

Weekday Trader ■ by Alexander Eule

Trading Down at the Supermarket

BARRON'S ONLINE

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Ralcorp at a Glance

Recent Stock Price	\$49.95
52-Week High	\$64.80
52-Week Low	\$48.08
Stock-Market Value	\$1.3 bil
Revenue	\$2.6 bil
EPS (Est. 2008)	\$3.47
P/E (Est. 2008)	14.4
Est. LT EPS Growth	9%

Source: Thomson Reuters

VALUE-SEEKING SHOPPERS ARE WELL acquainted with the store-brand products found on supermarket shelves. Now, surging food and gas prices are creating even more believers.

With consumers trading down, shares of **Ralcorp Holdings**—a leading maker of such private-label foods—could soon be headed up.

The company's products often carry the names of the stores that sell them and cost about 20% less than comparable national brands. Ralcorp's roster includes cereal, frozen bakery items, nuts, dressings and syrups.

Like its packaged goods, Ralcorp's stock (ticker: RAH) currently comes at substantial savings.

A pending acquisition of Post cereals and rising grain costs have pushed Ralcorp stock down 20%, to \$49.95, in the past three months, a steeper decline than those of food products peers. But with consumers in value mode, a Ralcorp comeback looks probable.

"If someone has a time horizon that's longer than six months, they probably like what's going on at Ralcorp," says Scott Harrison, a senior analyst for Argent Capital Management. "In a best-case scenario, and if these headwinds abate, it can be an \$80 stock."

This spring, **Safeway's** (SWY) chief financial officer told an investors' conference that there was "tremendous growth in our private-label products as consumers are looking for greater value in this economy."

For its first quarter ended March 22, Safeway said sales of its store brands grew four times faster than national brands.

Some analysts think the stock could be a smarter choice than those of branded food companies like **Kellogg** (K) and **General Mills** (GIS). "In this kind of environment it's probably more defensive," says BB&T Capital Markets analyst Heather Jones.

Still, the company's pending acquisition of Post cereals from **Kraft** (KFT) has created a significant overhang for the stock. The \$2.6 billion transaction, announced last November, boosts Ralcorp revenue by 50% and promises significant accretion to earnings.

Ralcorp has called the deal a "transforming event" that will create a "portfolio of businesses balanced between branded, private label and frozen bakery products."

The pending exchange offer between Kraft and Ralcorp will result in 30 million new shares of Ralcorp stock. The transaction has weighed on shares, and the pressure could continue in the near-term until the newly issued Ralcorp shares find their way into the hands of committed holders.

Kraft is ultimately offering the Ralcorp shares to its shareholders at a 10% discount, with the exchange offer set to expire on Aug. 4.

"When the exchange is over, in theory the pressure is over," says Stifel Nicolaus analyst Christopher Growe.

Argent Capital's Harrison says his firm has built its Ralcorp position in the months following the acquisition announcement. "They're doing very well in the private-label area," Harrison says, and the Post deal "just gives them another platform to increase their overall exposure and product breadth."

Post is the country's third largest branded cereal maker. Its labels include Honey Bunches of Oats and Grape-Nuts.

For fiscal 2008, analysts surveyed by Thomson Reuters expect Ralcorp to post \$2.6 billion in sales and earnings per share of \$3.47. With Post in the fold for a full year, those numbers could jump to \$3.2 billion and \$3.94 by 2009.

Ralcorp now trades at a modest 12.6 times estimated 2009 earnings per share. Over the past four years, Ralcorp's price/earnings multiple has ranged from 13 to 59. Packaged-goods peers currently trade at an average of 15.6 times expected 2009 earnings.

Ralcorp does face challenges. In addition to the Post deal, it's grappling with surging input costs. According to research from Wachovia Capital Markets,

input inflation accounted for \$33.5 million of new costs in Ralcorp's fiscal second quarter.

In a note to clients, Wachovia analyst Jonathan Feeney wrote that Ralcorp showed a better ability to manage the higher costs for the quarter, through price increases that generated \$31.5 million in additional sales. The \$2 million gap was a marked improvement from the previous quarter's \$9 million shortfall, Feeney noted.

Despite the price increases, private labels maintain a significant cost advantage for consumers. This week, at a Pottomac, Md., Safeway, an 18-ounce box of store-brand corn flakes cost \$2.79, compared with

\$3.99 for Kellogg's same-size version. A 12.8-ounce box of Safeway's Rice Pockets cereal was \$3.79, versus \$5.17 for the equivalent version of General Mills' Rice Chex.

The significant discounts make store brands compelling. You could say exactly the same about Ralcorp stock. ■

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