 2013. The dairy industry has particularly benefited from this trend. According to a Mintel report last year, of those consumers who chose to purchase natural and organic items, 86% of them buy organic dairy. This made it the second largest organic product category, showing 9.6% growth to \$4.3 billion in sales according to the OTA’s report. Beyond dairy, both major and minor food producers will continue to expand into an organic market which is growing at more than twice the rate of conventional foods.

➤ **US Exports Increasing—the New Middle-Classes are to Thank**

The USDA has recently forecasted US agricultural exports at \$136.5 billion for the fiscal year that ends in September 2012, and \$143.5 billion for fiscal year 2013. The 2012 figure is a slight year-on-year decline of about half a percent, following a record breaking year in 2011. Part of the projected rise in 2013 will be due to increased food prices due to drought conditions, and to a weakening Dollar making US food products more competitive. But we also believe that the rising global middle-class, which demands higher valued product categories such as meat and processed fruit and vegetables, will be an increasing growth contributor. High and middle-income countries constitute the fastest growing share of US agricultural exports, with the share of upper-middle income countries like China and Mexico surpassing those of high-income countries in 2011. In the years to come, as the global middle-class grows, their diets will increasingly incorporate a higher percentage of protein and higher value products such as oils, fruits and vegetables. We see continued export growth from the US to these emerging markets.

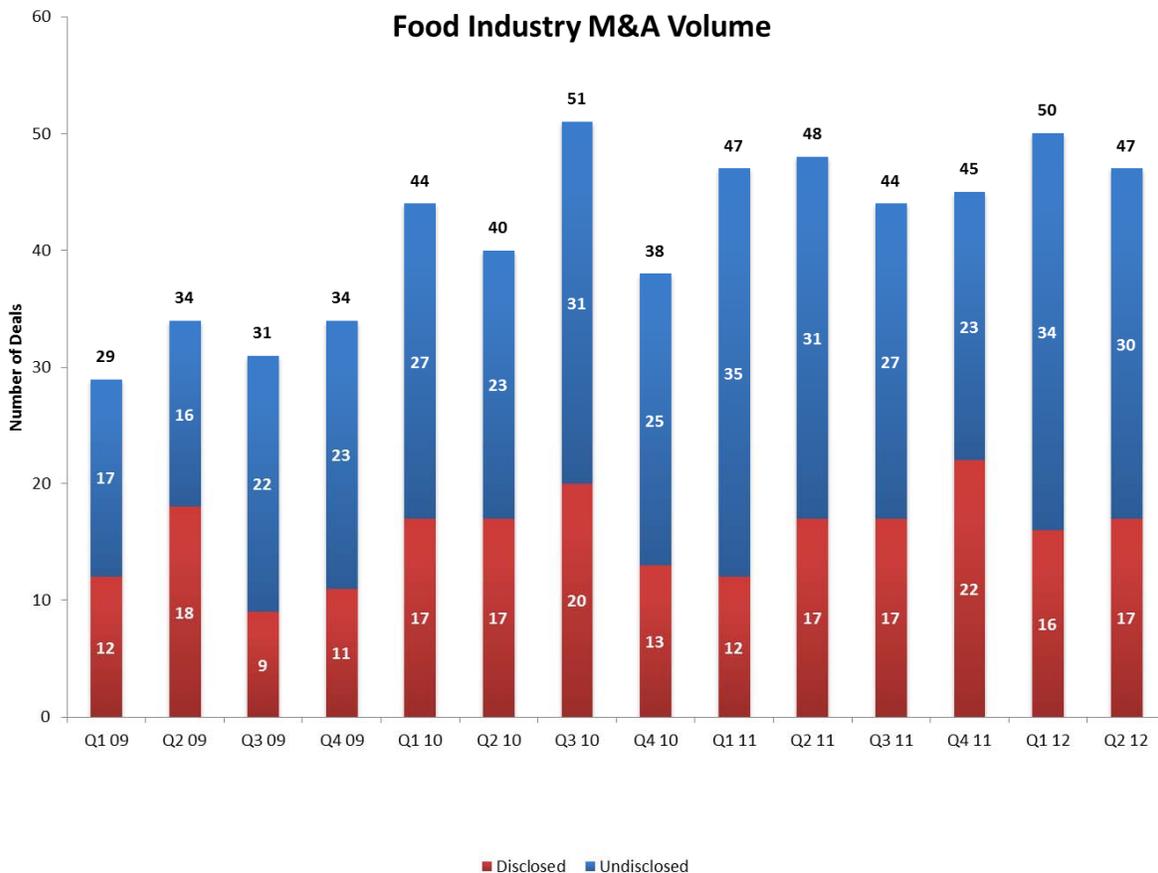
➤ **Food Safety**

With this rising global trade, there is an increased focus on food safety and sourcing. Increasingly, US consumers are focusing on origins and traceability of their food products. Recent media coverage of the ammonia-treated ground beef called “pink slime”, the recall of 200,000 pounds of ground beef due to contamination with salmonella, and Coca-Cola and PepsiCo’s decision to change their formulations due to carcinogenic concerns, demonstrates the public’s continued interest and consciousness in how food is produced and sourced. A study in Applied Economic Perspectives and Policy appeared to validate that both negative and positive food safety information significantly impacted consumers’ willingness to pay for “safer,” pricier food products. With the FDA Food Safety Modernization Act of 2011, the Federal Government is renewing its efforts to provide comprehensive, preventive-based controls across the food supply chain. Part of this effort will involve increased information collection from food producers and wholesalers, and revised labeling requirements to allow tracking of consumer products to origin. This will continue to provide upward

pressure on production costs and further encourage modernization and information technology improvements within the Food Industry

M&A TRANSACTIONS

The market continues to post strong quarters of M&A activity, continuing the rising trend from the doldrums of 2008 and 2009. As stated in our previous update, rising commodity costs and shrinking margins will potentially lead to further consolidation and will sustain high levels of M&A transaction volume in the near future as companies look to capitalize on economies of scale. Strategic buyers are expected to continue to dominate the deals both in number and size. The food industry with its relatively inelastic, recession-proof demand will remain attractive targets for private equity, particularly as they dip into their excess dry powder.



Source: S&P Capital IQ

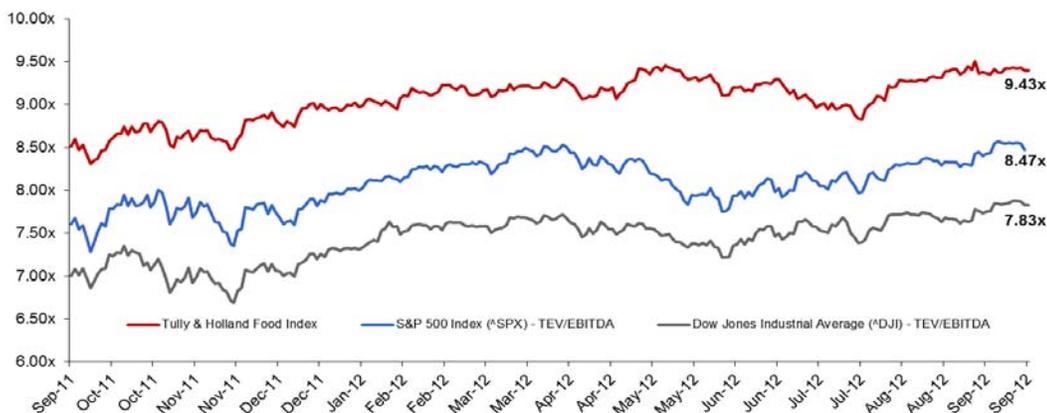
Top Food Industry Transaction Value By Size

<u>Closed Date</u>	<u>Target</u>	<u>Transaction Value (\$USDmm)</u>	<u>Buyers/Investors</u>
05/31/2012	The Wimble Company	2,695.0	Kellogg Company (NYSE:K)
08/06/2012	Wm. Bolthouse Farms, Inc.	1,550.0	Campbell Investment Company
07/03/2012	Lactalis American Group, Inc.	935.31	Parmalat Belgium SA
07/27/2012	Arctic Glacier Holdings, Inc.	434.5	H.I.G. Capital, LLC
10/11/2012	Snack Factory, LLC AND Princeton Vanguard LLC AND VMG Snack Factory Blocker, Inc.	340.0	Snyder's-Lance, Inc. (NasdaqGS:LNCE); S-L Snacks National, LLC
07/23/2012	Lepage Bakeries, Inc.	320.0	Flowers Foods, Inc. (NYSE:FLO)
08/20/2012	Conopco, Inc., Bertolli and P.F. Chang's Home Menu Frozen Meals Business Unit	267.0	ConAgra Foods, Inc. (NYSE:CAG)
06/19/2012	Imperial Sugar Co.	148.07	Louis Dreyfus Commodities LLC
07/02/2012	Udi's Healthy Foods, LLC	141.66	Smart Balance, Inc (NasdaqGS:SMBL)
08/10/2012	Michael's Finer Meats & Seafoods, Inc.	54.3	The Chefs' Warehouse Mid-Atlantic, LLC

Source: S&P Capital IQ

PUBLIC COMPARABLES

The following graph illustrates the valuation of companies within the Tully & Holland Food Index which consists of 18 publicly traded food manufacturers. The average trading multiple of the companies within the index has consistently outperformed both the DJIA and the S&P 500 over the course of the past year. Using a weighted average based on market capitalization the Tully & Holland Index is currently trading at an EV/EBITDA multiple of 9.42x versus the 8.47x and 7.36x that the S&P 500 and DJIA are currently trading at, respectively. We anticipate this strong performance will continue into the year ahead due to the industry's relatively recession-proof nature and steady cash flows. Additionally, increased revenues from emerging markets are driving growth for large diversified food companies as global consumers trade up to western-style eating habits.



Source: Capital IQ, Tully & Holland analysis

EV / EBITDA multiple represents the quotient of the summation of EVs and EBITDAs for each component over LTM

Tully & Holland Food Index Components: ADM, KFT, BG, TSN, GIS, K, CAG, DF, SFD, SLE, HNZ, HRL, CPB, DOLE, CPO, SJM, DMND, JJSF

VALUATION ANALYSIS

While 2012 saw the greatest number of H1 Food Industry M&A transactions in the past four years, the majority of the valuation metrics have not been publicized. In contrast, readily available public equity markets data can be used to provide accurate, relevant, up-to-date valuation guidance. As of September 25, 2012, eighteen of the major sales drivers in the food industry were trading at a mean enterprise multiple of 9.4x EV/EBITDA. Given that these multiples reflect large publicly traded companies, we would realistically apply size and liquidity discounts to determine valuations of smaller privately held companies. Past Tully & Holland experience suggests a valuation range of 6.5x to 8.5x last twelve months ETBITDA, depending on the size, growth potential, and liquidity of the company.

T&H CONCLUSIONS

With heavy drought in the central US helping to elevate commodity prices, there will be continuing pressure on industry margins which should lead to sustained high levels of M&A activity in the coming year as companies pursue economies of scale. Firms positioned to take advantage of the growth in organics and naturally-branded food products should do especially well. For those companies able to adapt, anti-obesity and food safety programs at both the national and local levels will provide opportunities to gain market share and public focus. The regulatory environment will continue through the foreseeable future to be a challenging one, placing renewed emphasis on product and infrastructure innovation in the food industry.

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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