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The Hershey Company

First Quarter 2022 Earnings Results
Prepared Remarks

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CORPORATE PARTICIPANTS

Melissa Poole, *Vice President, Investor Relations*

Michele Buck, *Chief Executive Officer and Chairman*

Steve Voskuil, *Senior Vice President and Chief Financial Officer*

PRESENTATION

Melissa Poole

Good morning, everyone, and welcome to the pre-recorded discussion of The Hershey Company's First Quarter 2022 Earnings Results.

My name is Melissa Poole and I'm the Vice President of Investor Relations at Hershey. Joining me today are Hershey's Chairman and CEO, Michele Buck, and Hershey's Senior Vice President and CFO, Steve Voskuil.

In addition to these remarks, we will host an analyst Q&A-only session at 8:30 am Eastern on the morning of April 28. A replay of this webcast and our subsequent Q&A session will be available on the Investor Relations section of our website, along with their corresponding transcripts.

During the course of today's discussion, Management will make forward-looking statements that are subject to various risks and uncertainties. These statements include expectations and assumptions regarding the Company's future operations and financial performance. Actual results could differ materially from those projected. The Company undertakes no obligation to update these statements based on subsequent events. A detailed listing of such risks and uncertainties can be found in today's press release and the Company's SEC filings.

Finally, please note that during today's discussion we will refer to certain non-GAAP financial measures that we believe will provide useful information for investors. The presentation of this information is not intended to be considered in isolation or as a substitute for the financial information presented in accordance with GAAP. Reconciliations to the GAAP results are included in this morning's press release.

It is now my pleasure to introduce our Chairman and CEO, Michele Buck.

Michele Buck

Thank you, Melissa, and good morning, everyone.

We have gotten off to a tremendous start to the year, with reported sales growth of 16% and adjusted EPS growth of almost 32% in Q1. Consumer demand for our products has remained resilient across categories and markets, despite rising inflation. Our teams have done a remarkable job relentlessly adapting, reprioritizing, and addressing opportunities and obstacles in a persistently complex environment. Given our performance in the first quarter and increased visibility into consumer and production trends for both our core business, as well as the acquisitions we closed on late last year, we are raising both our full year net sales and earnings outlook.

We are actively monitoring changes in consumer behavior, inflation, supply chain resiliency and the labor market to ensure we are positioned well to meet the needs of all of our stakeholders in 2022, and beyond.

In the first quarter, price elasticity trends were favorable, versus both historical and planned levels across our business. Despite mid- to high-single-digit price increases across the portfolio, everyday confection volume sustained at prior year levels and volumes within our North America Salty Snacks and International segments increased versus prior year. Compelling category fundamentals, including strong brand equities and minimal private label presence, are contributing to this strength, along with our strategic focus on enhancing our offerings and price points to ensure our category remains accessible to all consumers, even in periods of inflation.

A great example of this has been our investment in supply chain capacity and automation to more efficiently package smaller opening price point bags. This has enabled distribution increases across classes of trade and incremental placements across the store. Approximately 25% of our portfolio currently retails for around $2.00, or less, enabling consumers, including those managing a tight budget, to participate in our category.

These types of investments and capabilities to drive productivity will remain an important part of our multi-faceted approach to meeting the needs of our consumers and maintaining our strong margin profile, so that we can continue to invest in our brands and our people.

Our U.S. category strengths and strategies were further supported in the first quarter by extended SNAP benefits and sustained at-home consumption, as consumers looked for more economical food options in the face of high inflation. As we look ahead to the remainder of this year, we expect pricing power to remain strong, but elasticities to revert to historical levels as government benefits fall for the first time in two years and consumer savings are depleted as inflation outpaces wage growth for many consumers.

Higher prices in store and at the gas pump did not dampen consumers' excitement to celebrate the Easter season. Category retail sales grew double-digits behind a longer selling season and the return of community celebrations as COVID-19 cases declined. Category Easter retail sales growth outpaced Hershey Easter retail sales growth of high-single-digits, as expected, as capacity constraints prevented us from fully servicing this strong demand. During the last several weeks of the season, we saw accelerated everyday sales, as many consumers purchased everyday Hershey favorites to their fill their baskets and candy dishes, where Easter product was sold out.

This sustained confection demand, in addition to continued global supply chain volatility, is continuing to put pressure on our ability to fully service demand. Given our strong share gains over the past two years, these challenges are disproportionately impacting Hershey, compared to other manufacturers. In 2020 and 2021, Hershey's chocolate retail pounds sold increased a combined 7%, while our competitors' volumes, collectively, declined almost 1%. As a result, other manufacturers have been able to maintain advertising and promotional levels, and better service demand, to regain share to start the year.

Increasing production, inventory and service levels remains a critical priority for us. While we still have opportunity to further improve, we made progress in the first quarter. Our capacity and labor investments, as well as our proactive approach to moderating media and promotions, enabled us to increase production mid-single-digits in the first quarter and replenished distributor and retail inventory ahead of expectations. While some of this product is still making its way to retail, we expect on-shelf availability to improve in the coming weeks and throughout the remainder of the year. These improvements will enable us to increase investment in advertising and promotional activity as we progress through the year and improve our market share position, compared to the first quarter.

While we had to slightly reduce support in the first quarter compared to last year due to capacity constraints, we continued to invest meaningfully in our brands and drive strong consumer engagement.

Across the globe, we celebrated women with our Her-SHE Campaign, building off last year's success in our international market. In year two of the campaign, our International Team expanded to seven markets and celebrated women across fields, including business, science, music and sports. This was a great way to engage our consumers as we strengthen brand equity in these markets. In just two weeks, we received over 50,000 nominations for women to be recognized as part of the program and generated over 0.5 billion impressions. In the U.S., our first year of activation garnered over 3 billion impressions, as we executed both online and in stores, and helped support the Girls on the Run organization with a $150,000 scholarship.

Our teams in the U.S. continue to tap into consumers' love for both chocolate and their pets, with our Cadbury Bunny Contest. This year, votes cast were up 30%, versus 2021, and consumer impressions of over 8.1 billion set a new record for this campaign, as a nursing home English Doodle from Ohio, named Annie Rose, earned this year's honor.

Within our North America Salty Snacks segment, Skinny Pop and Pirate's Booty both delivered double-digit sales growth and share gains in the first quarter, driven by increases in both household penetration and frequency. Skinny Pop retail sales growth of over 13% resulted in a 60-basis-point share gain in the quarter, driven by incremental marketing investment and gains in both household penetration and frequency. Pirate's Booty maintained its momentum, with retail sales growth of 55%, as consumers continued to seek permissibility and convenience as they returned to pre-pandemic routines, including school lunches, road trips and socializing with friends. Dot's retail sales more than doubled versus last year in the latest 12 weeks, resulting in a 630-basis-point share gain of the pretzel category, bringing its total share of the pretzel category to 17% in the first quarter of 2022.

While we are confident in our ability to support demand as the year progresses, several products will remain capacity-constrained until 2023, and changes in the geopolitical landscape, combined with our stronger volume outlook, has added both complexity and cost versus our previous expectation.

While we have limited direct exposure to Eastern Europe, the Russia and Ukraine conflict's effect on commodity prices and supply availability is impacting our operations and financial outlook. Our cross-functional Crisis Management Team has done a great job of ensuring raw material supply continuity and price risk management, but the situation remains volatile. Steve will share more details in a few minutes.

This continued volatility highlights the importance of a sustainable and robust, dynamic planning process. Late last year, we initiated a project to more formally and efficiently institute some of the approaches we implemented during the COVID-19 crisis into our regular planning process. We believe this work is critical to enabling our teams to identify and respond to meaningful changes in consumer behavior and supply chain operations and costs more effectively.

While the external environment has required even more focus and attention on execution, it has not detracted us from advancing key strategic imperatives that we believe will enable us to deliver advantaged sales and earnings growth in the years ahead.

This year, we are completing the start-up and commissioning of three new distribution and fulfillment centers, unlocking new capacity from incremental production lines that are now operational, and beginning work to install an additional 10 new production lines to generate incremental capacity in 2023 and 2024 to support our growth goals.

Our pretzel acquisitions are pacing ahead of expectations as retail sales growth continues to accelerate. In addition, last month, we began leveraging the manufacturing assets we acquired in the deal to start producing product and add incremental capacity for other brands within our Salty Snacks portfolio to meet high demand.

Lily's is on track to fully integrate into our U.S. business next month as part of our holistic better-for-you Commercial Team. This team will capture untapped opportunity in the confection category by innovating on our core brands, leveraging new technologies in sugar reduction, and capitalizing on M&A and partnerships to drive growth and provide consumers with more choices to meet their evolving needs.

We are utilizing a similar multi-pronged approach to increase our presence in the fast-growing gummy sweets space, with incremental capacity supporting innovation on our Jolly Rancher Gummies products and the launch of Lily's Gummies this spring. These investments and innovations are helping drive strong growth and share gains within our Sweets portfolio.

We expect the environment to remain dynamic as we progress through the year. As we navigate impacts from geopolitical events, inflation and supply chain resiliency, we will strive to meet the needs of all stakeholders to ensure sustainable performance over the long term.

With that, let me turn it over to Steve to provide more details on our financial results and outlook.

Steve Voskuil

Thanks, Michele, and good morning, everyone.

As Michele shared, we had a fantastic quarter, with results ahead of expectations. This is a testament to our advantaged business model, dynamic teams and differentiated margin structure. Our strong start to the year, combined with increased visibility into the rest of the year, enables us to raise full year sales and earnings guidance, despite a higher inflation outlook and a complex operating environment.

In the first quarter, net sales grew 16.1%. Organic constant currency net sales growth was 11.5%, driven by balanced growth across all segments. Net price realization contributed 6.9 points of growth, as expected, behind mid- to high-single-digit price increases announced last year. Volume contributed 4.6 points of growth to the quarter, driven by stronger than planned price elasticity and distributor inventory replenishment. This inventory replenishment also paced ahead of expectations, contributing approximately 3 points of growth to the first quarter. Our Manufacturing Team did a great job leveraging investments in capacity and labor to increase production mid-single-digits, versus prior year, and, in fact, delivered our biggest production quarter yet. This was slightly ahead of expectations and enabled us to begin replenishing distributor inventory earlier in the year than we initially planned.

Our recent acquisitions of Dot's Pretzels, Pretzel's Inc. and Lily's contributed another 4.6 point benefit to net sales growth in the quarter.

As we look ahead to the rest of the year, we are increasing our sales outlook to reflect recent trends and incremental customer programming on our pretzel business, as well as production gains that will enable us to capture continued, elevated consumer demand. This, combined with our strong Q1 start, increases our full year net sales growth expectation to approximately 10% to 12%, an increase of two points, versus our prior outlook. This assumes pricing elasticities remain strong, but moderate to more historical levels in the remaining quarters, as broad-based inflation and the decline in government assistance is starting to impact some consumer goods categories.

There is no change to our full year inventory replenishment outlook, which is expected to contribute 1.5 to 2 points of volume growth to the year. However, we now anticipate this replenishment to occur more in the first half of the year.

Now, turning to profitability, first quarter adjusted gross margin was flat versus the prior year at 45.8%, slightly ahead of expectations. Net price realization and a timing benefit related to inventory valuation in the North America Confectionary segment benefited gross margin in the quarter. These benefits were complemented by productivity and fixed cost leverage driven by stronger sales and production growth. Together, these benefits entirely offset the broad-based supply chain inflation, as well as incremental costs incurred to support higher volume that we saw in the first quarter.

For the full year, we are now expecting higher inflation versus our previous outlook, as key raw materials, packaging and logistics costs have increased significantly due to geopolitical events. While we have a robust hedging process and came into this year relatively well covered, we have seen meaningful increases in costs for commodities that we do not or cannot hedge, including dairy, oils and packaging. Additionally, high oil prices are driving increases in both contracted and spot freight costs, ahead of our original expectations. Our stronger than expected sales growth across business segments has resulted in incremental outsourcing and more spot commodity logistics costs.

Combined, these factors are expected to pressure gross margins by an additional 60 to 80 basis points versus our original expectations for the full year. Inflation is driving approximately 80% of this dilution, while incremental costs to serve higher volume are responsible for approximately 20%. We now expect full year gross margin contraction of 120 to 140 basis points, though, given our strong sales growth outlook, we expect gross profit dollars to increase mid-single-digits for the year.

While the cost outlook and operating environment are challenging, we are confident in our ability to maintain our peer-leading margins through a balanced, multi-lever approach.

Advertising and related consumer marketing spend decreased about 1% in the first quarter. As we shared in February, we continued to purposely optimize marketing investments in capacity-constrained confectionary brands in the first quarter, while keeping a close watch on maintaining our category share of voice. Consumer impressions declined more significantly than advertising spend in the first quarter due to the way we allocate advertising spend across the year to align with sales. In addition, increases in advertising spend within our North America Salty Snacks segment partially offset declines in North America Confectionary segment.

Brand investment remains a critical lever to drive growth and we plan to increase investment as the year progresses and supportability improves. As a reminder, our consumer impressions are expected to increase for the full year, while advertising spend will remain comparable to the prior year, as new media partners and tools allow us to increase efficiency and effectiveness.

Strong net price realization and volume gains, on top of an advantaged margin structure, provided a 27.4% increase in adjusted operating profit and a 240-basis-point increase in adjusted operating profit margin in the first quarter, while managing a higher inflationary outlook and complex operating environment.

As we look across segments, I want to share some perspective on the profitability of the North America Salty Snacks segment. Sales mix was a 500-basis-point headwind due to recent acquisitions. Broad-based supply chain inflation led to higher commodity costs in kernels and oil. In addition to mix and inflation, which we expect to continue throughout the year, the segment also faced elevated costs unique to the quarter. Increased brand investment to support volume elasticities led to higher advertising expenses. While we plan to continue to invest in our brands, we expect advertising to moderate beginning next quarter. Incremental start-up costs related to distribution network expansion, along with sourcing costs related to strong sales, drove higher supply chain costs, that will lessen as demand moderates throughout the year. As we look forward, we remain committed to executing a balanced approach to margin expansion, similar to the rest of the Company. We expect year-over-year trends to improve as we continue to focus on long-term optimization.

With adjusted EPS growth of nearly 32% in the first quarter, we are now raising our previously communicated EPS range and expect adjusted EPS to grow approximately 10% to 12% for the year.

Strong sales performance and operating leverage drove healthy cash generation in the first quarter, with net operating cash flow of $656 million, an increase of approximately 8% versus the prior year period. This cash generated supported our dual focus on business reinvestment and shareholder returns.

Our capital allocation strategy remains focused on core confection capacity, snacking scale and optimization, and supply chain resiliency, with most 2022 spend in support of projects coming online in 2023, and beyond. In the first quarter, total capital additions, including software, were approximately $141 million. We expect capital projects to accelerate as the year progresses and are now expecting to spend closer to $600 million for the full year, the high end of our previously communicated range.

Shifting to dividends and repurchases, in the first quarter, we paid $181 million in cash dividends to shareholders and repurchased $203 million of stock, an amount consistent with our share repurchase levels from the past several years.

We had a strong start to the year, allowing for a raise to the full year outlook. As the operating environment continues to evolve, I am confident that our teams and, as a result, our business will continue to respond with agility and excellence to deliver another year of differentiated results.

With that, I'll pass it back to Michele.

Michele Buck

Thanks, Steve.

While new operational challenges continue to arise, I couldn't be prouder of our team's perseverance and dedication to face and solve them together. Thank you to all of our employees across the globe who have made these results possible.

We have strong momentum across our segments and opportunity ahead of us as our supply chain investments enable us to better capture unmet demand and further activate our portfolio.

Thank you for your time this morning.

I invite you to listen to our live question-and-answer webcast, which will begin today at 8:30 a.m. Eastern Time, and will be available at thehersheycompany.com. Thank you.