**General Mills (GIS - $55.06)**
**1/16/08**

**Intrinsic Value $69**
**Buy Now, Recommend for all accounts**

**Summary** – I believe General Mills is a good short-term defensive holding with compelling long-term value for patient, buy and hold type investors. While higher commodity prices may hold the stock price in check for the next several quarters, I believe GIS is in excellent position to at least maintain its margins in the face of higher input costs. Plus, food stocks in general tend to hold up well during U.S. economic recessions. The stock also has a better than average dividend yield (2.8% vs. 2.0% for the S&P 500), and I believe GIS shares have ~25% total upside potential.

**Background** – General Mills is known primarily for cereal (Cheerios, Wheaties, Lucky Charms), but cereal represents just 16% of total sales. They have other brands such as Betty Crocker, Pillsbury, Green Giant, Haagen-Dazs, and Old El Paso. The company generates just 10% of its operating profit outside the United States, but its international segment has been growing at a double digit % clip the last four years.

**Recent Stock History** – GIS has traded within a fairly tight band the last 12 months, ranging from $54.17 to $61.52. The stock is off from its 52-week high because of concerns over higher commodity costs, and expected negative reaction to its "Right Size, Right Price" initiative, where it shrank packaging sizes last summer. However, as I explain below, I believe GIS has the ability to absorb these higher input prices, and reaction to the reduction in its package sizes appears to have been overblown. Retailers have reported very little negative backlash from consumers because of the smaller package sizes.

**KEY INVESTMENT CONSIDERATIONS**

**A Good Defensive Holding** – Business Week magazine reported that food companies in general lost just an average of 2.3% during the last ten recessions, making it the fourth best performing industry over that time. Even with this negative return, food companies outperformed the broader U.S. equities markets in nine of the last ten recessions. GIS has very stable (and growing) cash flows.

**Returns on Invested Capital Should Improve** – GIS' return on capital of 4.9% trails its weighted average cost of capital of 6.6%, but I expect this to reverse in the coming months. Management began focusing on ROIC in 2006, and its goal is to increase ROIC by 50 bps each year. They are now more stringent in how they allocate capital, and they are shedding underperforming brands. EBIT margins fell from 18.3% in 2002 to 16.9% in 2006, but I believe this was in large part from the prolonged integration of Pillsbury, with whom GIS merged in 2001. That is now complete. For example, they are now operating at pretty much full capacity at their various production facilities in the U.S. EBIT margins were 17% in 2Q07 and 19% in 3Q07, even in the face of rising input commodity prices.

**General Mills Has the Ability to Fight Higher Commodity Prices** – JP Morgan's food analyst wrote a note last week in which he predicts grain prices will continue to hurt cereal makers like GIS, and that created some negative buzz for the stock. The analyst estimates that grain prices will increase 44% in 2008, and grain is ~22% of GIS' cost of goods sold. The USDA just took up its grain price forecast for 2008 as well. Management fully expects commodity prices to rise, yet it still reiterated its F2008 EPS guidance of $3.39-$3.43 during its mid-year update conference call on 1/11/08. I believe GIS can continue to increase to fight off higher commodity prices, for the following reasons:

- It has hedged roughly 85% of its input costs for 2008.
- Higher capex in calendar year 2007 should translate into productivity gains in calendar year 2008.
- There has been very little negative reaction to its "Right Size, Right Price" initiative from last summer, which held prices flat, but reduced packaging sizes, thereby increasing unit prices. They can also hike up absolute prices, and they plan to be aggressive about doing so to keep up with unhedged commodity price increases. So far, there has been little resistance to higher prices at the retail level.
- GIS introduced 200 new products in F1H08, and have another 140 ready to go in the F2H08. These are higher margined products, on average. Plus, they are eliminating slower growing, lower margin brands. New products are expected to be ~3%-4% of sales in FY08.
- Their international business, though small at just 10% of operating profit, is growing at very high rates. It has posted double digit percentage operating profit gains in each of the last four years.

**Increased Focus on Marketing & Product Development** – GIS also began ramping up its marketing efforts in early 2007, and it stepped up its R&D spending in 2005. That's what has led to the new product introductions so far in FY08. Management plans to continue increasing its R&D budget going forward.

**General Mills' Market Share is Down Slightly, But Not to The Detriment of Margins** – In its Mid-Year FY08 update on 1/11/08, GIS revealed it has lost a slight amount of market share in its U.S. retail portfolio (~69% of total sales) the last couple of quarters, although I don't have the actual data to quantify this. Cereal is the main driver behind this, and cereal is GIS' core product, but it accounts for just ~16% of total company sales. This is certainly something to monitor over time, but I'm not too concerned with it short-term, for the following reasons:

1.) From what I gather, slight changes in short-term market share are quite common in the food industry.
2.) Roughly 40% of their business is not included in the market share ratings. These tend to be newer products that are higher margin, and are growing more quickly.
3.) It is also likely at least some of the underperforming brands they have been discontinuing are no longer in the figure. That is a consequence of focusing on improving margins, which GIS has been successful in doing, and which is much more important than maintaining a few bps of market share.

**Higher Wholesale Prices Could Really Boost Margins Later** – One very important medium to long-term driver is that the higher prices GIS will likely charge this year should not only preserve margins near-term, but also drive margins potentially higher longer-term. The reason is that it would take a pretty aggressive price war to lower prices in the future, and I do not believe that would happen. That could lead to higher margins when commodity prices eventually start to gravitate toward more normalized levels, which I expect they will.

**Valuation**

- The stock seems undervalued no matter how I slice it.
- The current stock price assumes just a 1.3% growth in future cash flow, yet I think GM can easily achieve 4% annual cash flow growth going forward. Stated differently, the market assumes its EBIT margins will fall from their current 18%+ levels to <15% in the future. But once again, I believe the lower margins of the last five years, which bottomed at 16.9% for 2006, were primarily the result of the Pillsbury integration, which is now largely complete. Also, food is a pretty inelastic market, so there should not be significant margin erosions over the long-term.
- My DCF intrinsic value estimate is $69, based on very conservative assumptions (see attached).
- GIS is trading below its 5-year median price and enterprise multiples across the board, but is essentially trading right at its median 5-yr NTM P/E multiple of 15.9x. High commodity costs will likely keep short-term margins and EPS growth in check, which in turn will likely prevent investors from giving GIS a higher NTM EPS trading multiple, at least for the next couple of quarters. GIS tends to trade in a very tight trading range, and getting to the top of that range would make GIS just a $64 stock. So I think GIS will have to show continued EPS growth to eventually reach my $69 price target, hence my assertion that GIS is more appropriate for patient, long-term buy and hold type of investors.

**Other Positives/Notes**

- Buying back shares
- 2.8% dividend yield, and has been ramping up dividend growth rate the last couple of years. GIS increased its dividend twice in 2007.
- Debt/total cap is pretty high at 58%, but debt coverage ratios are fine, and management plans to pay down debt over the next few years. Whether it actually does is another story, but it is a focus point.

**Risks**

- The biggest risk is that input commodity prices spiral out of control, and/or management cannot pass along higher input prices.
- If consumers are slow to adopt their new products.
- If recent losses in its U.S. cereal market share turn out to be the start of a trend, rather than a short-term hiccup.

**General Mills - 3 Stage Discounted FCF Model**

| | Stage 1 (Yrs 1-5 | Yrs 1-5 From Output | Stage 2 (Yrs 6-10 | Terminal Period (From Below) |
|---|---|---|---|---|
| 5-Yr Sales Growth Rate | 4.5% | 4.5% | 3.5% | |
| EBIT Margin | 17.5% | 17.5% | 16.5% | |
| Cash Tax Rate | 35.0% | 35.0% | 35.0% | 35.0% |
| Cap Ex as % of Sales | 5.0% | | 4.5% | |
| Working Cap As % of Sales | 1.0% | | 1.0% | |
| % Other Net Liabilities as a % of Sales | 0.0% | | 0.0% | |
| Imputed Growth Pre-Tax Op Inc from Model | 3.9% | | 2.3% | |
| ected Growth in Pre-Tax Op Inc From 2007 ROE & 5-Yr Avg Reinvest Rate | 0.1% | | | |

| | Faster Growth Period | | | | | | Slower Growth Period | | | | | Terminal Year |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | **2007** | **2008** | **2009** | **2010** | **2011** | **2012** | **2013** | **2014** | **2015** | **2016** | **2017** | **2018+** |
| Sales | 12,890 | 13,256 | 13,819 | 14,310 | 14,954 | 15,627 | 16,174 | 16,740 | 17,326 | 17,932 | 18,560 | |
| Pre-Tax Operating Profit | 2,256 | 2,166 | 2,322 | 2,508 | 2,617 | 2,735 | 2,669 | 2,762 | 2,859 | 2,959 | 3,062 | 3,170 |
| | **2007** | **2008** | **2009** | **2010** | **2011** | **2012** | **2013** | **2014** | **2015** | **2016** | **2017** | **2018+** |
| After Tax Earnings Before Interest & Taxes (EBIT*(1-t)) | 1,466 | 1,408 | 1,509 | 1,630 | 1,701 | 1,778 | 1,735 | 1,795 | 1,858 | 1,923 | 1,991 | |
| Add Back After Tax Cost of Operating Leases | 62 | 62 | 47 | 47 | 14 | (8) | (8) | (8) | (8) | (8) | (8) | |
| Depreciation (Assumes grows with cap ex) | 418 | 451 | 486 | 521 | 559 | 598 | 634 | 672 | 711 | 751 | 793 | |
| Amortization | | | | | | | | | | | | |
| Increases in Deferred Liabilities (Assets) (IMBEDDED IN CASH TAX RATE) | - | - | - | - | - | - | - | - | - | - | - | |
| Cap Ex (Cap Ex plus acqs less disposals) | (517) | (663) | (691) | (715) | (748) | (781) | (728) | (753) | (780) | (807) | (835) | |
| Change To Working Capital | (245) | (126) | (131) | (136) | (142) | (148) | (154) | (159) | (165) | (170) | (176) | |
| Increase in Net Other Liabilities | - | - | - | - | - | - | - | - | - | - | - | |
| Free Cash Flow | 1,185 | 1,133 | 1,220 | 1,347 | 1,384 | 1,438 | 1,480 | 1,547 | 1,617 | 1,689 | 1,764 | 1,826 |
| Terminal Value | | | | | | | | | | | | 37,949 |
| Discounted FCF | | 1,063 | 1,074 | 1,112 | 1,072 | 1,045 | 1,009 | 990 | 970 | 951 | 932 | 20,046 |
| Simple Non-Growth Buffett DCF/Sh | $51.40 | $49.15 | $52.93 | $58.44 | $60.05 | $62.39 | $64.20 | $67.13 | $70.16 | $73.30 | $76.55 | |
| Net Cash/Sh | (13.53) | (13.53) | (13.53) | (13.53) | (13.53) | (13.53) | (13.53) | (13.53) | (13.53) | (13.53) | (13.53) | |
| Est Value/Sh (Futures Years Are Not-Discounted) | $37.88 | $35.62 | $39.40 | $44.92 | $46.53 | $48.86 | $50.67 | $53.60 | $56.64 | $59.78 | $63.02 | |
| Free Cash Flow | 1,185 | 1,133 | 1,220 | 1,347 | 1,384 | 1,438 | 1,480 | 1,547 | 1,617 | 1,689 | 1,764 | |
| Estimated Interest Payments | 311 | $310.72 | $310.72 | $310.72 | $310.72 | $310.72 | $310.72 | $310.72 | $310.72 | $310.72 | $310.72 | |
| Distributable Cash Flow | $873.85 | $821.95 | $908.96 | $1,036.11 | $1,073.21 | $1,126.98 | $1,168.79 | $1,236.31 | $1,306.20 | $1,378.54 | $1,453.40 | |
| Estimated Dividends | $539.20 | $539.20 | $539.20 | $539.20 | $539.20 | $539.20 | $539.20 | $539.20 | $539.20 | $539.20 | $539.20 | |
| Dividend Coverage | 1.62 | 1.52 | 1.69 | 1.92 | 1.99 | 2.09 | 2.17 | 2.29 | 2.42 | 2.56 | 2.70 | |

| | | |
|---|---|---|
| Total Discounted FCF | | 30,264 |
| Current Diluted Shares Outstanding | | 350 |
| FCFF per share | $ | 86.54 |
| Plus: Cash & Investments | $ | 1.77 |
| Plus: Equity Investments Per Share | $ | 0.84 |
| Plus: Other Non-Cash Flow Generating Assets Per Share | $ | - |
| Less: Debt Per Share | | 14.81 |
| Less: Minority Interest Per Share | | 0.69 |
| Less: Preferred Shares Per Share | | 0.00 |
| Less: Underfunded Pension Obligations Per Share | | (0.71) |
| Less: Equity Options Per Share | | 2.88 |
| Less: Expected Litigation Expense Per Share | | 0.00 |
| Less: Off-Balance Sheet Debt Per Share | | 0.67 |
| FCFE per share | $ | 70.82 |
| 10-Year Cumulative Bond Default Probability | | 3.0% |
| **FCFE per share (levered beta)** | **$** | **68.70** |

Reinvestment rate required to achieve stable growth in terminal period: 71.4%