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November 6, 2003

Interstate Bakeries Corporation

By Brady Willett & Todd Alway

Introduction

With a history of delivering fresh bread and cake products that dates back to 1927, to say that Interstate Bakeries owns brands that have staying power would be an understatement. To be sure, with the exception of 'Coke', it is difficult to think of two products - 'Wonder Bread' and 'Twinkies' – that are better known in American households. Owning these and other well known names affords IBC some degree of pricing power. However, the company, unlike Coke, is hardly impervious to the competition. Rather, as IBC struggles to return to profitability one statement, taken from the company's 2003 10K, rings louder than the company's brand names:

"*Economic downturns could cause consumers to shift their food purchases from branded products to lower priced items."*

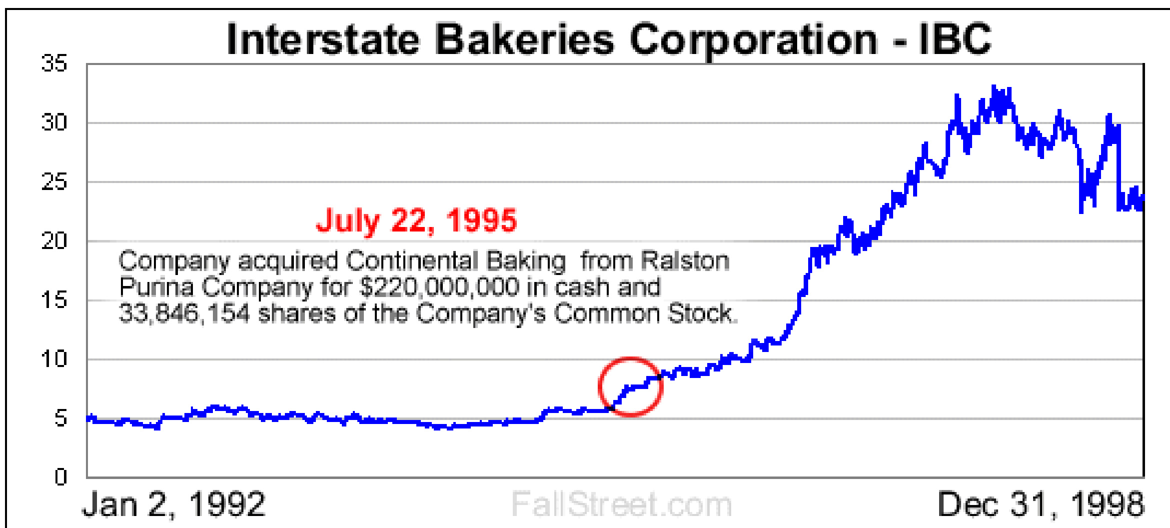
With this in mind – or after realizing that the margins and customer loyalty for 'Wonder Bread' are not as steady as those on Coke – looking beyond the company's brands to determine corporate worth is a worthwhile task. Indeed, simply knowing that IBC possesses some well-know brands means little until the long term and short term history of the company is better understood.

In short, and given our long-term investment orientation, IBC is generally attractive due to its brand longevity, historically consistent free cash flows, and dividend payouts. However, setbacks in recent quarters have hit the company's financials and stock price, making medium-term prospects questionable. In fact, these 'setbacks' could become long-term challenges for the company rather than medium term stumbling blocks. Like most prospective 'Watch List' companies, we believe that while IBC is a company worth monitoring for potential investment on weakness, it is not an attractive investment today. IBC shareholders need to be weary of being lulled into a false sense of brand security...

Early Success…

Incorporated in Delaware in 1987, IBC went public in July 1991. Since many of the company's best brands were acquired through a series of acquisitions after this point (notably the Continental Baking Company in 1995 (Hostess), and Drake's Baking Company and J.J. Nissen Baking Companies in 1998), using the 'in business since 1927' logo becomes less relevant. To be sure, IBC – a relatively new entity with only 12 years of complete financial information to draw on - is not as predictable an animal as say the popularity of HoHos.

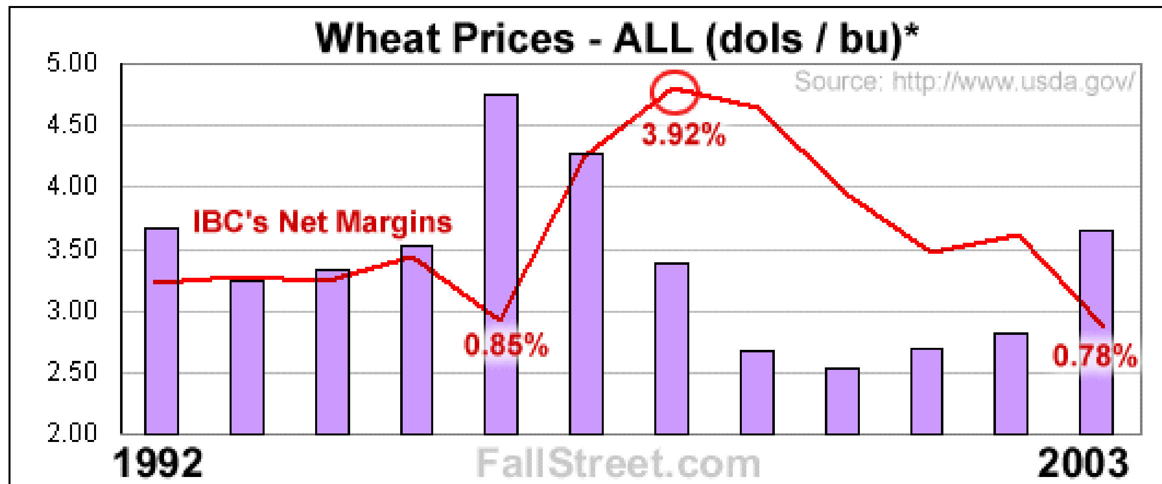
In the mid 1990s the company began to grow by leaps and bounds primarily due to acquisitions. For the three years ended May 1, 1997, revenues nearly tripled; from $1.14 billion in 1994 to more than $3 billion in 1997. These stellar gains -- arriving as asset growth outpaced growth in debt -- were the primary reason why the company's stock price rose to $33.20 in late 1997, or more than six times the low in IBC stock just 4-years earlier.



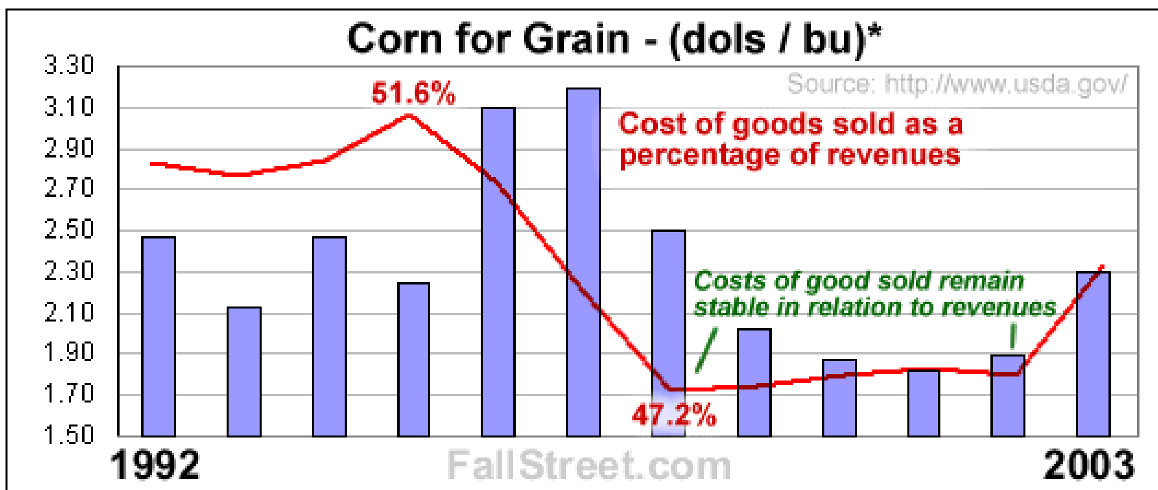
Suffice it to say, leading into 1998 IBC was a powerhouse: as revenues nearly tripled cash from operations more than quadrupled (from fiscal 1995-1998), and net margins went from an average of 1.3% (1993-1996) to 3.5% (1997-1999). All in the world seemed right.

…Costs The Company Dearly

Since peaking at $235 million in the year ended May 1998, IBC's operating income has sunk every year but one (2002) to a low of $83 million in 2003. Astonishingly, operating income has plummeted even as the company has reported an uptick in revenue and while two of IBC's primary commodities – wheat and corn – have remained in bear markets.



* Wheat prices represent average selling price in United States during IBC's fiscal year.

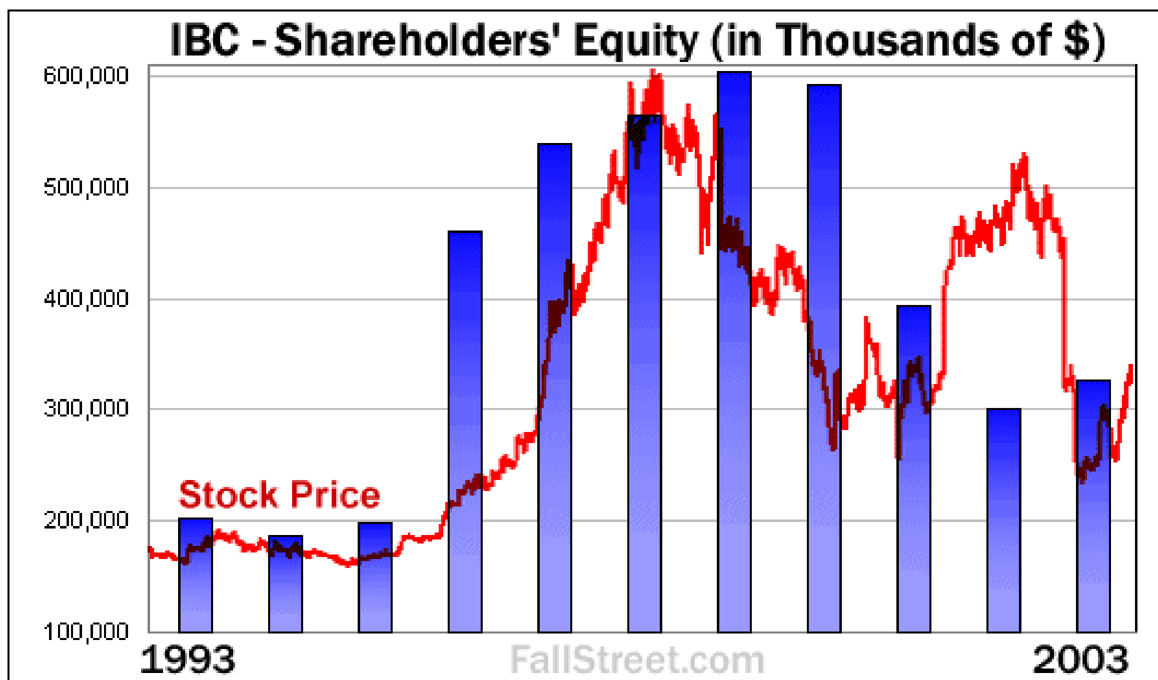


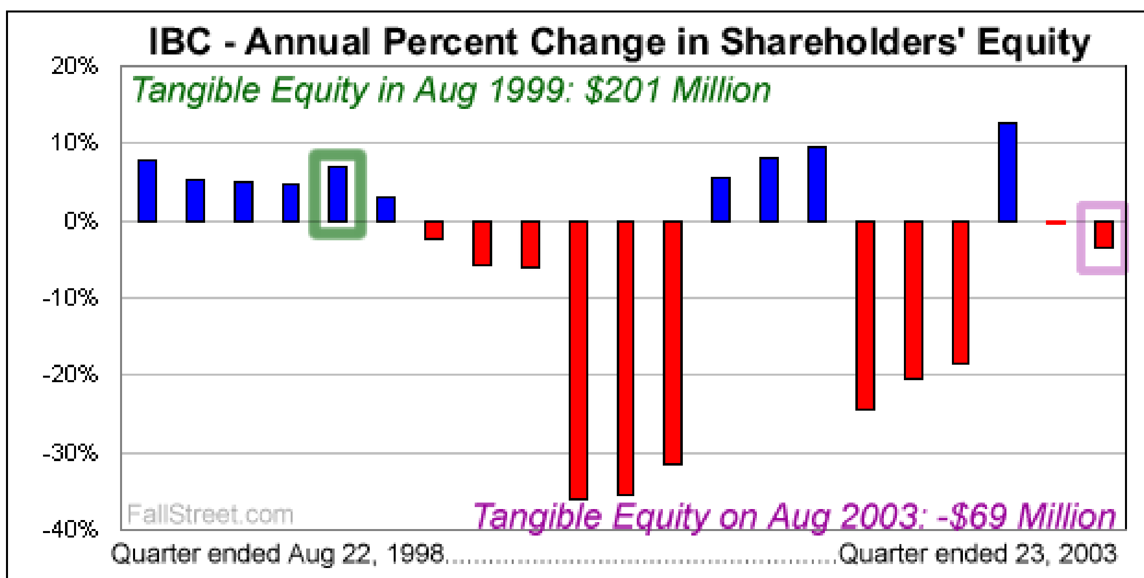
* Corn prices represent average selling price in United States for IBC's fiscal year.

As noted by increasing net margins (1997-98), the company originally reaped the benefits of falling wheat prices. However, and as a comparison to net margins and the 'cost of goods sold'/corn chart demonstrates, the company has had trouble simply maintaining rates of profitability even as material costs remain generally stable (1999-2002).

Suffice it to say, early successes following mammoth acquisitions have proven to be short term: since May 1993 total assets have appreciated by 180% while total debt has jumped by 240%. Much like escalating government deficits and a dwindling U.S. consumer savings rate, simple logic explains that such a trend in asset/debt growth is unsustainable.

The company's failure to generate sustainable improvements in shareholder worth is readily identifiable in the equity charts.

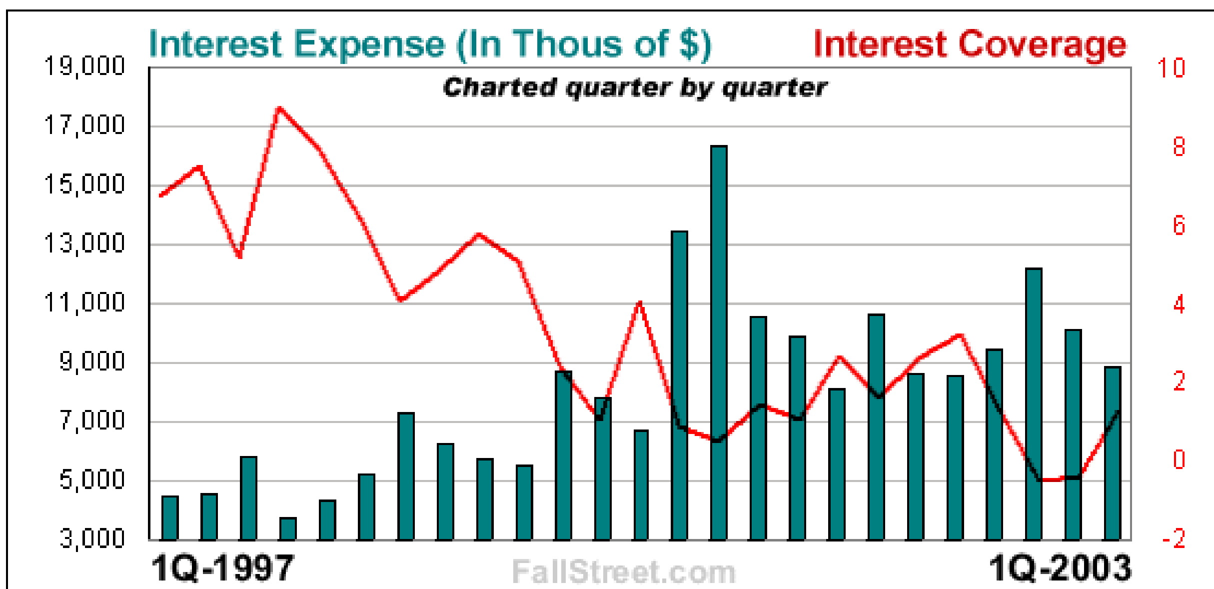




The first equity chart - which is telling of boom and bust in both IBC's equity and stock price – is placed into a better context when you consider the company's gargantuan stock issuance and purchases schemes (discussed below). Regardless, the second equity chart is telling of struggles: net equity has declined in 11 out of the last 15 quarters. Quite frankly, it is difficult to take a longer term investment approach when this near-term balance sheet carnage is occurring.

Problems Identified

The first notable problem with IBC's financials is the interest that the company is paying on its debt in relation to earnings. Escalating interest expense – which in fiscal 2003 nearly doubled net income – is the direct result of added debt loads not being readily contributory to earnings.



Why interest expense has risen and the company's financial performance has fallen is highly debatable. To be sure, management has focused on the company's inability to quickly centralize operations. However, other notables – including competing with its own brands via private label production, excessive management compensation, too many thrift stores, and reliance on premium brand price increases (rather than improving cost efficiencies) for better performance – also appear to be participatory causes of corporate slippage.

Even so, while the specific problems hounding IBC's performance are more than onerous, the sole issue at hand is one of execution. Much like management's 'centralized vs. decentralized' mantras, the word 'execution' is little more than a vague buzz word. However, 'program SOAR' (an acronym for Systems Optimization And Re-engineering) - the company's major

restructuring initiative – was only enacted earlier this year. That the company took so long to aggressively respond to financial degradation is certainly indicative of an inability to execute with any kind of vigor.

Problems Ignored

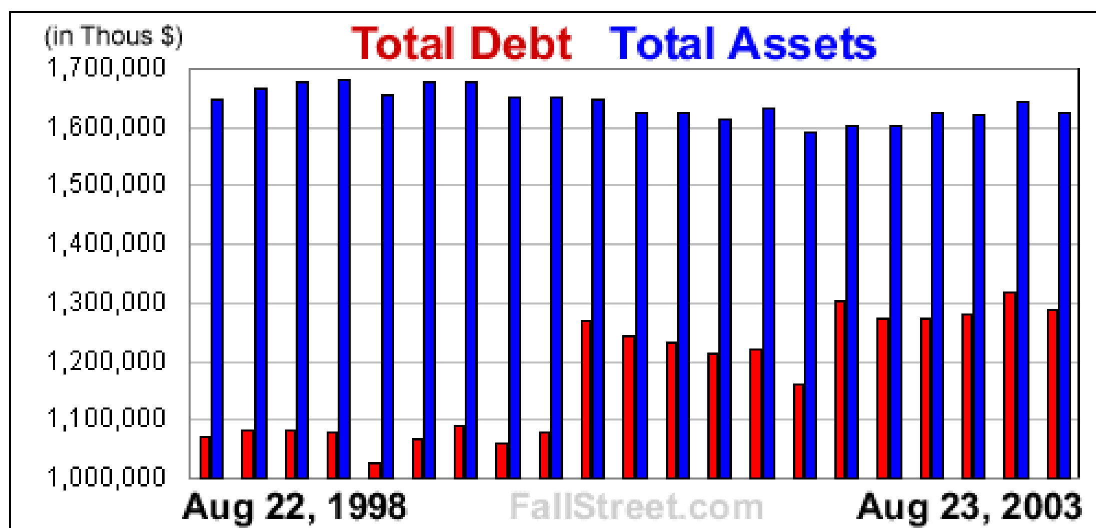
IBC's investor relations jockey, Mr. Paul Yard, states that interest expense has risen in recent years because the company acquired debt to repurchase IBC shares from Ralston (now Nestle Purina). Upon query, Mr. Yard elaborated that the company was under no pre-arranged obligation to purchase IBC shares from Ralston. As he put it, these buy backs were orchestrated more to combat dilution, and were not related to Ralston's July 29, 1997 'SAILS' issue. To simplify, IBC issued debt to repurchase shares. However, rather than benefiting from this action the company is paying for it today via increased interest expense (on the debt), and balance sheet degradation.

Not surprisingly, the company did not agree with our point of view. In fact, the mindset of former IBC CEO, Charles Sullivan remains intact today. Before disputing the company's claim that buybacks have not hurt the company, consider the party line from Sullivan:

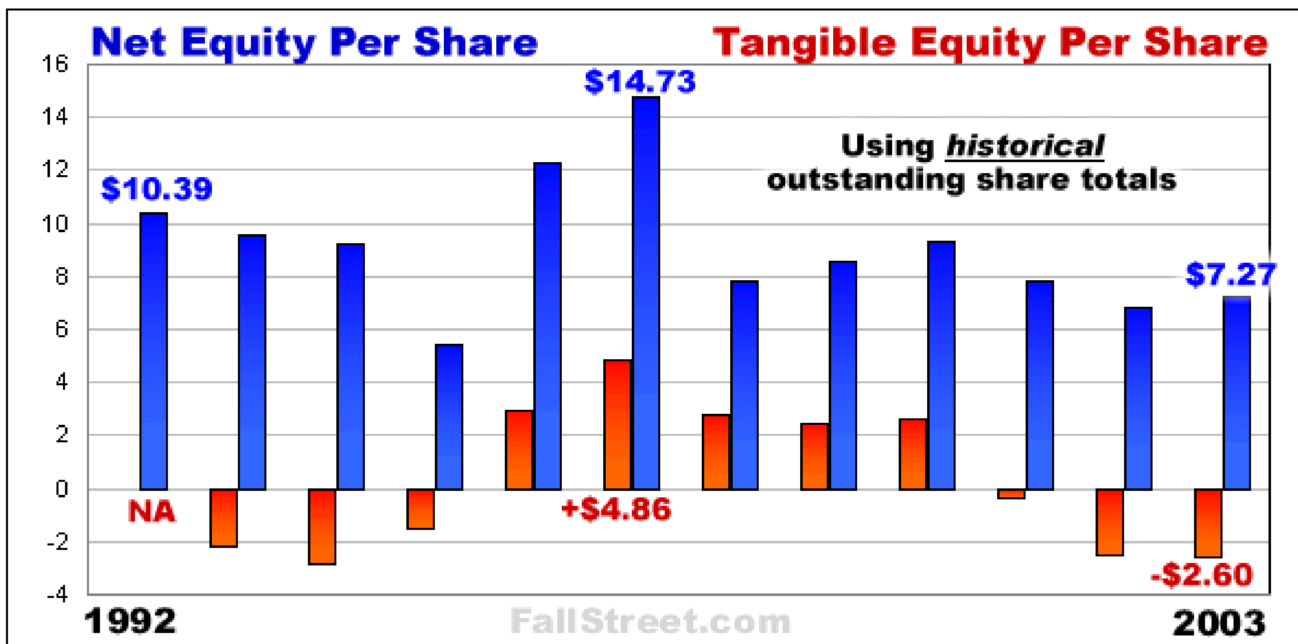
"In April 2002, IBC purchased 7,348,154 shares of the stock at a price of $21.50 per share for a total purchase price of approximately $158,000,000. During the following month, we assisted Nestlé in an underwritten public offering for the final 7,500,000 shares of our common stock at a price of $25.75 per share. Even though IBC did not receive any proceeds from the sale of these shares, ***significant benefits were achieved.*** *We added several major new investors to IBC, removed the market's uncertainty regarding this large block of shares and improved the overall market liquidity of our stock."* *2002 Annual Report.*

Given that IBC shares are below $15 a share today and that the added interest expense incurred from repurchasing shares are adding to the company's negative working capital position, one has to wonder what the 'significant benefits' from these and other buy backs were. Well, by squandering shareholder money on buy backs, management was able to keep the market liquid enough to absorb their insider sales…

Regardless, the chart that best identifies IBC's woes is one that offers a long-term look at total debt and total assets. The data pictured in this chart, Mr. Yard rebukes, does not take into account the company's aggressive stock buy backs. Fair enough - it is certainly true that if the number of pieces of pie outstanding decreases that each slice's net worth can increase, other things being equal.

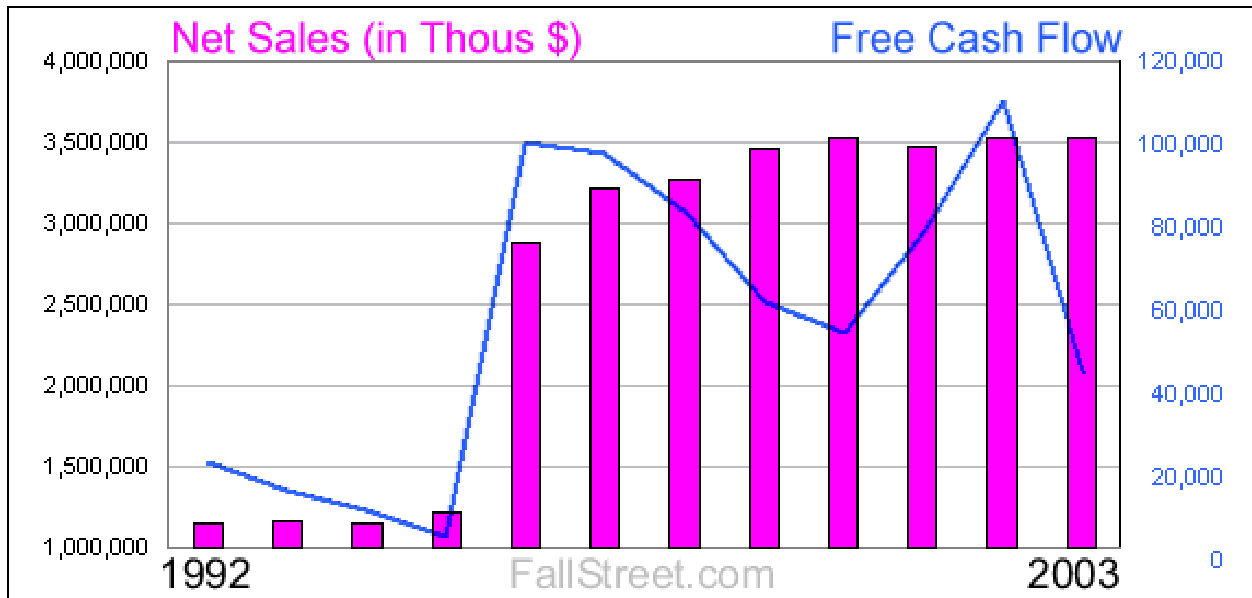


However, another chart – an adjusted look at net/tangible equity using historical share totals, quickly disproves Mr. Yard's theory. To be sure, what the adjusted figures confirm is that acquisitions and buy backs since 1995 (CBC) have not added wealth to the balance sheet.

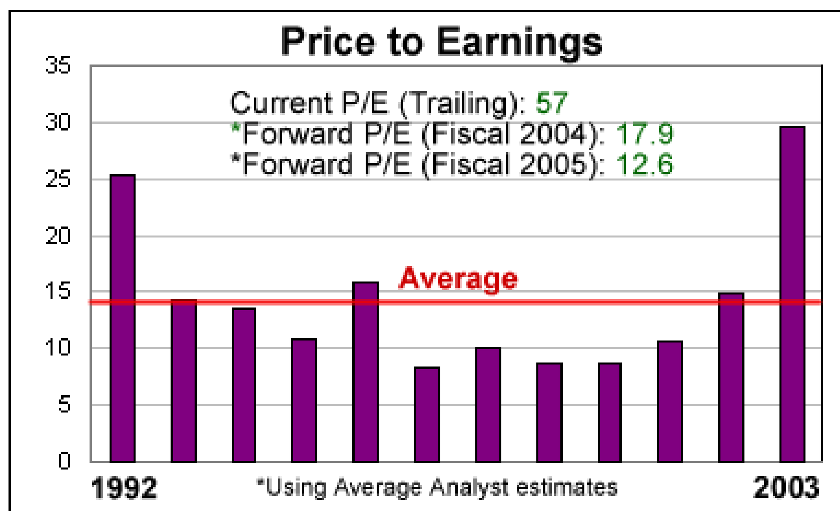


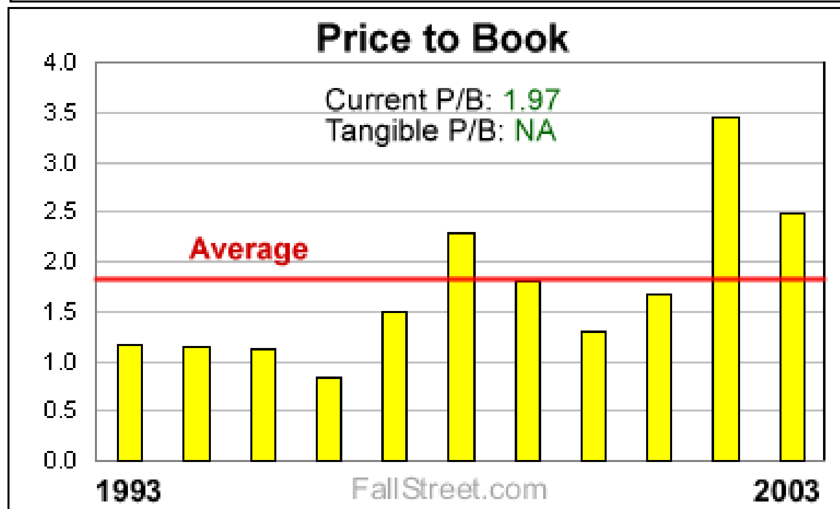
Historical Stock Premiums

While IBC's balance sheet has yet to show the benefits of the company's 1990s acquisition binge, gains in revenues were immediately realized and sustained (although not necessarily greatly improved upon mind you). Moreover, despite the fact that IBC posted its worst 'cash from operations' number in 2003 since before the acquisitions began ($156 million), CFO is still more than triple the level it was at in fiscal 1995 (as is Free Cash Flow).



If, at some point in the future, it can be concluded that IBC has made enough changes to thwart balance sheet deterioration, pinpointing a purchase price for IBC using historical valuation observations would nonetheless remain extremely difficult to do. Quite frankly, and here is where our long-term opinion takes over our medium term concerns, at less than 2 times book IBC shares are not exceptionally 'overvalued' today.





In fact, beyond earnings concerns (the optimistic forward P/E multiples assume the worst is over), IBC shares are attractive on a p/s and p/fcf basis.

Outlook & Conclusions

Expanding upon SOAR – an 'internal review' which the company forecasts will amount to a 3-year $55 million technology

investment – IBC announced to 150 company managers at a two-day meeting in Kansas City on September 29 and 30, 2003 that "You are present at the creation of a new IBC". Call us pessimists, but the changes put forth by the company to date are nothing 'new'.

Our pessimism surrounding the new IBC stems from the fact that management is touting a culture change more so than looking at quantifiable ideas. Quite frankly, the concept of moving from a "decentralized to centralized" business model, taking the 'best practices' from within IBC and implementing them across IBC, and investing in new technology, does not shed light on how successful IBC will become tomorrow. In fact, what the announced changes make us do is ask why non profitable bakeries and thrift stores were left open to begin with (whether they were decentralized, centralized, or buried underground), and why unprofitable business practices (or 'the worst' business practices) were not immediately eradicated.

The company expects SOAR to add to cash flows by the end of fiscal 2005, but does not explain exactly how or why. For a comparison, reading the 2002 Annual report is helpful - when Sullivan touted ESL (extended shelf life) capabilities as being the main reasons why margins were rebounding (the tiny rebound in margins lasted for a couple of quarters). This time around, CEO Elsesser is touting yet another restructuring plan:

"Our entire management team is committed to this restructuring plan. Its purpose is to make us more nimble, more consumer and customer focused, **more cost conscious** and, we hope, more profitable." CEO, Elsesser. Oct 16, 2003.

One term – '**more cost conscious' –** is ultimately what we believe the company should be focused on. This could mean more layoffs, less stock option issuance, plant closures, battles with unions, somehow reducing employment retirement benefits, etc….but it all means changing the cost structure of the business rather than trying to change the attitudes of employees.

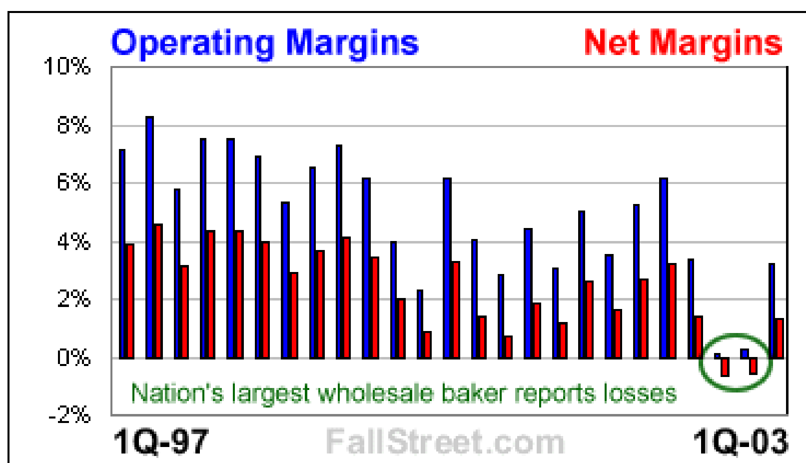
To be fair, thanks to a recent jump in commodity prices (primarily sweeteners, cocoa, edible oils and natural gas) and escalating employee expenses (medical, retirement) IBC's cost cutting endeavors to date have gone unrewarded.

In sum, how does a company that generated $623 million and $632 million in net earnings and free cash flow respectively since 1996 lose $140 million in net equity during this same time frame? IBC blames debt backed stock repurchases, yet the company had 37 million outstanding shares versus 44 million today…

IBC does not expense stock options, the company is active in commodity and interest rate derivatives, and negative working capital is threatening to become a company trademark (on a quarterly basis working capital has been in the red since quarter end August 2000). We are worried about one thing at the moment: the balance sheet – we are not worried about people continuing to purchase and enjoy Wonder Bread.

Notwithstanding what could turn out to be a long and arduous rebuilding process – a process that may ultimately see a smaller more focused IBC selling its best products and improving its balance sheet – we believe the company will succeed. Nevertheless, with change comes uncertainty; something we do not believe that the company's stock price is fully reflecting yet. In our opinion, paying anything above book value could prove dangerous.

The peculiar trend of stable revenues, stable material costs, and falling net margins began many years ago at IBC. With two quarterly losses now in the books and IBC's balance sheet stressing, the company is finally beginning to take notice.



Sincerely,

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