

DARLING INTERNATIONAL INC
Form 10-Q
November 15, 2004

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington, DC 20549

FORM 10-Q

(Mark One)

☒ QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended October 2, 2004

OR

☐ TRANSITION REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File Number 0-24620

DARLING INTERNATIONAL INC.

(Exact name of registrant as specified in its charter)

DELAWARE

(State or other jurisdiction
of incorporation or organization)

36-2495346

(I.R.S. Employer
Identification No.)

251 O'CONNOR RIDGE BLVD., SUITE 300, IRVING, TEXAS 75038

(Address of principal executive offices)

(972) 717-0300

(Registrant's telephone number)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes

☒ No ☐

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes ☐ No ☒

There were 63,918,346 shares of common stock, \$0.01 par value, outstanding at November 10, 2004.

DARLING INTERNATIONAL INC. AND SUBSIDIARIES
FORM 10-Q FOR THE THREE MONTHS ENDED OCTOBER 2, 2004

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DARLING INTERNATIONAL INC. AND SUBSIDIARIES**CONSOLIDATED BALANCE SHEETS****October 2, 2004 and January 3, 2004**

(in thousands, except shares and per share data)

	October 2, 2004	January 3, 2004
	-----	-----
ASSETS	(unaudited)	

Current assets:		
Cash and cash equivalents	\$ 41,191	\$ 25,383
Accounts receivable	27,489	29,353
Inventories	8,053	7,837
Prepaid expenses	4,365	4,509
Deferred income taxes	3,672	3,937
Assets held for sale	706	1,160
Other	25	16
	-----	-----
Total current assets	85,501	72,195
Property, plant and equipment, less accumulated depreciation of \$163,564 at October 2, 2004 and \$161,051 at January 3, 2004 ..	72,514	73,274
Collection routes and contracts, less accumulated amortization of \$28,208 at October 2, 2004 and \$28,118 at January 3, 2004	16,534	19,458
Goodwill, less accumulated amortization of \$1,077 at October 2, 2004 and January 3, 2004	4,429	4,429
Deferred loan costs	3,779	2,986
Other assets	3,032	2,307
	-----	-----
	\$185,789	\$174,649
	=====	=====
LIABILITIES AND STOCKHOLDERS' EQUITY		

Current liabilities:		
Current portion of long-term debt	\$ 5,030	\$ 7,489
Accounts payable, principally trade	9,391	9,059
Accrued expenses	29,453	24,132
Accrued interest	215	326
	-----	-----
Total current liabilities	44,089	41,006
Long-term debt, net	51,288	48,188
Other non-current liabilities	17,074	16,083
Deferred income taxes	4,948	4,878
Redeemable preferred stock, \$0.01 par value, 1,000,000 shares authorized, 100,000 shares outstanding at January 3, 2004	-	9,212
	-----	-----
Total liabilities	117,399	119,367
	-----	-----
Stockholders' equity:		
Common stock, \$0.01 par value; 100,000,000 shares authorized; 63,918,346 and 63,654,240 shares issued and outstanding at		

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October 2, 2004 and at January 3, 2004, respectively	639	637
Additional paid-in capital	77,328	77,179
Treasury stock, at cost; 21,000 shares at October 2, 2004 and January 3, 2004	(172)	(172)
Accumulated other comprehensive loss	(5,202)	(5,176)
Accumulated deficit	(4,203)	(17,186)
	-----	-----
Total stockholders' equity	68,390	55,282
	-----	-----
Commitments and contingencies		
	\$185,789	\$174,649
	=====	=====

The accompanying notes are an integral part of these consolidated financial statements.

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DARLING INTERNATIONAL INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

Three months and nine months ended October 2, 2004 and September 27, 2003

(in thousands, except per share data)
(unaudited)

	Three Months Ended		Nine Months Ended	
	October 2, 2004	September 27, 2003	October 2, 2004	September 27, 2003
Net sales	\$80,174	\$80,723	\$249,407	\$227,179
Costs and expenses:				
Cost of sales and operating expenses	57,966	62,839	183,494	173,494
Selling, general and administrative expenses	9,226	8,570	27,419	25,419
Depreciation and amortization	3,559	3,678	11,305	10,305
	-----	-----	-----	-----
Total costs and expenses	70,751	75,087	222,218	210,218
	-----	-----	-----	-----
Operating income	9,423	5,636	27,189	17,189
	-----	-----	-----	-----
Other expense:				
Interest expense	(1,664)	(716)	(5,224)	(1,716)
Other, net	(53)	(140)	(392)	(140)
	-----	-----	-----	-----
Total other expense	(1,717)	(856)	(5,616)	(1,856)
	-----	-----	-----	-----

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Income before income taxes	7,706	4,780	21,573	15,
Income taxes	(3,124)	(2,052)	(8,590)	(6,
	-----	-----	-----	-----
Net income	4,582	2,728	12,983	9,
Preferred dividends and accretion	-	-	-	(
	-----	-----	-----	-----
Net income applicable to common shareholders	\$ 4,582	\$ 2,728	\$ 12,983	\$ 8,
	=====	=====	=====	=====
Basic and diluted income per share:	\$ 0.07	\$ 0.04	\$ 0.20	\$ 0
	=====	=====	=====	=====

The accompanying notes are an integral part of these consolidated financial statements.

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DARLING INTERNATIONAL INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

Nine months ended October 2, 2004 and September 27, 2003

(in thousands)

(unaudited)

	Nine Months Ended	
	October 2, 2004	September 2003
	-----	-----
Cash flows from operating activities:		
Net income	\$12,983	\$ 9,327
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	11,305	10,958
Gain on disposal of property, plant, equipment and other assets	(315)	(52)
Gain on early extinguishment of debt	(1,306)	(555)
Preferred stock dividend and discount accretion	-	252
Loss on early redemption of preferred stock	1,678	-
Deferred taxes	335	-
Changes in operating assets and liabilities:		
Accounts receivable	1,864	(5,398)
Inventories and prepaid expenses	(72)	(1,695)
Accounts payable and accrued expenses	5,763	1,762
Accrued interest	(111)	(50)
Other	1,650	493
	-----	-----
Net cash provided by operating activities	33,774	15,042
	-----	-----
Cash flows from investing activities:		
Capital expenditures	(7,698)	(7,823)

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Business acquisitions	-	(1,131)
Gross proceeds from disposal of property, plant and equipment and other assets	450	75
	-----	-----
Net cash used by investing activities	(7,248)	(8,879)
	-----	-----
Cash flows from financing activities:		
Proceeds from debt	92,302	157,486
Payments on debt	(89,594)	(164,459)
Deferred loan costs	(2,228)	-
Redemption of preferred stock	(10,000)	-
Payment of preferred dividends	(1,240)	-
Contract payments	(110)	(268)
Issuance of common stock	152	1,316
	-----	-----
Net cash used by financing activities	(10,718)	(5,925)
	-----	-----
Net increase in cash and cash equivalents	15,808	238
Cash and cash equivalents at beginning of period	25,383	15,537
	-----	-----
Cash and cash equivalents at end of period	\$41,191	\$15,775
	=====	=====
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	\$ 4,443	3,661
	=====	=====
Income taxes, net of refunds	\$ 5,539	\$ 619
	=====	=====

The accompanying notes are an integral part of these consolidated financial statements.

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DARLING INTERNATIONAL INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

October 2, 2004

(unaudited)

(1) General

The accompanying consolidated financial statements for the three month and nine month periods ended October 2, 2004 and September 27, 2003 have been prepared in accordance with generally accepted accounting principles in the United States of America by Darling International Inc. (the Company) without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). The information furnished herein reflects all adjustments (consisting only of normal recurring accruals) which are, in the opinion of

management, necessary to present a fair statement of the financial position and operating results of the Company as of and for the respective periods. However, these operating results are not necessarily indicative of the results expected for a full fiscal year. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles have been omitted pursuant to such rules and regulations. However, management of the Company believes, to the best of their knowledge, that the disclosures herein are adequate to make the information presented not misleading. The accompanying consolidated financial statements should be read in conjunction with the audited consolidated financial statements contained in the Company's Form 10-K for the fiscal year ended January 3, 2004.

(2) Summary of Significant Accounting Policies

(a) Basis of Presentation

The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

(b) Fiscal Periods

The Company has a 52/53 week fiscal year ending on the Saturday nearest December 31. Fiscal periods for the consolidated financial statements included herein are as of October 2, 2004, and include the 13 and 39 weeks ended October 2, 2004, and the 13 and 39 weeks ended September 27, 2003.

(c) Earnings per Share

Basic income per common share is computed by dividing net earnings attributable to outstanding common stock by the weighted average number of common shares outstanding during the period. Diluted income per common share is computed by dividing net earnings attributable to outstanding common stock by the weighted average number of common shares outstanding during the period increased by dilutive common equivalent shares (stock options) determined using the treasury stock method, based on the average market price exceeding the exercise price of the stock options.

Pro forma treasury shares represent the shares which potentially may be reacquired by the Company as treasury shares from the proceeds of option shares for which the contractual exercise price is less than the market price (in the money), based upon a reacquisition price equal to the average market price of the Company's common shares during the period presented.

Net Income Per Common Share (in thousands, except per share amounts)

Three Months Ended

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	October 2, 2004			
	Income	Shares	Per Share	Income
Net income	\$4,582	63,890	\$0.07	\$2,728
Basic:				
Income available to common shareholders	4,582	63,890	0.07	2,728
Effect of dilutive securities:				
Add: Option shares in the money		1,115		
Less: Pro forma treasury shares		(440)		

Diluted:				
Income available to common shareholders	\$4,582	64,565	\$0.07	\$2,728
	-----	-----	-----	-----

	Nine Months Ended			
	October 2, 2004			
	Income	Shares	Per Share	Income
Net income	\$12,983	63,821	\$0.20	\$9,327
Less: Preferred dividends and accretion	-		-	(697)
	-----	-----	-----	-----
Basic:				
Income available to common shareholders	12,983	63,821	0.20	8,630
Effect of dilutive securities:				
Add: Option shares in the money		1,041		
Less: Pro forma treasury shares		(443)		

Diluted:				
Income available to common shareholders	\$12,983	64,419	\$0.20	\$8,630
	-----	-----	-----	-----

For the nine months ended October 2, 2004 and September 27, 2003, respectively, 81,000 and 981,430 outstanding stock options were excluded from diluted income per common share as the effect was antidilutive.

(d) Accounting for Stock-Based Compensation

The Company accounts for its stock option plan in accordance with the provisions of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. As such, compensation expense is recorded on the date of grant only if the current market price of the underlying stock exceeds the exercise price. Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation*, permits entities to recognize as expense over the vesting period the fair value of all stock-based awards on the date of grant. Alternatively, SFAS No. 123 allows entities to continue to apply the provisions of APB Opinion No. 25 and provide pro forma net income and pro forma earnings per share disclosures for employee stock option grants made in 1995 and future years as if the fair-value-based method defined in SFAS No. 123 had been applied. The Company has elected to continue to apply the provisions of APB Opinion No. 25 and provide the pro forma disclosure provisions of SFAS No. 123.

The following table illustrates the pro forma effect on net income and income per share if the fair value-based method had been applied to all outstanding and invested awards in each period.

	Three Months Ended			
	October 2, 2004		September 27, 2003	
	amount	per share	amount	per share
Reported net income applicable to common shareholders	\$4,582	\$0.07	\$2,728	\$ 0.04
Deduct total stock-based employee compensation expense determined under fair-value-based method for all rewards, net of tax	(206)	-	(222)	-
Pro forma effect	\$4,376	\$0.07	\$2,506	\$0.04
	Nine Months Ended			
	October 2, 2004		September 27, 2003	
	amount	per share	amount	per share
Reported net income applicable to common shareholders	\$12,983	\$0.20	\$8,630	\$ 0.14
Deduct total stock-based employee compensation expense determined under fair-value-based method for all rewards, net of tax	(379)	-	(411)	(0.01)
Pro forma effect	\$12,604	\$0.20	\$8,219	\$0.13

(3) Contingencies

LITIGATION

The Company is a party to several lawsuits, claims and loss contingencies incidental to its business, including assertions by certain regulatory agencies related to air, wastewater, and storm water discharges from the Company's processing facilities.

Self Insured Risks

The Company purchases its workers compensation, auto and general liability insurance on a retrospective basis. The Company estimates and accrues its expected ultimate costs related to claims occurring during each fiscal year and carries this accrual as a reserve until such claims are paid by the Company.

As a result of the matters discussed above, the Company has established loss reserves for insurance, environmental and litigation matters. At October 2, 2004 and January 3, 2004, the reserves for insurance, environmental and litigation contingencies reflected on the balance sheet in accrued expenses and other non-current liabilities were approximately \$14.2 million and \$12.4 million, respectively. Management of the Company believes these reserves for contingencies are reasonable and sufficient based upon present governmental regulations and information currently available to management; however, there can be no assurance that final costs related to these matters will not exceed current estimates. The Company believes that any additional liability relative to such lawsuits and claims which may not be covered by insurance would not likely have a material adverse effect on the Company's financial position, although it could potentially have a material impact on the results of operations in any one year.

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(4) Business Segments

The Company operates on a worldwide basis within two industry segments: Rendering and Restaurant Services. The measure of segment profit includes all revenues, operating expenses (excluding certain amortization of intangibles), and selling, general and administrative expenses incurred at all operating locations and excludes general corporate expenses. During the first quarter of Fiscal 2004, the Company increased the allocation of plant selling, general and administrative expense to the Restaurant Services segment, which resulted in additional expense of \$0.5 million and \$1.8 million of expense allocated to this segment during the third quarter and first nine months of Fiscal 2004, respectively.

During the third quarter of Fiscal 2004, the Company concluded a settlement with certain past insurers on certain policies of insurance issued primarily before 1972, whereby the Company received a cash payment of approximately \$2.8 million in return for an executed Settlement Agreement and Release in which the Company released the participating insurers from all actual and potential claims and liability under the subject insurance policies. The Company recorded receipt of the payment as a credit (recovery) of claims expense and previous insurance premiums included in cost of sales, within the Corporate segment.

Included in corporate activities are general corporate expenses and the amortization of intangibles. Assets of corporate activities include cash, unallocated prepaid expenses, deferred tax assets, prepaid pension, and miscellaneous other assets.

Rendering

Rendering consists of the collection and processing of animal by-products from butcher shops, grocery stores, food service industry and independent meat and poultry processors, converting these into products such as useable oils and proteins utilized by the agricultural and oleochemical industries.

Restaurant Services

Restaurant Services consists of the collection of used cooking oils from food service establishments and recycling them into similar products such as high-energy animal feed ingredients and industrial oils. Restaurant Services also provides grease trap servicing and equipment sales.

Business Segment Net Sales (in thousands):

	Three Months Ended		Nine Months Ended	
	October 2, 2004	September 27, 2003	October 2, 2004	September 27, 2003
Rendering:				
Trade	\$51,697	\$51,967	\$159,915	\$149,448
Intersegment	6,959	8,113	20,484	20,988
	<u>58,656</u>	<u>60,080</u>	<u>180,399</u>	<u>170,436</u>
Restaurant Services:				
Trade	28,477	28,756	89,492	78,462
Intersegment	2,901	3,720	8,838	10,861
	<u>31,378</u>	<u>32,476</u>	<u>98,330</u>	<u>89,323</u>
Eliminations	<u>(9,860)</u>	<u>(11,833)</u>	<u>(29,322)</u>	<u>(31,849)</u>
Total	<u>\$80,174</u>	<u>\$80,723</u>	<u>\$249,407</u>	<u>\$227,910</u>

Business Segment Profit (in thousands):

	Three Months Ended		Nine Months Ended	
	October 2, 2004	September 27, 2003	October 2, 2004	September 27, 2003
Rendering	\$7,858	\$5,269	\$24,987	\$16,005
Restaurant Services	4,686	5,586	17,392	17,404
Corporate	(6,298)	(7,411)	(24,172)	(22,455)
Interest Expense	(1,664)	(716)	(5,224)	(1,627)
Net Income	\$4,582	\$2,728	\$12,983	\$9,327

Certain assets are not attributable to a single operating segment but instead relate to multiple operating segments operating out of individual locations. These assets are utilized by both the Rendering and Restaurant Services business segments and are identified in the category called Combined Rendering/Restaurant Services. Depreciation of Combined Rendering/Restaurant Services assets is allocated based upon management's estimate of the percentage of corresponding activity attributed to each segment.

Business Segment Assets (in thousands):

	October 2, 2004	January 3, 2004
Rendering	\$ 47,284	\$ 52,931
Restaurant Services	16,563	13,853
Combined Rendering/Restaurant Services	64,277	67,291
Corporate	57,665	40,574
Total	\$185,789	\$174,649

(5) Income Taxes

The Company has provided income taxes for the three-month and nine-month periods ended October 2, 2004, based on its estimate of the effective tax rate for the entire 2004 fiscal year.

In determining whether its deferred tax assets are more likely to be recoverable, than not recoverable, the Company assessed its ability to carryback net operating losses, scheduled reversals of future taxable and deductible amounts, tax planning strategies, and the extent of evidence currently available to support projections of future taxable income. The Company is unable to carryback any of its net operating losses and recent favorable operating results do not provide sufficient historical evidence at this time of sustained future profitability sufficient to result in taxable income against which certain net operating losses can be carried forward and utilized.

(6) Financing

(a) Refinancing - Senior Credit Agreement

The Company entered into a new Senior Credit Agreement with new lenders on April 2, 2004, and entered into a new lender acknowledgement on May 28, 2004, that increased the committed amount as permitted by the Senior Credit Agreement. The refinancing replaces the prior Amended and Restated Credit Agreement executed on May 13, 2002. The new Senior Credit Agreement provides for \$75 million in financing facilities, has a term of five years, maturing on April 2, 2009, and bears interest at a rate which may be based upon either prime or LIBOR, or a combination of both rates plus a margin which may be adjusted quarterly based upon the Company's leverage ratios. The new Senior Credit Agreement provides for a \$25.0 million Term Loan Facility, with scheduled amortization of \$1.25 million each quarter during the five-year agreement. Additionally, the new Senior Credit Agreement provides for a \$50 million Revolver Facility which includes a \$25.0 million Letter of Credit sub-facility. At October 2, 2004, the interest rate for the \$21.25 million balance of the term loan was based upon a three-month LIBOR rate of 1.63% per annum, plus a margin of 2.75% per annum for a total of 4.38% per annum.

The refinancing provides increased availability and liquidity, an extended term, lower interest rates, and more flexible capital investment limitations than the prior Amended and Restated Credit Agreement. Restrictive covenants in the Company's new Senior Credit Agreement permit the Company, within limitations defined in the new Senior Credit Agreement, to incur additional indebtedness; issue additional capital or preferred stock; pay dividends; redeem common shares as treasury stock; create liens; merge, consolidate, or acquire other businesses; sell and dispose of assets; and make investments; and requires the maintenance of certain minimum financial ratios.

On April 2, 2004, proceeds of the new Term Loan Facility were used to pay off the outstanding balance of the prior Amended and Restated Credit Agreement of approximately \$18.0 million. Additional proceeds were used for other general corporate and working capital purposes. The terms of the new Senior Credit Agreement required the Company to redeem the Company's preferred stock during the second quarter of 2004. As such, the remaining proceeds and cash on hand were used to redeem the Company's preferred stock at face value of \$10.0 million plus accumulated preferred dividends of approximately \$1.2 million, for a total aggregate consideration of \$11.2 million. The preferred stock had a carrying value of approximately \$9.5 million at April 3, 2004. Consequently, redemption of the preferred stock and accumulated dividends during the second quarter of 2004 resulted in a loss on extinguishment of approximately \$1.7 million, which is included in other expense.

On May 13, 2002, the Company consummated a recapitalization and executed the prior Amended and Restated Credit Agreement with its lenders. The prior Amended and Restated Credit Agreement reflects the effect of applying the provisions of Statement of Financial Accounting Standards No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (SFAS No. 15). SFAS No. 15 requires that the previously existing amount of debt owed by the Company to the lenders be reduced by the fair value of the equity interest granted and that no gain from restructuring the Company's bank debt be recognized. As a result, the carrying amount of the debt of \$20.6 million exceeded its contractual amount of \$18.3 million by \$2.3 million at January 3, 2004. The outstanding balance of the prior Amended and Restated Credit Agreement at April 2, 2004 of approximately \$20.1 million was reduced to zero through a payment of approximately \$18.0 million in cash proceeds from the new Senior Credit Agreement. The remaining balance related to the SFAS 15 effect of approximately \$2.1 million was recorded as a gain on early retirement of debt, included in other income in the operating statement, net of related deferred loan costs of approximately \$0.8 million, also extinguished upon payment of the related debt, which results in a net gain on early retirement of debt of approximately \$1.3 million recorded in the first quarter of Fiscal 2004.

(b) Senior Subordinated Notes

On December 31, 2003, the Company issued Senior Subordinated Notes in the principal amount of \$35,000,000 and applied the net proceeds of such issuance to reduce the outstanding term loan portion of its prior Amended and Restated Credit Agreement executed on May 13, 2002. The Senior Subordinated Notes have a term of six years, maturing on December 31, 2009. Interest accrues on the outstanding principal balance of the Senior Subordinated Notes at an annual rate of 12% that is payable quarterly in arrears. Restrictive covenants in the Senior Subordinated Notes permit the Company, within limitations defined in the Senior Subordinated Notes, to incur additional indebtedness and to pay cash dividends.

The Company's new Senior Credit Agreement, Senior Subordinated Notes, and prior Amended and Restated Credit Agreement consisted of the following elements at October 2, 2004 and January 3, 2004, respectively (in thousands):

	October 2, 2004	January 3, 2004
	-----	-----
Senior Credit Agreement:		
Term Loan	\$ 21,250	-
	=====	=====
Revolving Credit Facility:		
Maximum availability	\$ 50,000	-
Borrowings outstanding	-	-
Letters of credit issued	13,700	-
	-----	-----
Availability	\$ 36,300	-
	=====	=====
Senior Subordinated Notes Payable:	\$ 35,000	\$ 35,000

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	=====	=====
Prior Amended and Restated Credit Agreement:		
Term Loan:		
Contractual amount	-	\$18,266
SFAS 15 effect	-	2,303
	-----	-----
Carrying amount	-	\$20,569
	=====	=====
Revolving Credit Facility:		
Maximum availability	-	\$17,337
Borrowings outstanding	-	-
Letters of credit issued	-	10,450
	-----	-----
Availability	-	\$ 6,887
	=====	=====

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Substantially all of the Company's assets are either pledged or mortgaged as collateral for borrowings under the new Senior Credit Agreement. The new Senior Credit Agreement contains certain terms and covenants which permit the incurrence of additional indebtedness, the payment of cash dividends, the retention of certain proceeds from sales of assets, and capital expenditures, within limitations defined by the new Senior Credit Agreement, and requires the maintenance of certain minimum financial ratios. At October 2, 2004, the Company had unrestricted cash of \$37.8 million, compared to unrestricted cash of \$24.8 million at January 3, 2004.

(7) Derivative Instruments

The Company makes limited use of derivative instruments to manage cash flow risks related to natural gas expense. The Company does not use derivative instruments for trading purposes.

Through October 2, 2004, the Company had forward purchase agreements in place for purchases of approximately \$2.4 million of natural gas. These agreements have no net settlement provisions and the Company intends to take physical delivery, which it has done under similar forward purchase agreements, during Fiscal 2003 and the first nine months of Fiscal 2004. Accordingly, the agreements are not subject to the requirements of Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS No. 133), because they qualify as normal purchases as defined in the standard.

(8) Comprehensive Income

The Company follows the provisions of Statement of Financial Accounting Standards No. 130, *Reporting Comprehensive Income* (SFAS 130). SFAS 130 establishes standards for reporting and presentation of comprehensive income or loss and its components. Total comprehensive income for the nine months ended October 2, 2004, and September 27, 2003, were \$13.0 million and \$9.3 million, respectively.

(9) Revenue Recognition

The Company recognizes revenue on sales when products are shipped and the customer takes ownership and assumes risk of loss. Collection fees are recognized in the month the service is provided.

(10) Assets Held for Sale

Assets held for sale consist of the following (in thousands):

	October 2, 2004	January 3, 2004
Petaluma, CA	\$ 497	\$ 497
Tyler, TX	183	183
London, Ontario Canada	26	-
Billings, MT	-	421
Oklahoma City, OK	-	59
	<u>\$706</u>	<u>\$1,160</u>

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Assets held for sale are carried at the lower of cost, less accumulated depreciation, or fair value. The assets are expected to be sold within the next twelve months. These assets were previously utilized in rendering operations. The Billings, MT location was reclassified to operating property, plant and equipment and prepaid costs of sale during the second quarter of Fiscal 2004 because the sale of the asset is not expected to occur within the next twelve months. The Company signed a letter of intent to sell its transfer station at London, Ontario, Canada, during the second quarter of Fiscal 2004. The Company was not able to consummate an agreement for the sale with the potential buyer on terms acceptable to both parties. The Company is currently evaluating its options with respect to the future of the London site. From time to time, the Company receives offers from prospective buyers of Company assets. Until the offers meet criteria established by the Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long Lived Assets* (SFAS No. 144), the assets remain classified as property, plant and equipment. The Company's Oklahoma City, OK site was sold during the first quarter of Fiscal 2004.

(11) Employee Benefit Plans

The Company has retirement and pension plans covering substantially all of its employees. Most retirement benefits are provided by the Company under separate final-pay noncontributory pension plans for all salaried and hourly employees (excluding those covered by union-sponsored plans) who meet service and age requirements. Benefits are based principally on length of service and earnings patterns during the five years preceding retirement.

Net pension cost for the nine months ended October 2, 2004 and September 27, 2003 includes the following components (in thousands):

	October 2, 2004	September 27, 2003
Service cost	\$ 1,314	\$ 1,074
Interest cost	2,989	2,868
Expected return on plan assets	(3,029)	(2,778)
Amortization of prior service cost	104	96
Amortization of net (gain) loss	652	497
Net pension cost	\$2,030	\$1,757

Contributions

The Company's funding policy for employee benefit pension plans is to contribute annually not less than the minimum amount required nor more than the maximum amount that can be deducted for federal income tax purposes. Contributions are intended to provide not only for benefits attributed to service to date, but also for those expected to be earned in the future.

The Company contributed \$0.5 million to its pension plan in the second quarter of Fiscal 2004 in order to meet minimum funding requirements, which reduced current accrued expenses on the Company's balance sheet at October 2, 2004. The Company made a voluntary contribution of \$0.8 million during the third quarter of Fiscal 2004.

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements that involve risks and uncertainties. The Company's actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including those set forth below under the heading "Forward Looking Statements" and elsewhere in this report, and under the heading "Risk Factors" in the Company's Annual Report on Form 10-K for the year ended January 3, 2004, and in the Company's other public filings with the SEC.

The following discussion should be read in conjunction with the historical consolidated financial statements and notes thereto.

Overview

Darling International Inc. is a leading provider of rendering, recycling and recovery solutions to the nation's food industry. The Company collects and recycles animal by-products and used cooking oil from food service establishments and provides grease trap cleaning services to many of the same establishments. The Company processes such raw materials at 24 facilities located throughout the United States, into finished products such as protein (primarily meat and bone meal, MBM), tallow (primarily bleachable fancy tallow, BFT), and yellow grease (YG). The Company sells these products nationally and internationally, primarily to producers of oleo-chemicals, soaps, pet foods, and livestock feed, for use as ingredients in their products or for further processing. The Company's operations are organized into two segments: rendering and restaurant services. The accompanying consolidated financial statements should be read in conjunction with the audited consolidated financial statements contained in the Company's Form 10-K for the fiscal year ended January 3, 2004.

Major challenges faced by the Company during the third quarter of Fiscal 2004 included a reduction in raw material supplies as a result of negative cattle slaughter margins and the continued lack of exports for finished meat products and their by-products due to the occurrence of a single case of bovine spongiform encephalopathy (BSE) or mad cow disease in the United States at the end of Fiscal 2003 and a single case of BSE in Canada in late spring of Fiscal 2003. Finished product prices, although higher than the same period a year ago, continued to erode during the quarter, pending expectations of the largest soybean crop and corn crop in U.S. history, which are sources of competing products to the Company's finished products. Natural gas prices and diesel fuel prices continued to escalate during the quarter. The Company continued work on compliance with the new requirements imposed by Section 404 of the Sarbanes-Oxley Act of 2002, which required the Company to incur additional costs.

During the third quarter of Fiscal 2004, mild summer weather reduced the volume of the typical seasonal quality downgrades of tallow to yellow grease. Tallow is normally sold by the Rendering segment, while yellow grease is normally sold by the Restaurant Services segment. This resulted in lower volume sales of yellow grease in the third quarter of Fiscal 2004 compared to the third quarter of Fiscal 2003. Also in the third quarter of Fiscal 2004 compared to the same period a year earlier, sales prices of yellow grease in the Company's coastal markets experienced reduced price levels compared to the Illinois markets quoted on the Jacobsen index, primarily due to reduced exports.

The Company, however, did reach a settlement with past insurers whereby, in exchange for releasing all actual and potential claims and liability under the subject insurance policies, the Company received a cash payment. The effects of these challenges during the third quarter and year-to-date Fiscal 2004 are summarized in the sections which follow.

While operating income increased by \$3.8 million in the third quarter of Fiscal 2004 compared to the third quarter of Fiscal 2003, these challenges indicate there can be no assurance that operating results achieved by the Company in the third quarter of Fiscal 2004 are indicative of future operating performance of the Company.

Summary of Critical Issues Faced by the Company During the Third Quarter of 2004

- Overall, the Company enjoyed higher commodity prices for its finished products. This, however, was nearly offset by lower volumes of raw material, primarily in red meat, as a result of difficult market conditions within the meat processing industry. Cattle slaughter margins remained negative throughout the quarter and ultimately forced one of the Company's suppliers to close its operations indefinitely. While the Company cannot predict when this situation will improve, it does not believe that it will materially impact on-going operations.
- During the third quarter of Fiscal 2004, the Company concluded a settlement with certain past insurers on certain policies of insurance issued primarily before 1972, whereby the Company received a cash payment of approximately \$2.8 million in return for an executed Settlement Agreement and Release in which the Company released the participating insurers from all actual and potential claims and liability under the subject insurance policies. The Company recorded receipt of the payment as a credit (recovery) of claims expense and previous insurance premiums included in cost of sales, within the corporate segment.
- Higher contract labor expense and audit fees were incurred during the third quarter of Fiscal 2004 compared to the third quarter of Fiscal 2003 as a result of the Company's efforts to comply with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002. These expenses relate to the Company's documentation and evaluation of its system of internal controls in accordance with the requirements of the Act.
- High historical energy prices for both natural gas and diesel fuel were experienced in the third quarter of Fiscal 2004, though average natural gas expense incurred during the third quarter of 2004 was lower than the third quarter of 2003. Management believes that high prices were due in part to fears of potential natural gas shortages and from fears of potential crude oil shortages resulting from war in Iraq and ongoing strife in the Middle East. The Company attempts to manage natural gas price risk by entering into forward purchase agreements with all of its natural gas suppliers that permit such contracts, in order to purchase natural gas for future months when prices are relatively favorable. The Company also possesses the capability to produce energy by utilizing yellow grease as a boiler fuel. When economics favor this method, the Company has flexibility in switching several plants to this energy source. The Company has limited diesel fuel storage capabilities at its plant locations and regional suppliers have not been willing to enter into forward purchase agreements on terms acceptable to the Company. The financial impact of higher natural gas and diesel fuel prices is summarized below in Results of Operations.

Summary of Critical Issues and Known Trends Faced by the Company in 2004 and Thereafter

- A case of BSE was diagnosed in a cow in the state of Washington on December 23, 2003. A summary of the immediate impact of this case of BSE follows:
 1. Within days of the initial media reports of the case of BSE, many countries banned imports of U.S. produced beef and beef products, including MBM and initially BFT, though this initial ban on BFT was relaxed to permit imports of U.S.-produced tallow with less than 0.15% impurities.

2. U.S. government regulations issued in response to the case of BSE include:

- a. On December 30, 2003, the Secretary of Agriculture announced new beef slaughter/meat processing regulations to assure consumers of the safety of the meat supply. The regulations prohibit downer animals from entering the food chain, require removal of specified risk materials (SRM) at slaughter, and prohibit carcasses from cattle tested for BSE from entering the food chain until the animals are shown negative for BSE.
- b. On January 26, 2004, the FDA announced intentions to modify its feed rule (21 CFR 589.2000) by removing the exemptions for certain products, including blood and blood products, and requiring dedicated processing lines for handling and processing restricted use and exempted proteins. On this date, the FDA also announced its intent to ban the use of certain animal tissue derived materials in food, supplements and cosmetics.
- c. On July 14, 2004, the FDA announced regulations prohibiting SRM and downer or dead cattle from human food, dietary supplements and cosmetics regulated by the FDA and proposed recordkeeping requirements to aid enforcement activities. BFT that is either derived from SRM-free raw materials or contains less than 0.15% hexane insoluble impurities will be permitted in human food and cosmetics. Derivatives of BFT (glycerin and fatty acids) are exempt from these regulations. The Company is in compliance with these standards on BFT sold for export. In addition, management has taken the necessary steps to ensure that the Company will comply with these new requirements for domestic sales within the time period prescribed by the regulation.

Also on July 14, 2004, agencies within the USDA and FDA jointly requested public comment on possible actions to further mitigate the risk of BSE. In addition to seeking input on intended modifications to the feed rule (21 CFR 589.2000) proposed by the FDA in January, the agencies requested comment on regulations that would: 1) prohibit material derived from SRM and dead or downer cattle in animal feed; 2) prohibit all animal proteins in feed for ruminant animals; and/or 3) require that only BFT either derived from SRM-free material or containing less than 0.15% impurities be allowed in animal feed. Only questions were posed in this announcement of proposed rulemaking to which the Company, among others, responded in comments submitted to the dockets. No new regulations affecting animal feed or modifying the feed rule (21 CFR 589.2000) have been issued to date. This situation will likely continue to be fluid into 2005. Management is developing contingency plans to address any new regulations that might be proposed, introduced or implemented, and will continue to closely monitor this and other regulatory issues.

3. As a result of the BSE case, many foreign countries closed their borders to U.S. beef products, including MBM. As of November 10, 2004, many foreign countries continued to refuse shipments of U.S. produced MBM. Despite the MBM market price fluctuations that occurred during late December 2003 and January 2004, the Company does not anticipate the need to make significant changes in its business plan or daily operations at this time. The Company's management monitors market conditions and prices for its finished products on a daily basis. If market conditions or prices were to significantly change, the Company's management would evaluate and implement such measures, if any, that it deems necessary to respond to the change in market conditions. On larger formula-based pricing suppliers, the indexing of finished product price to raw material cost effectively fixes the gross margin on finished product sales at a stable level, providing some protection to the Company from price declines.

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- Expenses related to compliance with requirements of the Sarbanes-Oxley Act of 2002 are expected to remain high throughout 2004 and thereafter. Upon completion of initial efforts to document the Company's system of internal controls, the Company expects recurring costs of testing and auditing of the system, as required by the Act.
 - Energy prices for natural gas and diesel fuel are expected to remain high throughout 2004 and thereafter. The Company consumes significant volumes of natural gas to operate boilers in its plants to generate steam to heat raw material. High natural gas prices represent a significant cost of factory operation included in cost of sales. The Company also consumes significant volumes of diesel fuel to operate its fleet of tractors and trailers used to collect raw material. High diesel fuel prices represent a significant component of cost of collection expenses included in cost of sales. Though the Company will continue to manage these costs and attempt to minimize these expenses, prices remain relatively high in 2004 and represent an ongoing challenge to the Company's operating results for future periods.

These challenges indicate there can be no assurance that operating results of the Company achieved in the third quarter of Fiscal 2004 are indicative of future operating performance of the Company.

Results of Operations

Three Months Ended October 2, 2004 Compared to Three Months Ended September 27, 2003

Summary of Key Factors Impacting Third Quarter 2004 Results:

Principal factors which contributed to a \$3.8 million (67.9%) increase in operating income, which are discussed in greater detail in the following section, were:

- Higher finished product prices
- Insurance settlement with certain of the Company's past insurers
- Improved recovery of collection expenses

These increases were partially offset by:

- Lower raw material volumes
- Higher raw material prices
- Higher contract labor and audit fees related to Sarbanes-Oxley Act compliance
- Higher diesel fuel expenses

Summary of Key Indicators of 2004 Performance:

Principal indicators which management routinely monitors and compares to previous periods as an indicator of problems or improvements in operating results include:

- Finished product commodity prices (quoted on the Jacobsen index)
- Raw material volume
- Production volume and related yield of finished product
- Collection fees and collection operating expense

These indicators and their importance are discussed below in greater detail.

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Prices for finished product commodities that the Company produces are quoted each business day on the Jacobsen index, an established trading exchange price publisher. These finished products are MBM, BFT, and YG. The prices quoted are for delivery of the finished product at a specified location. These prices are relevant because they provide an indication of a component of revenue and achievement of business plan benchmarks on a daily basis. The Company's actual sales prices for its finished products may vary from the Jacobsen prices because the Company's finished products are delivered to multiple locations in different geographic locations which utilize different indexes. During the third quarter of Fiscal 2004, sales prices of yellow grease in the Company's coastal markets experienced reduced price levels compared to the Illinois markets quoted on the Jacobsen index, primarily due to reduced exports, compared to the third quarter of Fiscal 2003. Average Jacobsen prices (at the specified delivery point) for the third quarter of Fiscal 2004 compared to average Jacobsen prices for the third quarter of Fiscal 2003 follow:

	Avg. Price 3rd Quarter 2004	Avg. Price 3rd Quarter 2003	Increase	% Increase
MBM				
(Illinois)	\$202.97 /ton	\$192.01 /ton	\$10.96 /ton	5.7%
BFT				
(Chicago)	\$ 17.83 /cwt	\$ 16.86 /cwt	\$ 0.97 /cwt	5.8%
YG (Illinois)	\$ 15.55 /cwt	\$ 12.01 /cwt	\$ 3.54 /cwt	29.5%

The increases in average price of the finished products the Company sells had a favorable impact on revenue which was partially offset by a negative impact to the Company's raw material cost, due to formula pricing arrangements which compute raw material cost, based upon the price of finished product.

Raw material volume represents the quantity (pounds) of raw material collected from suppliers, including beef, pork, poultry, and used cooking oils. Raw material volumes provide an indication of future production of finished products available for sale and are a component of potential future revenue.

Finished product production volumes are the end result of the Company's production processes, and directly impact goods available for sale, and thus become an important component of sales revenue. Yield on production is a

ratio of production volume (pounds) divided by raw material volume (pounds), and provides an indication of effectiveness of the Company's production process. Factors impacting yield on production include quality of raw material and warm weather during summer months, which rapidly degrades raw material. During the third quarter of Fiscal 2004, mild summer weather reduced the volume of the typical seasonal quality downgrades of tallow to yellow grease. This resulted in lower volume sales of yellow grease in the third quarter of Fiscal 2004 compared to the third quarter of Fiscal 2003.

The Company charges collection fees which are included in net sales in order to offset a portion of the expense incurred in collecting raw material. Each month the Company monitors both the collection fee charged suppliers, which is included in net sales, and collection expense, which is included in cost of sales. The monitoring of collection fees and collection expense provides an indication of achievement of the Company's business plan.

Net Sales. The Company collects and processes animal by-products (fat, bones and offal), and used restaurant cooking oil to produce finished products of MBM, BFT, and YG. Sales are significantly affected by finished goods prices, quality of raw material, and volume of raw material. Net sales include the sales of produced finished goods, collection fees, grease trap services, and finished goods purchased for resale, which constitute approximately 13.3% of total sales.

During the third quarter of Fiscal 2004, net sales decreased by \$0.5 million (0.6%) to \$80.2 million as compared to \$80.7 million during the third quarter of Fiscal 2003. The decrease in net sales was primarily due to the following (in millions of dollars):

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- Lower raw material volume	\$(3.5)
- Lower finished product purchased for resale	(1.7)
- Lower yield on production	(0.3)
- Other sales decreases	(0.2)

These decreases were partially offset by:

- Higher finished goods prices	4.4
- Improved recovery of collection expenses	<u>0.8</u>
	<u>\$(0.5)</u>

Cost of Sales and Operating Expenses. Cost of sales and operating expenses include cost of raw material, the cost of product purchased for resale, and the cost to collect and process the raw material. The Company utilizes both fixed and formula pricing methods for the purchase of raw materials. Fixed prices are adjusted where possible for changes in competition and significant changes in finished goods market conditions, while raw materials purchased under formula prices are correlated with specific finished goods prices.

During the third quarter of Fiscal 2004, cost of sales and operating expenses decreased \$4.8 million (7.6%) to

\$58.0 million as compared to \$62.8 million during the third quarter of Fiscal 2003. The decrease in cost of sales and operating expenses was primarily due to the following (in millions of dollars):

- Settlement with past insurers	\$ (2.8)
- Lower purchases of finished product for resale	(1.7)
- Lower raw material volume	(0.9)
- Lower hauling expenses	(0.4)

These decreases were partially offset by:

- Higher raw material prices	0.3
- Higher gas, diesel fuel and oil expense	0.3
- Other expense increases	<u>0.4</u>
	<u>\$(4.8)</u>

Selling, General and Administrative Expenses. Selling, general and administrative expenses were \$9.2 million during the third quarter of Fiscal 2004, a \$0.6 million increase (7.0%) from \$8.6 million during the third quarter of Fiscal 2003, primarily due to the following (in millions of dollars):

- Higher payroll and related benefits	\$ 0.7
- Higher contract labor and audit fees expense related to Sarbanes-Oxley Act compliance	0.4

These increases were partially offset by:

- Lower legal expense	(0.2)
- Other expense decreases	<u>(0.3)</u>
	<u>\$(0.6)</u>

Depreciation and Amortization. Depreciation and amortization charges decreased \$0.1 million (2.7%) to \$3.6 million during the third quarter of Fiscal 2004 as compared to \$3.7 million during the first quarter of Fiscal 2003.

Interest Expense. Interest expense was \$1.7 million during the third quarter of Fiscal 2004 compared to \$0.7 million during the third quarter of Fiscal 2003, an increase of \$1.0 million, primarily due the following (in millions of dollars):

- Reduced amortization of SFAS 15 effect increased interest expense	\$ 0.7
- Interest expense on the contractual amount of debt increased	0.5
- Other increases	0.1

These increases were partially offset by:

- Preferred stock dividends and accretion decreased interest expense (0.3) resulting from adoption of SFAS 150 in the third quarter of Fiscal 2003

\$ 1.0

Other Income/Expense. Other expense was \$0.1 million in the third quarter of Fiscal 2004, nearly unchanged from other expense of \$0.1 million in the third quarter of Fiscal 2003.

Income Taxes. The Company recorded income tax expense of \$3.1 million for the third quarter of Fiscal 2004, compared to income tax expense of \$2.1 million recorded in the third quarter of Fiscal 2003, an increase of \$1.0 million (47.6%), primarily due to the increased pre-tax earnings of the Company in Fiscal 2004. The estimated combined effective annual tax rate for state and Federal income taxes for Fiscal 2004 is approximately 39.9% and for Fiscal 2003 is approximately 36.9%.

Nine Months Ended October 2, 2004 Compared to Nine Months Ended September 27, 2003

Summary of Key Factors Impacting the First Nine Months of Fiscal 2004 Results:

Principal factors which contributed to a \$10.1 million (59.1%) increase in operating income, which are discussed in greater detail in the following section, were:

- Higher finished product sales prices
- Improved recovery of collection expenses
- Insurance settlement with certain of the Company's past insurers

These increases were partially offset by:

- Higher raw material prices
- Lower raw material volume
- Higher payroll and related benefit expense
- Higher diesel fuel expenses
- Higher contract labor and audit fees related to Sarbanes-Oxley Act compliance

Summary of Key Indicators of 2004 Performance:

Principal indicators which management routinely monitors and compares to previous periods as an indicator of problems or improvements in operating results include:

- Finished product commodity prices (quoted on the Jacobsen index)
- Raw material volume
- Production volume and related yield of finished product
- Collection fees and collection operating expense

These indicators and their importance are discussed below in greater detail.

Prices for finished product commodities that the Company produces are quoted each business day on the Jacobsen index, an established trading exchange price publisher. These finished products are MBM, BFT, and YG. The prices quoted are for delivery of the finished product at a specified location. These prices are relevant because they provide an indication of a component of revenue and achievement of business plan benchmarks on a daily basis. The Company's actual sales prices for its finished products may vary from the Jacobsen prices because the Company's finished products are delivered to multiple locations in different geographic locations which utilize different indexes. Average Jacobsen prices (at the specified delivery point) for the first nine months of Fiscal 2004 compared to average Jacobsen prices for the first nine months of Fiscal 2003 follow:

	Avg. Price Nine Months 2004	Avg. Price Nine Months 2003	Increase	% Increase
MBM (Illinois)	\$205.76 /ton	\$177.62 /ton	\$28.14 /ton	15.8%
BFT (Chicago)	\$ 18.72 /cwt	\$ 16.69 /cwt	\$ 2.03 /cwt	12.2%
YG (Illinois)	\$ 15.68 /cwt	\$ 12.74 /cwt	\$ 2.94 /cwt	23.1%

The increases in average price of the finished products the Company sells had a favorable impact on revenue which was partially offset by a negative impact to the Company's raw material cost, due to formula pricing arrangements which compute raw material cost, based upon the price of finished product.

Raw material volume represents the quantity (pounds) of raw material collected from suppliers, including beef, pork, poultry, and used cooking oils. Raw material volumes provide an indication of future production of finished products available for sale and are a component of potential future revenue.

Finished product production volumes are the end result of the Company's production processes, and directly impact goods available for sale, and thus become an important component of sales revenue. Yield on production is a ratio of production volume (pounds) divided by raw material volume (pounds), and provides an indication of effectiveness of the Company's production process. Factors impacting yield on production include quality of raw material and warm weather during summer months, which rapidly degrades raw material.

The Company charges collection fees which are included in net sales in order to offset a portion of the expense incurred in collecting raw material. Each month the Company monitors both the collection fee charged to suppliers, which is included in net sales, and collection expense, which is included in cost of sales. The monitoring of collection fees and collection expense provides an indication of achievement of the Company's business plan.

Net Sales. The Company collects and processes animal by-products (fat, bones and offal), and used restaurant cooking oil to produce finished products of MBM, BFT and YG. Sales are significantly affected by finished goods prices, quality of raw material, and volume of raw material. Net sales include the sales of produced finished goods, collection fees, grease trap services, and finished goods purchased for resale, which constitute approximately 12.5% of total sales.

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During the first nine months of Fiscal 2004, net sales increased by \$21.5 million (9.4%) to \$249.4 million as compared to \$227.9 million during the first nine months of Fiscal 2003. The increase in net sales was primarily due to the following (in millions of dollars):

- | | |
|---|--------|
| - Higher finished goods pricess | \$21.3 |
| - Improved recovery of collection expenses | 2.8 |
| - Higher sales of finished product purchased for resale | 1.8 |

These increases were partially offset by:

- | | |
|-----------------------------|----------------------|
| - Lower raw material volume | (2.6) |
| - Lower hide sales | (1.0) |
| - Other sales decreases | <u>(0.8)</u> |
| | <u>\$21.5</u> |

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Cost of Sales and Operating Expenses. Cost of sales and operating expenses include cost of raw material, the cost of product purchased for resale, and the cost to collect and process the raw material. The Company utilizes both fixed and formula pricing methods for the purchase of raw materials. Fixed prices are adjusted where possible for changes in competition and significant changes in finished goods market conditions, while raw materials purchased under formula prices are correlated with specific finished goods prices.

During the first nine months of Fiscal 2004, cost of sales and operating expenses increased \$9.6 million (5.5%) to \$183.5 million as compared to \$173.9 million during the first nine months of Fiscal 2003. Included in operating expenses during the first nine months of Fiscal 2004 are incremental labor and freight costs of transferring finished product from cities with lower MBM prices to cities with higher MBM prices incurred earlier in 2004. The increase in cost of sales and operating expenses was primarily due to the following (in millions of dollars):

- | | |
|---|--------|
| - Higher raw material prices | \$ 9.3 |
| - Higher purchases of finished product for resale | 1.8 |
| - Higher payroll and related benefits | 1.7 |
| - Higher gas, diesel fuel and oil expense | 0.9 |

These increases were partially offset by:

- | | |
|-----------------------------------|----------------------|
| - Settlement with past insurers | (2.8) |
| - Lower contract hauling expenses | (0.8) |
| - Other expense decreases | <u>(0.5)</u> |
| | <u>\$ 9.6</u> |

Selling, General and Administrative Expenses. Selling, general and administrative expenses were \$27.4 million during the first nine months of Fiscal 2004, a \$1.4 million increase (5.4%) from \$26.0 million during the first nine months of Fiscal 2003, primarily due to the following (in millions of dollars):

- | | |
|---|--------|
| - Higher payroll and related benefits expense | \$ 1.7 |
|---|--------|

- Contract labor and audit fees related to Sarbanes-Oxley Act compliance 0.7

These increases were partially offset by:

- Lower legal fees (0.5)
 - Lower telephone expense (0.2)
 - Other expense decreases (0.3)
- \$ 1.4**

Depreciation and Amortization. Depreciation and amortization charges increased \$0.3 million (2.7%) to \$11.3 million during the first nine months of Fiscal 2004 as compared to \$11.0 million during the first nine months of Fiscal 2003, primarily due to impairment recorded in the second quarter of Fiscal 2004 on various property and equipment of \$0.3 million.

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Interest Expense. Interest expense was \$5.2 million during the first nine months of Fiscal 2004 compared to \$1.6 million during the first nine months of Fiscal 2003, an increase of \$3.6 million, primarily due to reduced amortization of SFAS 15 effect related to the prior Amended and Restated Credit Agreement of May 2002, interest expense on the Company's Senior Subordinated Notes with an outstanding balance of \$35.0 million which bears interest at a fixed rate of 12.0% per annum, and inclusion of preferred stock dividends and accretion in interest expense as a result of the adoption of SFAS 150 in the third quarter of Fiscal 2003. The increase in interest expense was primarily due to the following (in millions of dollars):

- Reduced amortization of SFAS 15 effect increased interest expense \$ 2.2
 - Interest expense on the contractual amount of debt increased 1.2
 - Preferred stock dividends and accretion increased interest expense, 0.1
resulting from adoption of SFAS 150 in the third quarter of Fiscal 2003
 - Other increases, primarily fees for letters of credit 0.1
- \$ 3.6**

Other Income/Expense. Other expense was \$0.4 million in the first nine months of Fiscal 2004, an \$0.4 million increase in expense from other expense of less than \$0.1 million in first nine months of Fiscal 2003. The increase in other expense in the first nine months of Fiscal 2004 is primarily due to the following (in millions of dollars):

- Loss on early redemption of preferred stock \$ 1.7
- This increase was partially offset by:
- Increase in gain on extinguishment of bank debt (0.7)
 - Increase in gain on disposal of assets (0.3)

- Other income increase (0.3)
\$0.4

The Company's new Senior Credit Agreement required early redemption of the Company's preferred stock outstanding at its face value of \$10.0 million and accumulated dividends of approximately \$1.2 million, or total aggregate consideration of \$11.2 million. The Company's preferred stock had a carrying value of approximately \$9.5 million at April 3, 2004. Subsequent to April 3, 2004, the Company issued an irrevocable notice of redemption to holders of the Company's preferred stock. The Company incurred a loss of approximately \$1.7 million which is included in other expense in the first nine months of Fiscal 2004 on the early redemption of the preferred stock. The Company expects that early redemption of the preferred stock will generate incremental savings on interest expense.

Gain on extinguishment of debt in the first nine months of Fiscal 2004 was \$1.3 million, which resulted from retirement of debt with a carrying value of \$20.1 million extinguished by a cash payment of \$18.0 million, reduced by related deferred loan costs of \$0.8 million, also extinguished upon payment of the debt. Also included in other income in the first nine months of Fiscal 2004 is gain on the sale of property and equipment of approximately \$0.3 million, which includes the sale of the Company's land in Oklahoma City, OK. Included in other income in the first nine months of Fiscal 2003 was a gain on extinguishment of debt of \$0.6 million, which resulted from retirement of debt with a carrying value of \$4.9 million with a cash payment of \$4.1 million due to SFAS 15 accounting, reduced by related deferred loan costs of \$0.2 million.

Income Taxes. The Company recorded income tax expense of \$8.6 million for the first nine months of Fiscal 2004, compared to income tax expense of \$6.1 million recorded in the first nine months of Fiscal 2003, an increase of \$2.5 million (41.0%), primarily due to the increased pre-tax earnings of the Company in Fiscal 2004 and the loss on early redemption of preferred stock of \$1.7 million which is non-deductible for tax purposes, but is treated as a return of equity to preferred shareholders, creating an incremental tax effect of approximately \$0.6 million. The estimated combined effective annual tax rate for state and Federal income taxes for Fiscal 2004 is approximately 39.9% and for Fiscal 2003 is approximately 36.9%.

FINANCING, LIQUIDITY, AND CAPITAL RESOURCES

On April 2, 2004, the Company entered a new Senior Credit Agreement with new lenders, and entered into a new lender acknowledgement on May 28, 2004, that increased the committed amount as permitted by the Senior Credit Agreement. This refinancing replaces the prior Amended and Restated Credit Agreement executed on May 13, 2002, which is summarized below. The principal components of the refinancing consist of the following.

- The new Senior Credit Agreement provides for a total of \$75.0 million in financing facilities, consisting of a \$25.0 million Term Loan Facility and a \$50.0 million Revolver Facility, which includes a \$25.0 million Letter of Credit subfacility. The Revolver Facility may vary based on EBITDA, as defined in the new Senior Credit Agreement.
- The new Senior Credit Agreement has a term of five years and matures on April 2, 2009.

- The new Senior Credit Agreement provides for scheduled amortization payments on the Term Loan Facility of \$1.25 million, due each quarter during the five-year term of the agreement.
- The new Senior Credit Agreement bears interest at a rate which may be based upon either prime or LIBOR or a combination of both rates, plus a margin which may be adjusted quarterly based upon the leverage ratio of the Company, as defined by the new Senior Credit Agreement.
- The refinancing provides increased availability and liquidity, an extended term, lower interest rates, lower banking fees, and more flexible capital investment limitations than the prior Amended and Restated Credit Agreement dated May 13, 2002.
- On April 2, 2004, proceeds of the new Term Loan Facility were used to pay off the outstanding balance of the prior Amended and Restated Credit Agreement of approximately \$18.0 million. The remaining proceeds and cash on hand were used to redeem the Company's preferred stock during the second quarter of Fiscal 2004 at face value of \$10.0 million and accumulated preferred dividends of approximately \$1.2 million, and for other general corporate and working capital purposes.
- Restrictive covenants in the Company's new Senior Credit Agreement permit the Company, within limitations defined in the new Senior Credit Agreement, to incur additional indebtedness; issue additional capital or preferred stock; pay dividends; redeem common shares as treasury stock; create liens; merge, consolidate, or acquire other businesses; sell and dispose of assets; and make investments; and require the maintenance of certain minimum financial ratios.

On December 31, 2003, the Company issued Senior Subordinated Notes in the amount of \$35.0 million and applied the net proceeds to the reduction of the outstanding term loan of its then outstanding prior Amended and Restated Credit Agreement executed on May 13, 2002. The Senior Subordinated Notes have a term of six years, maturing on December 31, 2009. Interest accrues on the outstanding principal balance of the Senior Subordinated Notes at an annual rate of 12%, payable quarterly in arrears. Restrictive covenants in the Senior Subordinated Notes permit the Company, within limitations defined in the Senior Subordinated Notes, to incur additional indebtedness and to pay cash dividends.

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The Company's new Senior Credit Agreement and Senior Subordinated Notes consist of the following elements at October 2, 2004 (in thousands):

Senior Credit Agreement:

Term Loan:	\$ 21,250
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Revolving Credit Facility:	
Maximum availability	\$ 50,000
Borrowings outstanding	-
Letters of credit issued	13,700
Availability	\$ 36,300
Senior Subordinated Notes Payable:	\$35,000

Substantially all of the Company's assets are either pledged or mortgaged as collateral for borrowings under the new Senior Credit Agreement. The new Senior Credit Agreement contains certain terms and covenants, which permit the incurrence of additional indebtedness, the payment of cash dividends, the retention of certain proceeds from sales of assets, and capital expenditures, within limitations defined by the new Senior Credit Agreement, and require the maintenance of certain minimum financial ratios, including: minimum fixed charge coverage ratio; maximum leverage ratio, and minimum tangible net worth ratio, each as defined in the new Senior Credit Agreement. The Company is currently in compliance with all of the covenants contained in the new Senior Credit Agreement.

The classification of long-term debt in the accompanying October 2, 2004 consolidated balance sheet is based on the contractual repayment terms of the debt issued under the Senior Subordinated Debt and the new Senior Credit Agreement pursuant to the refinancing.

On October 2, 2004, the Company had working capital of \$41.4 million and its working capital ratio was 1.94 to 1 compared to working capital of \$31.2 million and a working capital ratio of 1.76 to 1 on January 3, 2004. At October 2, 2004, the Company had unrestricted cash of \$37.8 million and funds available under the revolving credit facility of \$36.3 million, compared to unrestricted cash of \$24.8 million and funds available under the revolving credit facility of \$6.9 million at January 3, 2004.

Net cash provided by operating activities was \$33.8 million and \$15.0 million for the nine months ended October 2, 2004 and September 27, 2003, respectively, an increase of \$18.8 million, primarily due to increases in accounts receivable, inventory and prepaid expense in Fiscal 2003 and reductions in accounts receivable and prepaid expense in Fiscal 2004. Cash used by investing activities was \$7.2 million for the first nine months of Fiscal 2004, compared to \$8.9 million for the first nine months of Fiscal 2003, a decrease of \$1.7 million, primarily due to lower capital investment in Fiscal 2004. Net cash used by financing activities was \$10.7 million for the nine months ended October 2, 2004, compared to cash used of \$5.9 million for the nine months ended September 27, 2003, an increase of cash used of \$4.8 million, principally due to redemption of the Company's preferred stock and payment of cumulative dividends in Fiscal 2004, net of proceeds of the Company's new Senior Credit Agreement.

The Company made capital expenditures of \$7.7 million during the first nine months of Fiscal 2004, compared to capital expenditures of \$7.8 million and acquisitions of rendering and grease businesses for a net investment of approximately \$1.1 million in Fiscal 2003, for a net decrease of \$0.1 million primarily due to timing of planned capital investment between the two years. Capital expenditures related to compliance with environmental regulations were \$0.9 million and \$1.6 million for the nine months ended October 2, 2004 and September 27, 2003, respectively.

Based upon the underlying terms of the new Senior Credit Agreement, the Company was required to pay approximately \$11.2 million during the second quarter of Fiscal 2004 for redemption of the Company's preferred stock at face value of \$10.0 million and accumulated preferred dividends of approximately \$1.2 million. The Company's preferred stock had a carrying value of approximately \$9.5 million at April 3, 2004. Consequently, the Company incurred a loss on early redemption of the preferred stock and accumulated dividends of approximately \$1.7 million, which is included in other expense.

Based upon the underlying terms of the new Senior Credit Agreement, approximately \$5.0 million in current debt, which is included in current liabilities on the Company's balance sheet at October 2, 2004, will be due during the next twelve months, consisting of scheduled installment payments of \$1.25 million due each quarter. The Company made a voluntary payment of an additional \$1.25 million on the Term Loan during the third quarter of Fiscal 2004.

Based upon the annual actuarial estimate, current accruals, and claims paid during the first nine months of Fiscal 2004, the Company has accrued approximately \$6.4 million it expects will become due during the next twelve months in order to meet obligations related to the Company's self insurance reserves and accrued insurance which are included in current accrued expenses at October 2, 2004. The self insurance reserve is composed of estimated liability for claims arising for workers' compensation, and for auto liability and general liability claims. The self insurance reserve liability is determined annually, based upon a third party actuarial estimate. The actuarial estimate may vary from year to year, due to changes in cost of health care, the pending number of claims, or other factors beyond the control of management of the Company. No assurance can be given that the Company's funding obligations under its self insurance reserve will not increase in the future.

Based upon current actuarial estimates, the Company paid approximately \$0.5 million in order to meet minimum pension funding requirements during the second quarter of Fiscal 2004, which reduced current accrued compensation and benefit expenses at October 2, 2004. The Company made a voluntary contribution of \$0.8 million during the third quarter of Fiscal 2004. The minimum pension funding requirements are determined annually, based upon a third party actuarial estimate. The actuarial estimate may vary from year to year, due to fluctuations in return on investments or other factors beyond the control of management of the Company or the administrator of the Company's pension funds. No assurance can be given that the minimum pension funding requirements will not increase in the future.

The Company's management believes that cash flows from operating activities at the current level in Fiscal 2004, unrestricted cash, and funds available under the new Senior Credit Agreement should be sufficient to meet the Company's working capital needs and capital expenditures for at least the next twelve months. The impact on cash flows from operations in Fiscal 2004 of the occurrence of BSE in the United States, resulting regulations by government agencies, the impact on export markets, and the impact on market prices for the Company's finished products is not known at this time. These factors, coupled with high prices for natural gas and diesel fuel, among others, could negatively impact the Company's results of operations in 2004 and thereafter. The Company cannot provide assurance that the cash flows from operating activities generated in the first nine months of Fiscal 2004 are indicative of the future cash flows from operating activities which will be generated by the Company's operations.

The current economic environment in the Company's markets has the potential to adversely impact its liquidity in a variety of ways, including through reduced sales, potential inventory buildup, or higher operating costs.

The principal products that the Company sells are commodities, the prices of which are quoted on established commodity markets and are subject to volatile changes. Although the current market prices of these commodities are favorable, a decline in these prices has the potential to adversely impact the Company's liquidity. A disruption in

international sales, a decline in commodities prices, or a rise in energy prices resulting from the recent war with Iraq and the subsequent political instability and uncertainty, has the potential to adversely impact the Company's liquidity. There can be no assurance that a decline in commodities prices, a rise in energy prices, a slowdown in the U.S. or international economy, or other factors, including political instability in the Middle East or elsewhere, and the macroeconomic effects of those events, will not cause the Company to fail to meet management's expectations, or otherwise result in liquidity concerns.

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CONTRACTUAL OBLIGATIONS AND OTHER COMMERCIAL COMMITMENTS

The following table summarizes the Company's expected material contractual payment obligations, including both on- and off-balance sheet arrangements at October 2, 2004 (in thousands):

	Total	Less Than 1 Year	1 - 3 Years	3 - 5 Years
Contractual obligations:				
Long-term debt obligations	\$56,318	\$ 5,030	\$10,038	\$ 6,250
Operating lease obligations	22,439	4,673	5,139	2,893
Purchase commitments	5,209	5,209	-	-
Other long-term liabilities	271	76	189	6
Total	\$84,237	\$14,988	\$15,366	\$ 9,149

The Company's off-balance sheet contractual obligations and commercial commitments as of October 2, 2004 relate to operating lease obligations, letters of credit, forward purchase agreements, and employment agreements. The Company has excluded these items from the balance sheet in accordance with accounting principles generally accepted in the United States.

The following table summarizes the Company's other commercial commitments, including both on- and off-balance sheet arrangements at October 2, 2004.

Other commercial commitments:	
Standby letters of credit	\$13,700
Total other commercial commitments:	\$13,700

OFF BALANCE SHEET OBLIGATIONS

Based upon the underlying purchase agreements, the Company has commitments to purchase \$5.2 million of finished products and natural gas during the next twelve months, which are not included in liabilities on the Company's balance sheet at October 2, 2004. These purchase agreements are entered into in the normal course of the Company's business and are not subject to derivative accounting. The commitments will be recorded on the balance sheet of the Company when delivery of these commodities occurs and ownership passes to the Company during Fiscal 2004, in accordance with accounting principles generally accepted in the United States.

Based upon the underlying lease agreements, the Company expects to pay approximately \$4.7 million in operating lease obligations during the next twelve months which are not included in liabilities on the Company's balance sheet at October 2, 2004. These lease obligations are included in cost of sales or selling, general, and administrative expense as the underlying lease obligation comes due, in accordance with accounting principles generally accepted in the United States.

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CRITICAL ACCOUNTING POLICIES

The Company follows certain significant accounting policies when preparing its consolidated financial statements. A complete summary of these policies is included in Note 1 to the Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended January 3, 2004.

Certain of the policies require management to make significant and subjective estimates or assumptions which may deviate from actual results. In particular, management makes estimates regarding the fair value of the Company's reporting units in assessing potential impairment of goodwill, estimates regarding future undiscounted cash flows from the future use of long-lived assets whenever events or changes in circumstances indicate that the carrying amount of a long-lived asset may not be recoverable, estimates regarding the net realizable value of long-lived assets held for sale, estimates regarding pension expense, estimates of bad debts and estimates regarding self insured risks including insurance, environmental and litigation contingencies.

In assessing impairment of goodwill, the Company uses estimates and assumptions in determining the estimated fair value of reporting units. In assessing the impairment of long-lived assets where there has been a change in circumstances indicating the carrying value of a long-lived asset may not be recoverable, the Company has estimated future undiscounted net cash flows from use of the asset based on actual historical results and expectations about future economic circumstances including future business volume, finished product prices and operating costs. The estimates of fair value of reporting units and of future net cash flows from use of the asset could change if actual prices and costs differ due to industry conditions or other factors affecting the level of business volume or the Company's performance. In assessing impairment of long-lived assets held for sale, the Company has estimated the net realizable value of such assets based on information from various external sources regarding possible selling prices for such assets. The estimate of reserve for bad debts is based upon the Company's bad debt experience, market conditions, aging of trade accounts receivable, and interest rates, among other factors. Pension expense is based upon actuarial estimates. These estimates could change based on changes in market conditions, interest rates, and other factors. In estimating liabilities for self insured risks, the Company considers information from outside consultants and

experts, and past historical experience, in projecting future costs expected to be incurred. These estimates could change if future events are different than assumed by management, actual costs to settle the liabilities differ from those estimated and the circumstances associated with the self insured risks change.

NEW ACCOUNTING PRONOUNCEMENTS

No new accounting pronouncements were issued during the third quarter of Fiscal 2004.

FORWARD LOOKING STATEMENTS

This Quarterly Report on Form 10-Q includes forward-looking statements that involve risks and uncertainties. The words believe, anticipate, expect, estimate, intend, and similar expressions identify forward-looking statements. All statements other than statements of historical facts included in the Quarterly Report on Form 10-Q, including, without limitation, the statements under the section entitled Business, Management's Discussion and Analysis of Financial Condition and Results of Operations and Legal Proceedings and located elsewhere herein regarding industry prospects and the Company's financial position are forward-looking statements. Actual results could differ materially from those discussed in the forward-looking statements as a result of certain factors. Although the Company believes that the expectations reflected in such forward-looking statements are reasonable, it can give no assurance that such expectations will prove to be correct.

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In addition to those factors discussed in this report and under the heading Risk Factors in Item 7A of Part I of the Company's annual report on Form 10-K for the year ended January 3, 2004, and in the Company's other public filings with the SEC, important factors that could cause actual results to differ materially from the Company's expectations include: the Company's continued ability to obtain sources of supply for its rendering operations; general economic conditions in the American, European and Asian markets; prices in the competing commodity markets which are volatile and are beyond the Company's control; and BSE and its impact on finished product prices, export markets, energy prices and government regulation are still evolving and are beyond the Company's control. Among other things, future profitability may be affected by the Company's ability to grow its business which faces competition from companies which may have substantially greater resources than the Company.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

Market risks affecting the Company are exposures to changes in interest rates on debt and the price of natural gas used in the Company's plants. The Company has used interest rate and natural gas swaps to manage these related risks. The Company is not currently party to any interest rate swap agreements. The Company uses natural gas forward purchase agreements with its suppliers to manage the price risk of natural gas used in its facilities.

As of October 2, 2004, the Company had forward purchase agreements in place for purchases of approximately \$2.4 million of natural gas.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures. As required by Exchange Act Rule 13a-15(b), the Company's management, including the Chief Executive Officer and Chief Financial Officer, conducted an evaluation as of the end of the period covered by this report of the effectiveness of the design and operation of the Company's disclosure controls and procedures. As defined in Exchange Act Rule 13a-15(e) and 15d-15(e) under the Exchange Act, disclosure controls and procedures are controls and other procedures of the Company that are designed to ensure information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is recorded, processed, summarized and reported within time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is accumulated and communicated to Company management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of the end of the period covered by this report.

Changes in Internal Control Over Financial Reporting. As required by Exchange Act Rule 13a-15(d), the Company's management, including the Chief Executive Officer and Chief Financial Officer, also conducted an evaluation of the Company's internal control over financial reporting to determine whether any change occurred during the quarter covered by this report that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting. Based on that evaluation, there have been no significant changes in the Company's internal controls or in other factors that could significantly affect the internal controls subsequent to the date of their evaluation in connection with the preparation of this quarterly report on Form 10-Q.

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DARLING INTERNATIONAL INC. AND SUBSIDIARIES FORM 10-Q FOR THE THREE MONTHS ENDED OCTOBER 2, 2004

PART II: Other Information

Item 6. EXHIBITS AND REPORTS ON FORM 8-K.

(a) Exhibits

31.1 Certification pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of

1934, of Randall C. Stuewe, the Chief Executive Officer of the Company.

- 31.2 Certification pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, of John O. Muse, the Chief Financial Officer of the Company.
- 32.1 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, of Randall C. Stuewe, the Chief Executive Officer of the Company.
- 32.2 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, of John O. Muse, the Chief Financial Officer of the Company.

(b) Reports on Form 8-K

Current report on Form 8-K (Items 7 and 12) filed on August 16, 2004.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

DARLING INTERNATIONAL INC.

Registrant

Date: November 15, 2004

By: /s/ Randall C. Stuewe
Randall C. Stuewe
Chairman and
Chief Executive Officer

Date: November 15, 2004

By: /s/ John O. Muse
John O. Muse
Executive Vice President
Administration and Finance
(Principal Financial Officer)

