

## Food Processing Stocks and Sara Lee

### Greetings from LFS



Dear Clients and Friends:

Here is my quarterly newsletter, *Invest*. The goal of *Invest* is to keep you abreast of what is happening in the financial market, inform you about new investments and keep you informed about your current investments.

I welcome any questions, comments or suggestions.

Sincerely,

*Doug Ruth*  
Douglas Ruth

### Invest

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Food processing stocks have been depressed for the last 18 months or so. Many of them are currently trading at 3 or 4 year lows. The low price of many of the stocks can be explained by the following:

- The industry has been unable to substantially increase sales and profits.
- Industry participants have not been able to introduce a break-through food product.
- Investors appeared to be more interested in the technology sector; however, with the recent pullback in technology, more interest in food companies again has been shown by investors.

Historically, the industry has been resonant. When an industry cannot increase sales, the participants focus on cutting and controlling expenses. This means selling, spinning off or closing non-core operations. The companies then can focus on the internal growth of the remaining businesses.

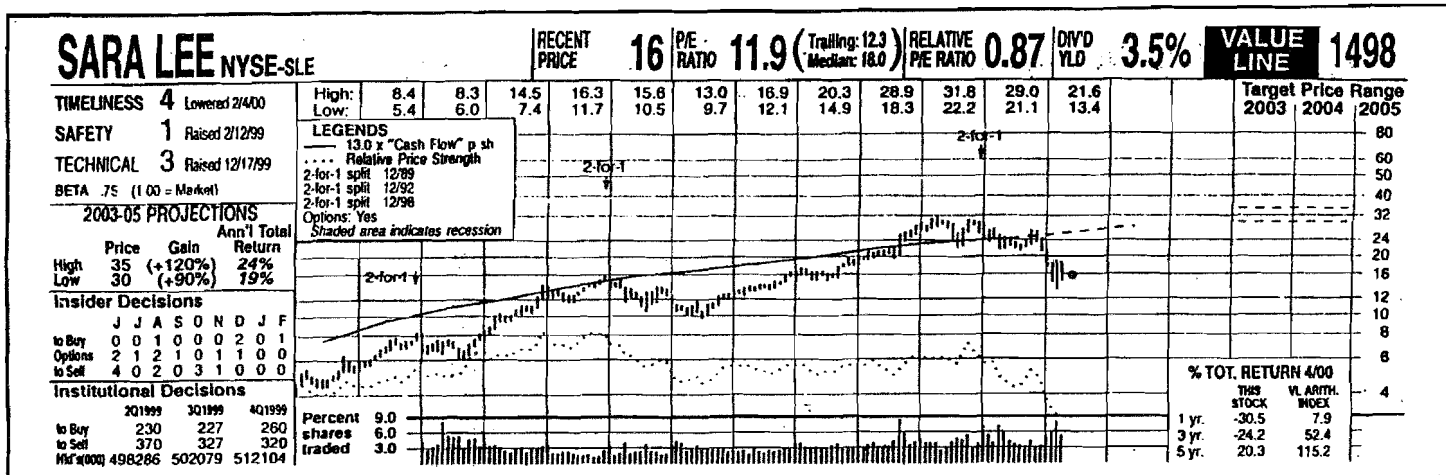
I believe Sara Lee is a company which offers the potential for a satisfactory return over the next 3 to 5 years.

On May 31, 2000, Sara Lee announced that the company is "reshaping" the business to focus on three primary areas:

- Food and beverage;
- Intimates and underwear; and
- Household products.

The Sara Lee name is known in households around the globe. Some of the brand names are decades old and are leaders in their categories.

The company is made up of 5 divisions, one of which is named Sara Lee Foods. The other 4 divisions include Coffee and Tea, Household and Body Care, Food Service, and Branded Apparel. The newsletter will examine each division and then describe the company's plans for the future.



Sara Lee explains the common theme among all these brands: They are products that everyone purchases periodically throughout their lives. The company adds, "We are not a food company or an apparel company or a shoe care company. We are – and shall continue to be – a global marketer of branded consumer packaged products."



**Sara Lee Foods Division:** The following chart shows some selected financial data:

Year	Sales	Net Income	Return on Investment*
1994	\$4,046	\$173*	45.7%
1995	\$4,206	\$186	53.0%
1996	\$4,422	\$207	52.3%
1997	\$5,357	\$232	47.2%
1998	\$5,441	\$252*	58.8%
1999	\$5,249	\$266*	91.1%
5 year compound growth rate	5.3%	8.9%	--

\*Excludes unusual items net of tax, of (\$13) in 1994, (\$133) in 1998, and (\$50) in 1999.

**About the footnotes:** You can see that Sara Lee presents the results of its different businesses with footnotes. The footnote explains why the results are actually different than presented.

The company explains that if a certain event did not occur the income would have been as presented, but because of a one-time event, it is actually lower.

This is questionable accounting because, in reality, there are no one-time events. Good and bad financial events occur in everyone's life. These are simply part of living. Two examples illustrate this point:

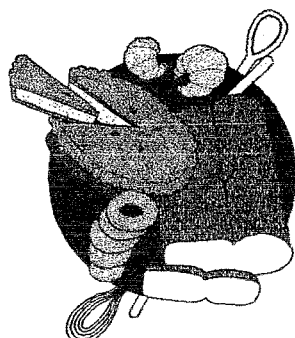
- An negative example is if the family car needed a new transmission. Owning and maintaining a car is part of our daily life. It would not be surprising to hear that the family budget was broken when the transmission went out.
- A positive example would be receiving an inheritance. It is not uncommon for someone to receive an inheritance when someone dies. This is also part of daily life.

Ultimately, what is important is the trend line. You can see that Sara Lee's sales are earnings are trending up.

**Packaged Meats:** In the United States, Sara Lee Packaged Meat brands are number one in the following categories:

Brand	Food Item
Ball Park	Hot dogs, cocktail links
Hillshire Farms	Breakfast sausage, smoke sausage
Jimmy Dean Foods	Breakfast sandwiches and breakfast sausage
State Fair Foods	Corn dogs

The company's products are sold in the United States, Mexico, Europe and Asia.



Sara Lee Bakery is the number one frozen baked goods company in the United States, Australia and the United Kingdom (U.K.):

- The company has 18% of the U.S. frozen baked goods market segment.
- The company has 49% market share in Australia, where it markets the top three frozen baked good items.
- In the U.K., the company markets 4 of the top 5 products and has a 23% market share.

Other brand names in this division include:

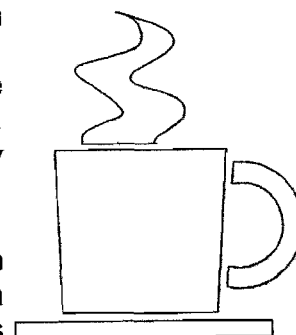
**Packaged Meats:** Aoste, Argal, Best Kosher, Bil Mar, Bryan, Cochonou, Cornby, Dacor, Galileo, Hygrade, Imperial, Justin, Bridou, Kahn's, King Cotton, Kir, Marcassou, Mr. Turkey, Nobre, Rudy's Farm, Sara Lee, Seitz, Sinai 48, Sweet Sue, and Stegeman.

**Bakery:** Brossard, Nutrine, Sara Lee, and Savane.

**Coffee and Tea Division:** The majority of the coffee and tea is sold outside the United States. Many of the brands are unfamiliar to Americans (see chart below):

Coffee			
Market	Market Share	Market Position	Major Brands
Netherlands	65%	1	Douwe Egberts
Belgium	49%	1	Douwe Egberts
Denmark	31%	1	Merrild Brand
Hungary	39%	1	Douwe Egberts
Norway	37%	1	Frieie Brand
Czech Rep	25%	2	Douwe Egberts
Australia	22%	2	Douwe Egberts
Spain	22%	1	Marcilla Soley
Greece	23%	2	Bravo
France	17%	2	Maison du Cafe
Brazil	6%	2	Café de Ponto, Seletto

Sara Lee maintains a number one position in retail-roasted coffee in the Netherlands, Belgium, Denmark, Hungary, Norway and the United Kingdom.



The European tea business totals \$6 billion a year. The company holds the number one market share for tea in the Netherlands, Hungary and Spain. Sara Lee's number one position includes the Homiman's and Sueños de Oro brands.

The chart below shows some selected financial data for the Coffee and Tea Division:

Coffee and Tea Division (dollars in millions)			
Year	Sales	Net Income	Return on Investment*
1994	\$2,090	\$189*	93.6%
1995	\$2,777	\$231	97.2%
1996	\$2,896	\$273	111.0%
1997	\$2,813	\$290	142.0%
1998	\$2,806	\$285*	130.8%
1999	\$2,627	\$279*	112.9%
5 year compound growth rate	4.7%	8.0%	--

\*Excludes unusual items net of tax, of (\$16) in 1994, (\$46) in 1998, and (\$97) in 1999.

**Household and Body Care Division:** The most global segment of Sara Lee's business, the Household and Body Care division, markets branded products in more than 125 countries. Many of the products are not sold in the U.S. so the brand names may not mean much to Americans. The company emphasizes high margin products that hold leading positions.

Four core categories are included in this division. Each of these categories has several brand names (see chart on next page).

Category	Brand Names
Shoe care	The Kiwi brand is the world's top name in the market. Other Sara Lee brands include Bama, Eri, Golden Rooster, Meltonian, Nugget, Tana, Tuxan.
Body care	Aqua Velva, Badedas, Body Mist, Brylcreem, Delial, Duschdas, Monsavon, Quenty, Radox, Sanex, Satina, Savane, She, Williams.
Insecticides	Bloom, Catch, Goodknight, Ridsect, Vapona.
Air fresheners	Ambi-Pur



The company sells the leading brand of insecticides (bug killer) in both France (Pyrel) and India (Goodknight).

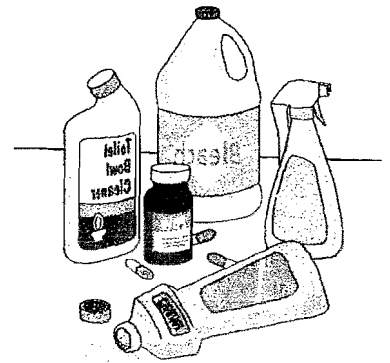
Believe it or not, the air freshener business is a growth industry in international markets. The company sells the leading brand (Ambi-Pur) of air fresheners in the Netherlands, Spain, Italy, Greece and Hungary.

The chart below shows some selected financial data for the Household and Body Care division.

Year	Sales	Net Income	Return on Investment*
1994	\$1,530	\$94*	43.3%
1995	\$1,691	\$91	52.4%
1996	\$1,837	\$118	59.6%
1997	\$1,843	\$130	53.4%
1998	\$2,003	\$142*	54.9%
1999	\$2,095	\$160	75.4%
6 year compound growth rate	6.5%	11.3%	—

\*Excludes unusual items net of tax, of (\$36) in 1994 and (\$164) in 1998.

Other non-core categories in this division include **Baby Care** (Famar, Fissan, Petit Cheri and Zwitsal brands), **Direct Selling** (Avroy Shlain, HomCare, House of Fuller, House of Sara Lee and NutriMetics brands), **Oral Care** (Prodent, Yijianxi and Zendium brands), and **Specialty Products** (Behold, Biotex, Endust, Kitten, Kiwi/Peli, Neutral, Nuclear, Ty-D-Bol, and White King brands).



**Food Service Division:** Consisting of Monarca and Monarch brands, this division is currently for sale. It is considered to be part of the non-core businesses and will be spun off (see "Plans for the Future" on page 6).

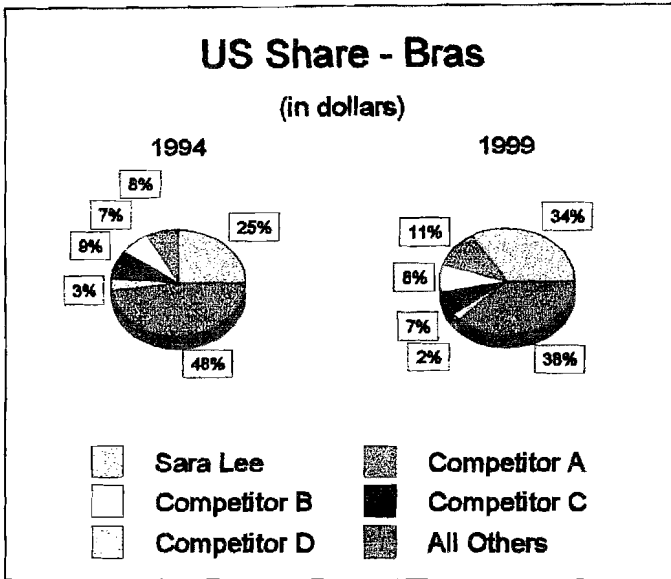
The **Branded Apparel Division** consists of three main categories: Intimates and Accessories, Knit Products, and Legwear.

The chart below shows some selected financial data for the Branded Apparel Division:

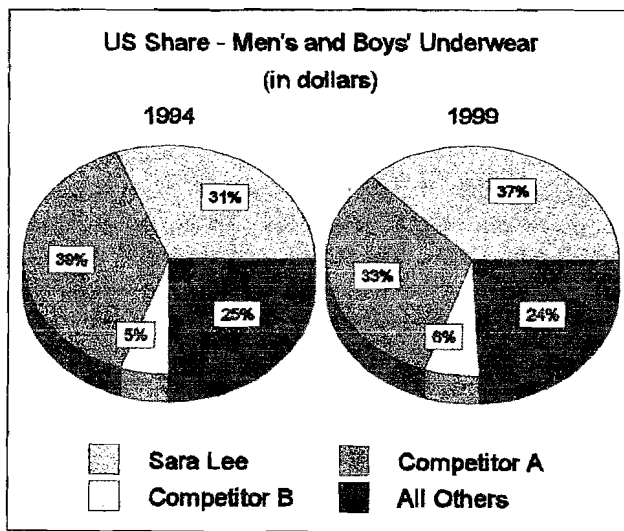
Year	Sales	Net Income	Return on Investment*
1994	\$6,449	\$311*	20.8%
1995	\$7,151	\$387	25.4%
1996	\$7,370	\$436	25.8%
1997	\$7,482	\$483	27.2%
1998	\$7,317	\$484*	33.5%
1999	\$7,440	\$518	42.5%
6 year compound growth rate	2.9%	10.8%	—

\*Excludes unusual items net of tax, of (\$430) in 1994 and (\$1,281) in 1998.

Sara Lee is increasing its market share in the \$4.4 billion U.S. bra industry (see pie chart):



Additionally, the company is increasing its market share in the underwear industry (see pie chart):



Some of the brands included in this division are:

Category	Brand Names
Intimates and Accessories	Antinea, Bali, Daisyfresh, Dim, Hanes Her Way, Hanes Sport, Just My Size, Lovable, Playtex, Rien, Rosy, and Wonderbra. Coach
Knit Products*	Abanderado, Beefy-T, Champion, Champion Jobra, Dim, Hanes, Hanes Her Way, Hanes Sport, HanesWear, Liabel, Ocean, Princesa, Rinbros, and ShowToons.

Category	Brand Names
Legwear	Bellinda, Bonds, Cameo, Diam's, Dim, DKNY Coverings, Donna Karan, Elbeo, Filodoro, Hanes, Hanes Her Way, Legacy, L'eggs, Little L'eggs, Nur Die, Philippe Maignon, Pretty Polly, Razzamatazz, Reliance, Resilience, Sheer Comfort, Sheer Energy, Silk Reflections, Smooth Illusions, Smooth Silhouettes, and Spanel.

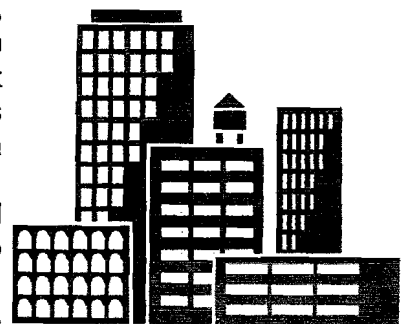
\*Note that the Knit Products division, International Fabrics, is currently for sale. Considered to be part of the non-core businesses, it will be spun off later this year (see "Plans for the Future" on page 6).

**Vertical Integration and Sara Lee:** As recently as late 1997, Sara Lee was fully vertically integrated. This means that the company retained ownership of all elements of production.

In the case of making pork sausage, the company owned the slaughter houses where the hogs were butchered, laboratories where new products were developed, and kitchens where recipes were tested and refined as well as the processing plant where the sausage was made.

Then, starting in 1997, Sara Lee began to rely on outside contractors to produce its products, a system that remains in place today.

From time to time, a story will appear in the newspaper that the company has closed a manufacturing plant. Sometimes, the local politicians will try to arrange a meeting with Sara Lee's management to try



and "save" the plant. However, Sara Lee is interested in maximizing profits and while they will meet with the community, they usually will not reconsider the decision to close the plant.

In the case of making sausage, ultimately the only asset that would remain after closing is a small laboratory to develop new products. The plant and kitchen would be closed or sold off.

**Plans for the Future:** Sara Lee plans to sell or spin off four brands later this year.

- **Champion:** Manufacturer, marketer and distributor of athletic and casual wear.
- **Coach:** Designer, producer and marketer of high-quality leather goods.
- **PYA/Monarch:** Regional food service distributor in the southeastern U.S.
- **International Fabrics:** Producer of fabrics sold to makers of intimate apparel.

Sara Lee is selling/spinning off these parts of the company because they either,

- Do not have the high profit margins of the remaining core businesses; or
- Do not have leading positions in their respective industries.

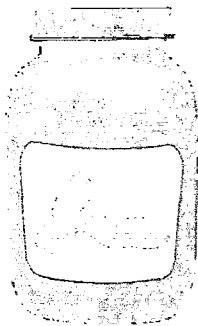
Ultimately, the company believes it can raise the net profit margin and spend more resources on core businesses. This should increase the earnings and cause the stock price to increase.

## The World Food Companies

Sara Lee is not the only food stock depressed. The problems extend throughout the industry. The top three world food companies are

- Nestle AG
- Unilever
- Kraft

At one time, Unilever was number three but it recently acquired Bestfoods, maker of Skippy peanut butter and Hellmann's mayonnaise. Additionally, it acquired Ben and Jerry's Homemade, Inc., and Slimfast Foods Company. These purchases increased their position to number two.



The prestige of being number one and the inability of the three company's to introduce new products will likely cause the industry to consolidate more. The inability to substantially increase sales and profits explains the low stock price of many of the food companies.

When you get a pay raise, you don't rush right out and buy more peanut butter or mayonnaise! Bestfood's business, while stable, was pretty much stagnant.

We all are familiar with the quote: *"Imitation is the sincerest form of flattery."* It appears that it is Nestle's or Kraft's turn to buy something. Currently, Nabisco is for sale. Nabisco brands include A.1., Breathsavers, Bubble Yum, Chips Ahoy!, Care Free, Cream of Wheat, Grey Poupon, Lifesavers, Milk Bone, Newtons, Oreo, Planters, Premium, Ritz, Snackwell's, Triscuit, and Wheat Thins.

In effect, Nabisco is auctioning off the company to the highest bidder. So far, Philip Morris, owner of Kraft, and Danone, French manufacturer of cookies and salted biscuits, have made bids to buy Nabisco.

It is possible that Nestle may make a bid. In the June 14, 2000, *Wall Street Journal* Nikhil Deogun and Shelly Branch wrote an article titled "Three Bidders Weigh Final Offers for Nabisco Holdings." The two writers speculated about other bidders and their interest in purchasing Nabisco:

**Nestle:** Interested in buying Lifesavers or Milk Bone.

**Danone:** Purchasing Nabisco's cookie and salted biscuit brands would complement the French group's existing products in that area and fulfill its goal of strengthening its North American position.



**Heinz:** Interested in buying Nabisco's condiments, Grey Poupon and A-1 steak sauce.

**Cadbury:** Interested in Nabisco's confectionary group.

The auction is scheduled to be completed almost immediately. The buyer, whoever it ultimately is, will probably focus on cutting and controlling expenses so they can focus on the internal growth of the remaining businesses. This should increase the purchaser earnings and cause the stock price to rise.

## Where We Stand

As we approach the mid-point of the year, it is interesting to review the progress of the financial markets. The Dow Jones Industrial average, which you hear quoted on television and radio, was down 9.11% as of June 16, 2000. For the same time period, the Standard and Poor 500 was down 0.33 of 1%.

Because numbers can be deceiving, investors can get a better understanding of what is actually happening in the economy by looking at how various industries are performing. The chart on the next page from the *Wall Street Journal* illustrates the percentage of change year-to-date.

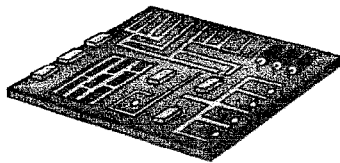
Five industries posted returns of 30% or better while six industries posted a negative 30% return. The *Value Line* analysis of some of these high and low performers is described below:

### High Performers

**Oil Industry:** Four of the five oil industry categories have had an over-30 increase. We all know about the very high current price of gasoline. No further discussion is needed.

### Semiconductors:

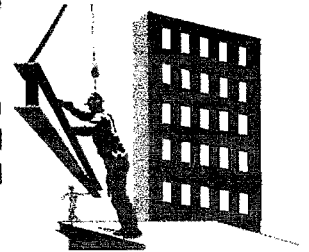
The astounding growth of the Internet has created great opportunities for many chip makers. This segment is up 55.93 year-to-date.



### Low Performers

**Forest Products:** There is an over-supply of forest products, which leads many in the industry to believe that prices may be headed lower.

**Steel:** There have been near-record imports of steel and rising costs in the steel industry.



**Household Products:** The household products industry, once considered a defensive group of equities, has not been as reliable as it once was. There have been several profit warnings from the industry leaders.

In addition to the three previously mentioned low performers, Non-ferrous (excluding Aluminum), Consumer Services and Non-durable goods had over 30-point decreases.

**Summing up:** As mentioned in previous newsletters, when you look at the industries that have done the best, there is a universal theme. They have done one of three things. They have:

- increased sales;
- increased prices; and
- cut expenses.

Businesses spend more time on pricing than on anything else; i.e, how much should be charged for goods or services. The challenge all businesses face is how to maximize profits. Auto manufacturers, retailers and communication companies all did this in the first half of 1998. The challenge they now face is continuing their success.

## Industry Group Performance

	% Chg YTD		% Chg YTD		% Chg YTD
<b>Basic Materials</b>	-22.83	<b>Travel</b>	+8.58	<b>Pharma &amp; Biotech</b>	+19.62
<b>Chemicals</b>	-18.89	Airlines	+5.80	Biotechnology	+22.58
Chemical-commodity	-24.81	Lodging	+9.44	Pharmaceuticals	+20.00
Chemical-specialty	-8.64	<b>Consumer, noncyclical</b>	-16.32	<b>Industrial</b>	-4.60
<b>Forest products &amp; paper</b>	-29.08	Consumer services	-33.54	Aerospace/Defense	+2.32
Forest products	-34.73	Cosmetics	-14.45	<b>Const &amp; Materials</b>	-7.65
Paper products	-24.75	Food retailers	+2.73	Building materials	-10.51
<b>Mining &amp; Metals</b>	-26.04	<b>Food &amp; Beverage</b>	+3.20	Heavy construction	+8.46
Aluminum	-24.90	Agriculture	0.00	<b>Containers &amp; pkgng</b>	-23.74
Mining, diversified	+16.78	Distillers & Brewers	+8.79	Industrial Equipment	+10.26
Non-ferrous (ex Alum)	-33.78	Food	+2.45	Adv industrial equip	+29.07
Precious metals	-11.43	Soft drinks	+2.56	Elec comps & equip	-16.71
Steel	-35.16	<b>Household products</b>	-33.44	Factory equipment	+22.79
<b>Consumer, Cyclical</b>	-11.77	Durable	-21.28	Heavy machinery	-18.20
Advertising & Media	-15.11	Non-durable	-34.15	<b>Industrial services</b>	-20.78
Advertising	-27.25	<b>Tobacco</b>	+8.35	Industrial svcs	-21.10
Broadcasting	-13.57	<b>Energy</b>	+17.34	Pollution control	-6.97
Publishing	-12.00	Coal	+5.80	<b>Industrial transportation</b>	-9.57
<b>Auto mfg &amp; parts</b>	-14.77	<b>Oil &amp; Gas</b>	+17.94	Air freight	-8.04
Auto manufacturers	-14.66	Oil cos, major	+5.12	Marine transport	+7.63
Auto parts	-15.37	Oil cos, secondary	+34.95	Railroads	-10.09
Tires & Rubber	-13.25	Oil drilling	+56.19	Trucking	-17.27
<b>Entertainment</b>	+4.09	Oilfield equip/svcs	+39.77	<b>Industrial, diversified</b>	-1.43
Casinos	+13.54	Pipelines	+47.90	Transportation equip	-21.23
Consumer electronics	+13.59	<b>Financial</b>	+0.34	Land transportation	-22.77
Entertainment	+17.52	Banks	-8.05	Shipbuilding	0.00
Recreation Products	+1.92	<b>Insurance</b>	+2.57	<b>Technology</b>	+6.20
Restaurants	-17.51	Full line	+5.70	Hardware & Equipment	+17.84
Toys	-11.22	Life	-8.56	Communications tech	-1.39
<b>Home const &amp; furn</b>	-13.71	Property/casualty	+6.38	Computers	+12.72
Furnishings	-16.67	<b>Real estate</b>	+10.97	Office equipment	-7.82
Home construction	-3.08	Specialty Finance	+6.27	Semiconductors	+55.93
<b>Retailers</b>	-17.72	Diversified financial	+2.72	<b>Software</b>	-18.02
Retailers, apparel	-13.09	<b>Savings and loan (US only)</b>	+2.76	<b>Telecommunications</b>	-12.34
Retailers, broadline	-22.59	Securities brokers	+15.64	Fixed Line Comm	-14.92
Retailers, drug-based	+4.63	<b>Health Care</b>	+19.57	Wireless Comm	+10.47
Retailers, speciality	-18.65	Healthcare providers	+19.69	<b>Utilities</b>	+18.04
<b>Textile &amp; Apparel</b>	-10.21	Medical Products	+19.03	Electric	+19.32
Clothing/Fabrics	-8.02	Advcd Med Devices	+29.44	Gas	+7.24
Footwear	-14.83	Medical supplies	+11.54	Water	+1.81

**KEY:** ***Bold italics*** indicate an increase of 30 points or more.  
*Italics* indicate a decrease of 30 points or more.