



## Horizon Organic Holding

(NASDAQ: HCOW)

Company Update

### Outperform

Above Average Risk

## Strong Sales Momentum - Outlook Unchanged

### Event

Q4 earnings recap.

### Investment Conclusion

- Shares remained under pressure yesterday despite a positive earnings release and progress toward farm sale.
- Business momentum remains strong and outlook is unchanged.
- We believe the recent weakness reflects valuation concerns, although this is not a new issue.
- With fundamentals intact and valuation at more attractive levels, we recommend investors buy on the recent weakness.

### Valuation

Based on 2004 estimates, HCOW trades 11.6x EV/EBITDA and 23.3x earnings, reflecting a significant premium to its peers. We believe earnings estimates do not fully reflect Horizon's potential, however, as the company is investing heavily in selling & marketing to capitalize on heightened demand for organic food. Accordingly, we believe it is appropriate to include EV/Sales as a relevant valuation metric. At our \$18 target, HCOW would trade at 0.8x EV/Sales, in line with its closest peer, The Hain Celestial Group (HAIN \$15.13, Sector Perform, Above Average Risk).

### Impediment

Horizon Organic operates a complex business model. Inability to improve margins could impede achievement of our price target.

### Q4 Recap

Horizon Organic reported Q4 EPS from continuing operations of \$0.13, vs. \$0.12 last year. Earnings were in line with our estimate and consensus and fell within management's guidance of \$0.12-\$0.15. Sales increased 21.3% to \$53.0 million (above our estimate of \$52.6 million), marking the third consecutive quarter of accelerated revenue growth. Q4 sales would reportedly have been \$1 million higher if not for supply constraints in the butter category.

U.S. sales were particularly strong (+25%), driven by positive publicity (supported by advertising spending) surrounding the new organic standards. Management commented that growth accelerated during the quarter, contradicting recent concerns over an industry slowdown in the month of

For pertinent disclosure, see Disclosure section at the end of this report.

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Price: 11.57

Price Target: 18.00

52-Wk High: 19.26

52-Wk Low: 10.96

Float (MM): 5.6

Debt to Cap: 41.0%

Shares Out (MM): 10.2

Market Cap (MM): 118

Dividend: 0.00

Yield: 0.0%

Tr. 12 ROE: 5.80%

Est 3-Yr EPS Gr: 27.50%

Trading Vol. (MM): 0.100

Institutional Own.: 26%

(FY Dec)	2001A	2002A	2003E	2004E
Diluted EPS	0.16	0.34	0.42	0.50
P/E	72.31x	34.03x	27.55x	23.14x

Diluted EPS	Q1	Q2	Q3	Q4
2001	(0.02)A	0.04A	0.04A	0.09A
2002	0.08A	0.06A	0.07A	0.13A
2003	0.08E	0.09E	0.10E	0.15E
2004	0.10E	0.11E	0.12E	0.17E

EPS From Continuing Operations

All values in USD unless otherwise noted.

December. Sales of milk and dairy products both increased 26%, while juice sales declined an estimated 5%.

Sales in the U.K. increased 6% and accounted for 17% of total sales. While U.K. growth fell short of our 9% forecast, Rachel's sales increased more than 150% and exceeded our expectation. The strong growth was driven by 36% growth in yogurt, its core product category, and sales of recently introduced organic milk. Because Rachel's has become the company's main growth vehicle in the U.K. and generates higher margins than private label, the strong sales growth strengthens the growth outlook for the U.K. business. Rachel's now accounts for 45% of U.K. sales, vs. just 17% last year, and management expects it to account for more than 50% of sales in 2003. Anecdotally, management stated that in late Q4, the company added Rachel's milk to Safeway, a large grocery chain, and expanded its milk distribution in Sainsbury (its No. 1 customer in the U.K.) to 350 stores from 129 stores.

On the cost side, operating margins declined to 4.4% from 5.2% last year, and EBITDA margins declined to 6.2% from 8.3% last year. The YOY decline in margins reflects increased selling & marketing spending (21.3% of sales vs. 18.7% of sales last year) to capitalize on increasing consumer awareness of organic products. Gross margins improved 150 basis points YOY (32.1% vs. 30.6% last year) and were 50 basis points above our estimate. The upside to our gross margin estimate was more than offset, however, by higher-than-expected G&A expense (5.7% vs. 5.0% last year). As a result, operating margins fell moderately short of our 4.8% estimate.

### 2003 Outlook

The company reaffirmed its 2003 guidance, including 20%-25% sales growth and earnings growth in the high teens to low twenties. Some of the company's specific goals for 2003 include:

- Expanding ACV to 70% from 60% in 2002.
- Increasing depth of distribution by increasing the number of organic dairy sections to 3,000 from 2,000.
- Improving the value equation of its juice business (4% of sales) by passing on cost savings from a planned manufacturing consolidation.
- Accelerating sales growth in the U.K. to the 20%-25% range.
- Introducing new, higher margin products, including a dry grocery product later in the year.

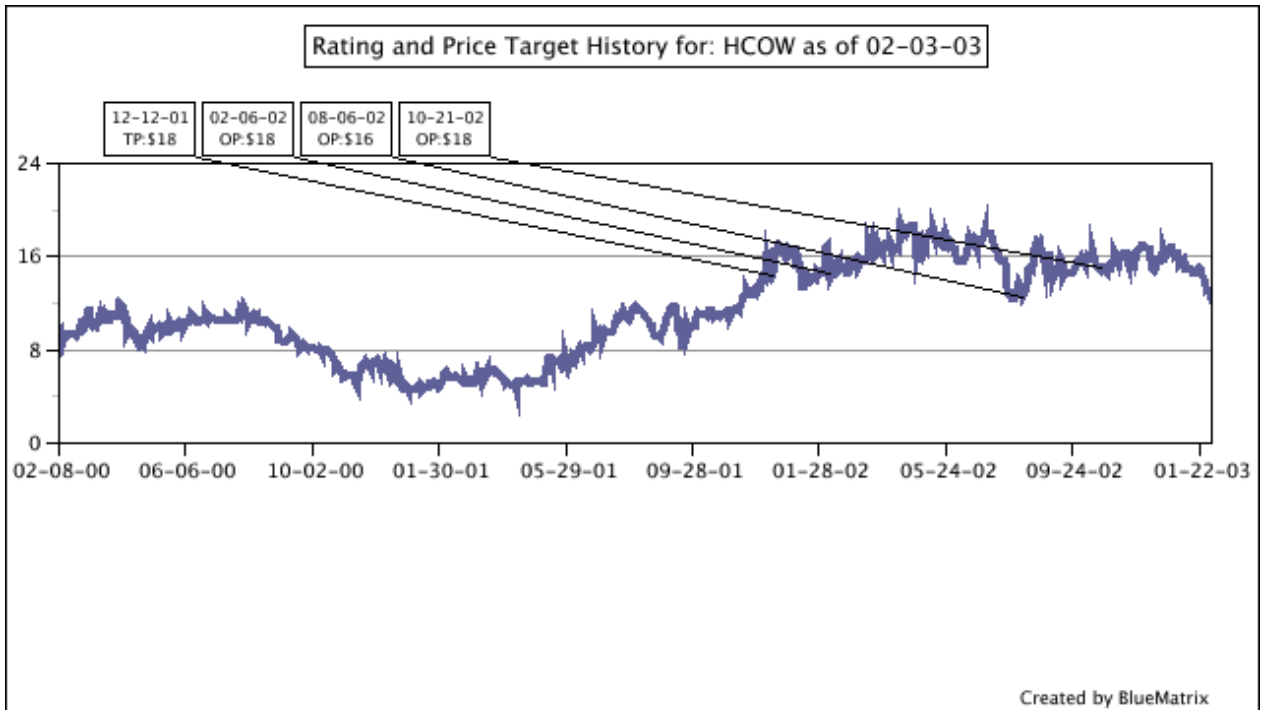
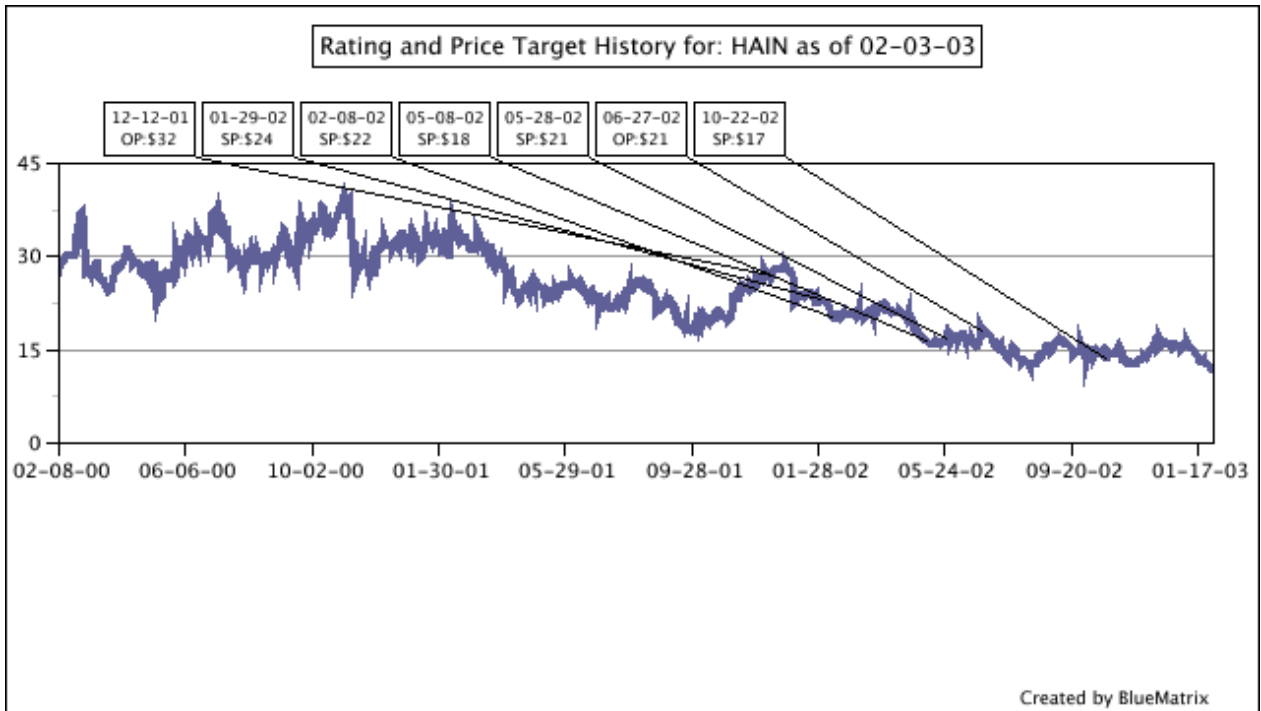
Our 2003 sales and EPS estimates of \$226.5 million and \$0.42 reflect 21% growth and 23% growth, respectively. Our gross margin assumption of 32.0% (vs. 31.9% in 2002) is in line with guidance. While gross margins should benefit from a favorable product mix shift in the both the U.S. and the U.K., these benefits should be offset by tight organic milk supply. We expect selling & marketing spending to increase 20 basis points to 22.3%. Our selling & marketing forecast assumes advertising spending remains unchanged as a percentage of sales (this is consistent with management's comments on yesterday's conference call). Finally, we are modeling a modest 10 basis point reduction in G&A expense, which is consistent with management's guidance. These factors result in EBITDA margins and operating margins of 5.3% and 3.5%, respectively, vs. 5.5% and 3.4%, respectively, in 2002.

### Company Description

Horizon Organic Holding Corporation (Longmont, Colorado) is the leading consumer brand of certified organic fluid milk and dairy products in the United States. In addition to being the only national brand of milk in the United States, Horizon Organic also markets organic dairy products in the United Kingdom.

### Disclosures

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**Horizon Organic Dairy  
Income Statement**  
(In thousands, except for per-share data)

	1997*	1998*	1999	2000	2001	Mar-02	Jun-02	Sep-02	Dec-02	2002	Mar-03E	Jun-03E	Sep-03E	Dec-03E	2003E	Mar-04E	Jun-04E	Sep-04E	Dec-04E	2004E	
<b>Sales:</b>																					
Fluid milk	21,736	35,646	57,550	74,700	90,700	24,100	25,800	27,687	31,676	109,263	30,366	31,657	33,861	38,645	134,528	35,832	37,355	39,278	44,828	157,294	
Other U.S. dairy (includes industrial)	8,554	14,163	20,527	25,559	29,253	7,500	7,900	10,266	11,247	36,913	9,488	9,915	12,883	14,115	46,400	11,575	12,096	15,202	16,656	55,528	
Juice	-	500	3,977	6,800	8,200	1,900	2,000	2,048	1,946	7,894	1,919	2,080	2,171	2,101	8,271	2,073	2,246	2,344	2,269	8,933	
International Dairy Sales	-	NA	4,354	22,240	31,874	7,830	8,106	8,336	8,861	33,133	8,456	9,160	9,670	10,455	37,741	9,725	10,534	11,120	12,024	43,403	
Royalties	17	241	222	249	283	67	67	67	67	268	67	67	67	67	268	67	67	67	67	268	
Gross Sales	30,307	50,550	86,630	129,548	160,310	41,397	43,873	48,403	53,797	187,470	50,296	52,878	58,651	65,384	227,209	59,271	62,298	68,012	75,844	265,425	
Spoils and other	(741)	(1,191)	(1,859)	(2,342)	(1,440)	821	840	(772)	(822)	67	400	400	(700)	(850)	(750)	400	400	(700)	(850)	(750)	
<b>Net Sales</b>	<b>\$29,566</b>	<b>\$49,360</b>	<b>\$84,771</b>	<b>\$127,206</b>	<b>\$158,870</b>	<b>\$42,218</b>	<b>\$44,713</b>	<b>\$47,631</b>	<b>\$52,975</b>	<b>\$187,537</b>	<b>\$50,696</b>	<b>\$53,278</b>	<b>\$57,951</b>	<b>\$64,534</b>	<b>\$226,459</b>	<b>\$59,671</b>	<b>\$62,698</b>	<b>\$67,312</b>	<b>\$74,994</b>	<b>\$264,675</b>	
COGS (4)	22,639	32,615	59,217	89,406	111,847	28,368	30,646	32,681	35,986	127,681	34,447	36,346	39,493	43,764	154,050	40,482	42,720	45,718	50,748	179,668	
<b>Gross Profit</b>	<b>6,927</b>	<b>16,745</b>	<b>25,554</b>	<b>37,800</b>	<b>47,023</b>	<b>13,850</b>	<b>14,067</b>	<b>14,950</b>	<b>16,989</b>	<b>59,856</b>	<b>16,249</b>	<b>16,931</b>	<b>18,458</b>	<b>20,770</b>	<b>72,409</b>	<b>19,189</b>	<b>19,978</b>	<b>21,595</b>	<b>24,246</b>	<b>85,008</b>	
<b>Operating Expenses:</b>																					
Selling & marketing	5,656	11,007	18,399	25,389	31,341	9,430	9,900	10,762	11,297	41,389	11,407	11,881	13,039	14,197	50,524	13,545	14,107	15,280	16,649	59,581	
General & administrative	2,384	3,338	6,186	8,643	8,036	2,520	2,659	2,490	3,035	10,704	2,940	3,037	3,187	3,549	12,714	3,401	3,511	3,769	4,125	14,806	
Goodwill Amortization	-	-	1,058	2,389	3,115	325	326	328	328	1,307	325	325	325	325	1,300	325	325	325	325	1,300	
Restructuring charge	-	-	320	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	
Total Operating Expenses (4)	8,040	14,345	25,643	36,421	42,492	12,275	12,885	13,580	14,660	53,400	14,672	15,243	16,551	18,072	64,538	17,272	17,943	19,374	21,098	75,687	
<b>Operating Income</b>	<b>(1,113)</b>	<b>2,400</b>	<b>(89)</b>	<b>1,379</b>	<b>4,531</b>	<b>1,575</b>	<b>1,182</b>	<b>1,370</b>	<b>2,329</b>	<b>6,456</b>	<b>1,577</b>	<b>1,689</b>	<b>1,907</b>	<b>2,698</b>	<b>7,871</b>	<b>1,917</b>	<b>2,035</b>	<b>2,220</b>	<b>3,148</b>	<b>9,320</b>	
<b>Other Expenses:</b>																					
Interest expense (income)	1,073	825	(1,930)	401	1,568	119	88	88	25	320	107	106	103	108	425	106	99	99	100	404	
Other	35	-	93	147	182	70	34	96	25	225	25	25	25	25	100	25	25	25	25	100	
Total other expense	1,108	825	(1,837)	548	1,750	189	122	184	50	545	132	131	128	133	525	131	124	124	125	504	
Earnings before min. int. & taxes	(2,221)	1,575	1,748	831	2,781	1,385	1,060	1,186	2,279	5,910	1,445	1,557	1,779	2,565	7,346	1,787	1,911	2,097	3,023	8,817	
Income tax expense (benefit)	(513)	1,089	743	353	1,119	540	413	462	889	2,305	564	607	694	1,000	2,865	697	745	818	1,179	3,439	
Minority interest in loss of subsid. (2)	(686)	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	
Income from continuing operations	(1,022)	486	1,005	478	1,662	845	647	724	1,390	3,605	882	950	1,085	1,565	4,481	1,090	1,165	1,279	1,844	5,378	
<b>EPS - Continuing Ops. (1,3,6)</b>	<b>(\$0.22)</b>	<b>\$0.06</b>	<b>\$0.10</b>	<b>\$0.05</b>	<b>\$0.16</b>	<b>\$0.08</b>	<b>\$0.06</b>	<b>\$0.07</b>	<b>\$0.13</b>	<b>\$0.34</b>	<b>\$0.08</b>	<b>\$0.09</b>	<b>\$0.10</b>	<b>\$0.15</b>	<b>\$0.42</b>	<b>\$0.10</b>	<b>\$0.11</b>	<b>\$0.12</b>	<b>\$0.17</b>	<b>\$0.50</b>	
Shares Outstanding	4,627	7,742	9,992	10,030	10,213	10,545	10,617	10,556	10,609	10,583	10,641	10,673	10,705	10,737	10,689	10,769	10,801	10,834	10,866	10,818	
<b>Discontinued Operations:</b>																					
Net income (loss) from discontinued ops.	-	-	397	227	78	(2,519)	(294)	(399)	(426)	(3,638)	-	-	-	-	-	-	-	-	-	-	
<b>EPS - Discontinued Ops. (6)</b>			<b>\$0.04</b>	<b>\$0.02</b>	<b>\$0.01</b>	<b>(\$0.24)</b>	<b>(\$0.03)</b>	<b>(\$0.04)</b>	<b>(\$0.04)</b>	<b>(\$0.34)</b>											
<b>% Growth</b>																					
Fluid milk	77%	64.0%	61.4%	29.8%	21.4%	12.0%	18.0%	24.3%	26.0%	20.5%	26.0%	22.7%	22.3%	22.0%	23.1%	18.0%	18.0%	16.0%	16.0%	16.9%	
Other U.S. dairy (includes industrial)	113.9%	65.6%	44.9%	24.5%	19.6%	11.8%	27.7%	35.9%	27.7%	26.2%	26.5%	25.5%	25.5%	25.5%	25.7%	22.0%	22.0%	18.0%	18.0%	19.7%	
Juice	-	-	71.0%	20.4%	-1.9%	-0.5%	-5.8%	-5.0%	-3.7%	-3.7%	1.0%	4.0%	6.0%	8.0%	4.8%	8.0%	8.0%	8.0%	8.0%	8.0%	
International	-	-	410.8%	43.3%	-1.7%	2.9%	8.6%	6.0%	3.9%	3.9%	8.0%	13.0%	16.0%	18.0%	13.9%	15.0%	15.0%	15.0%	15.0%	15.0%	
<b>Total Sales Growth</b>	<b>84.9%</b>	<b>66.9%</b>	<b>71.7%</b>	<b>50.1%</b>	<b>24.9%</b>	<b>12.3%</b>	<b>15.8%</b>	<b>22.1%</b>	<b>21.3%</b>	<b>18.0%</b>	<b>20.1%</b>	<b>19.2%</b>	<b>21.7%</b>	<b>21.8%</b>	<b>20.8%</b>	<b>17.7%</b>	<b>17.7%</b>	<b>16.2%</b>	<b>16.2%</b>	<b>16.9%</b>	
<b>Internal Sales Growth</b>			<b>51.5%</b>	<b>23.5%</b>	<b>17.2%</b>	<b>12.3%</b>	<b>15.8%</b>	<b>22.1%</b>	<b>21.3%</b>	<b>18.0%</b>	<b>20.1%</b>	<b>19.2%</b>	<b>21.7%</b>	<b>21.8%</b>	<b>20.8%</b>	<b>17.7%</b>	<b>17.7%</b>	<b>16.2%</b>	<b>16.2%</b>	<b>16.9%</b>	
<b>EPS Growth</b>			<b>60.2%</b>	<b>-52.6%</b>	<b>241.6%</b>	<b>NM</b>	<b>448.0%</b>	<b>67.1%</b>	<b>8.7%</b>	<b>109.3%</b>	<b>3.4%</b>	<b>46.1%</b>	<b>47.9%</b>	<b>11.2%</b>	<b>23.0%</b>	<b>22.2%</b>	<b>21.2%</b>	<b>16.5%</b>	<b>16.4%</b>	<b>18.6%</b>	
<b>% of Sales</b>																					
Fluid milk	73.5%	72.2%	67.9%	58.7%	57.1%	57.1%	57.7%	58.1%	59.8%	58.3%	59.9%	59.4%	58.4%	59.9%	59.4%	60.0%	59.6%	58.4%	59.8%	59.4%	
Other U.S. dairy	28.9%	28.7%	24.2%	20.1%	18.4%	17.8%	17.7%	21.6%	21.2%	19.7%	18.7%	18.6%	22.2%	21.9%	20.5%	19.4%	19.3%	22.6%	22.2%	21.0%	
Juice	-	-	4.7%	5.3%	5.2%	4.5%	4.5%	4.3%	3.7%	4.2%	3.8%	3.9%	3.7%	3.3%	3.7%	3.5%	3.6%	3.5%	3.0%	3.4%	
International	-	-	5.1%	17.5%	20.1%	18.5%	18.1%	17.5%	16.7%	17.7%	16.7%	17.2%	16.7%	16.2%	16.7%	16.3%	16.8%	16.5%	16.0%	16.4%	
Spoils and other	-2.4%	-2.4%	-2.1%	-1.8%	-0.9%	2.0%	1.9%	-1.6%	-1.5%	0.0%	0.8%	0.8%	-1.2%	-1.3%	-0.3%	0.7%	0.6%	-1.0%	-1.1%	-0.3%	
<b>Total Sales</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	
Costs of Goods Sold	76.6%	66.1%	66.7%	70.3%	70.4%	67.2%	68.5%	68.6%	67.9%	68.1%	67.9%	68.2%	68.1%	67.8%	68.0%	67.8%	68.1%	67.9%	67.7%	67.9%	
<b>Gross Margin</b>	<b>23.4%</b>	<b>33.9%</b>	<b>30.1%</b>	<b>29.7%</b>	<b>29.6%</b>	<b>32.8%</b>	<b>31.5%</b>	<b>31.4%</b>	<b>32.1%</b>	<b>31.9%</b>	<b>32.1%</b>	<b>31.8%</b>	<b>31.9%</b>	<b>32.2%</b>	<b>32.0%</b>	<b>32.2%</b>	<b>31.9%</b>	<b>32.1%</b>	<b>32.3%</b>	<b>32.1%</b>	
<b>Operating Expenses</b>																					
Selling & marketing	19.1%	22.3%	21.7%	20.0%	19.7%	22.3%	22.1%	22.6%	21.3%	22.1%	22.5%	22.3%	22.5%	22.0%	22.3%	22.7%	22.5%	22.7%	22.2%	22.5%	
General & administrative	8.1%	6.8%	7.3%	6.8%	5.1%	6.0%	5.9%	5.2%	5.7%	5.7%	5.8%	5.7%	5.5%	5.5%	5.6%	5.7%	5.6%	5.6%	5.5%	5.6%	
Amortization of goodwill	-	-	1.2%	1.9%	2.0%	0.8%	0.7%	0.7%	0.6%	0.7%	0.6%	0.6%	0.6%	0.5%	0.6%	0.5%	0.5%	0.5%	0.4%	0.5%	
<b>Operating Margin</b>	<b>-3.8%</b>	<b>4.9%</b>	<b>-0.1%</b>	<b>1.1%</b>	<b>2.9%</b>	<b>3.7%</b>	<b>2.6%</b>	<b>2.9%</b>	<b>4.4%</b>	<b>3.4%</b>	<b>3.1%</b>	<b>3.2%</b>	<b>3.3%</b>	<b>4.2%</b>	<b>3.5%</b>	<b>3.2%</b>	<b>3.2%</b>	<b>3.3%</b>	<b>4.2%</b>	<b>3.5%</b>	
Net Margin - continuing operations	(3.5%)	1.0%	1.2%	0.4%	1.0%	2.0%	1.4%	1.5%	2.6%	1.9%	1.7%	1.8%	1.9%	2.4%	2.0%	1.8%	1.9%	1.9%	2.5%	2.0%	
Taxes	23.1%	69.1%	42.5%	42.5%	40.2%	39.0%	39.0%	39.0%	39.0%	39.0%	39.0%	39.0%	39.0%	39.0%	39.0%	39.0%	39.0%	39.0%	39.0%	39.0%	

**Notes:**

- (1) 1995 EPS and net income excludes loss from discontinued operations of \$406 and gain on disposal of \$513
- (2) Majority of Idaho farm purchased in early 1997
- (3) 1998 EPS includes extraordinary item - early extinguishment of senior subordinated promissory notes -