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HJ Heinz Company ~ HNZ (NYSE)

Investment Overview

Founded in 1869 and incorporated in 1900, there are few global brands (excepting perhaps Coke) that are as dominant as Heinz. However, like so many other long-lived American icon companies, over the course of many years the company has reduced its focus on its core specialty (ketchup/condiments) and moved into other loosely related areas in an attempt to fuel growth. These expansion tactics have undoubtedly helped to grow the business. However, not every brand has the staying power of Heinz Ketchup: as certain acquisitions and newly introduced products fail, the sustainability of the entire Company (rather than its core product line) is less and less assured. Although a slight exaggeration, it is as if Heinz lives by the adage that a rolling stone gathers no moss...but when the stone stops rolling lets all stop for a moment and thank the rock (Ketchup) for saving our professional lives.

Despite having a negative tangible book value – a clear red flag and something that would normally cause us to shy away from a company – it should be pointed out that over the last three years HNZ has produced \$920 million, \$1,017 million, and \$752 million in free cash flow (before dividends). Accordingly, when taking into account the company's \$11.59 billion market cap and using a free cash flow average over the last 3-years of \$896 million, a price to free cash flow valuation of 12.93 is gleaned. As a quick reference, the same test applied to General Mills, Campbell Soup, and Kraft sees FCF valuations of 17, 22, and 16 respectively. Clearly, other things being equal, Heinz is a screaming cash flow buy.

But other things are not equal. Rather, Heinz has a current total net debt position (assets less equity) of more than \$9 billion. Moreover, it is going to take even more time before the acquisitions/divestitures fog clears. Point being, when you combine the company's aggressive dividend policies with an 11-14 times future free cash flow figure (using the company's 2006-2008 annual free cash target of \$800-\$1 billion) everything looks roses...but the stench of debt and restructuring is not disappearing anytime soon.

We believe that when the dust settles the cash flows from this food giant will still be there, and at an attractive multiple to market cap. And while many contend that Heinz is an attractive dividend investment or a future takeover target for a Kraft or Unilever, we are selecting Heinz as a long-term turnaround investment for the 2006 Wish List based upon attractive valuation prospects. We also believe investors could be well served by implementing a covered call strategy, although we do not regularly update our covered call opinions.

The Final Major Restructuring?

The three areas of focus today for Heinz are 1) Condiments and sauces, 2) Meals and snacks, and 3) Infant nutrition. The company's 15 'power brands' represented 64% of sales in fiscal 2005 (+7.1%).

% of Revs (Years ended)	27-Apr-05	28-Apr-04	30-Apr-03	1-May-02	2-May-01
Condiments and sauces	36.29%	36.22%	33.58%	35.18%	35.12%
Frozen foods	24.79%	23.15%	23.94%	26.26%	24.89%
Convenience meals	22.50%	22.27%	20.60%	18.97%	19.48%
Infant foods	9.60%	10.80%	10.58%	10.42%	11.65%
Other	6.82%	7.56%	11.29%	9.17%	8.86%

In fiscal 1999 Heinz announced its 'Operation Excel' program. Like all corporate restructurings, the company's aim was to focus on its strengths and get rid of its weaknesses. However, the terminologies and catch-phrases used were unique: For a total cost of \$1.2 billion (2001-10K) the company's 'multi-faceted' program established 'manufacturing centers of excellence', realigned management teams, invested in growth initiatives, sold underperforming business lines (notably Weight Watchers classroom business in Fiscal 2000), and focused its portfolio of product lines on six core food categories: "ketchup, condiments and sauces; frozen foods; tuna; soup, beans and pasta meals; infant foods; and pet products." On a less thrilling note, the company also reduced its headcount by 7,100.

When the OE dust settled the company claimed a pretax savings of \$70 million in 2000, \$135 million in 2001, \$185 million in 2002, and a forecasted \$200 million in 2003. Anyone capable of basic addition can see that the savings didn't justify the costs. For that matter, anyone can fire someone and claim savings. With OE not exactly a shining success, the company blamed unfavorable foreign exchange rates, missed savings targets from the consolidation of factories in Asia/Pacific, and the poor decision not to transfer certain European baby food production.

The next restructuring came in the fourth quarter of 2001, and was called "Streamline". This was the second major restructuring banner flown by new boss William R. Johnson (appointed in 1998). Thankfully "Streamline" left the verbiage of OE behind and cut to the chase: reduce costs. During this restructuring the company spun-off SKF Foods (to Del Monte), slashed more SKUs, and reduced headcount by 2,600 employees.

The latest restructuring effort was unveiled in August/September 2005, and has yet to be named. As with all restructuring (something food giants are always doing) the game is to *focus on strengths and get rid of weaknesses*. This time around the company has already exited its HAK vegetables and Tegel Food units (New Zealand poultry producer) and is looking to exit its European frozen-food and tuna businesses. The estimated proceeds from sales are expected to be around \$1 billion.

In hindsight, one of the main problems with all of these restructurings is debt. What about debt you say? Its still there! Over the last 10-years Heinz's revenues have gone nowhere while long-term debt has almost doubled. At the end of the fiscal 1999 the company had total liabilities of \$6.2 billion and - after two major restructurings mind you - total liabilities were more than \$8 billion at the end of fiscal 2003. The company touts its strong cash flows, but the fact is that debt has grown **faster** than cash flows. Thus, more cash coming in is relative – relative to what will need to be paid out at a later date!

With restructuring still fresh on the brain Heinz purchased majority stake in Petrosoyuz, the second-largest maker of ketchup in Russia (May 2005), and in August 2005 the company made the biggest acquisition in its history, paying out \$820 million for HP Foods. You have to wonder what is the point of operational excellence, streamlining, and cost cutting if at the end of the day the expected returns are not allowed to be reaped, but rather funneled back into more potentially risky acquisitions.

In short, the expectation from shareholders is that the company can find a mix of dominant product lines to build equity while drawing down debt. On this front there is reason for some optimism: the company's North American interests are performing strongly, the high price paid for HP (and popular Asian brand Amoy) should further the company's reach and dominance in condiments and sauces, and there is a pipeline of popular brands being integrated into the psyche of consumers by Heinz in places like China. Quite frankly, and forgetting about debt for the moment, the company is laying an impressive global footprint that should enable the company to lock in new growth opportunities at higher margin rates in the future. Not every developing market (Russia, Indonesia, China, and India) will be as profitable as the company's North American consumer business tomorrow mind you. But a potentially potent collection of global brands is being molded. Now, if only the restructuring can temporarily end...

Operating profits by region	27-Apr-05	28-Apr-04	30-Apr-03	1-May-02	2-May-01
NA Consumer Products	23.50%	22.96%	18.53%	24.01%	23.56%
U.S. Foodservice	14.95%	14.78%	14.57%	17.36%	8.78%
Europe	15.97%	19.44%	17.84%	19.34%	15.05%
Asia/Pacific	10.37%	11.62%	9.31%	7.84%	9.23%
Consolidated Totals	15.20%	16.39%	14.25%	17.07%	14.15%

Financially Speaking

After our lambasting of Heinz's restructuring prowess, or lack thereof, you may be wondering what is attractive about the company. Here it is:

HNZ - in thous \$	26-Oct-05	27-Jul-05	27-Apr-05	26-Jan-05	27-Oct-04	28-Jul-04
CFO quarter	227,567	165,916	654,647	126,584	193,382	186,180
Capex quarter	52,447	47,162	109,647	48,404	44,180	38,440
Divs quarter	101,386	104,208	99,617	99,730	99,552	99,970
FCF after dividends	73,734	14,546	445,383	-21,550	49,650	47,770
	28-Apr-04	28-Jan-04	29-Oct-03	30-Jul-03	30-Apr-03	29-Jan-03
CFO quarter	431,954	323,794	227,323	265,936	344,853	144,249
Capex quarter	112,144	44,980	45,240	29,597	61,720	28,706
Divs quarter	95,018	94,869	94,943	95,096	90,620	146,574
FCF after dividends	224,792	183,945	87,140	141,243	192,513	-31,031

Since the SKF spin-off on December 20, 2002 the slimmed down Heinz has produced free cash flow *after dividends* in every quarter but one (quarter ended Jan 26, 05). All told, the free cash flow tally since the last major restructuring is \$1.43 billion, or an average of \$130 million per quarter over the last 11-quarters. To note, this is not \$130 million the company earns per quarter before the current debt obligations are paid, but after!

We stress this figure because, in theory, when you combine this cash with the company's current \$877 million working capital figure, the future does not appear that ominous. In fact, by our calculations (assuming working capital is utilized and \$130 million free cash keeps coming in), the obligations below are challenging but manageable with *no growth*.

Contractual obligations (thous \$)	> 1-year	1-3 years	3-5 years	< 5-years	Total
Long Term Debt	543,868	302,672	327,394	3,297,305	4,471,239
Capital Lease Obligations	1,103	2,093	2,402	19,735	25,333
Operating Leases	79,836	249,363	62,813	189,107	581,119
Purchase Obligations	314,468	475,415	173,250	93,958	1,057,091
Other Long Term	85,465	166,119	151,565	170,303	573,452
Total	1,024,740	1,195,662	717,424	3,770,408	6,708,234
Funds available assuming no growth	1,401,027	1,422,953	1,273,957		

Unfortunately de-leveraging the balance sheet is the least of Mr. Johnson's worries. With more acquisitions and stock buy backs this year – not to mention another round of restructuring charges on the way – the above figures, *which are current as of April 27, 2005*, have been blown up. In the first two quarters of fiscal 2006 total debt is up by more than a billion dollars, and cash now stands at its lowest point since the SKF divestiture. Here is the company's balance sheet in all its dowdiness:

HNZ - in thous \$	26-Oct-05	27-Jul-05	27-Apr-05	26-Jan-05	27-Oct-04	28-Jul-04
Cash and equivalents	600,205	1,206,833	1,083,749	834,805	1,267,694	1,173,637
Total Current Assets	3,410,794	3,672,062	3,645,576	3,531,446	4,027,149	3,557,226
PP&E, net	2,172,446	2,107,740	2,163,938	2,125,560	2,093,062	2,051,651
Intangible Assets	3,901,447	2,904,301	2,961,726	2,886,496	2,828,006	2,769,723
Other non-current assets	1,658,025	1,695,214	1,806,478	1,409,365	1,499,762	1,381,886
Total Assets	11,142,712	10,379,317	10,577,718	9,952,867	10,447,979	9,760,486
Current Debt	2,533,100	2,285,404	2,587,068	1,814,933	2,580,074	2,249,770
Total Debt	9,051,113	8,183,249	7,975,145	7,631,977	8,282,355	7,793,257
Shareholders' Equity	2,091,599	2,196,068	2,602,573	2,320,890	2,165,624	1,967,229
Tangible Equity	(1,809,848)	(708,233)	(359,153)	(565,606)	(662,382)	(802,494)
	28-Apr-04	28-Jan-04	29-Oct-03	30-Jul-03	30-Apr-03	29-Jan-03
Cash and equivalents	1,180,039	1,016,166	848,696	804,734	801,732	824,117
Total Current Assets	3,610,796	3,609,028	3,456,619	3,224,421	3,284,320	3,463,338
PP&E, net	2,057,286	2,060,133	1,984,682	1,952,566	1,957,866	1,977,198
Intangible Assets	2,753,735	2,801,702	2,707,572	2,657,342	2,594,349	2,598,116
Other non-current assets	1,455,372	1,439,114	1,261,327	1,226,485	1,388,216	1,580,394
Total Assets	9,877,189	9,909,977	9,410,200	9,060,814	9,224,751	9,619,046
Current Debt	2,469,068	2,340,734	1,871,450	1,760,988	1,926,134	2,125,985
Total Debt	7,983,000	8,112,299	7,868,292	7,702,517	8,025,594	8,048,007
Shareholders' Equity	1,894,189	1,797,678	1,541,908	1,358,297	1,199,157	1,571,039
Tangible Equity	(859,546)	(1,004,024)	(1,165,664)	(1,299,045)	(1,395,192)	(1,027,077)

Surprisingly, the debt loads have not yet had a major impact on the company's income statement. Rather, interest coverage has actually risen since the first restructuring began, and stands at a respectable 2.66 (compared to other food giants). The same can not be said, however, for the company's working capital position, which is showing signs of strain, and is partially behind a recent debt downgrade from Fitch.

As for the income statement, consistency is the order of the day: revenues have increased by more than 5% in each of the last 7-quarters, and gross/net margins have, with little exception, stayed at effective levels for the company (35+% and 8+% respectively). EPS (on a diluted basis) may not be increasing as rapidly as many shareholders would like (which helps explain why the stock is down another 15% in 2005), but, as with cash flow trends, overall income statement trends are nonetheless positive.

I-Statement Highlights	26-Oct-05	27-Jul-05	27-Apr-05	26-Jan-05	27-Oct-04
Gross Margins	36.02%	35.72%	34.62%	36.26%	36.37%
SG&A as a % of sales	22.74%	22.39%	20.65%	21.68%	20.76%
Net Margins	8.71%	7.45%	8.43%	6.74%	9.05%
EPS per diluted share	0.60	0.45	0.58	0.43	0.56
	28-Jul-04	28-Apr-04	28-Jan-04	29-Oct-03	30-Jul-03
Gross Margins	36.88%	35.20%	37.16%	37.37%	37.30%
SG&A as a % of sales	19.92%	21.23%	20.21%	20.67%	18.89%
Net Margins	9.73%	8.43%	9.64%	9.16%	11.29%
EPS per diluted share	0.55	0.55	0.57	0.54	0.60
	30-Apr-03	29-Jan-03	30-Oct-02	31-Jul-02	1-May-02
Gross Margins	34.05%	36.20%	35.78%	36.57%	38.68%
SG&A as a % of sales	23.78%	20.92%	20.01%	20.48%	22.27%
Net Margins	4.68%	7.20%	10.10%	5.44%	18.72%
EPS per diluted share	0.29	0.43	0.60	0.28	0.63

Investment Opinion and Conclusions

Heinz's pension assumptions are overly optimistic (see 10K), the company's aggressive stock buy backs have proven to be a waste of capital, and the restructurings can be summed up best as never ending. Since HNZ shares have done nothing for more than 5-years, the argument could be made that management is oblivious to the company's sagging stock price. Ironically, the exact opposite seems true: aggressive accounting, buy backs (EPS manipulation), and restructurings to possibly groom the company as a takeover target are what management believes is required to increase shareholder value.

Other things being equal, we would stay away from Heinz because of these concerns. However, other things are not equal:

HNZ owns dominant global brands, shares are sitting at 52-week and nearly 10-year lows, the company is attractive from a free cash flow perspective, and the stock yields 3.5%.

In sum, we believe that HJ Heinz Company at \$33.84 a share is an attractive entry position. This is not an exact bottom call. We simply believe that it is worth picking at the vine at these price levels....

Sincerely,

Brady Willett

Todd Alway