H. M. Payson & Co.

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RESEARCH NOTES

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Among the more difficult elements of our research process is to acknowledge when our reasons for owning a security need to change. Such is the case with Sara Lee (SLE), a somewhat special situation for us, which we recognized was a pure cash flow story we found compelling even without a good growth outlook. Several clients questioned us about this idea, and we want to be clear about our recent decision to sell the stock in the face of SLE's discouraging guidance concerning the outlook for profit margins. Below is the analyst's most recent commentary on SLE.

RATINGS CHANGE ON SARA LEE CORP (SLE $16.60)

We have recently changed our opinion on Sara Lee. Although we are still intrigued by the company's strong cash flow generation capabilities and yield characteristics, intense competition combined with higher than expected commodity prices have created a strong headwind that will likely keep earnings growth and valuations depressed for too long.

Although Sara Lee's recent quarterly earnings were ahead of analyst expectations, management guided profit margin expectations lower. Now management does not expect operating profit margins to reach double digits until 2010. We have incorporated these lower longer-term margin expectations into our valuation metrics and have decided it's time to use Sara Lee holdings as a source of funds

Sara Lee's long awaited spin-off of their Hanes apparel division will take place on September 5th when shareholders will get one share for every eight shares of Sara Lee. After the spin-off, Hanes will borrow $2.6 billion and transfer $2.4 billion to Sara Lee. Sara Lee will use a portion of the cash to pay down debt and to buy back stock. Sara Lee's management has committed to maintaining the dividend payout ratio. However, since Hanes will have such a large debt burden, it is unlikely that they will have the ability to pay a dividend. The net effect for current Sara Lee shareholders will be a dividend cut.

In light of disappointing operating margins and what appears to be essentially a dividend cut, we are lowering our fair value estimate and our rating on the stock to "source of funds".

If you have questions or comments regarding this Research Note, please feel free to contact the Research Department.