Off Wall Street

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New Rec: Tyson Foods (TSN: $14.77) August 7, 2012

Position: Buy **Target: $20**

$ooo	Q212	Q312	Q412e	Q113e	2012E	2013E	2014E
Rev	8,268	8,308	8,398	8,512	33,303	34,453	35,510
EPS$	0.45	0.51	0.40	0.18	1.78	1.42	2.02
Y/Y	10%	15%	86%	-58%	-4%	-20%	42%
PE	n/a	n/a	n/a	n/a	8.2	10.3	7.2
PSR	n/a	n/a	n/a	n/a	0.2	0.2	0.2
Cons.	n/a	n/a	n/a	n/a	1.80	n/a	n/a

Shares Out: 362M **Market Cap: $5.1B** **FYE: September**

Concept:

1. TSN shares have sold off sharply amidst the worst US drought in 56 years. TSN is cheap at 0.9x BV and 4.4X EBITDA; far below historical averages.
2. ~60% of TSN's chicken volume under flexible contracts that enable pricing/cost sharing.
3. Chicken producers will need to reduce production, creating room for prices to increase

and margins to progressively normalize. TSN is the low-cost producer.

4. TSN's wide product diversification should provide a defensive advantage in any downturn, and positions TSN to gain share vs. weaker competitors.
5. The balance sheet has improved markedly since 2008. Net debt/EBITDA is <1x

Summary: Tyson Foods (TSN) is one of the world's largest meat protein companies. It operates a vertically integrated poultry production business, and is a leading processor of live cattle (beef) and hogs (pork). It also has a growing prepared foods division, and is the largest supplier of pizza toppings. TSN products are sold to myriad retail and foodservice customers. The company is a dominant player in all four businesses. Worldwide demand for beef, chicken and pork is growing, the result of emerging middle classes and rising incomes.

TSN shares have declined markedly amidst the worst U.S. drought in 50 years, which has led to surging prices for corn and soy meal, the key ingredients for livestock feed. The suddenness, persistence, and broad geographic reach of the current drought has left TSN (and the entire protein industry) vulnerable to near term cost shocks. From a price of \$5.60/bushel in early June, the price of corn has surged to ~\$8 for the nearby contract, an increase of 40%. Like most producers, TSN had anticipated a record grain harvest as recently as May, based on USDA estimates. Thus, it maintained a light hedge program. It is currently covered through September, after which it will begin to lose money in chicken at current spot prices. Using current spot commodity prices, we estimate the all-in cost of raising a live chicken has increased by roughly \$0.10/lb to \$0.51/lb, an untenable situation for chicken producers.

Investors appear to have two concerns regarding TSN. The main concern is that surging grain prices will result in substantial losses in poultry (34% of sales). A secondary concern is that an accelerated cattle slaughter (due to dry pastures and uneconomical feed costs) could result in a scarcity of live cattle in calendar 2013/2014, leading to higher input costs for TSN and reduced consumer demand for beef. In the report that follows, we argue that while both concerns are valid, they should be problems that TSN can easily withstand, and TSN could possibly emerge from the situation in an even stronger position relative to its competitors. Thus, we recommend that investors begin to build positions in TSN shares now, as we think the concerns are mostly discounted into the share price.

In the coming months, chickens will begin to consume the higher priced grain feed, at a time when seasonality of chicken prices begins to weaken. This will cause producers to lose money at current prices for most cuts of poultry. However, if grain prices remain elevated, industry supply should begin to decline, and prices should increase, as they have in the past, to re-establish industry profitability. Whether this takes 1 quarter or 3 quarters depends on how much pain industry participants are willing and able to withstand in the interim. Industry contacts have told us that the major agricultural lenders are no longer extending credit to smaller producers as they had done in the past. As the low cost producer with a pristine balance sheet ($828M in cash and $1.8B in total liquidity), and ownership of its feed mills, TSN appears to be well positioned relative to its competitors.

High grain prices are not necessarily bad for TSN, in the long run. In fact, elevated prices could actually give it an advantage over smaller competitors that lack the same cost efficiency. It is the severe price swings that impact earnings the most. We also note that industry production is down roughly 5% ytd, which should add some support to prices, and we would expect further production cuts from marginal producers should grain prices remain elevated, as we expect. Interestingly, TSN has increasingly become a net buyer of chicken parts (mostly breast meat) on the market, when prices enable it to make an attractive spread on further-processed products (breaded tenders, nuggets etc.). Recently, it has been buying chicken at below its production cost. This enables it to maintain tight production, while avoiding exposure to oversupplied chicken parts. Moreover, more than 50% of TSN's poultry volume is tied to contracts that adjust in various ways to account for increased grain prices. Its customers also realize that if supply eventually gets rationalized, it could be difficult to access the high volumes that only a top producer (like TSN) can deliver. This should benefit TSN's price negotiations.

There is also concern about future cattle supply. Given the recent spike in feed costs, as well as severely dry pastures and scarce hay and water supplies, ranchers have been accelerating delivery of cattle to auction, opting for discounted cash upfront, instead of enduring feed driven losses. This has resulted in a flood of cattle supply and reduced wholesale prices (input costs) for TSN. However, depending on the degree of the slaughter (and the number of heifers retained), a cattle shortage could emerge sometime in the latter part of 2013, since the time to raise cattle to full weight is ~3 years. This could result in increased cattle prices (higher input costs), which TSN would need to pass along to customers, and ultimately to consumers who could reduce their beef consumption. As we discus in the report, however, we think consumer demand will remain stronger than is generally anticipated in the face of increasing beef prices, enabling TSN to generate a reasonable margin. We also note that TSN's beef processing facilities are strategically situated near the largest feedlots, providing ample supply as well as a key freight cost advantage. In fact, higher beef prices should be good for TSN over time as it could generate greater gross profit dollars. High beef prices should also create room for chicken prices to increase.

TSN's diversified multi-protein model is a key differentiator vs. other meat producers, and should provide added protection against negative external pressures, as weak earnings in any one of TSN's four business segments should not overwhelm profits from the other divisions. Its strong export sales and growing international production should provide additional diversity. However, even if total operating earnings were to become temporarily depressed, there are several potential offsets to help mitigate the impact. TSN's balance sheet has improved markedly since 2008, as it used strong cash flow to reduce debt and refinance existing debt at more favorable rates. Net debt/EBITDA is just 1X, compared to 3.5X in 2008. Interest expense continues to decline rapidly, and total liquidity is $1.8B. The strong balance sheet should enable TSN to ride out any spike in grain prices without having to cut production. TSN has also been exceptional at reducing costs. In the chicken division, TSN has reduced the cost structure by $920M over the past 4 years and anticipates another $100M in reductions over the next year. When the poultry cycle eventually turns up, TSN's profits could surge. Lastly, TSN has repurchased 5% of outstanding shares over the past year, which should provide additional offset to potential declines in EPS.

TSN has spent heavily on capex in the past several years ($2B in the past 3 years), well above its 10-year average, and substantially greater than its depreciation expense. Capital has been directed primarily to productivity-enhancing projects as well as expanding production outside the US, much of which remains in the ramp-up stage, and is thus masking current profitability. TSN has a relatively small, but rapidly expanding chicken operation in China, where it is well positioned to serve the large and growing premium QSR and retail industries. TSN is also expanding vertically-integrated chicken production in Brazil and Mexico. Capex should decline significantly in FY2013 and 2014, resulting in improved cash flow.

TSN possesses substantial competitive advantages. These include product quality, food safety, and grain procurement and production efficiency. We also think investors are ignoring the enormous intangible value in TSN's supply chain, including the advantageous geographic footprint of its processing facilities. Its sheer scale enables TSN to guarantee delivery of large quantities of product, which is important to major customers, especially ones that are expanding or running promotions. This helps TSN obtain price increases when input costs rise.

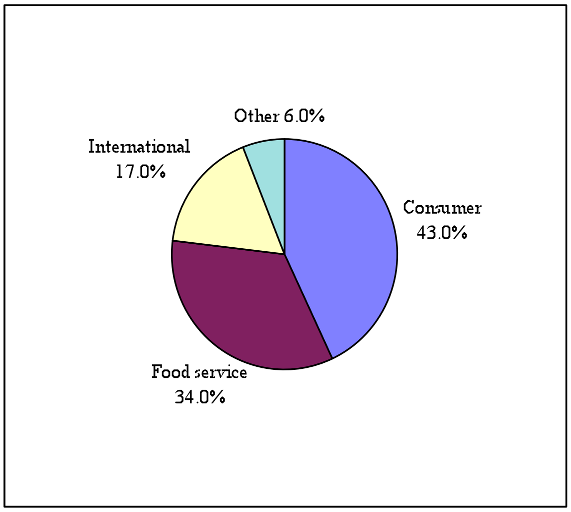
TSN shares appear to be inexpensive at <10X what appears to be trough EPS in 2013 and 0.9X BV. Downside should be limited to about 15% based on the low valuation, the buyback program, the strong balance sheet and TSN's leading position in the protein industry. Based on our analysis, we think a worst case 12-month EPS could be $1.25, which would mark a trough for TSN. Normalized earnings power is $2.50+. We forecast EPS of $1.45 and $2.02 for FY13 and FY14 respectively based on a range of conservative assumptions that we detail in the report. As the company has delivered higher and far more consistent earnings and FCF in recent years, and with a much improved balance sheet and higher ROIC, TSN shares could eventually be granted a higher average multiple. This would narrow the existing discount to the typical agricultural enterprise.

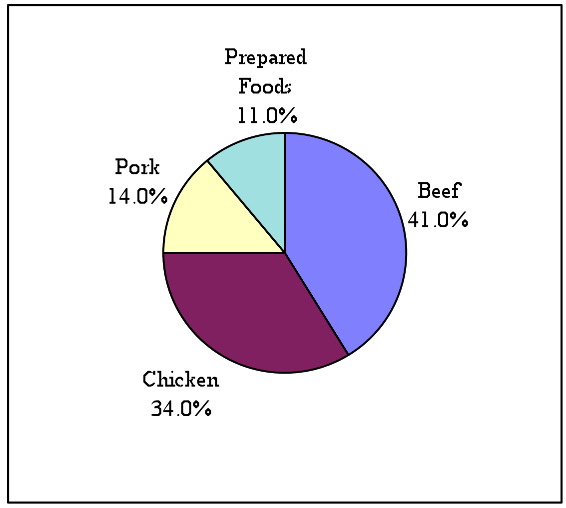
While the share price could remain depressed and perhaps move lower in the near term, we think long-term investors should consider purchasing TSN shares now to capitalize on the extreme negative sentiment and inexpensive valuation. Investors must be willing to look past the next several quarters during which the chicken segment will probably sustain losses. Over time, TSN has proven that it can earn consistent profits in all of its businesses. The product diversity creates additional stability. There are also several ways an investor could win in the nearer term. One or more competitors could shutter beef packaging capacity. There could be an indication of reduction in industry chicken capacity. Looking out to next spring, the corn and soybean crops could prove to be substantial. TSN might also decide to re-accelerate its share repurchase program. TSN has historically traded at an average of 6.2X forward EBITDA and 10.5X EPS, much higher than the current valuation. For perspective, TSN reported EPS of ($0.58) and $0.75 in FY06 and FY07 respectively, and carried a much higher level of net debt. Over those two years, TSN's share price averaged $16.90 and traded as high as $24. Although we are not attempting to time a bottom in the share price, we think the time to begin buying is when the news has been very negative and the story is not fully understood by investors. We are setting a price target of $20.

Background:

TSN Foods (TSN) is one the world's largest meat protein companies, and the second largest food production company in the Fortune 500. TSN produces distributes and markets chicken, beef, pork, prepared foods and associated animal byproducts. The company operates a vertically-integrated poultry production process. It also processes live fed cattle and hogs into various meat cuts, case ready beef and pork, and fully cooked meats. TSN also produces a wide range of prepared foods, including pizza crusts and toppings, tortillas, frozen and refrigerated products, soups and sauces. Its products are sold primarily by its internal sales staff to grocery retailers, wholesalers, meat distributors, warehouse club stores, military commissaries, industrial food processors, chain restaurants, convenience stores, schools, hospitals and hotels. TSN also exports beef, pork and chicken products. Wal-Mart accounted for 13% of FY2011 sales. Lastly, TSN has a 50/50 joint venture (Dynamic Fuels) that aims to commercialize its large supply of poultry litter and animal fats into renewable synthetic fuels. The company was founded in 1935 and is based in Springdale, Arkansas.

Table 1: Revenue Mix





Discussion:

1. TSN is the largest producer of chicken in the US, with an estimated 22% of the market. Its operations are vertically integrated resulting in high efficiency and product quality. TSN essentially controls the entire seven-stage process of growing a chicken: breeding stock; pullet placement; egg set; hatchery; broiler farm; processing plant; distribution. It sells chicken in one of three forms: primary (commodity bulk sales to volume users); case-ready tray pack (refrigerated parts for consumer purchase at retail); and further value-added (for in-home and foodservice applications).

In FY 2011, TSN processed more than 8B lbs of chicken (~42M heads/week) and generated $11B in sales, a 9.5% y/y increase. This was driven by a 2.1% increase in slaughter pounds, a 2.5% reduction of volumes in inventory, and a 4.7% increase in average price/lb sold (driven by increased prices and better mix). TSN has consistently increased the amount of chicken sold as higher value-added product, which brings higher prices and better margins. Moreover, international sales increased 20% to $2.3B, or 21% of total chicken sales. Nearly two thirds of international sales were comprised of sales from TSN's foreign production operations in China, Mexico and Brazil and India, while the remaining third was from export sales to more than 100 countries. In Table 2, we detail the Chicken segment sales and EBIT.

Chicken feed, which is comprised of corn (70%) and soybean meal (30%), is TSN's largest input cost, accounting for more than half the cost of growing a chicken to full weight. TSN owns and operates 33 feed mills, where it produces scientifically formulated feeds. Although the company uses futures contracts and options to hedge its anticipated commodity purchases, it generally only hedges out about six weeks in order to cover projected production. To quote management, "we really just want to provide a ceiling so that the corn costs can't get away from us." However, unusual and untimely spikes in the price of grain can result in large swings to quarterly profits. Grain costs were already elevated in 2011, rising 60% from June 2010 to July 2011. As a result, TSN reported $675M increase in grain and other feed costs for FY2011.

Table 2: Chicken segment

FYE Sept	2009	2010	2011	2012e	2013e	2014e
Sales ($mil)	9,660.0	10,062.0	11,017.0	11,519.8	12,360.7	12,731.5
EBIT	(137.0)	510.0	164.0	409.5	136.0	438.5
% margin	-1.4%	5.1%	1.5%	3.6%	1.1%	3.4%
TSN normalized margin	5-7%					

From the late 1970s through 2005, corn traded mostly in the range of $2-$3 per bushel. However, following the implementation of the Renewable Fuels Standard (ethanol) in 2005, the corn market appears to have experienced a paradigm shift to the $3-$6/bushel range. Over the past several years, corn has been trading at $5-$7 and is currently at about $8/bushel, mostly the result of the current drought in the Midwest. The drought has not only been severe, but the timing in relation to the development of the corn crop was truly a worst case scenario.

Investors are rightly concerned about TSN's near term chicken profits. According to management, it is hedged through September. After that, TSN will start booking the high-priced feed from the latest crop. This should cause significant margin compression (and losses) for TSN and for the entire chicken industry, most likely for the next several quarters. However, we think much of that is discounted in the current share price. Most importantly, today's high grain prices and industry pressure should sow the seeds for the eventual stabilization and margin upturn. The key determining factor of when margins will normalize will be to what extent and when the industry reduces production, which should enable higher pricing.

The US poultry industry is dominated by TSN and Pilgrim's Pride, which control a combined 42% of the market. Perdue and Sanderson Farms each have a share of ~6.5%. That leaves 45% of the market highly fragmented, with many small local producers. TSN estimates the normal EBIT margin for its chicken segment to be in the 5%-7% range, although it has been unable to maintain such a margin for very long in recent years. While it earned a 5.1% margin in FY2010, TSN quickly fell back to a 1.5% margin in FY2011, as the industry over produced early in the year only to experience a weak Memorial Day and Fourth of July grilling season. More recently, production has declined and retail prices have been stable. In the first 9 months FY12, TSN earned a margin of 3.8% led by a 5% margin in both the March and June quarters. We note that TSN's rev/lb increased 9.3% in the first nine months of 2012 against a volume decline of 3.7% resulting in sales growth of 5.1%. We expect a similarly strong margin in the September quarter (Q412). We view these results as a good indication that the elasticity of consumer demand for chicken is moderate, a view confirmed by our recent interviews with supermarket managers.

If TSN (the low cost producer) would lose money at current spot grain and chicken prices, then so would the rest of the industry. Smaller producers have much higher cost structures and many are located on either the East or West coast, which creates a high cost of accessing Midwest corn. This puts TSN in a very strong competitive position. Recently, we have learned that several of the key agricultural lending institutions have been unwilling to extend credit to small chicken producers (unlike in prior cycles) unless the industry commits to meaningful production cuts. We think these smaller players will be forced to cut production sooner than expected to avoid going out of business.

Producer profitability ultimately relates to protein availability (production + freezer stocks less exports) on the US market. We note that even before the recent drought, there was evidence of production declines. For one thing, pullet placements (female egg producing chickens) have declined roughly 5%-6% in 2012. Chicken inventories are also down. Through June 2012, inventories in cold storage are down about 17% y/y and remain near 5-year lows. However, it is costly (high upfront costs) to reduce production and there is political sensitivity to actually closing a plant. Thus, unless producers are convinced that grain prices will remain elevated, they are unlikely to make quick decisions about reducing production. For this reason, production decisions likely won't occur until the early fall when final crops are known. We think grain prices will remain elevated and that production cuts will materialize.

There are myriad factors that should work to offset a meaningful portion of the adverse cost impact to TSN. First, we estimate that more than 50% of TSN's chicken sales volume is generated under flexible-type contracts that enable it to take pricing as a result of changes in feed costs. According to management, less than 15% of its contracts are fixed on an annual basis, a figure that has declined markedly in recent years. As a result, TSN's total exposure to grain could be much lower than investors believe. TSN is also an important supplier to many of the largest restaurant chains and one of the few that can deliver massive volumes of safe quality chicken on time. These customers are well aware of the grain situation and according to TSN, they are displaying a willingness to accept necessary price increases.

It is also important to understand that TSN focuses on demand forecasting (13-14 weeks in advance) for each individual chicken part and manages the business to total revenue components – parts, exports, and value-added products. To help keep production balanced, TSN has increasingly purchased chicken on the spot market rather than increasing production just to get the parts that are in greatest demand, only to be stuck with the rest of the bird. In fact, it has increasingly become a net buyer when conditions warrant. TSN balances to the nearest whole bird increment and then buy the parts it needs, primarily breast meat, which has been in ample supply. Management noted that it consistently has been able to buy parts at prices below its own production cost, a favorable situation.

TSN has also aggressively reduced costs in the chicken business, taking out roughly $920M in costs since 2008. This involves improved yields, labor and line efficiencies, product mix changes, freight optimization and reductions in live costs. The company estimates that by the end of 2012, it will have reduced its cost of producing a chicken by $0.095 per pound. As the largest and low-cost producer, TSN has a major advantage over smaller competitors that comprise the majority of the industry. Additional cost reductions are in the works ($100M+), and should provide some offset to the recent grain price increases.

TSN also continues to increase the production of value-added chicken products, which earn higher prices and margins. In fact, 9 of the top 10 selling frozen prepared chicken products in the US are made by TSN. It commands the dominant share of the frozen breaded chicken category, and it grew share in the latest quarter, including at Wal-Mart. Innovative new products continue to do well, including Tyson Whole Grain Chicken Chunks and Stuffed Mini-Bread Bowls in the grocery channel, and Grilled Chicken Tenderloins in the Club Store channel. It will soon be introducing gluten-free chicken strips and nuggets. TSN ships more than 22,000 tons of Tyson brand chicken nuggets each year.

Finally, high beef and pork prices should support chicken prices, as consumers seek cheaper protein alternatives in a stagnant economy. This should provide flexibility for the industry to respond to increased grain costs with higher prices. Certain chicken parts are also experiencing strong prices. For example, chicken wing prices have surged more than 80% over the past year to a recent $1.88/lb. As evidence, Buffalo Wild Wings, a fast growing US chain, pointed to higher wing prices for the cause of its recent earnings miss (Q212). The company also said it expects wing prices to average $1.95/lb in the current quarter and is raising its own prices 3% in Q3 and 4% in Q4 as a result.

We forecast TSN to remain moderately profitable in chicken for FY2013, followed by a significant profit increase in FY2014 (though still well below its normalized margin). We think there could be significant upside to our forecasts.

2. TSN is a major processor of beef. Unlike in its chicken business, TSN does not raise its own cattle. Instead, it purchases and slaughters live fed cattle into various meat cuts and case-ready products for sale to grocery and club stores, foodservice distributors, restaurant chains and other processors. It also sells hides, organ meats and tallow to a variety of customers. The beef industry is highly concentrated with TSN, Cargill and JBS holding similar shares that combined form roughly 65% of the US market. National Beef has a 10% share. TSN's beef operation is essentially a low margin spread business. It acquires cattle (on a daily basis) through direct negotiated purchases with feedlot operators on a spot, formula (price + some amount) or a fixed-priced (tied to futures price) basis. Margins are affected primarily by the availability and price of live cattle, beef industry processing capacity, consumer demand for beef and the prices of competing meats. Animal disease outbreaks and food safety issues can also impact margins.

According to the company, there is little room to beat competitors on the actual buy side of the equation, as the market won't allow TSN to purchase cattle much cheaper than other industry players. Thus, TSN focuses on minimizing its operating costs and on being the low-cost, high-revenue player in each region. It strives to maximize revenue by having a good portfolio mix, with a growing amount of value-added products, solid exports, excellent customer service and a strong customer base. TSN's profit spread has consistently outperformed the industry. One of its key advantages is the location of its 12 beef processing facilities, which are strategically located in close proximity to the largest feedlots, and are well dispersed throughout the key cattle regions (Kansas, Nebraska, Illinois, Iowa and Northern Texas). This provides TSN with ample supply (which enables solid plant utilization) as well as a major freight cost advantage on the buy side. We note that several years ago, TSN removed nearly 2M head of slaughter capacity in uncompetitive areas. TSN estimates its normalized beef margin to be in the range of 2.5%-4.5%. We highlight the beef segment in Table 3.

Table 3: Beef

FYE Sept	2009	2010	2011	2012e	2013e	2014e
Sales ($mil)	10,937.0	11,707.0	13,549.0	13,803.8	13,900.5	14,609.4
EBIT	214.0	542.0	468.0	172.1	244.2	245.5
% margin	2.0%	4.6%	3.5%	1.2%	1.8%	1.7%
TSN normalized margin	2.5-4.5%					

In the near term, TSN's beef margins are most affected by the availability of cattle in the market. According to management, it attempts to forecast revenues three weeks in advance, and projects what cattle should cost to manage the margin. Historically, TSN has most effectively managed the spread when the availability of cattle is abundant, enabling it to more easily match its forecasted customer demand with required supply. There is a very strong correlation between the cut-out value (market price of beef) and the cost of livestock. That is the very nature of the spread business. Aside from that, TSN focuses all its attention on managing its operating costs and maximizing revenue through value-added programs and exports. Its goal is to add to the margin differential on the revenue each year. As with its chicken business, TSN has strong customer relationships and a reputation for safety, efficiency and customer service in beef processing.

Feed accounts for roughly 80% of the cost of raising cattle. In an interesting twist, however, the current drought appears to be driving lower cattle prices in the near term, as ranchers push their cattle to auction (and likely slaughter) earlier than normal. Ranchers across much of the cattle producing states have run out of grass to feed their herds. Water supplies (ponds, streams) have also dwindled and the cost of hay has surged**.** These feeder calves are still too small to be slaughtered, but many ranchers can't afford to hold on and are selling at significant discounts to normal prices. Moreover, the feedlot operators that buy these calves are absorbing surging corn prices, which they use to fatten the calves for 4-5 months before selling them to processors (like TSN) for slaughter. This has reduced feedlot demand. A major feedlot operator estimated the additional cost to be $200 per cow (for corn) vs. 2 months ago. Feedlots have very high overhead costs and need to operate near capacity. Thus, there has also been a shift to more cattle being fed in the larger 1,000-head-plus feed lots, which is favorable for TSN's plant locations.

The flood of supply has reduced live cattle prices (TSN's main input cost) and should position TSN to negotiate very favorable prices for high volume purchases. With lower near term input costs, TSN should generate normal profits in beef over the next 2 quarters. By mid-2013, however, a shortage of cattle could arise if today's herd is reduced too aggressively. The U.S. herd was already impacted by the 2011 drought in the southern plains and is currently approaching a multi-decade low. Unlike most commodities, cattle supply can't quickly be replenished, as it takes 2-3 years to grow a calf to slaughter weight. Ranchers also require ample grass to add new cattle. Thus, there is concern that beyond the next several quarters TSN could be faced with a shortage of live cattle and a resulting spike in input costs at a time when beef prices are already elevated and consumer demand is weak. However, based on our conversations with butchers and supermarket managers in several states, we think the industry will manage to increase prices enough to offset any resulting decline in consumer demand. Beef prices have increased nearly 60% over the past 6 years, with a resulting volume decline of perhaps 25%. The consumer has become conditioned to high beef prices (similar to gasoline). TSN has also demonstrated the ability to maintain its margin over time in the face of substantial price increases.

It's important to note also that TSN has a strong beef export business driven by the increasing global demand for quality beef, a result of the growing middle classes around the world. In 2011, the US became a net beef exporter for the first time ever. Importantly, the US is one of the few countries with the natural resources, infrastructure and expertise to efficiently produce large quantities of high quality beef products. In 2011, TSN generated $2.1B in export sales to more than 100 countries. Key export markets include Mexico, China, Japan, Latin America, South Korea and Vietnam. Moreover, its share of the growing beef export market is increasing.

Our forecasts for the Beef segment are conservative. We estimate beef margins of 1.8% and 1.7% in FY2013 and FY2014 respectively. These are below TSN's estimated normalized range of 2.5% - 4.5% and should provide upside potential to our forecasts.

3. TSN is also a processor of pork (live hogs), which it processes into primal and sub primal meat cuts and case-ready products (bacon, etc), which are then marketed and sold to food retailers, distributors and restaurants. This is a spread business similar to TSN's beef operation. TSN purchases live hogs and fabricates them into various consumer products. Pork consumption is seasonal with the highest demand during the fall and winter months.

Table 4: Pork

FYE Sept	2009	2010	2011	2012e	2013e	2014e
Sales ($mil)	3,875.0	4,552.0	5,460.0	5,563.8	5,672.3	5,615.6
EBIT	160.0	381.0	560.0	420.7	394.1	383.4
% margin	4.1%	8.4%	10.3%	7.6%	6.9%	6.8%
TSN normalized margin	6-8%					

As we detail in Table 4, pork has been TSN's highest margin segment over the past several years. Management expects normalized margins to be in the range of 6%-8% over time. This is far higher than its expectations for its beef segment. TSN outperforms the pork industry in terms of margin per hog slaughtered. Like its beef operation, TSN has 9 strategically situated processing facilities close to key hog supplies. Five companies control 75% of the domestic pork market with TSN's share at roughly 17%. Smithfield Foods is the leading player with 28% share. However, unlike TSN, Smithfield is vertically integrated (raises its own hogs). The hog cycle is roughly 1.5 years.

In FY2011, TSN's pork revenue increased 19.5% to $5.5B with a 10.3% EBIT margin. This was driven by a 4% volume increase and a 15% average price increase (associated with increased livestock costs) and improved mix. It also has a very strong export business with sales to Japan, Mexico, Canada, China, South Korea and Russia. International sales increased 25% y/y and accounted for 22% of TSN's pork sales in FY2011. Management recently noted that morning meal traffic (among quick serve restaurants) has increased and servings of breakfast sandwiches that include sausage, bacon and steak are growing.

4. TSN's Prepared Foods division accounts for 11% of total sales. Sales are split between foodservice (61%) and retail/other (39%). TSN sells a wide variety of frozen and refrigerated products to retail grocers, distributors, restaurant chains, schools hotels, hospitals and the military. It is the largest supplier of pepperoni and pizza toppings to the foodservice industry, as well as to manufacturers of frozen pizza. It is the second largest manufacturer of flour and corn tortillas and chips in the US, sold mainly to quick service Mexican restaurant chains, which are expanding rapidly. TSN also supplies bacon, hams and stuffed chicken breasts to the foodservice channel, and sells custom soups to casual dining chains. Its Wright brand of bacon is one of the best selling products at retail. The brand was recently expanded into dinner sausages. Lastly, TSN it makes deli meats, franks, sauces and various ethnic foods. We detail segment sales and EBIT in Table 5.

Table 5: Prepared Foods

FYE Sept	2009	2010	2011	2012e	2013e	2014e
Sales ($mil)	2,836.0	2,999.0	3,215.0	3,230.1	3,359.3	3,433.2
EBIT	148.0	124.0	117.0	181.9	157.9	171.7
% margin	5.2%	4.1%	3.6%	5.6%	4.7%	5.0%
TSN normalized margin	4-6%					

TSN management intends to aggressively grow the prepared foods business both via internal development, category expansion, and bolt-on acquisition. We view this as a relatively steady business with fairly predictable margins over time. Moreover, a large % of its contracts are short term in nature, which enables TSN to offset rising input costs through pricing. TSN recently opened a state of the art expansion at its Council Bluffs, Iowa pepperoni plant. Pizza toppings are a fast growing category for TSN as it serves major producers such as Dominos, Papa Johns and Pizza Hut as well as the major frozen pizza manufacturers.

5. One of the most attractive parts of the TSN story is the marked improvement in the balance sheet over the past several years. Since Q209, TSN has retired > $1.6B in senior notes. It recently issued $1B in 4.5% 10-year notes which it used to retire its 10.5% notes due in 2014. This will reduce future annual interest expense by $55M. TSN also amended restrictive covenants in its credit facility, which provides it with additional borrowing flexibility should earnings volatility increase. Moreover, TSN received credit rating upgrades from all three major ratings

agencies and maintains an investment grade rating. Management's policy is to maintain at least $1.2B of total liquidity (cash + available borrowing capacity) and it ended Q312 with $1.8B. Net debt declined from $2.7B in 2008 to a recent $1.6B, while net debt/EBITDA declined from 3.2x to a current 1x. Interest expense has declined from $310M in FY2009 to an estimated $135M in FY2013.

TSN has also been generating higher and more consistent FCF. It has achieved positive FCF in 4 of the past 5 years despite substantial increases (and volatility) in grain costs. Aside from reducing debt, TSN has significantly increased capex, mainly in the foreign and domestic chicken business. In China and Brazil alone, TSN has spent an estimated $400M in the past 3 years establishing its vertically integrated poultry operations. These are still in the ramp up phase and have yet to deliver anything close to a normal return on investment. Management has targeted a 15%-20% return on capital (ROIC). Thus, these foreign businesses should add meaningful earnings over the coming years. Total capex was $550M and $643M in FY2010 and 2011 respectively, and should be roughly $700M in the current FY. This compares to an average capex of $400M during the 2003-2009 period. Importantly, capex should decline to $500M-$550M in FY2013.

TSN has also begun a meaningful share repurchase program. In FY2011, it spent $170M to repurchase 9.7M shares (avg. $17.53), and, to date, has repurchased 19M shares. However, while it recently increased its repurchase authorization by 35M shares, we expect TSN to hold off on additional buybacks until it has better visibility in to the grain situation. Still, the reduction of the share count should add some offset to the expected impact from rising grain costs, and should create significant earnings leverage when the environment eventually stabilizes. We note that the Tyson family remains a substantial shareholder, with a roughly 20% ownership stake (mostly through B-class shares).

6. In addition to export sales, TSN has vertically integrated chicken production operations in Mexico, China, Brazil and India. International-based sales were $1.4B in FY2011. The company is focused on areas with emerging middle classes, as it thinks that as incomes rise, one of the first lifestyle changes people make is to add protein to their diets. In Mexico, TSN holds the #3 market share position and is the leading provider of value-added chicken. In China, its model is 100% company owned operations with controlled live production. With a population of 1.3B and chain restaurants opening at a rapid clip (Yum Brands, MCD), the Chinese market needs additional poultry production. TSN believes that food safety, food quality and supply chain integrity are key competitive advantages. By 2014, it expects to process 3M head/week in China, all provided by its 100% owned biosecure poultry facilities. These currently account for just 20% of TSN's China sales.

7. The key risk to an investment in TSN shares is significant volatility in the price of corn (and soybean meal), which we have highlighted in the report. There is also the risk of over supply of any of TSN's three major protein meats, which could result in weak industry prices. Other risks include outbreaks of animal diseases, food safety issues, trade barriers and economic recession. A large acquisition could also result in a lower share price in the short run.

8. Recent results

In the most recent quarter ended 6/30/12 (Q3), sales increased 1% to $8.3B. In Chicken, sales increased 3.6% to $2.9B driven by an 8% average price increase and improved mix, offset by a 4% decline in volume. EBIT was $153M or 5.3% of sales vs. $28M (1.0% margin) in Q311. Beef sales declined 0.8% to $3.5B. Beef volume declined 13.9% and was severely impacted by the media controversy surrounding lean finely textured beef (LFTB) in April 2011. Average pricing increased 15.2% due to continued declined in industry production, improved mix and increased export sales. Beef EBIT was a $71M vs. $140 in Q311 as margins were compressed during the aforementioned LFTB issue. In Pork, sales declined 4.5% to $1.3B on a 6.9% decline in average price and a 2.5% increase in volume. EBIT declined to $69M (5.1% margin) from $124M in Q311 (8.8% margin). Lastly, prepared food sales declined 5% to $764M. EBIT increased to $47M vs. $30M y/y.

Total consolidated EBIT was $336M (3.7% of sales) vs. $312M in Q311. Net interest expense declined from $56M to $46M. This resulted in Q312 EPS of $0.50 vs. $0.44 in Q311, on a 3.7% decline in average shares. At 6/30/12, cash was $828M against debt of $2.4B. Net debt to TTM EBITDA was 1.0x.

9. Financial Assumptions

For Fiscal 2013 (Sept), we make the following assumptions: Chicken sales increase 7% to $12.3B driven by a 9.5% increase in average rev/lb (including mix) and a 2.9% decline in volume. We forecast EBIT margin of 1.1% ($136M) or roughly $0.02/lb. We assume the segment is unprofitable in the first half of the fiscal year. Next, we estimate beef sales to increase 0.7% to $13.9B based on a 3% increase in rev/lb and a 2.5% volume decline. The price decline from the current accelerated slaughter should be more than offset by tightening prices in the latter half of FY2013. Beef EBIT should be $244M or 1.8% of sales. For Pork, we estimate sales increase 1.9% to $5.7B on +3% pricing and a 1% volume decline. EBIT is estimated at $394M or 6.9% of sales. Finally, we estimate sales of prepared foods to increase by 4% to $3.4B, with EBIT of $158M (4.7% margin). Our forecasts result in consolidated sales of $34.4B (+3.5% y/y), and EBIT of $922M, -19.5% y/y. Interest expense should decline 23% to $137M. Factoring in income tax and minority interest, net income should be $517M in FY2013. Average shares should decline 2% to 363M, resulting in EPS of $1.42. This should represent trough earnings for TSN.

For Fiscal 2014, we estimate Chicken sales to increase 2.9% to $12.7B driven by a 3% increase in average rev/lb (including mix) and a 0.5% increase in volume. We forecast EBIT margin of 3.4% in chicken to $438M or roughly $0.057/lb. Next, we estimate beef sales increase 5% to $14.6B based on a 7% rebound in rev/lb and a 2% decline in volume. The price increase is a factor of anticipated tightness in cattle supply. We estimate Beef EBIT at $246M or 1.7% of sales. For Pork, we estimate sales decline 1% to $5.6B on flattish pricing and a slight reduction in volume. EBIT is estimated at $383M or 6.8% of sales. Finally, we estimate sales of prepared foods to increase by 2.2% to $3.43B, with EBIT of $172M. Our estimates result in consolidated sales of $35.5B (+3% y/y), and EBIT of $1.2B. Net interest expense should decline 6% to $128M. Factoring in income tax and minority interest, net income should be $718M in FY2014, or EPS of $2.02. At 9/30/14, we estimate TSN to have net debt of $1.1B, or 0.7x EBITDA. 2014 BV is estimated at $19.35.

10. TSN's current share price discounts a short-term earnings decline due to the unusual spike in feed costs and potentially seasonally constrained chicken prices in the near term. We think potential losses in chicken are sufficiently discounted into TSN's share price. Looking ahead 6-9 months, chicken prices should respond to anticipated industry production cuts and TSN's chicken business should move back toward normal profitability. In the beef segment, expected price increases for beef (based on reduced cattle herds) should result in volume declines that are less than widely feared, especially as it relates to TSN, which should be able to maintain a reduced but sufficiently profitable margin. (Any volume declines should be largely offset by pricing). Moreover, higher prices for beef should create room for TSN to increase chicken prices in order to cover the higher feed costs.

As we discussed in the report, TSN has the balance sheet to manage through the current grain shock. The company's heavy capex spending has resulted in an industry leading low cost structure, which could lead to a surge in future earnings in a more favorable industry environment. TSN's strategically positioned plant locations and extensive sourcing and distribution network are also considerable competitive advantages, as are the company's 75 years of protein and commodity buying experience. Moreover, its diversified multi-protein model and buy vs. grow strategy should reduce future earnings volatility, as it benefits from the natural interrelationship between beef, pork and chicken supply and demand. TSN's international and export sales add additional diversity and position TSN to capitalize on the increasing global demand for protein both on the retail front and from expanding QSR chains such as KFC, Dominos, McDonald's and Burger

King.

FY2013 should mark the earnings trough for TSN, followed by a significant increase in FY2014, driven by higher but still subdued combined margins. However, we expect the share price to increase long before normalized earnings are re-established. Longer term, TSN could also be awarded a higher multiple (a smaller discount to agriculture and packaged goods entities) if it continues to demonstrate more consistent earnings and cash flow with low leverage. Patient investors, willing to look beyond the next 1-2 quarters, should be rewarded over time by both higher earnings and a moderate multiple expansion. Our initial price target is $20, based on 10X our estimated FY2014 EPS. This translates into a price/BV of 1.1X and an EV/EBITDA multiple of 5.9X based on our FY2014 estimates. Over the past decade, TSN has traded at an average PE of 10.5X; a P/BV of 1.2X; an EV/EBITDA multiple of 6.25X. Our price target implies a total return of 38% over the next 12-18 months.

11. Financial Projections

a. Annual projections	2011	2012e	2013e	2014e	2015e
Chicken	11,017.0	11,519.8	12,360.7	12,731.5	13,024.4
Beef	13,549.0	13,803.8	13,900.5	14,609.4	14,901.6
Pork	5,460.0	5,563.8	5,672.3	5,615.6	5,559.4
Prepared Foods	3,215.0	3,230.1	3,359.3	3,433.2	3,508.7
Intersegment sales	(974.0)	(860.0)	(840.0)	(880.0)	(900.0)
Total sales	32,267.0	33,257.5	34,452.7	35,509.7	36,094.0
Cost of sales	30,067.0	31,226.2	32,612.6	33,360.6	33,677.2
Gross profit	2,200.0	2,077.2	1,840.1	2,149.1	2,416.9
SG&A	914.0	902.0	918.0	920.0	930.0
EBIT	1,286.0	1,175.2	922.1	1,229.1	1,486.9
Interest expense, net	231.0	177.0	137.0	128.0	123.0
Other expense (income)	(9.0)	(19.0)	(9.0)	(8.0)	(7.0)
Pretax income	1,064.0	1,017.2	794.1	1,109.1	1,370.9
Income taxes	383.0	366.2	285.9	399.3	493.5
Minority interest	(17.0)	(10.0)	(9.0)	(9.0)	(5.0)
Net income	698.0	661.0	517.2	718.8	882.3
EPS	$1.84	$1.78	$1.42	$2.02	$2.51
Average shares - FD	380.0	370.5	363.0	355.5	351.0
Gross profit	6.8%	6.2%	5.3%	6.1%	6.7%
SG&A	2.8%	2.7%	2.7%	2.6%	2.6%
EBIT	4.0%	3.5%	2.7%	3.5%	4.1%
Interest expense, net	0.7%	0.5%	0.4%	0.4%	0.3%
Other expense (income)	0.0%	-0.1%	0.0%	0.0%	0.0%
Pretax income	3.3%	3.1%	2.3%	3.1%	3.8%
Income taxes	36.0%	36.0%	36.0%	36.0%	36.0%
Net income	2.2%	2.0%	1.5%	2.0%	2.4%

Y/Y % Chg	2011	2012e	2013e	2014e	2015e
Revenue	13.5%	3.2%	3.5%	3.1%	1.6%
Gross profit	-11.1%	-5.6%	-11.4%	16.8%	12.5%
SG&A	-1.6%	-1.3%	1.8%	0.2%	1.1%
EBIT	-16.9%	-8.6%	-21.5%	33.3%	21.0%
Interest expense, net	-16.0%	-23.4%	-22.6%	-6.6%	-3.9%
Pretax income	-15.8%	-4.4%	-21.9%	39.7%	23.6%
Income taxes	-15.8%	-4.4%	-21.9%	39.7%	23.6%
Net income	-15.3%	-5.3%	-21.8%	39.0%	22.8%
EPS	-15.5%	-2.9%	-20.1%	41.9%	24.3%
Average shares - FD	0.3%	-2.5%	-2.0%	-2.1%	-1.3%

(amounts in $000, except ratios)

Current debt	2,345,000
Current Equity	5,871,000
Current tangible BV	3,980,000
Current market value	6,435,520
Current cash	828,000
Current DSO	15
Current DIO	29

FYE September	2011	2012e	2013e
EBIT	1,286,000	1,175,222	922,125
EBITDA	1,792,000	1,666,222	1,412,125
Free cash flow	403,000	267,022	322,240
Surplus cash flow (NI+D&A - capex)	596,000	452,022	477,240
Capex	643,000	700,000	530,000
EV/EBITDA	4.4	4.6	5.2
EV/(EBITDA-capex)	6.9	8.0	8.4

b. Quarterly projections	Q411	Q112	Q212	Q312	Q412e	Q113e
Total sales	8,404.0	8,329.0	8,268.0	8,308.0	8,398.5	8,511.8
Cost of sales	8,013.0	7,836.0	7,733.0	7,746.0	7,911.2	8,156.1
Gross profit	391.0	493.0	535.0	562.0	487.2	355.6
SG&A	219.0	215.0	233.0	226.0	228.0	223.0
EBIT	172.0	278.0	302.0	336.0	259.2	132.6
Interest expense, net	52.0	47.0	47.0	46.0	37.0	37.0
Other expense (income)	(5.0)	(12.0)	(2.0)	(3.0)	(2.0)	0.0
Pretax income	125.0	243.0	257.0	293.0	224.2	95.6
Income taxes	44.0	85.5	90.5	106.9	80.7	34.0
Minority interest	0.0	(2.0)	(2.0)	(3.0)	(3.0)	(3.0)
Net income	81.0	159.5	168.5	189.1	146.5	64.6
EPS	$0.22	$0.42	$0.45	$0.51	$0.40	$0.18
Average shares - FD	375.0	376.0	373.0	369.0	364.0	362.0
Gross profit	4.7%	5.9%	6.5%	6.8%	5.8%	4.2%
SG&A	2.6%	2.6%	2.8%	2.7%	2.7%	2.6%
EBIT	2.0%	3.3%	3.7%	4.0%	3.1%	1.6%
Interest expense, net	0.6%	0.6%	0.6%	0.6%	0.4%	0.4%
Other expense (income)	-0.1%	-0.1%	0.0%	0.0%	0.0%	0.0%
Pretax income	1.5%	2.9%	3.1%	3.5%	2.7%	1.1%
Income taxes	35.2%	35.2%	35.2%	36.5%	36.0%	35.6%
Net income	1.0%	1.9%	2.0%	2.3%	1.7%	0.8%