

Hillshire Brands Company

HSH - \$37.32 - NYSE



Go Meat & More!

Hillshire Brands Company (HSH - \$37.32 - NYSE)

Go Meat & More! - Buy

FYE: 6/30	EPS	P/E	PMV	Dividend: \$0.70	Current Return: 1.9%
2016P	2.20	16.7	\$53		
2015P	2.00	18.5	50	Shares O/S: 122.4	
2014E	1.75	20.9	46	52-Week Range: \$38.01-\$30.35	
2013A	1.72	21.4	44		

SUMMARY AND OPINION

Hillshire Brands Company headquartered in Chicago, Illinois was renamed from the Sara Lee Corporation following the tax-free spin-off to shareholders on June 28, 2012 of the international coffee and tea company, D.E. MASTER BLENDERS 1753. Hillshire generates over \$4 billion in annual revenue of which nearly 90% is generated from meat-based products under leading brands, such as *Jimmy Dean*, *Hillshire Farms*, *Ballpark*, *Aidells* and *Gallo*. The remaining businesses include the *Sara Lee* branded retail bakery products and the *Chef Pierre* and *Sara Lee* foodservice bakery products. In fiscal 2014, we expect the company to generate revenue, EBITDA and earnings per share of \$4.0 billion, \$521 million and \$1.75, respectively.

We recommend shares of Hillshire Brands:

- Hillshire competes today in mostly meat-centric categories, such as breakfast and smoked sausages, frozen breakfast meals, hot dogs and lunchmeat with retail sales totaling \$13.8 billion. This represents ample expansion opportunities for its leading brands which generate approximately two-thirds of company sales; *Hillshire Farms* (\$1 billion), *Jimmy Dean* (\$1 billion), *Ball Park* (\$400 million) and *State Fair* (\$130 million). Hillshire is increasing innovation and has recently announced the expansion of several of its brands into adjacent categories, including frozen dinners/entrées, a category worth an additional \$9 billion in retail sales.
- The management team, including CEO, Sean Connolly and CFO, Maria Henry, have committed to enhancing the revenue growth rate and achieving 10% operating margins by fiscal 2015. We expect revenue growth to accelerate due to a greater mix of new products, distribution additions and as it fully supports its leading brands through marketing and promotional spending increasing from 3.5% to 5.0% of sales.
- We expect Hillshire Brands to generate industry-leading growth over the next two years as it strives to attain its medium-term financial objectives of 10% operating margin from operating leverage, higher margin products, and \$105 million of cost savings; accordingly we expect the company to generate high single-digit earnings growth over the next five years.
- The company may be an attractive acquisition target, as protein competitors look to develop a portfolio of leading brands and shift its offering to more value-added products with higher and more stable margins.
- The valuation is attractive as Hillshire shares trade at 9.5x June 2015 projected EBITDA and 18.7x earnings. We calculate a PMV of \$50 based on 2015 estimates, a 25% discount to the current market price.

Table 1 **Hillshire Brands Company Earnings Model**

2012 - 2018P

Fiscal year end 6/30 (\$ in millions, except per share)	2012	2013	2014E	2015P	2016P	2017P	2018P	CAGR '13-'18P
Revenue	\$ 3,958	\$ 3,920	\$ 4,005	\$ 4,152	\$ 4,298	\$ 4,468	\$ 4,645	3.5 %
% Growth	-1.5%	-1.0%	2.2%	3.7%	3.5%	3.9%	4.0%	
EBITDA	501	498	521	545	572	603	636	5.0
Margin	12.7%	12.7%	13.0%	13.1%	13.3%	13.5%	13.7%	
EPS, cont ops	\$ 1.72	\$ 1.75	\$ 2.00	\$ 2.20	\$ 2.40	\$ 2.65	\$ 2.65	9.0
% Growth		2.9%	12.7%	10.7%	9.4%	9.4%	9.4%	
TEV/EBITDA Multiple	10.4x	9.9x	9.5x	9.0x	8.6x	8.1x		
P/E Multiple	21.7	21.0	18.7	16.9	15.4	14.1		
CapEx	139	118	121	125	128	132		

Source: Company data and Gabelli & Company estimates.

SEPARATION

Sara Lee was formed in 1939, followed by sixty years acquiring and diversifying its operations; however, starting in the twenty-first century the company began to narrow its focus. Former management began to divest and spin-off several of its disparate businesses, including the spin-offs of Coach, Inc. (COH – NYSE) in 2001 and HanesBrands Inc. (HBI – NYSE) in 2006, as well as the sales of its international household and body care businesses in 2010 and its fresh bakery businesses in the US and Spain in 2011. The culmination was in January 2011, when the company announced its intention to separate the remaining meat and coffee businesses into two separately managed public companies; Hillshire Brands Company and D.E MASTER BLENDERS 1753, as well as pay a \$3 special dividend.

The spin-off was completed on June 28, 2012; accordingly, shareholders received \$3 in cash from the special dividend and one share of D.E MASTER BLENDERS 1753, a Dutch-listed company, which included the international coffee and tea businesses generating approximately \$3.6 billion of annual revenue. Shareholders also retained one share in the Sara Lee Corporation, consisting of the North American meat and bakery businesses, which subsequently underwent a reverse split of 1-for-5 and was renamed the Hillshire Brands Company. In September 2013, D.E MASTER BLENDERS was acquired for €12.50 per share by Joh A. Benckiser.

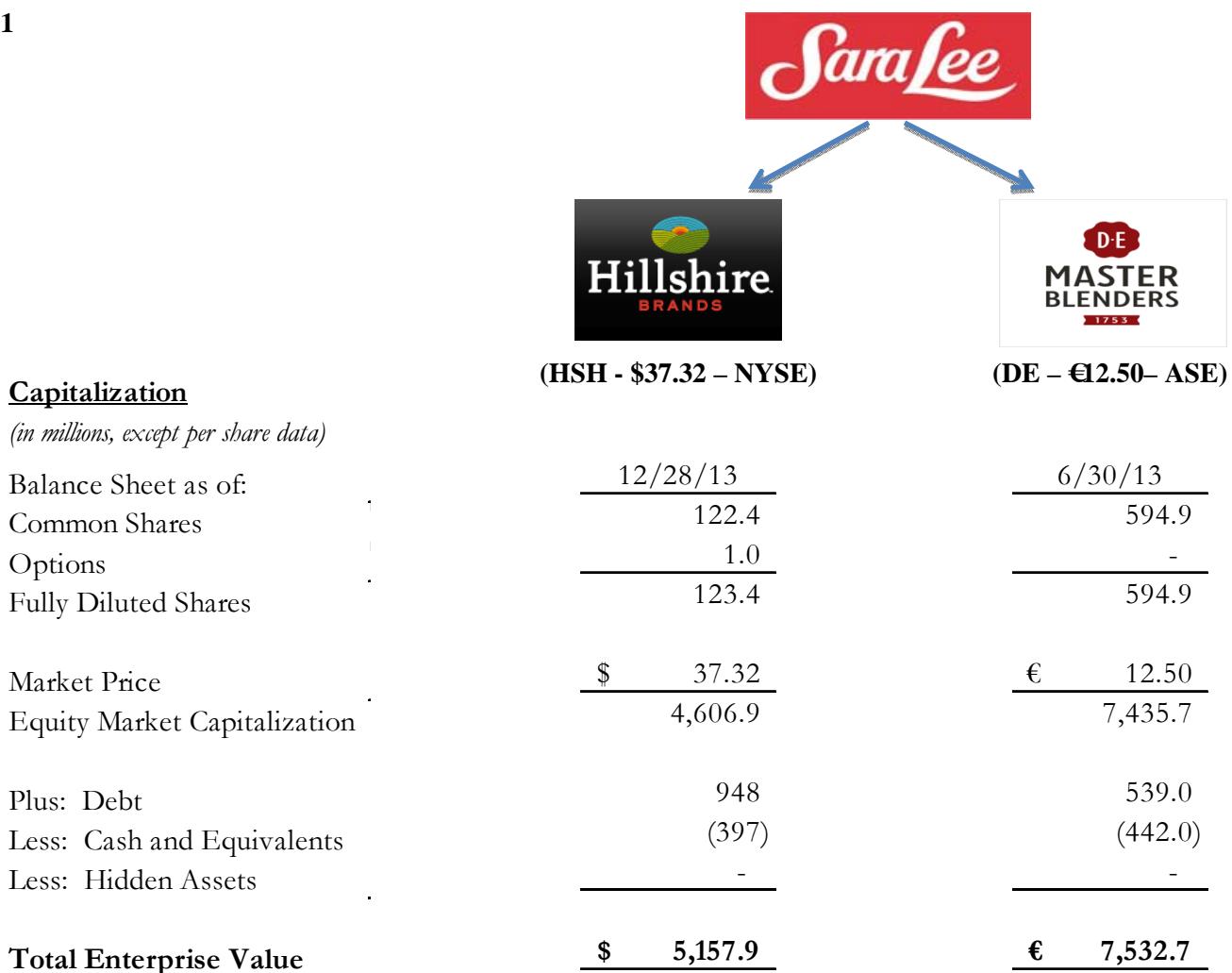
Table 2

Former Sara Lee Corporation Sum of the Parts

HSH/share	DE/share	Spec. dividend	=	Total
\$7.46	\$16.90	\$3.00	=	\$27.37

Source: Gabelli & Company

Exhibit 1



Source: Company filings

PROTEIN

Protein is a chain of amino acids, which is used by every cell, tissue and organ in the body. Some amino acids are not produced by the body; as a result, it is necessary to supplement the body's daily needs through food. Essential amino acids are found in meat, poultry, fish, milk, eggs, soybeans, nuts and legumes. The Institute of Medicine recommends calories from protein comprise about 10-35% of total daily calories consumed; however, according to the National Health and Nutrition Examination Survey only 15% of calories in the average American diet are from protein. Today, more research is showing that protein may be beneficial in managing weight, as it takes longer to metabolize, more calories to digest and process, which results in longer periods of satiety. Timing may also have an impact, according to Donald Layman, Ph.D., a professor emeritus of nutrition at the University of Illinois, it is important to get at least 30 grams of protein at breakfast. These are the trends which Hillshire is capitalizing on as it restores its new product pipeline and extends its brands into new categories to fuel long-term revenue growth and margin expansion.

LEADING BRANDS

Today, Hillshire competes in meat categories which generate approximately \$13.8 billion of retail sales, including frozen breakfast protein meals, breakfast and smoked sausages, hot dogs and lunchmeat, which is just a fraction of the \$68 billion total meat-product meals industry.

Hillshire's Retail division generates 74% or nearly \$3 billion of sales, while its leading brands generate approximately two-thirds of total company sales: *Hillshire Farms* (\$1 billion), *Jimmy Dean* (\$1 billion), *Ball Park* (\$410 million) and *State Fair* (\$130 million). *Aidells*, its next largest retail brand, generates approximately \$110 million of annual sales, growing high single-digits. Hillshire is the leading branded manufacturer of frozen protein breakfast (54% market share), breakfast sausage (31%), smoked sausage (30%) and hot dogs (22%).

Table 3

Category	Retail Sales (\$ millions)	3-Year CAGR	Market Share
Frozen protein breakfast	\$1,500	9.6 %	54 %
Breakfast sausage	1,800	6.0	31
Smoked sausage	1,800	4.3	30
Hot dog	2,500	1.1	22
Lunchmeat	6,200	(1.5)	9
	\$13,800		



Source: Hillshire Brands (SymphonyIRI data ended 1/5/14)

The company is focusing on upgrading its core products, including packaging and quality to accelerate sales growth and take advantage of its capabilities and assets, such as its state of the art meat slicing facility in Kansas City. Management is targeting 13-15% of sales generated from new products introduced in the last three years by 2015 from historical levels closer to 9%. The most recent product announcements and launches include *Hillshire Farm* American Craft sausage links and new flavors and varieties across *State Fair* corn dogs and *Jimmy Dean* rolled sausage. Hillshire is expanding into the \$1 billion premium lunchmeat category with the launch of Aidells premium lunchmeat, as well as *Hillshire Farm Naturals* lunchmeat. HSH is also looking to capitalize on the growing trend of snacking as it penetrates the \$19 billion protein-snacking category, of which meat is a smaller, faster-growing sub-segment, with the acquisition in the fiscal 1Q of Golden Island premium jerky and the introduction of *Hillshire* snacking products. Lastly, it is extending the *Jimmy Dean* frozen portfolio into additional day parts with the introduction of frozen sandwiches and entrées. In the US, the frozen dinner/entrée category generates \$9 billion in retail sales, according to research firm, IRI.

The Foodservice segment generates the remaining \$1 billion of company revenue selling meat and bakery products, such as hot dogs, sausage, frozen pies and cakes, mostly to distributors, as well as restaurants, institutions and military. The foodservice division, particularly meats, leverages the existing asset base of the company. The segment includes its sales of commodity turkey, as well as higher-margin branded products, such as Chef Pierre pies, which has a market share of approximately 50%. Hillshire has upgraded its Tarboro bakery facility and exited lower-margin business; however, revenue and profitability has remained weak due to softer industry trends, higher input costs and some higher internal costs associated with the bakery facility.



MARGIN ENHANCEMENT

The new management team announced its three-year goals at its analyst day in June 2012, which remain applicable; revenue growth of 4-5% and operating margins of 10% by fiscal 2015. The margin improvement will be driven by operating leverage from faster revenue growth, improved product mix, annual productivity savings of 3-4% and \$145 million of cost savings, of which \$40 million was achieved in 2013, which is incremental to the \$130 million of savings from 2011-2013. These initiatives will not only fuel the 200bps margin expansion but also fund the increase in marketing and promotion (MAP) spending from 3.5% to 5.0% of sales. This level of MAP spending indicates that nearly 6% of sales will be reinvested to support the branded retail business, considering the \$1 billion foodservice business requires a lesser amount of brand support.

Exhibit 2

Gross Margin by Product Type



Source: Hillshire Brands Company

Gross margin expansion is contributing to the operating margin improvement driven by two factors. First, Hillshire will accelerate new product growth around faster-growing categories, such as branded meal components and ready meals, which carry higher gross margins of 30-35% compared to commodity products closer to 15% (Exhibit 2) and company average of approximately 30% in fiscal 2013. It will also extend into higher margin categories, such as snacking and introduce premium innovation. Second, productivity is expected to generate 3-4% of savings on average annually from labor and material cost reductions, as well as improved manufacturing efficiencies. Together these efforts in conjunction with pricing should offset commodity costs over time, while also contributing to margin improvement.

**Exhibit 3 Daily Lean Hog Price & Volume (CME)
March 2010 – March 2014**



Source: NASDAQ

**Exhibit 4 Daily Feeder Cattle Price & Volume (CME)
March 2010 – March 2014**



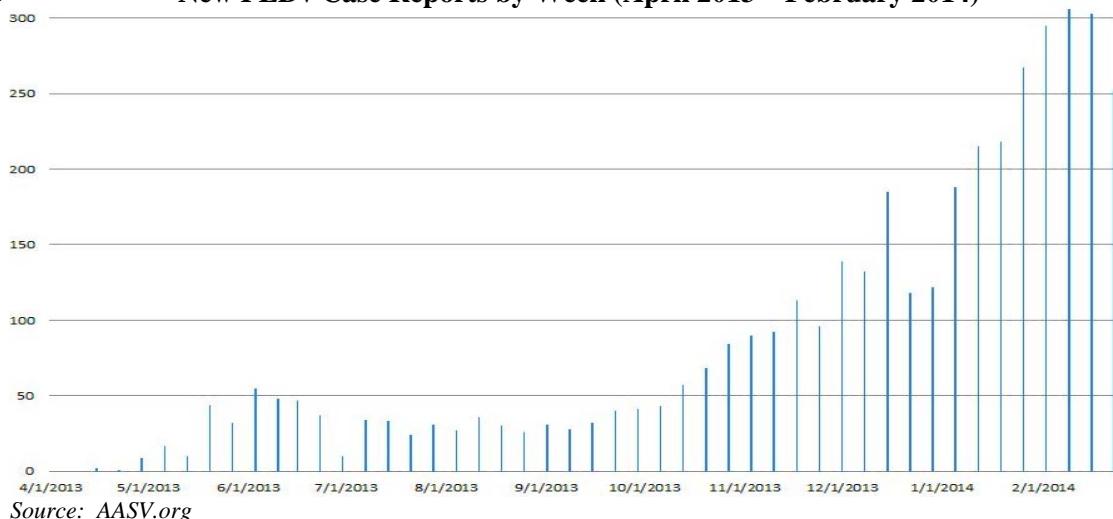
Source: NASDAQ

Near-term Risk: Protein Prices

Commodity costs will cause fluctuations, as raw materials, such as protein, packaging and energy comprise over 60% of cost of goods sold. Protein is approximately one-third of total input costs, which includes pork, beef and poultry, of which Hillshire is vertically integrated in only turkey. In 2013 and early calendar 2014, market prices for its largest inputs, pork and beef have increased significantly for several reasons, including reduced supply following the 2012 U.S. drought and the subsequent rise in feed costs, as well as strong exports. Since beef supply takes approximately two years to rebuild consequently this has led to higher prices, making pork more attractive. However, pork supply has been impacted by Porcine Epidemic Diarrhea virus (PEDv), which was first confirmed in the U.S. in May 2013. YTD slaughter is down 2.6%; however production is approximately flat at 3.9 billion pounds. PEDv has a morbidity rate as high as 100% on a farm with temporary impact, while it has a mortality rate of up to 100% in suckling piglets. PEDv may reduce supply this year, despite potential weight gains partially offsetting some of these losses. Concerns have increased as the reported number of cases continued to escalate into early calendar 2014 (Exhibit 5). Near term protein prices may continue to increase (Exhibits 3 and 4), particularly as we enter the seasonally high consumption period but over time price increases should subside as the protein supply rebuilds and feed prices remain relatively low.

Exhibit 5

New PEDv Case Reports by Week (April 2013 – February 2014)



Source: AASV.org

VALUATION

We expect Hillshire Brands to generate industry-leading growth over the next two years and attain its objectives of at least 4% revenue growth and 10% operating margins by 2015; accordingly we expect high-single digit earnings growth over the next five years. We expect sales growth to accelerate as the company improves its innovation pipeline of higher-margin products, extends into adjacencies and expands distribution, while fully supporting its brands with higher MAP spending (5% of total sales). Margins should improve as a result of operating leverage from faster growth, favorable mix from new products (target is 13-15% of sales vs. 11% in 2013), stable or lower input costs in the medium-term, overhead reductions and the realization of the \$105 million of costs savings. Earnings growth may be further augmented by share repurchases in the absence of acquisitions.

Management emphasized at the CAGNY conference in February its intention to be acquisitive given its healthy balance sheet (net debt of only \$551 million) and strong cash flow. It is interested in leading domestic brands across the meals, meal components and snacking sectors, which fits its financial criteria. It is no longer focusing on just meat-centric categories but across grocery in order to add strong brands and/or to enhance its capabilities and scale. Hillshire management would prefer to stay investment grade and below 3.5x Net debt/EBITDA (currently 1.1x). The most recent acquisition was Golden Island jerky for \$35 million, which is acquired in the first quarter of fiscal 2014.

The valuation is attractive as Hillshire shares trade at 9.5x projected June 2015 EBITDA and 18.7x P/E. We expect earnings per share to increase approximately 9% over the next five years, including double-digit growth in the fiscal years ending June 2015 and 2016. Hillshire shares trade at a discount to its packaged food competitors (Table 5) including Hormel Foods (HRL - \$47.21 - NYSE) and Kraft Foods Group (KRFT - \$55.72 - NASDAQ).

The company may also be an attractive acquisition target, as protein competitors look to expand their portfolios of brands and shift their offerings to more value-added products with higher and more stable margins. Hillshire estimates that on average its commodity products generate 15% gross margins compared to meal components estimated at 30% and branded ready meals at 35%. This may be an attractive proposition for a protein manufacturer to enlarge its presence into branded categories with pricing power given commodity cost volatility, while also leveraging its protein supply and processing assets, therefore potentially earning a higher valuation multiple. Prior to Sara Lee's spin-off announcement in January 2011, media reports speculated JBS S.A. (JBSS3 – BZL 7.35 – BR), a large, global protein processor based in Brazil, was interested in acquiring the meat operations, which still makes strategic sense. Others, such as Tyson (TSN - \$40.47 - NYSE) may also be attracted to Hillshire's portfolio of leading brands. We calculate a PMV of \$50 per share based on 2015 estimates using 12x EBITDA on the Retail segment, a discount to the multiple Berkshire Hathaway and 3G Capital paid to acquire the H.J. Heinz Company in June 2013, and 10x Foodservice. Shares currently trade at a 25% discount to our private market value estimate.

Table 4

Hillshire Brands Company								
Private Market Value Analysis								
2012 - 2018P								
<i>Fiscal year ends 6/30 (\$ in millions, except per share)</i>	2012	2013	2014E	2015P	2016P	2017P	2018P	
Retail								
Hillshire Farm (estimated)	\$ 1,055	\$ 1,023	\$ 1,044	\$ 1,086	\$ 1,129	\$ 1,174	\$ 1,221	
Jimmy Dean	971	1,029	1,060	1,113	1,168	1,227	1,288	
Ball Park	406	410	418	433	448	464	480	
State Fair	142	131	131	134	137	141	144	
Aidells	102	111	121	131	141	153	165	
Sara Lee	60	55	56	57	58	59	61	
Gallo	30	32	33	35	36	38	39	
Sara Lee Bakery	118	104	107	109	112	115	118	
Other	0	(1)	0	0	0	0	0	
Revenue	2,884	2,894	2,969	3,097	3,231	3,370	3,516	
EBITDA	402	417	445	455	487	520	555	
Valuation Multiple	12.0x	12.0x	12.0x	12.0x	12.0x	12.0x	12.0x	
Segment Value	\$ 4,824	\$ 5,004	\$ 5,344	\$ 5,457	\$ 5,839	\$ 6,236	\$ 6,660	
Foodservice/Other								
Bakery (estimated)	\$ 382	\$ 343	\$ 340	\$ 348	\$ 357	\$ 366	\$ 375	
Meat	698	683	697	707	711	732	754	
Revenue	1,080	1,026	1,036	1,055	1,067	1,098	1,129	
EBITDA	116	99	103	120	117	116	115	
Valuation Multiple	10.0x	10.0x	10.0x	10.0x	10.0x	10.0x	10.0x	
Segment Value	\$ 1,160	\$ 990	\$ 1,033	\$ 1,197	\$ 1,166	\$ 1,160	\$ 1,153	
Australian Bakery								
Segment Value	\$ 85	\$ 85						
Corporate	(21)	(18)	(28)	(30)	(31)	(32)	(34)	
Total Private Market Value	6,069	6,079	6,377	6,653	7,005	7,396	7,813	
Less: Net Debt	(699)	(551)	(618)	(548)	(501)	(481)	(468)	
Less: Options Payments ^(a)	(79)	(116)	(94)	(108)	(123)	(139)	(156)	
Equity Private Market Value	5,291	5,412	5,664	5,998	6,382	6,775	7,188	
Shares Outstanding	120.6	123.2	122.2	120.7	119.2	117.7	116.2	
PMV per share	\$ 44	\$ 44	\$ 46	\$ 50	\$ 54	\$ 58	\$ 62	
<i>Current Market - Discount to PMV</i>	14.9%	15.0%	19.5%	24.9%	30.3%	35.1%	39.6%	

^(a) After-tax payments to buy out options holders at Private Market Value.

Source: Company data and Gabelli & Company estimates.

Table 5

**Hillshire Brands Company
Comparable Valuation Grid**

<i>(in millions, except per share data) (numbers are pro forma if appropriate)</i>	ConAgra Foods CAG - NYSE	Hillshire Brands HSH - NYSE	Hormel Foods HRL - NYSE	Kraft Foods Group KRFT - Nasdaq
12-Month High/Low	\$ 37.28	\$ 28.09	\$ 38.01	\$ 30.35
Capitalization	FYE 5/31	FYE 6/30	FYE 10/31	FYE 12/31
Balance Sheet as of:				
Shares Outstanding	420.4	122.4	264.0	596.3
Options/Converts	2.8	1.0	7.4	3.9
Fully Diluted Shares Outstanding	423.2	123.4	271.4	600.2
<u>Price as of 3/12/2014</u>	<u>\$ 29.82</u>	<u>\$ 37.32</u>	<u>\$ 47.21</u>	<u>\$ 55.72</u>
Equity Market Capitalization	12,618.7	4,606.9	12,813.4	33,442.6
Total Debt and Preferred Stock	9,184.7	948.0	250.0	9,976.0
Minority Interest	89.5	-	6.7	0.0
Cash and Equivalents	(192.7)	(397.0)	(639.8)	(1,686.0)
Hidden Assets	(1,228.8)	-	-	0.0
Total Enterprise Value (TEV)	\$ 20,471.4	\$ 5,157.9	\$ 12,430.2	\$ 41,732.6
<u>Consolidated:</u>				
Net Revenues	2015P	\$ 15,838.7	-11.1%	\$ 4,152.5
<i>(growth)</i>	2014E	17,809.9	15.0%	4,005.5
	2013A	15,491.4	7.8%	3,920.0
EBITDA	2015P	\$ 2,251.7	14.2%	\$ 544.9
<i>(margin)</i>	2014E	2,373.3	13.3%	520.6
	2013A	2,030.1	13.1%	498.0
EPS	2015P	\$ 2.38	7.3%	\$ 2.00
<i>(growth)</i>	2014E	2.22	3.4%	1.77
	2013A	2.15	4.9%	1.72
TEV/EBITDA	2015P	9.0		9.5
	2014E	9.1		9.9
	2013A	10.6		10.4
P/E	2015P	12.4		18.7
	2014E	13.3		21.0
	2013A	13.7		21.7
Private Market Value	2015P	\$ 55		\$ 50
	2014E	49		46
	2013A	37		44
Total Debt/EBITDA		4.5	x	1.9
EBITDA/Interest		10.4	x	11.6
Net Debt/TEV		45.3	%	10.7
Additional Information:		<i>Omaha, Nebraska</i>		<i>Chicago, IL</i>
Dividend	\$ 1.00	3.4%	\$ 0.70	1.9%
		<i>Austin, Minnesota</i>		<i>Northfield, IL</i>
		\$ 0.80	1.7%	\$ 2.10
				3.8%

Source: Company data and Gabelli & Company estimates.

Other Companies Mentioned:

Coach, Inc.	(COH	-	NYSE)
ConAgra Foods, Inc.	(CAG	-	")
HanesBrands Inc.	(HBI	-	")
Hormel Foods Corporation	(HRL	-	")
JBS S.A.	(JBSS3	-	BR)
Kraft Foods Group, Inc.	(KRFT	-	NASDAQ)
Tyson Foods, Inc.	(TSN	-	NYSE)

I, **Sarah Donnelly**, the Research Analyst who prepared this report, hereby certify that the views expressed in this report accurately reflect the analyst's personal views about the subject companies and their securities. The Research Analyst has not been, is not and will not be receiving direct or indirect compensation for expressing the specific recommendation or view in this report.

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Important Disclosures

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Ratings

Analysts' ratings are largely (but not always) determined by our "private market value," or PMV methodology. Our basic goal is to understand in absolute terms what a rational, strategic buyer would pay for an asset in an open, arms-length transaction. At the same time, analysts also look for underlying catalysts that could encourage those private market values to surface.

A **Buy** rated stock is one that in our view is trading at a meaningful discount to our estimated PMV. We could expect a more modest private market value to increase at an accelerated pace, the discount of the public stock price to PMV to narrow through the emergence of a catalyst, or some combination of the two to occur.

A **Hold** is a stock that may be trading at or near our estimated private market value. We may not anticipate a large increase in the PMV, or see some other factors at work.

A **Sell** is a stock that may be trading at or above our estimated PMV. There may be little upside to the value, or limited opportunity to realize the value. Economic or sector risk could also be increasing.

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As of February 28, 2014, our affiliates beneficially own on behalf of their investment advisory clients or otherwise approximately 3.93% of Hillshire Brands and less than 1% of Coach Inc., ConAgra Foods Inc., HanesBrands Inc., Kraft Foods Group, Inc. and Tyson Foods, Inc. Because the portfolio managers at our affiliates make individual investment decisions with respect to the client accounts they manage, these accounts may have transactions inconsistent with the recommendations in this report. These portfolio managers may know the substance of our research reports prior to their publication as a result of joint participation in research meetings or otherwise. The analyst who wrote this report may receive commissions from our customers' transactions in the securities mentioned in this report. Our affiliates may receive compensation from the companies referred to in this report for non-investment banking securities-related services, or may be soliciting these companies as clients for non-investment banking securities-related services. The analyst who wrote this report, or members of her household, owns no shares of any company mentioned.