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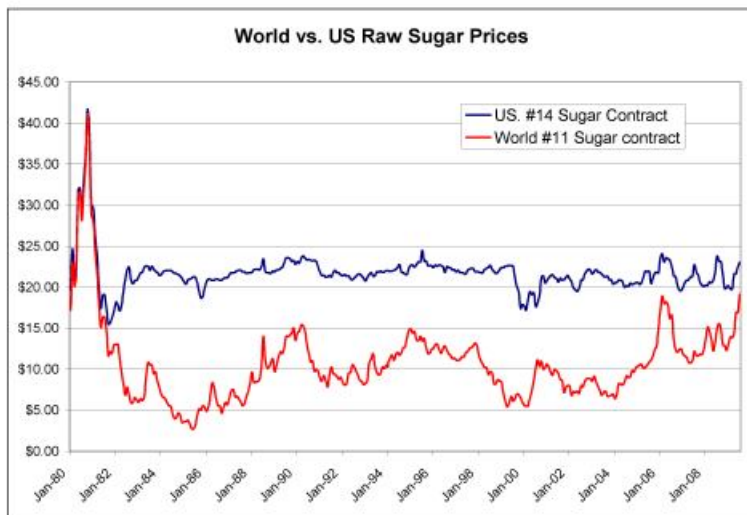
In Case You Missed It: The Eleven Quotes that Matter from This Earnings Season

Heading Back to the Sugar Shack: Long Imperial Sugar Company (IPSU)

August 4, 2009 – 9:46 am

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Digg It might not be well known to most equity investors but the global market for sugar has been on a tear lately. Just this week, the price of raw sugar traded on ICE (94.25 ↓1.89%) Futures hit a **submit** three and a half year high. This is due in large part to raw sugar cane crop shortages in India and other markets. As the chart below, demonstrates the US market for raw sugar has not followed suit. This is due in large part to the USDA's sugar policy created as part of the 2002 Farm Act, which is an allotment program which puts a cap on domestic production and also restrains imports through tariff rate quotas. As a result, the volatility in raw sugar prices here in the US has been considerably lower.



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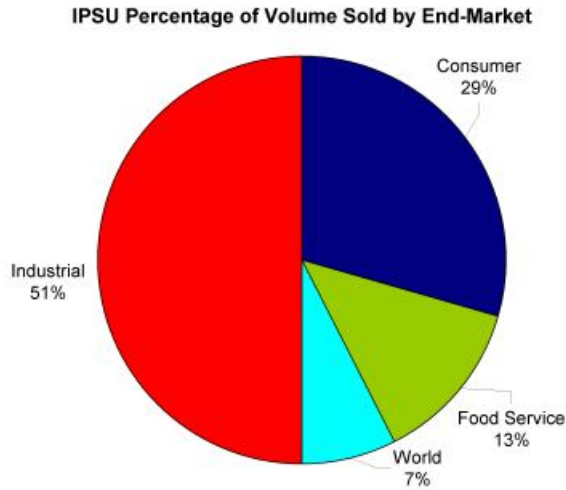
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Source: ICE Futures

There are very few ways to invest in sugar in the equity markets. However, the recent run-up in world sugar prices led us to revisit one of our favorite trading stocks from 2005-2007, Imperial Sugar Company (IPSU 13.7 ↑0.00%).

Company Background

IPSU is one of the largest processors and marketers of refined sugar in the US. The company owns and operates two refineries in Georgia and Louisiana. At full capacity, IPSU accounts for more than 15% of the total refined sugar produced in the US. Unlike most other sugar refiners in the US, IPSU is not vertically integrated and does not own any raw sugar cane or sugar beet fields. IPSU's products are best known to the consumer under the following brands: Dixie Crystals, Holly and Imperial. The company sells sugar into three primary channels: retail, industrial and food service. The company also sells some of its sugar in the global market through "toll sales". The table below outlines the volume of sugar sold by end-market:



Source: Company reports

The company's industrial and in some cases food service contracts are negotiated on a one-year or multi-year basis. Most of these negotiations occur during the spring/summer season during which contracts are renegotiated or signed. Over the past few years, IPSU has made two significant equity investments, the first in a Wholesome Sweeteners, Inc., an organic sugar producer and the second in a Mexican sugar producer, Ingenios Santos. IPSU owns a 50% stake in each company and accounts for its ownership under the equity method.

IPSU's business model is reasonably straightforward, the company purchases raw sugar and then processes it, packages it and ships it to end-users as refined sugar. Like other refiners, IPSU's gross margins are dictated in large part by the spread between the price of refined sugar and that of raw sugar. In the case of IPSU, energy costs are a significant variable in the company's gross margins. Natural gas and coal are the company's primary sources of energy.

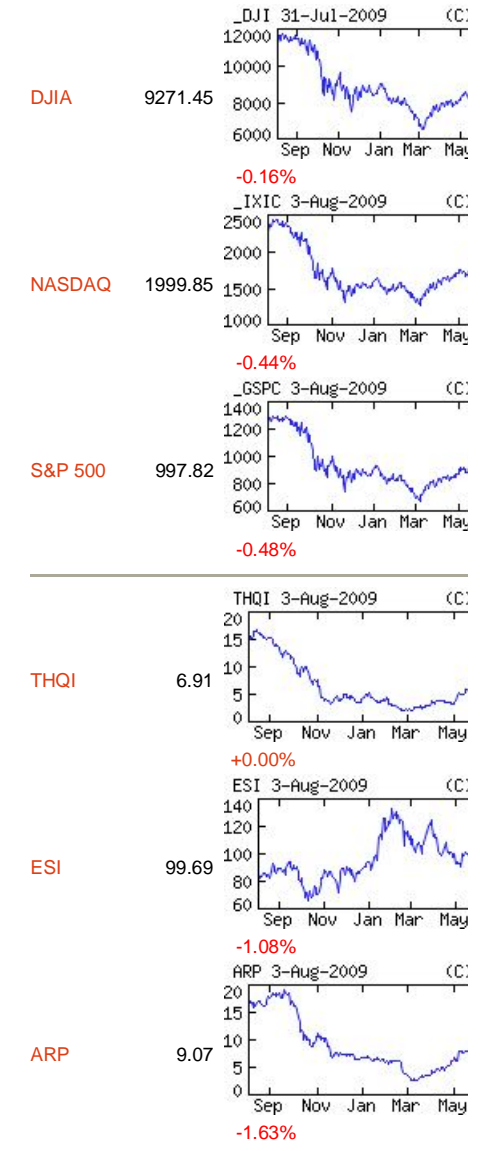
There have been two major events that have significantly altered the earnings profile of IPSU and its stock



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Market Quotes and Current Investment Ideas



price over the past five years – Hurricane Katrina and the Savannah refinery explosion.

Hurricane Katrina

On August 29, 2005 Hurricane Katrina made landfall as a category 3 hurricane just east of New Orleans. American Sugar Refining Inc. (Domino Sugar), owns and operates the largest sugar refining plant in the country in Chalmette, Louisiana which was severely impacted by the storm. As a result, approximately 10% of total capacity in the US was lost completely for almost four months and it took almost a year for the refinery to return to full production levels. Suddenly, the market was short refined sugar and prices quickly surged. According to Milling and Baking News, the average price of refined sugar increased from \$26.75 (cwt) in August 2005 to \$40.10 (cwt) in September 2005 – a 50% sequential increase! IPSU was a direct beneficiary of the lack of capacity. The company was able to lock in longer term contracts with food service and industrial clients at levels not seen in a generation. This enabled IPSU to generate EPS from continuing operations of \$4.28 in FY06 (Sept fiscal year end) and \$2.88 in FY07. Normalized gross margins typically have ranged between 5-8%. During the period following Hurricane Katrina, the company's gross margins reached a high of 17.1%. Not until the the December quarter in 2007 did the company's gross margins finally revert to what we consider the mean.

Port Wentworth, GA Refinery Explosion

On February 7, 2008, an explosion occurred at IPSU's sugar refinery in Port Wentworth (Savannah), GA. The explosion killed thirteen people and wounded 42. The explosion was caused by a dust explosion, which can occur when sugar particles in the air become ionized due to friction. Outside of the human tragedy, which is significant, the explosion more or less completely destroyed IPSU's refinery. For the past 18-months, IPSU has been solely operating its facility in Grammercy, LA, while rebuilding its refinery in Savannah. The company has also continued to pay workers from the plant until it is fully rebuilt. The refinery is now expected to re-open the vast majority of its operations in the fall of this year.

The Savannah refinery explosion has created a number of potential liabilities for IPSU, some of which are quantifiable and others which are not. We thought it might be helpful to list the liabilities and where IPSU stands in recognizing them from a P&L and cash flow perspective:

Overall, the company has recognized \$92.5 million in charges related to the explosion.

These have been offset by approximately \$57.1 million in gains from insurance recoveries, which results in total net charges of \$35.4 million. Here are some of the major components of the charges taken thus far:

- \$13 million write-off of the book value of the plant
- \$7.2 million for lost inventory
- \$16.9 million for cleanup and repairs
- \$25.6 million for refinery payroll costs
- \$14.8 million in legal and consulting bills

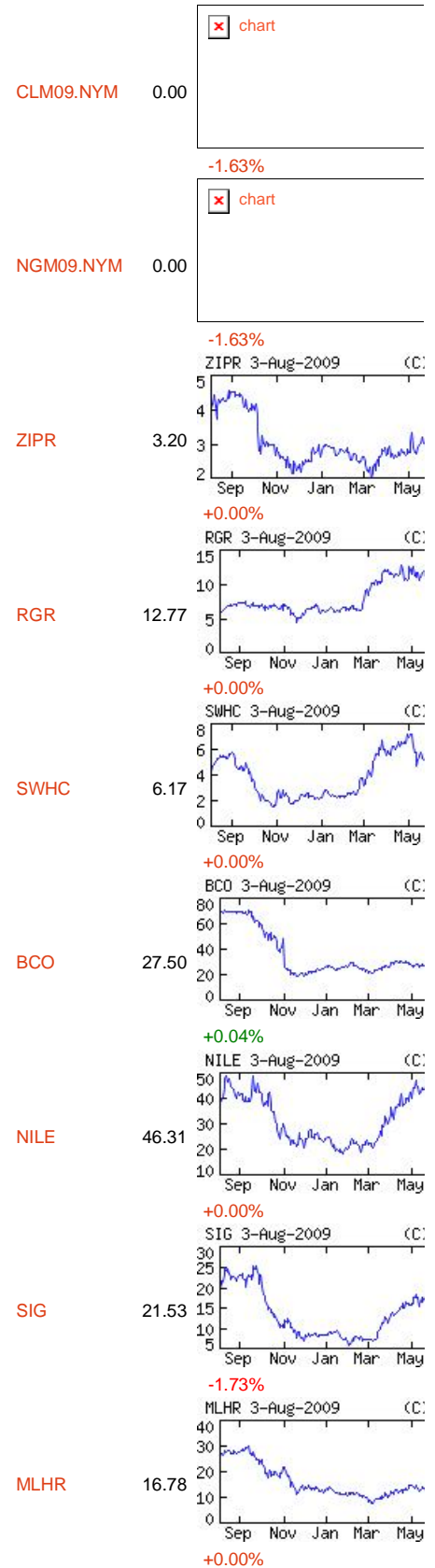
Total cost to rebuild the plant \$200-\$220 million. IPSU has indicated that it could cost as much as \$220-\$220 million to rebuild the plant, which should be covered by the company's business interruption insurance policy of \$350 million. **Thus far the company has received a total of \$160 million in insurance advances.**

OSHA fine of \$8.8 million. The OSHA fines are not covered under the company's insurance policies. Thus far the company has reserved \$3.5 million for these fines. IPSU expects to have an appeals hearing in May or June of 2010

\$6.4 million charge from its worker's comp insurance carrier. The company's worker's comp insurance coverage of \$100 million, includes a provision that the insurer can pass through any Subsequent Injury Trust Fund charges from the state of Georgia. IPSU has not reserved yet for this charge.

A host of shareholder lawsuits and related litigation. As one might expect there are a number of shareholder suits at varying stages in the legal process.

That's a fairly long list, but it is important to note that the company has large insurance policies. Its \$350 million business interruption policy should cover the costs to rebuild the refinery and its worker's

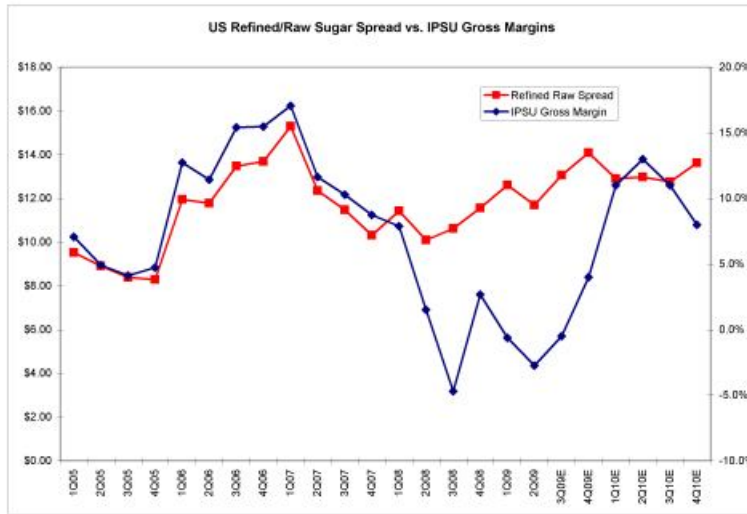


compensation policy should cover the ongoing salary expenses for current employees of the refinery. We think the risks associated with the refinery explosion are becoming more granular, while the path towards profitability looks increasingly clear. We think IPSU shares have substantial upside from current levels. Our enthusiasm is based on the following:

1) Port Wentworth Is Finally On the Brink of Re-opening, Which Should Restore IPSU’s Earnings Power

From an operational perspective, IPSU has continued to try to service its clients that relied on sugar production from its Savannah facility. **The company estimates that higher transportation costs and start-up costs related to the Port Wentworth facility have been a combined drag on gross profit margins as much as 10%.** As a result, IPSU has generated negative gross margins for each of the past two quarters.

As we mentioned earlier, IPSU has historically generated 5-8% gross margins during periods of relatively tight refined/raw sugar spreads. The company’s gross margins are highly correlated to the difference between refined and raw sugar prices. As the chart below demonstrates, the company has not benefitted from the recent expansion in spreads due to the issues at its Savannah refinery.



Source: Company reports, PAA Research

IPSU recently **announced**, that it had started bulk sugar production and that it remains on target to have full packaging capabilities sometime in the fall of this year. The Port Wentworth facility represented 60% of total production for IPSU and approximately 8-9% of total industry capacity in the US. While adding additional refining capacity to the marketplace should put some downward pressure on prices, overall supplies in the sugar market remain very tight. **We think this should enable the company to achieve 10%+ gross margins in FY10, which would imply earnings of \$2.00+.**

2) Lower Natural Gas Prices Could Boost Gross Margins by 150-200 bps in FY10

IPSU has always pursued a hedging policy with regard to its natural gas exposure. Historically, the company’s facility in Grammercy, LA has fulfilled all of its energy needs through natural gas, while the facility in Savannah used a mix of natural gas and coal. The company typically hedges its natural gas needs through futures contracts purchased during the second half of the calendar year. IPSU put its hedges in place for this fiscal year during the last stages of the bull market in natural gas a year ago. As a result of this strategy the company has incurred remarkably high natural gas costs this year, \$9.39 per mmbtu in the first six-months of this fiscal year. As these contracts roll-off, the company will be able to purchase natural gas at levels consistent with today’s 12-month strip average of \$5.62 per mmbtu. We estimate this could be a 150-



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200 bps tailwind to gross margins in FY10. The table below highlights the company’s natural gas needs over the past few years and our expectations going forward:

	NG usage (mmbtu)	Avg. Price	Total Cost	NG %	% of Revs
FY07	2,652,000	\$7.90	20,950,800	59.0%	2.4%
FY08	2,244,000	\$9.13	20,487,720	75.0%	3.5%
F09E	2,200,000	\$7.99	17,578,000	100.0%	3.3%
FY10E	2,500,000	\$5.62	14,041,538	60.0%	1.6%

Source: Company reports, PAA Research

Even After the Recent Run-up, IPSU Appears to be Trading Below Replacement Cost – Boxing Litigation Risk

On the surface, it looks like IPSU is trading at approximately 1.2x current book value, which appears reasonable for a company with substantial litigation risk, volatile earnings and low margins. However, putting on our **Tobin hats** for a moment, we think the replacement value of IPSU is considerably higher. In the table below we’ve put together a fairly simple sum of the parts analysis. For this analysis, we have assumed that the company will receive insurance proceeds which will cover the TOTAL cost of production to rebuild the Savannah refinery. That is a big assumption, but the rate of insurance advances thus far suggests that the company should have its construction costs covered. We have also included an additional \$50 million in liabilities from regulatory charges, shareholder suits, non-covered worker’s comp claims or anything else that could arise. We don’t expect additional charges to arise, but we want to see how much margin for error we have in our investment. Additionally, we have assumed that the company’s investments in Wholesome Sweeteners and Santos are worth approximately 10x net income, which could be conservative. **Our sum of the parts analysis suggests that IPSU shares could be worth north of \$21, or 50% higher than where shares trade today.**

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Asset/Liability	Value	Per Share
Port Wentworth, Ga	210	\$17.80
Grammercy, LA	100	\$8.47
Wholesome Sweeteners/Santos Ownership	30	\$2.54
Total Asset Value	340	\$28.81
Total Debt	30	\$2.54
OSHA Liability (cash)	8.8	\$0.42
State of Georgia Fines	6.4	\$0.54
Other contingent non-insured liabilities	50	\$4.24
Total Liabilities	91.4	\$7.75
Total Equity Value	248.6	\$21.07
Difference from current price		53.8%

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Source: PAA Research

It is not unreasonable to think this company could become an acquisition candidate. In the spring of 2005, Shultze Asset Management, one of the company's largest shareholders (then and now) offered to purchase the company for \$17.00/share. The offer was rejected. Additionally, IPSU has been in discussions with Cargill and the company's largest raw sugar cane supplier to form a joint-venture with its Grammercy, LA facility. Our analysis implies that the "buy vs. build" argument leans further in favor of "buy" for IPSU the more you can box the litigation and regulatory risk associated with the refinery fire. We have looked at two key variables in our analysis: the value of IPSU's Grammercy Facility and the potential contingent non-insured liabilities. In our base case, we assumed there were \$50 million in non-insured contingent liabilities, which we think is VERY conservative. We have heard from key industry participants that the Grammercy facility could be worth as much as \$150 million as opposed to the \$100 million we used in our base case. As you can see from the table below, in most cases IPSU shares have upside strictly on a replacement value basis.

IPSU Value per Share Based on Key Inputs

		Value of Grammercy Facility (\$MM's)				
		\$50	\$75	\$100	\$125	\$150
	\$0	\$21.07	\$23.19	\$25.31	\$27.42	\$29.54
	\$10	\$20.22	\$22.34	\$24.46	\$26.58	\$28.69
	\$20	\$19.37	\$21.49	\$23.61	\$25.73	\$27.85
	\$30	\$18.53	\$20.64	\$22.76	\$24.88	\$27.00
Other	\$40	\$17.68	\$19.80	\$21.92	\$24.03	\$26.15
Non-Insured	\$50	\$16.83	\$18.95	\$21.07	\$23.19	\$25.31
Contingent	\$60	\$15.98	\$18.10	\$20.22	\$22.34	\$24.46
Liabilities	\$70	\$15.14	\$17.25	\$19.37	\$21.49	\$23.61
(\$MM's)	\$80	\$14.29	\$16.41	\$18.53	\$20.64	\$22.76
	\$90	\$13.44	\$15.56	\$17.68	\$19.80	\$21.92
	\$100	\$12.59	\$14.71	\$16.83	\$18.95	\$21.07
	\$110	\$11.75	\$13.86	\$15.98	\$18.10	\$20.22
	\$120	\$10.90	\$13.02	\$15.14	\$17.25	\$19.37
	\$130	\$10.05	\$12.17	\$14.29	\$16.41	\$18.53
	\$140	\$9.20	\$11.32	\$13.44	\$15.56	\$17.68
	\$150	\$8.36	\$10.47	\$12.59	\$14.71	\$16.83

Source: PAA Research

IPSU will report 3Q09 results before the market opens on Wednesday. Our call is not predicated on the company's earnings results for the quarter. The company will likely post another operating loss. Management does not provide guidance so we think the vast majority of the call will focus on the company's rebuilding efforts and how quickly production can ramp up. We think the company is on the brink of substantial shareholder value creation over the next 6-9 months once the Savannah facility comes back online. Our scenario analysis implies a total probability weighed return of 28.6% for IPSU shares. At 10x our FY10 EPS estimate the stock would trade at \$21.

IPSU - LONG							Total
Return Matrix	Current Price	Target Price	Conviction Level	Absolute Return	Holding Period	Annualized Return	Probability Weighted Return
Upside	\$13.70	\$21.00	35.0%	53.3%	1.0x	53.3%	28.6%
Base	\$13.70	\$17.50	45.0%	27.7%	1.0x	27.7%	
Downside	\$13.70	\$12.00	20.0%	-12.4%	1.0x	-12.4%	

Source: PAA Research

As always, please act accordingly...

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