

TreeHouse Foods (THS)

SMALL & MID CAP RESEARCH

2Q Pricing Delay Is An Air Pocket, Not A Black Hole; Maintain Neutral

In our view, TreeHouse's earnings miss in second quarter reflects a temporary mismatch between rising commodity costs and their efforts to raise prices. We do not think it represents a structural problem with TreeHouse's ability to manage commodity cost volatility or its negotiating power with customers. However, despite the stocks' tempting sell-off, it is still too expensive for us to recommend given that it is trading in-line with our 12-month target price of \$53/share and a P/E multiple of 15.5x our 2012 EPS estimate.

- **Retailer pushback.** We expect packaged foods companies like General Mills, Campbell, Kraft, and Kellogg to echo the same theme that TreeHouse and ConAgra struck today about pricing delays. Wal-Mart publicly stated that they were requiring more documentation from their customers before allowing a second round of pricing to go through. But unlike TreeHouse, investor expectations for the large cap stocks aren't particularly high. In addition, we believe that the branded companies have more cushion in their budgets to mitigate the pressure from higher commodity costs by cutting advertising or shifting the timing of trade funds.
- **Visibility for 3Q is good.** The main reason for the negative surprise in 2Q was that packaging costs spiked rapidly almost immediately after TreeHouse announced their first round of pricing. The second round of pricing covered these problems. Going forward, the company is vulnerable to big spikes in oil, resin, and tinplate if they occur.
- **Revising estimates.** We are lowering our 2011 EPS estimate by \$0.10 to \$2.95 (versus new guidance of \$2.90-\$3.10) and our 2012 EPS estimate to \$3.40. Recall that 2011 includes \$0.15 of incrementally higher information systems spending that will decline in 2012.

Financial and valuation metrics

Year	12/10A	12/11E	12/12E	12/13E
EPS (CS adj.) (US\$)	2.78	2.95	3.40	3.65
Prev. EPS (US\$)	—	3.08	3.50	3.75
P/E (x)	21.0	19.8	17.2	16.0
P/E rel. (%)	160.3	172.0	165.1	173.6
Revenue (US\$ m)	1,817.0	2,042.5	2,138.5	2,224.0
EBITDA (US\$ m)	264.0	302.7	335.1	352.9
OCFPS (US\$)	6.81	5.10	5.64	6.02
P/OCF (x)	7.5	11.5	10.4	9.7
EV/EBITDA (current)	11.5	10.1	9.1	8.6
Net debt (US\$ m)	971	971	971	971
ROIC (%)	6.60	6.82	7.19	7.15
Source: Company data, Credit	35.50	IC (current, US\$ m)		1,949.07
BV/share (current, US\$)	27.5	EV/IC (x)		1.4
Net debt (current, US\$ m)	950.5	Dividend (12/10A, US\$)		—
Net debt/tot. cap. (current, %)	45.8	Dividend yield (%)		—
Source: Company data, Credit Suisse estimates.				

Rating	NEUTRAL*
Price (22 Jun 11, US\$)	58.50
Target price (US\$)	53.00 ¹
52-week price range	60.93 - 40.36
Market cap. (US\$ m)	2,076.91
Enterprise value (US\$ m)	3,048.02

*Stock ratings are relative to the relevant country benchmark.
¹Target price is for 12 months.

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- **Signs of encouragement.** Despite their complaints about price increases, the grocers continue to avidly buy TreeHouse's wares. Management said that volume growth improved to 5.0% in North American retail stores compared to 4.3% in 1Q. In addition, the company has secured distribution of "Big Win," value-added new products valued at \$125 million. The company's R&D capabilities are a competitive advantage.
- **Maintaining target price at \$53/share.** Our \$53/share implies a large-cap packaged food group forward P/E multiple of 15.5x against our 2012 estimate. While private label is a structurally lower margin business than branded foods where pricing tends to lag commodity costs, we think TreeHouse merits an in-line valuation multiple due to its effective acquisition strategy and management team. In addition, we believe TreeHouse may itself become a take-out target in the coming years.

Exhibit 1: THS Quarterly Earnings

	Q1 10A	Q2 10A	Q3 10A	Q4 10A	2010A	Q1 11A	Q2 11E	Q3 11E	Q4 11E	2011E	2012E	2013E
Net Sales	397.1	446.2	464.2	509.5	1,817	493.5	488.6	515.3	545.1	2,043	2,138	2,224
% Sales Growth	11.7%	19.8%	22.5%	25.9%	20.2%	24.3%	9.5%	11.0%	7.0%	12.4%	4.7%	4.0%
COGS	308.3	337.3	354.0	383.7	1,383	372.6	378.7	395.5	407.9	1,555	1,621	1,675
Gross Profit	88.8	108.9	110.2	125.7	434	120.9	109.9	119.8	137.2	488	518	549
Gross Margin	22.4%	24.4%	23.7%	24.7%	23.9%	24.5%	22.5%	23.2%	25.2%	23.9%	24.2%	24.7%
Selling and Distribution	26.8	30.9	28.7	33.7	120	36.3						
G&A	20.0	23.2	25.6	28.0	96.7	29.2						
Management fee to Parent (PF)					-							
Other operating ex/(inc)	0.1	(0.3)	(0.4)	(3.1)	(3.7)	0.3						
Amortization of intangibles	4.4	7.3	7.0	7.6	26.4	8.0						
Total SG&A	51.3	61.1	60.9	66.2	239.5	73.8	71.7	59.2	60.5	265.1	266.4	284.2
as % of sales	12.9%	13.7%	13.1%	13.0%	13.2%	15.0%	14.7%	11.5%	11.1%	13.0%	12.5%	12.8%
Operating Income	37.5	47.8	49.3	59.5	194.0	47.1	38.2	60.6	76.8	222.7	251.3	265.2
Operating Income Growth	40.5%	70.8%	56.7%	46.1%	53.0%	25.8%	-20.0%	23.0%	29.0%	14.8%	12.8%	5.5%
Operating Margin	9.4%	10.7%	10.6%	11.7%	10.7%	9.5%	7.8%	11.8%	14.1%	10.9%	11.8%	11.9%
Interest Expense	6.8	11.8	12.9	14.2	45.7	13.9	13.8	13.8	13.8	55.1	54.9	54.9
Other Expense	(0.0)	(1.4)	(0.9)	(0.2)	(2.5)	0.2				0.2	-	-
Pre Tax Income	30.7	37.4	37.3	45.5	150.9	33.0	24.5	46.9	63.0	167.4	196.4	210.3
Income Taxes	10.3	12.3	12.1	16.1	50.9	11.2	8.4	16.2	21.7	57.5	68.8	73.6
Tax Rate	33.7%	32.9%	32.4%	35.5%	33.7%	33.8%	34.5%	34.5%	34.5%	34.4%	35.0%	35.0%
Net Income from Continuing Ops	20.3	25.1	25.2	29.3	100.0	21.9	16.0	30.7	41.3	109.9	127.7	136.7
(Loss) from Discontinued Ops	-	-	-	-	-	-	-	-	-	-	-	-
Diluted Shares Outstanding	34.6	36.0	36.4	36.7	35.9	36.8	37.2	37.5	37.5	37.2	37.5	37.5
EPS from Continuing Ops	\$ 0.59	\$ 0.70	\$ 0.69	\$ 0.80	\$ 2.78	\$ 0.59	\$ 0.43	\$ 0.82	\$ 1.10	\$ 2.95	\$ 3.40	\$ 3.65
											1498%	
	Q1 10A	Q2 10A	Q3 10A	Q4 10A	2010A	Q1 11A	Q2 11E	Q3 11E	Q4 11E	2011E	2012E	2013E
Volume	3.1%	-0.7%	2.9%	0.6%	1.5%	1.0%	0.9%	-1.4%	0.0%	0.1%	2.0%	2.0%
Acquisitions	6.7%	20.9%	22.7%	24.1%	18.9%	23.3%	6.6%	6.4%	0.0%	9.1%	0.0%	
Price	-0.3%	-1.8%	-3.1%	0.6%	-1.1%	0.0%	2.0%	6.0%	7.0%	3.8%	2.8%	2.0%
Mix/other	-0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	
Currency	<u>2.3%</u>	<u>1.4%</u>	<u>0.0%</u>	<u>0.5%</u>	<u>1.0%</u>	<u>0.0%</u>	<u>0.0%</u>	<u>0.0%</u>	<u>0.0%</u>	<u>0.0%</u>	<u>0.0%</u>	
Total Sales Growth	11.7%	19.8%	22.5%	25.9%	20.2%	24.3%	9.5%	11.0%	7.0%	12.9%	4.8% #	4.0%

Source: Company data, Credit Suisse estimates

Exhibit 2: THS Quarterly Value Drivers

	Q1 10A	Q2 10A	Q3 10A	Q4 10A	2010A	Q1 11A	Q2 11E	Q3 11E	Q4 11E	2011E	2012E	2013E
Cash	4	3	4	6	6	2	4	4	6	6	6	6
Inventory	299	296	313	287	287	299	324	347	323	323	338	354
A/R	102	107	125	127	127	129	118	139	142	142	149	156
A/P	170	181	119	202	202	196	199	132	228	228	238	249
Working Capital	231	222	320	212	212	233	243	355	238	238	249	261
Capital Expenditures	7	10	14	31	62	11	21	21	32	85	53	56
Depreciation + Amortization	14	18	18	19	70	20	20	20	20	80	84	88
Intangibles	1,357	1,341	1,342	1,540	1,540	1,511	1,978	1,959	2,025	2,025	2,092	2,178
Total Assets	2,173	2,168	2,202	2,391	2,391	2,397	2,423	2,450	2,496	2,496	2,586	2,694
Total Current Liabilities	172	183	207	203	203	197	200	133	228	228	239	250
Total Liabilities	1,275	1,266	1,265	1,413	1,413	1,385	1,363	1,340	1,323	1,323	1,285	1,255
Shareholder's Equity	898	902	937	978	978	1,012	1,061	1,110	1,174	1,174	1,301	1,439
Current Debt	1	1	1	1	1	1	1	1	1	1	1	1
Total Debt	922	887	877	978	977	953	953	953	977	977	977	977
Net Debt	918	884	873	971	971	950	949	949	971	971	971	971
Operating Cash Flow	54	62	34	95	245	33	28	53	76	190	211	226
Free Cash Flow	48	52	20	64	183	21	15	29	39	105	158	170
Dividends/Share	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Invested Capital	1,998	1,983	1,993	2,183	2,183	2,199	2,221	2,314	2,262	2,262	2,341	2,439
NOPAT	25	32	33	38	129	31	25	40	50	146	163	172
ROIC	5.0%	6.5%	6.7%	7.0%	5.9%	5.7%	4.5%	6.9%	8.9%	6.5%	7.0%	7.1%
EBITDA	52	66	67	79	264	67	58	80	97	303	335	353

Source: Company data, Credit Suisse estimates

Exhibit 3: THS Annual Earnings

	2004 (PF)	2005	2006	2007	2008	2009	2010	2011 (e)	2012 (e)	2013 (e)
Net Sales	694.6	707.8	939.4	1,157.9	1,500.7	1,511.7	1,817.0	2,042.5	2,138.5	2,224.0
Sales Growth	-0.2%	1.9%	32.7%	23.3%	29.6%	0.7%	20.2%	12.4%	4.7%	4.0%
COGS	538.0	560.1	736.9	913.6	1,205.9	1,185.3	1,383.4	1,554.6	1,620.7	1,674.6
Gross Profit	156.6	147.7	202.5	244.3	294.7	326.4	433.6	487.9	517.8	549.4
Gross Margin	22.6%	20.9%	21.6%	21.1%	19.6%	21.6%	23.9%	23.9%	24.2%	24.7%
Selling and Distribution	61.5	61.0	74.9	94.6	115.7	107.9				
G&A	19.6	32.1	59.9	54.0	61.7	78.6				
Management fee to Parent	6.3	2.9	-	-	-	-				
"Other" operating expense/(income)	-	14.1	(21.8)	(0.1)	1.0	-				
Amortization of intangibles	1.5	1.7	3.3	7.2	13.5	13.4				
Total SG&A (ex "other")	88.9	97.8	138.0	155.8	192.0	199.6	239.5	265.1	266.4	284.2
As % of Sales	12.8%	13.8%	14.7%	13.5%	12.8%	13.2%	13.2%	13.0%	12.5%	12.8%
Operating Income	67.8	49.9	64.5	88.5	102.7	126.8	194.0	222.7	251.3	265.2
Operating Income Growth	-34.0%	-30.3%	-4.9%	37.4%	16.1%	23.4%	53.0%	14.8%	12.8%	5.5%
Operating Margin	9.8%	7.0%	6.9%	7.6%	6.8%	8.4%	10.7%	10.9%	11.8%	11.9%
Interest Expense, Other	1.6	1.0	12.3	21.7	30.1	15.5	43.2	55.3	54.9	54.9
Pre Tax Income	66.2	48.9	52.1	66.8	72.6	111.3	150.9	167.4	196.4	210.3
Income Taxes	24.4	19.7	20.0	25.6	21.6	38.4	50.9	57.5	68.8	73.6
Tax Rate	36.9%	40.3%	38.3%	38.3%	29.8%	34.5%	33.7%	34.4%	35.0%	35.0%
Net Income	41.8	29.2	32.2	41.2	51.0	72.9	100.0	109.9	127.7	136.7
EPS	\$ 1.35	\$ 0.94	\$ 1.02	\$ 1.32	\$ 1.62	\$ 2.23	\$ 2.78	\$ 2.95	\$ 3.40	\$ 3.65
% Change		-30.4%	9.2%	28.7%	23.2%	37.7%	24.7%	6.0%	15.4%	7.1%
Diluted Shares Outstanding	31.1	31.1	31.4	31.3	31.4	32.6	35.9	37.2	37.5	37.5
Discontinued Ops earnings		(0.7)								
Depreciation	14.9	16.9	24.6	33.9	45.9	46.0	69.8	72.0	72.0	72.0
EBITDA	82.6	66.8	89.0	122.4	148.6	172.8	263.8	294.7	323.3	337.2

Source: Company data, Credit Suisse estimates

Companies Mentioned (Price as of 22 Jun 11)

Campbell Soup Company (CPB, \$33.98, NEUTRAL, TP \$35.00)
 ConAgra Foods, Inc. (CAG, \$25.42, RESTRICTED)
 General Mills (GIS, \$37.93, OUTPERFORM, TP \$40.00)
 Kellogg Company (K, \$54.67, NEUTRAL, TP \$64.00)
 Kraft Foods, Inc. (KFT, \$34.66, OUTPERFORM, TP \$37.00)
 TreeHouse Foods (THS, \$58.50, NEUTRAL, TP \$53.00)
 Wal-Mart Stores, Inc. (WMT, \$53.01, NEUTRAL, TP \$58.00)

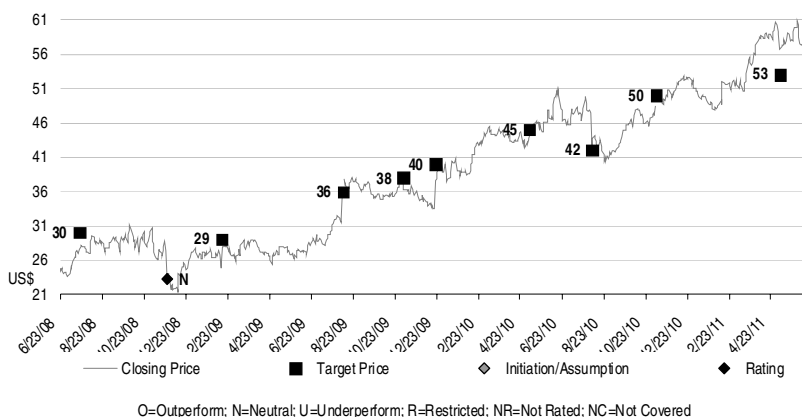
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See the *Companies Mentioned* section for full company names.

3-Year Price, Target Price and Rating Change History Chart for THS

THS	Closing Price	Target Price	Initiation/
Date	(US\$)	(US\$)	Rating Assumption
7/21/08	27.49	30	
11/25/08	23.25		N
2/13/09	27.97	29	
8/9/09	37.89	36	
11/4/09	36.34	38	
12/21/09	37.7	40	
5/7/10	44.42	45	
8/6/10	43.68	42	
11/7/10	49.82	50	
5/6/11	56.81	53	



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Restricted	3%	

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See the Companies Mentioned section for full company names.

Price Target: (12 months) for (THS)

Method: Our \$53/share implies a large-cap packaged food group forward P/E multiple of 15.5x against our 2012 estimate of \$3.37

Risks: Risks to our \$53/share target price on THS are that branded competitors in the highly competitive pickle category out-promote private label or that THS loses bid business to discount competitors. In addition, rising energy costs would harm profit margins as they flow through packaging and distribution costs and acquisition integration could fall short of management's targets

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