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HSY - Q4 2018 Hershey Co Earnings Call

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OVERVIEW:

HSY reported 4Q18 net sales of $1.99b and adjusted diluted EPS of $1.26. Expects 2019 net sales growth to be 1-3%.

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PRESENTATION

Operator

Good morning, everyone, and welcome to The Hershey Company's Fourth Quarter 2018 Results Conference Call. My name is Aaron, and I will be your conference operator today. (Operator Instructions) This call is scheduled to end about 9:30 a.m. (Operator Instructions) Please note, this call may be recorded. Thank you.

It is now my pleasure to turn the program over to Ms. Poole. You may begin.

Melissa Poole - *The Hershey Company - Senior Director of IR*

Thank you, Aaron. Good morning, everyone. We appreciate you joining us for The Hershey Company's Fourth Quarter 2018 Earnings Conference Call and Webcast. Michele Buck, the President and CEO; and Patricia Little, Senior Vice President and CFO, will provide you with an overview of our results, followed by a Q&A session.

Before we begin, please remember that during the course of this call, we may make forward-looking statements within the meaning of the federal securities laws. These statements are based on our current expectations and involve risks and uncertainties that could differ materially from actual events and those described in these forward-looking statements contained in our 2017 10-K filed with the SEC and today's press release.

Finally, please note that on today's call, 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. Please refer to today's press release for a reconciliation of the non-GAAP financial measures to the most comparable measures prepared in accordance with GAAP.

With that, I would like to turn the call over to Michele.

Michele Gross Buck - *The Hershey Company - President, CEO & Director*

Thanks, Melissa, and good morning to all of you on the phone and webcast. As I reflect on the progress that we've made against our strategic plan and the initiatives we have under way for 2019 and beyond, I am confident and excited about the future of this company.

Before I get into the details of our results, I'd like to take a moment to reflect on our 125th anniversary that we are celebrating this year. It's an incredible privilege to lead a company that remains as relevant with consumers today as we were more than a century ago.

Everyone here at Hershey has tremendous pride in our incredible portfolio of brands, and it's the care and attention that we put in each of our brands that resonates with our consumers. Our job is to deliver on our consumers' expectations each and every day.

We are also entrusted to make the strategic decisions to ensure that Hershey is well positioned long term. I'd like to thank my Hershey colleagues for their consistent passion and commitment.

Now turning to the business at hand. We are fortunate to participate in growing categories with amazing brands that consumers love. We have advantaged margins, a healthy balance sheet and differentiated capability. In a dynamic and highly competitive operating environment in 2018, we grew our business and delivered on our financial commitment while strategically investing for the future.

In our U.S. core confection business, we invested in new brand positioning and launched new campaigns for our 2 largest brands, Reese's and Hershey's. We shifted investments to new marketing capabilities that enable us to support more confection brands within our portfolio.

By leveraging consumer insights and new capacity, our team drove strong growth and share gains during the Halloween and Holiday sales periods while improving our sell-through and reducing markdowns. At the same time, our SKU rationalization program and pricing actions are enabling progress on improving our margins.

We also expanded our portfolio to capture incremental consumer occasions with the complementary acquisitions of Amplify and Pirate Brands. These 2 high-growth, high-margin, better-for-you snacking assets are a great fit with our Hershey portfolio. They are performing well in the marketplace, and they are on track to deliver against our goals.

We made tremendous progress with our international business transformation plan, delivering a record year of profit as well as solid growth. This growth was balanced with organic constant currency sales and operating income gains in each of our key markets. Importantly, our team diligently continued to reduce our foundational cost structure to enable investment in growth-generating assets and capabilities.

Our ERP initiative is on track and modules are coming online according to plan. In the second half of 2018, we launched 2 commercial-focused modules, trade promotion and marketing expenses, and we are pleased with the early results. This ERP initiative is a key enabler to our broader digital transformation efforts.

We also will continue to invest in core capacity as we did with our new Reese's and Kit Kat lines in 2018 as well as incremental capacity on Ice Breakers gums and in our broader distribution network. While our gross margin was below expectation for the year, we made progress and improved performance as we progressed through the year. We believe the SKU rationalization program and previously announced price increase position us well to make additional progress in 2019.

Now let's turn specifically to progress made in the fourth quarter. We delivered sales and EPS in line with our expectations. Constant currency net sales increased 3.1%, including a net benefit from acquisitions and divestitures of approximately 3 points.

Foreign currency exchange was a 0.6 point headwind. Adjusted earnings per share diluted of $1.26 increased 23.5% compared to the fourth quarter last year. Our strong Holiday program resulted in both sales growth and seasonal market share gains as well as improved sell-through at retail.

Hot Cocoa Kisses was the #1 new Holiday item in the category and helped drive merchandising support and growth for the entire Kisses franchise. This Holiday strength resulted in measured channel Hershey CMG takeaway increasing 1% in the 12 weeks ended December 30. This was in line with our expectations. As a reminder, takeaway was greater than fourth quarter net sales growth due to the inventory reductions that we anticipated and discussed on our last quarter's call. For the fourth quarter, Hershey CMG market share declined slightly, approximately 20 basis points, as competitive activity remained robust.

Hershey chocolate takeaway was up 1.9% in the quarter, driven by strength in our Reese's brand, which grew 4%. Our new #NotSorry campaign and strong seasonal execution enabled by the capacity expansion we implemented in the first quarter of last year were key contributors of this growth.

We activated additional chocolate brands within the portfolio in 2018, and we are pleased with the results. Combined retail takeaway for York, Almond Joy, Mounds and PAYDAY was up 2% in the fourth quarter, a 7 point improvement versus their 2017 trend, and it was driven by velocity. We leveraged new more efficient marketing models to support these brands and believe there is additional opportunity to bring more of our smaller but highly differentiated products to life in 2019 with this approach.

Our Ice Breaker business continued to perform very well with retail takeaway growth of more than 9% during Q4. This was driven by distribution and velocity gains on our gum business, resulting in growth of over 18% during the quarter. Our investments in digital commerce are resulting in consistent, solid net sales growth of approximately 40%. We expect to see similar momentum in 2019 as we continue partnering with our retailers on differentiated offerings that meet our consumers' needs.

These gains were partially offset by continued softness in our non-chocolate portfolio and sales declines from items impacted by our SKU rationalization program. We expect these headwinds to persist in 2019 as we focus on initiatives to drive growth within our chocolate portfolio and continue to reduce complexity to improve margins.

As we look more broadly across the portfolio, total Hershey retail takeaway in the fourth quarter was slightly higher at 1.2%, driven by Skinny Pop and Pirate's Booty. Skinny Pop retail takeaway remained strong with growth of 9% in the 12 weeks ending December 30. The core ready-to-eat popcorn portfolio grew 6.5%, led by continued household penetration gains. This resulted in a category share gain of 28 basis points in the quarter. Pirate's Booty grew approximately 5% in the quarter, outpacing the category. Similar to Skinny Pop, these gains were driven by increases in household penetration.

For 2019, we have a balanced plan to build on our second half 2018 momentum. We expect annual net sales growth of 1% to 3% and adjusted earnings per share diluted growth of 5% to 7%. We believe this growth will be driven by improving organic sales growth and profitability within North America.

Let me provide you with some details around our plans. For our U.S. confection business, we anticipate growth from seasonal strength, pricing, core distribution gains, innovation and new brand positioning, a very balanced set of growth levers. Our seasonal growth will benefit from late Easter, adding approximately 3 weeks of additional selling days for the season. While there will be some offset in our everyday sales, we do expect a net positive impact to the business based on historical patterns.

Merchandising is already off to a strong start on consumers' Easter favorites, Reese's and Cadbury Eggs. Additionally, we expect our strong Halloween and Holiday performance from 2018 to result in increased orders for the upcoming season.

Our previously announced price increase of approximately 2.5% is on track. As a reminder, we expect the P&L impact to build over the course of the year. Similar to past price increases, we anticipate some volume impact on items experiencing higher retail shelf prices.

As we rationalize less productive SKUs in the portfolio, we continue to make progress in securing distribution on higher-velocity items to maintain and optimize our shelf space and improve productivity for both Hershey and our retailer partners.

We are also focused on securing incremental space for the entire category. We are consistently collaborating with our retailers on ways to adapt to this rapidly changing environment and optimize space to drive sales and margin. We recently partnered on and implemented a new front-end planogram at a key customer to increase space for snacking, and it's showing promising results so far. Hershey performance in stores that implemented this change are currently facing 500 basis points ahead of stores with the old planogram. Strong retail partnerships are always a key priority for us and have helped to fuel our success.

We are excited about our core marketing and innovation plans for 2019. As we discussed last year, we have both packaging and product innovation that we believe will drive consumer engagement and increase sales. The transformation of our packaged candy portfolio is on track and starting to hit shelves after Easter. This will benefit many of our chocolate brands with better shelf impact and improved velocity.

Additionally, we will continue to leverage our in-house creative studio and new media models to support the rest of our portfolio in 2019. Investing in our portfolio has always been and will remain a critical part of our business model. We constantly look for ways to engage with our consumers in new, different and more efficient ways.

Our Reese's Thins launch will be in this new improved packaging and is on track to hit shelves after Easter. This great-tasting product gives consumers another way to enjoy their favorite combination of chocolate and peanut butter, and it will be available in both milk and dark chocolate varieties. Reese consumers are passionate about their cups, and we will leverage TV media, in-store merchandising and social to engage with them and drive excitement and, ultimately, incremental purchase.

And we'll continue to have a lineup of news, such as our Hershey with Reese's Pieces launch, to drive relevancy and merchandising. While our overall innovation lineup is comparable to 2018, the contribution will be slightly skewed to the second half. Also, as a reminder, the late Easter will drive slower retail performance in February and March and then rebound in April.

We expect the category to accelerate slightly in 2019 driven by the longer Easter, and we expect our performance to be in line with the category. We feel confident about the actions we are taking both to compete today and to build for the future. But as you all know, the competitive environment is intense and it is taking more to win. We are committed to investing in our business to maintain our leadership position while also delivering our financial commitment.

Now for an update on our 2019 plans for our recently acquired snacking assets. Amplify remains on track and is expected to grow mid-single digits in 2019. Skinny Pop is projected to grow share in the ready-to-eat popcorn category behind additional distribution gains and a new marketing campaign. As we shared last year, some of our confection capabilities can be applied to broader snacking. This has been a priority area for us, and we are seeing some great progress.

The Pirate's Booty integration is proceeding nicely, and the Amplify team in Austin is preparing to take over some responsibilities. As with Skinny Pop, Pirate's Booty has a focused set of core SKUs with high velocities that warrant greater shelf presence, and we plan to leverage our category management capability to drive distribution in 2019. I want to thank all the teams working hard to integrate and drive sustainable growth on these important brands.

I'd also like to take a few minutes to recognize our international team, who have done an amazing job executing our transformation plans. We expect to make continued progress internationally in 2019, albeit at a slower pace, given the significant gains we drove in 2018. We will continue to leverage our strengths and focus on our Hershey's first strategy, which has resulted in solid Hershey brand share gains in our focus markets.

In Mexico, the Hershey brand has grown share of the chocolate category for 17 straight [quads]. In Brazil, the Hershey brand is growing share of the bar category in a highly competitive environment. And in India, we are gaining share in syrup, spreads and drinks. The Kisses launch in India is on track, and we are excited by the opportunity here.

We have also launched gifting items under the Kisses brands in Mexico, which we believe will enable us to capture an incremental premium occasion to drive growth. While we are confident in the plans we are executing, we remain cognizant of potential geopolitical risks that could impact international performance in 2019. We are focused on driving actions within our control and managing risks as effectively as possible.

In summary, in 2018, we delivered our financial commitment and we continued to invest in our future growth. Our core confection sales and margin trends are improving, and we believe we can further build on this momentum with a balanced 2019 plan. Our recently acquired snacking brands continue to see strong growth and deliver against our financial objectives, and our international business remains on track. We remain focused on driving long-term shareholder value by delivering balanced top and bottom line growth in 2019, while investing in differentiated capabilities to expand our competitive advantage in the future.

I'll now turn it over to Patricia, who will provide you with details of our financial results.

Patricia A. Little - *The Hershey Company - Senior VP & CFO*

Thank you, Michele. Good morning, everyone. As anticipated, fourth quarter net sales of $1.99 billion increased 2.5% versus the same period last year. Constant currency net sales increased 3.1% with foreign currency exchange a 60 basis point headwind. The net impact of acquisitions and divestitures was a 3 point benefit to net sales growth. Volume was a 90 basis point benefit, which was partially offset by anticipated negative net price realization of 80 basis points.

For the full year 2018, net sales increased 3.7%. The net impact of acquisitions and divestiture was a 3.6 point benefit. Organic constant currency net sales growth of 0.3% was partially offset by unfavorable foreign exchange of 0.2 points.

Adjusted earnings per share diluted of $1.26 in the fourth quarter represented an increase of 23.5% versus the same period last year. This was driven by a more favorable tax rate, SM&A decline, acquisitions and volume growth.

For the full year 2018, adjusted earnings per share diluted of $5.36 was an increase of 14.3% versus the full year 2017. This was driven by favorable tax, SM&A and acquisitions, partially offset by gross margin declines.

By segment, in the fourth quarter, North America net sales increased 4.3% versus the same period last year. The Amplify and Pirate Brands acquisitions added 4.8 points, and organic volume gains contributed 80 basis points. Net price realization and foreign currency exchange rates were 110 and 20 basis points headwind, respectively. These results were in line with expectations.

North America advertising and related consumer marketing spend declined 13.3% in the quarter. This was in line with expectations. Consistent with what we shared throughout 2018, these declines were driven by optimization of emerging brand spend as well as media efficiency gains as we leverage new models and channels to reach consumers. Despite the spend declines for the full year, our consumer impressions were up on our chocolate brands. In 2019, we expect the year-over-year changes in advertising and related consumer marketing spend to be more comparable to our historical patterns and grow relatively in line with sales.

Now for an update on Amplify and Pirate Brands. Accounting for the Tyrrells divestiture, the Amplify business came in according to plan on both the top and bottom line. The acquisition was approximately $0.08 EPS accretive, consistent with our previous guidance. The Pirate Brands contributed slightly to our overall sales performance and had a negligible impact on our earnings in 2018.

Fourth quarter total International and Other segment net sales decreased 8.9%, including an 8.4 point impact from divestitures and a 3.1 point headwind from unfavorable foreign currency exchange. Volume and net price realization were a 190 and a 70 basis point benefit, respectively. Organic constant currency net sales in our focus markets, Mexico, Brazil, India and China, grew 7%. International and Other advertising and related consumer marketing declined 13%, in line with our expectation as we rightsize our investments to drive more profitable growth.

Now turning to gross margin. Adjusted gross profit of $844 million increased 1.9%, resulting in an adjusted gross margin of 42.5%, a decline of 20 basis points versus the fourth quarter of last year. This was a meaningful improvement versus our first half and third quarter trends, although slightly below our estimate for the quarter. The slightness was driven by the disposition of underutilized packaging assets related to the upcoming migration of our packaged candy line in the second quarter of 2019. Excluding this impact, our gross margin was slightly up versus prior year, in line with our expectations. We believe we will continue to make progress in 2019 and expect modest gross margin expansion for the year.

Fourth quarter adjusted operating profit of $369 million increased 13.1% versus the fourth quarter of 2017. This resulted in an adjusted operating profit margin of 18.6%, an increase of 180 basis points, driven by lower selling, marketing and administrative expenses. As we look forward to 2019, we expect operating profit margin to expand slightly above our recent historic average. This is driven by pricing and productivity initiatives in both cost of goods sold as well as SM&A.

As a reminder, we over-delivered our Margin for Growth Program expectations in 2018 with savings of approximately $90 million, partially driven by the acceleration of some savings originally slated for 2019. Additionally, we expect some of the remaining savings to flow through into 2020 due to the phasing of our ERP implementation. We continue to expect our overall Margin for Growth Program savings to be towards the high end of our $150 million to $175 million range.

Moving down the P&L. Interest expense of $38 million increased $12 million versus Q4 last year, driven by the Amplify and Pirate Brands acquisitions. Full year 2018 interest expense of $139 million was in line with our previous guidance. In 2019, interest expense is expected to be approximately $150 million to $160 million, a slight increase versus 2018 due to acquisitions.

The adjusted tax rate for the fourth quarter was 9.5% versus 15.1% in the year-ago period. This resulted in a full year 2018 adjusted tax rate of 19.2% versus 26.6% in the year-ago period, in line with our expectations. Both the fourth quarter and full year tax favorability was driven primarily by U.S. tax reform. In 2019, we expect our tax rate to be approximately 17%.

In the fourth quarter, other expense was $38 million, an additional expense of $10 million versus the year-ago period. This year-over-year decline is driven by timing related to our investment tax credit strategy as well as favorable non-service-related pension expense. Full year 2018 expense of $69 million was in line with our expectations. In 2019, we expect other expense to be approximately $105 million to $115 million. This reflects a higher investment in tax credits as well as additional expense associated with our pension assets due to the year-end negative stock market performance.

For the fourth quarter of 2018, weighted average shares outstanding on a diluted basis were approximately 211 million. In November, the company purchased $48 million of common stock from the Hershey Trust in connection with the exercise of stock options. The company did not repurchase common shares in the fourth quarter against the October 2017 or the July 2018 share repurchase authorizations. The total combined outstanding authorization is $560 million.

Total capital additions, including software, was $87 million in the fourth quarter. For the full year 2018, capital additions were approximately $329 million. This was slightly the lower estimate, driven primarily by lower capital spending required to support the Amplify integration.

For the full year 2019, we estimate that CapEx will be in the $330 million to $350 million range. As a percent of net sales, this remains slightly higher than our long-term target as we continue to advance our ERP transformation and invest in core capacity.

We continue to return cash to our shareholders with fourth quarter dividends of $147 million. This was our 356th consecutive quarterly dividend on the common stock. We expect full year 2019 net sales to increase 1% to 3%, including approximately 0.5 point net benefit from acquisitions and divestitures.

We are planning a negligible FX impact for the year, however, the environment is very volatile. We anticipate FX will be a slight headwind in the first half and a slight tailwind in the second half.

As a reminder, the SKU rationalization program we announced last spring will continue to impact net sales for the first half of this year. This, in addition to the timing of divestitures, key marketing activities around innovation and packaging and FX impacts, are expected to result in stronger net sales growth in the second half of the year.

Full year adjusted earnings per share diluted are estimated to grow 5% to 7%, driven by operating profit margin gains as well as a more favorable tax rate. Due to the timing of investments throughout the year as well as the dating of the sales growth, we expect EPS growth to be stronger in the second half of the year.

We take a balanced and disciplined approach to building our brand and evolving our business model for the future. We have strong cash flow and a healthy balance sheet that gives us flexibility to make the necessary investments to drive long-term shareholder value.

That concludes my financial discussion. Thank you for your time this morning, and I'll now turn it back over to Michele for some closing remarks.

Michele Gross Buck - *The Hershey Company - President, CEO & Director*

Thanks, Patricia. I remain confident in our strategy, and I am excited about what we here at Hershey have ahead of us in 2019 as we look to drive a year of balanced growth. As we talked about, the marketplace continue to advance at an accelerated pace. I am optimistic that this change creates opportunities for us to engage with our consumers in new and innovative ways to unlock growth.

As I mentioned at the top of our call, 2019 is our 125th anniversary, and it's an incredible time to be here at the company. Our remarkable employees are dedicated to delivering the best quality and the best experience for our consumers each and every day. That hasn't changed over the past century and it will continue into the next.

Patricia, Melissa and I are now available to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We will take our first question from Ken Goldman with JPMorgan.

Kenneth B. Goldman - *JP Morgan Chase & Co, Research Division - Senior Analyst*

I just wanted to poke around a little bit on the deload. Can you frame for us -- I don't think you quantified the impact of it. So if you did, forgive me, but I'm just trying to get a little bit of a sense of the number there. And then I also want to get a sense for where retail inventories currently sit as far as you can tell. Are they still up year-on-year after the deal? I really just want to get an idea of further risk as we look ahead because I know you guys talked about how the deload was in line with your expectations, but I don't think most people on The Street were quite prepared for it as perhaps you guys were.

Michele Gross Buck - *The Hershey Company - President, CEO & Director*

So let me just start, Ken, and then I'll turn it over to Patricia for more details. The year did close in line with our expectations. And we know that as more data and analytics are available, retailers are constantly looking in how they can optimize inventory levels, as we all are, and we do expect that to continue into 2019, and those assumptions are built into our guidance. But I'll let Patricia give a little bit more detail around that.

Patricia A. Little - *The Hershey Company - Senior VP & CFO*

Yes. As we talked about in the third quarter, we have good insight, especially on some of the bigger -- some of our bigger customers in terms of their inventory. And we knew that there would be some deload in the fourth quarter, and you saw that play through in the difference between the sales and the retail takeaway. That was absolutely in line with our expectation. We don't have as good an analytics on all of the -- many, many customers, but we know that overall, this inventory came down through the system. We expect that to continue into 2019, as Michele said, again, really related to broad secular trends in the industry. On any given quarter, that will have a lot of movement based on season, based on timing of pricing, which we think was an impact this year, looking at when promo activity is, innovation, timing. So quarters can be very -- have a lot of movement, but this was exactly what we -- near exactly as we expected.

Operator

And our next question comes from Bryan Spillane with Bank of America.

Bryan Douglass Spillane - *BofA Merrill Lynch, Research Division - MD of Equity Research*

Just one clarification and one quick question. Just on the clarification, Patricia, you talked a little bit about share repurchases, and it just wasn't -- I want to make sure we're clear, the guidance -- the EPS guidance range for this year does not assume a reduction in the share count?

Patricia A. Little - *The Hershey Company - Senior VP & CFO*

We have a long-term sort of historic average of doing share repurchase on a discretionary basis every year and we always put that into our plans because otherwise, it would just show us, especially in the absence of acquisitions which are hard to -- which we don't put in plan, which will show us build in cash. So there is a modest amount of our normal run rate share repurchase included in the plan.

Bryan Douglass Spillane - *BofA Merrill Lynch, Research Division - MD of Equity Research*

Okay. So nothing -- but nothing unusual relative to history?

Patricia A. Little - *The Hershey Company - Senior VP & CFO*

Correct. Nothing unusual.

Bryan Douglass Spillane - *BofA Merrill Lynch, Research Division - MD of Equity Research*

Okay. All right. And then, Michele, you talked a little bit about the, I guess, the gap between -- in North America, the takeaway of chocolate versus non-chocolate and just so the non-chocolate being a drag, and I guess that skewed up. Can you just give us a little bit more color, what the magnitude of that is? And then I know -- I guess, it's still going to be a drag in '19, but is it less of a drag in '19 than it was in 2018?

Michele Gross Buck - *The Hershey Company - President, CEO & Director*

Yes. So the SKU rationalization is probably the bigger impact on the business, and that's about 1 point in 2019, and that's about the same as it was in 2018. And then relative to the non-chocolate portfolio, I would say the impact will be similar in '19 versus '18. As you know, the large proportion of our business is chocolate. So from a magnitude perspective, I think that could give you a little bit of a feel of the size of that.

Operator

We will take our next question from Andrew Lazar with Barclays.

Andrew Lazar - *Barclays Bank PLC, Research Division - MD & Senior Research Analyst*

I know heading into this year, Hershey obviously had worked through a decent chunk of some SKU rationalization, as you've talked about, some trade inventory reductions made, capacity investments and divested some businesses that have been a drag. This year, you got obviously the benefit of a longer Easter, getting some pricing in place and then you still got incremental cost saves as well. So I guess my question is, maybe why wouldn't we see maybe more of like an algorithm type of year with respect to the top and bottom line? Maybe in other words, would you characterize '19 as a year of -- still a year of incremental investment or perhaps you're being a little bit more cautious on things like volume elasticity in relation to the pricing and things of that nature?

Michele Gross Buck - *The Hershey Company - President, CEO & Director*

Yes. We feel really good about the plans and the activations we have this year. And I think what we feel great about is how balanced -- how much -- how many different growth levers we think we're really pulling. So as you know, as we mentioned, we expected to accelerate performance in our important North America market. However, that SKU rationalization is still impacting us at about that point, as I mentioned. And if you add that back into where growth is, that really puts us smack dab in terms of where the long-term guidance is. So the price increase, which will have a little bit of an impact, we feel good about the price increase, but we do anticipate a little bit of volume conversion which, as you know, based on history, you get a bigger volume impact and then it works its way back up throughout the year. And we'll continue to see that little bit of softness as retailers continue to optimize inventory. But we feel great about the plans and the acceleration, but that SKU rat is really the biggest -- kind of the biggest offset.

Operator

Our next question comes from Robert Moskow with Crédit Suisse.

Robert Bain Moskow - *Crédit Suisse AG, Research Division - Research Analyst*

When I try to add up the big building blocks for 2019, it does shape up to be a very different year in terms of what's driving the profit growth. In 2018, as far as I can tell, international segment profits grew a lot, and I think that was largely due to overhead reductions. You had a big advertising cut, like an 11% cut. And then when you think about 2019, those kinds of benefits kind of go away. And what's driving '19, it looks like, is more gross margin expansion, which is due a little bit by the pricing and maybe some other factors. And then maybe the tax rate is a benefit, too, although I'm a little unclear. So is that a more difficult task in '19 given the competitive nature -- competitive intensity that you brought up and also the pressure from retailers that's pushing inventory down?

Michele Gross Buck - *The Hershey Company - President, CEO & Director*

I feel confident that we've done a very solid job building this plan and that we have all the right building blocks to deliver that growth and profit algorithm in the way that we've laid out. So I wouldn't say that it is a -- I wouldn't say it's a more difficult task. I think we're excited about what we have to deliver in that. I think our pricing is on track, so some of the levers that are going to deliver that are already in place. The Easter season, which benefits us, pricing, we feel really good about the innovation that we have, so we feel great about it.

Patricia A. Little - *The Hershey Company - Senior VP & CFO*

And just a comment on the taxes. That will be a benefit, the slightly lower tax rate, but that will be basically offset by the fact that, as I mentioned, our non-service-related pension costs will be higher in 2019 due to just outside performance at the end of the year. So that's not a big net overall change to our EPS.

Michele Gross Buck - *The Hershey Company - President, CEO & Director*

Yes, Rob, what I would say is I just think we've taken into account a lot of the varying factors going on in the marketplace in a better way than we ever have in the past and have a strong plan.

Robert Bain Moskow - *Crédit Suisse AG, Research Division - Research Analyst*

I appreciate that. But can you comment on the pricing in North America? In the fourth quarter, it was more negative than I thought it would be. Did some of your price increase get implemented in the fourth quarter or did any of it get implemented?

Michele Gross Buck - *The Hershey Company - President, CEO & Director*

As we've seen over history, it really takes a period of time for our pricing to hit the marketplace because of us -- because of the seasons, which are so far in advance and then protecting promotional programs, which are usually also about 6 months out commitment. So that really would not normally hit until '19. That's when we're anticipating to hit. We've seen a little tiny bit of it show up already, but it will build as we go throughout the year. So it's totally in line with expectations.

Operator

Our next question comes from David Driscoll with Citi.

David Christopher Driscoll - *Citigroup Inc, Research Division - MD and Senior Research Analyst*

I wanted to ask about your price/volume elasticity expectations. You made a couple of references, Michele. But specifically, would volumes be negative in North America in 2019? You've got a longer Easter, but there's a price increase and so just curious if you actually would guide negative volume growth in North America for 2019.

Michele Gross Buck - *The Hershey Company - President, CEO & Director*

I would say closer to flattish on volume, given historically and what our elasticity data would show.

David Christopher Driscoll - *Citigroup Inc, Research Division - MD and Senior Research Analyst*

And Patricia, you mentioned and I think you reiterated in your script the margin for growth, the total program achieving $175 million. You've been at this level for a little while. It sounds like the program is going very well. Is there a possibility of upside to this program? And can you just give us some cadence here as to how you guys are thinking about that? It's been a while since this program was out. Just curious about your revision process and then specifically, what is the savings expected in 2019? And then I just would love an update on your CFO search, Michele, just to see how that's going. I don't think you mentioned that, but curious how that's going as well.

Patricia A. Little - *The Hershey Company - Senior VP & CFO*

Well, I'll start on the Margin for Growth Program. We've been really pleased with how it's done. In really 2 sentences, I just want to say, clearly, in one sense, and we've talked probably a lot about this, is in terms of the savings that we've had in a lot of functions. And I just want to thank all my colleagues on working on, I think, a very effective program. But I also want to say, and I just never want to forget this, we also used this as an opportunity to invest in more of our commercial capabilities. So it's really a change in that, and that's gone very well also. So we pulled ahead a fair amount into 2018, as I mentioned, that primarily comes out of 2019. There's a small piece that given just some of the timing as we get into the details of the program got pushed into 2020, and that relates around some of the, honestly, a lot of it is in the finance function gated by our ERP transformation. That will leave us, I think, pretty much where we expected to be earlier in the year, which is the high end of the program, closer to the $175 million range. And I would expect, if you sort of do that math, that puts us in the $30 million to $40 million range for 2019.

Michele Gross Buck - *The Hershey Company - President, CEO & Director*

And then, David, to follow up on the second part of your question regarding the CFO search, it's on track. I have nothing to report at this time, but you'll know as soon as we make our announcement.

Operator

And we will take our next question from Jonathan Feeney with Consumer Edge.

Jonathan Patrick Feeney - *Consumer Edge Research, LLC - Senior Analyst of Food & HPC, Director of research and Managing Partner*

I wanted to dig into the gross profit a little bit. And forgive me if this -- just tell me what you feel like you can. But I'm trying to understand, I know there are some moving parts, but what an organic rate of gross profit look like for the fourth quarter broadly. Was that particularly in line with your expectations? Because it was a little bit behind mine. And maybe what role costs played? Were they a headwind? Is it tailwind there? And what does that mean for all the cost piece for 2019? And really comment on gross profit or gross margin for 2019.

Patricia A. Little - *The Hershey Company - Senior VP & CFO*

Yes. So if we -- as I mentioned, we have the -- we did have a small write-off in the fourth quarter related to some under -- we disposed of some underutilized assets. As of that, we would have been closer to a positive 20 basis points for the quarter. In terms of the underlying cost structure, I would say that what we've really seen -- clearly, we as well as everybody else have been hit by inflationary pressures as well, some of the negative price realization. And what you see is that's stabilizing in the fourth quarter, especially things like freight, logistics, costs like that, we think will remain high but stable. Going into 2019, we don't see a real reduction in those. We think we're doing a good job of optimizing freight and logistics, but there's still a base level of inflation in that as well as packaging. We're also starting to see some of the wage inflation related to some of the high employment rates that you see, especially in some of like our distribution centers. So that's also a bit of a pressure on us. (inaudible) we will have some good news in our commodity based on where some of the commodities pricing or hedging program puts us. So all of those puts and takes puts us in a modest improvement for 2019 gross margin.

Jonathan Patrick Feeney - *Consumer Edge Research, LLC - Senior Analyst of Food & HPC, Director of research and Managing Partner*

That's really helpful, Patricia. But I guess, and again, if you don't want to comment, fine. But I was just thinking you brought Pirate Brands gross profit in. You've got a certain amount of the Amplify gross profit, and I know some of that got divested. But net of that, it looks like that seems to be a bigger number than the $15 million in adjusted gross profit year-over-year. And I know you have a divestiture. I mean, you've got rid of the divestiture you just talked about. When you net all that stuff out, I'm trying to understand what the trend is in your organic rate of gross profit so when all this stuff goes comparable, we kind of understand what's going on. Is that clear?

Patricia A. Little - *The Hershey Company - Senior VP & CFO*

Yes, it is. I'd have to think it through that way. And I think what we're saying, though, is those are already a big impact. What we said all along, you can see the -- we did a negative gross margin, and you see that going up to base at the fourth quarter. Don't think the -- I mean, there's a slight accretion...

Michele Gross Buck - *The Hershey Company - President, CEO & Director*

From Amplify and Pirates, there's really hardly anything in the fourth quarter.

Patricia A. Little - *The Hershey Company - Senior VP & CFO*

Yes. In fact, the Golden Monkey was a help.

Michele Gross Buck - *The Hershey Company - President, CEO & Director*

I mean, we've got a little bit further detail offline.

Operator

And our next question is from David Palmer with RBC Capital Markets.

David Sterling Palmer - *RBC Capital Markets, LLC, Research Division - MD of Food & Restaurants and Consumer Analyst*

A question on your U.S. organic growth as we head into '19. It feels like if one way to organize the outlook is to think about the big 3 things going on: you have the confectionery innovation that you're doing, you have that SKU rationalization, and then you have to build out a broader snacking and the distributions you might get there. Could you touch on the big buckets as you see them and perhaps compare that to 2018 and help us understand where you see an acceleration in organic growth coming from?

Michele Gross Buck - *The Hershey Company - President, CEO & Director*

Yes, absolutely. So I think at the kind of highest level, there will be an acceleration in North American growth driven by price. There will be acceleration driven by season, both Easter as well as Halloween and Holiday. And certainly, there will be a contribution from snacking that will be incremental as well. And I think -- I mean, I think those are the real biggest buckets to focus on as the biggest change from a year-on-year perspective.

David Sterling Palmer - *RBC Capital Markets, LLC, Research Division - MD of Food & Restaurants and Consumer Analyst*

I guess just a follow-up. If I were to concentrate on the core confectionery side of things, I guess one thing I wonder about is you've had a few different new products. Some of them are combinations of Reese's Pieces and your core trademarks. You've kind of gotten 2.5 years, it feels like, into some of these call them mega extensions, and I wonder about the incrementality of the new stuff you're doing versus perhaps the [sade] of some of the 2017 and 2018 vintages of these extensions. Is that something you're managing? Or do you think you can still manage that on a net positive basis?

Michele Gross Buck - *The Hershey Company - President, CEO & Director*

Yes. So as you think about '19, what I'm really excited about in our innovation plan is that our 2 big innovations are the chocolate packaged candy packaging reinvention, which is really a better package but the same product, which will drive shelf impact and usability, et cetera; and then Reese's Thins, and we've got a great track record of innovation on Reese and also anytime we innovate close to the core. So I think the innovations we have in '19 have a lot of the levers that -- or tend to be correlated with some of our bigger successes. And then I think you're right, as we look at SKU rationalization, we include in that some of the past innovation that has had a couple of good years of growth but maybe has dwindled down a bit to the point where we have more productive uses of the shelf space, and so that's kind of included in that.

Operator

And our next question comes from Jason English with Goldman Sachs.

Jason M. English - *Goldman Sachs Group Inc., Research Division - VP*

I was hoping you could comment on the amount of pricing that you expect to be realized in the P&L this year. I heard you say you're on track for the 250 bps contribution. But it sounds like the timing of the new bags is going to happen a bit later than we expected. And obviously, we're entering the year with what looks to be a fair amount of year-on-year increase in trade spend, at least what we're closing last year, which is creating a net price drag. As we contemplate the puts and takes of all that, what are you expecting to actually roll for the P&L?

Michele Gross Buck - *The Hershey Company - President, CEO & Director*

Approximately about 1.5 for the year. Yes, you're right, Jason. And as we talked in the last call, it does go throughout the course of the year, so the full 2.5 doesn't get realized in the overall P&L. You build up to that 2.5 by the time you get to the third quarter. So all in, it nets to about -- all about 1.5 for the year.

Jason M. English - *Goldman Sachs Group Inc., Research Division - VP*

Okay. And sorry if you guys had previously given that clarity. And then I wanted to come back on the SKU rationalization drag. I think your prepared remarks mentioned that SKU rationalization is the ability to swap out unproductive SKUs with more productive SKUs. If that's the case, shouldn't this be an acceleration? I know you're putting hyperactive SKUs on shelves. Shouldn't it be adding to growth net-net? And if not, I know you're slightly in a drag, what am I missing there?

Michele Gross Buck - *The Hershey Company - President, CEO & Director*

Well, there are inventories that get pulled back associated with some of those SKUs, and that's what drags part of that drag. So there's a transition timing, there's the inventory piece and that really creates that.

Jason M. English - *Goldman Sachs Group Inc., Research Division - VP*

Got it. And last question, just these are sort of rapid fire ones. I know in the last call, you flagged retail takeaway was tracking here about 2.5%. You were gaining share. Your retail takeaway has slowed. Your shares kind of flipped negative despite the strength in Halloween. Can you give us some context and color of what drove that sequential consumption deceleration?

Michele Gross Buck - *The Hershey Company - President, CEO & Director*

Yes, we -- I think I believe we stated we expected our retail takeaway to be about 1% in the fourth quarter, and that's exactly where we came in. And the key drivers were as we expected. We had some really strong seasonal strengths. That was the biggest driver. And our share decline decelerated as well, which was expected.

Operator

Our next question comes from Alexia Howard with Bernstein.

Alexia Jane Burland Howard - *Sanford C. Bernstein & Co., LLC., Research Division - Senior Analyst*

Can I just have a little poke into the drivers of gross margin? I know there's been a couple of questions on this. But I'm thinking particularly around the outlook for 2019. Over the last 18 months, I think you've had some headwinds from packaging, things like the shelf ready packaging being a lower gross margin product. Maybe some extra packaging costs because of online different formats than maybe having to go out to pro manufacturers a bit more often to get those different pack size. Is that still a headwind? Or is it becoming a bit EPS? And what are you seeing on the ingredients side of the outlook for 2019?

Patricia A. Little - *The Hershey Company - Senior VP & CFO*

Alexia, it's Patricia. Clearly, we do expect gross margin expansion. Pricing will be a piece of this. Although I do want to remind everyone that a part of it relates to our new packaging that we're bringing on shelf after Easter, and that has a cost implication, too, so that pricing is really designed to cover the cost of that. So that doesn't -- that's not a net drop down to gross margin. In terms of ingredients, we do expect commodity cost to benefit us this year because when you look at the price of the underlying commodities and then the timing that we get from hedging, so that should be a help to us. But we do continue to expect inflation on things like packaging, which is both core. It's like just pure inflation on packaging, which we definitely see, as well as continuing to build out things like RRP, our retail ready packaging, and some of those programs. Freight is well stabilized. It's not stabilized at a better number. It's stabilized at where it is. And then as I mentioned I think earlier today, we are starting to see some wage inflation related to low unemployment rate. So you can really tell from that, that there are a number of puts and takes. But overall, we definitely expect modest gross margin improvement.

Operator

We will take our next question from John Baumgartner with Wells Fargo.

John Joseph Baumgartner - *Wells Fargo Securities, LLC, Research Division - VP and Senior Analyst*

Patricia, I wanted to come back to your thoughts on reinvestment. I mean, it sounds as though there won't be any real robust uptake in advertising spending in '19. We haven't really seen trade spending increase for about 4 or 5 years now, and I can't recall a lot having heard of any real material uptake in feet on the street sales force presence. So as you think about the CMG category sticking below the long-term growth rate, the competition from adjacent categories ratcheting up, I mean, how do you think about those buckets of investment? I mean, is there any area where you see incremental needs being larger? Or how we should think about the ROI on those buckets evolving? Just any clarity there would be helpful.

Michele Gross Buck - *The Hershey Company - President, CEO & Director*

John, it's Michele. So I'm going to kick off with some thoughts, and Patricia will probably jump in as well. I think -- let me start with advertising. As you think about advertising, while we definitely look at our rate of spend as a percent of net sales, we are also very focused on our delivery of media impressions to the consumer. So as we look at the past year, our consumer impressions, our media impressions on our chocolate brands were actually up over 3% for the full year. So what we're constantly trying to do is optimize how we approach each of these line items to get even more efficient. Sometimes we will increase the spending to get impact, and other times we'll go for efficiencies. So some of the ways we were able to do that, we've continued to advance our media capabilities and gotten smarter about how we are targeting some of that media. That's driven some of that. We've increased the earned impression using that as a lever, which has helped us optimize the portfolio spend. And then also, we created this in-house content studio, which really let us take production cost down, which enables us to put more of that spend into media. So I would say for media, if you think about that, that's a good analogy how we think about every item -- every one of our line items. As we look at trade promotion, we mentioned previously that one of our ERP applications is a new trade promotion module that we think gives us better insights, frankly, industry-leading insights, and that will enable us to get more -- book more effectiveness, more impact, but also hopefully more efficiency that helps to drive net price realization as well. And so we are constantly looking at how we build those differentiated capabilities, e-commerce and other place that we're looking to build those that as the world has evolved, even though we value very much our retail force in bricks and mortar and we constantly upgrade the skills there, we look at e-commerce as a new channel. And we certainly invested a lot to build capability in that area, invested in new distribution and capacity. So we think that we're investing in a balanced way while also trying to optimize within.

Patricia A. Little - *The Hershey Company - Senior VP & CFO*

Yes, that sounds great. I agree with everything you said.

Operator

And we will take our next question from Steve Strycula with UBS.

Steven A. Strycula - *UBS Investment Bank, Research Division - Director and Equity Research Analyst*

So just to circle back on a question that you had touch on a little bit earlier, so I apologize if there's any redundancy here. But on the SKU rationalization, Michele, could you just help us understand and unpack what was the key catalyst we kind of embarked on this mission maybe last year? Was it more of just better intelligence as you kind of look across the portfolio or maybe we're on optimizing certain space? Or is it more focused on some of the smaller brands such as Krave and whatnot? So that would be the first part of my question, and I have a follow-up.

Michele Gross Buck - *The Hershey Company - President, CEO & Director*

Okay, sure. So the real impetus was complexity. We were starting to see the complexity creating some challenges in gross margin, frankly. And so it was really about simplification to drive that productivity through reducing merch units, assortments, some of our innovation, et cetera.

Steven A. Strycula - *UBS Investment Bank, Research Division - Director and Equity Research Analyst*

Okay. And then a question for your full year guidance, just wanted to understand a little bit more. Should we think about the benefit of a longer Easter season being about 0.5 point for your org sales growth over the full year? Is that pretty fair? And then on the input cost assumptions, the way you build out your gross margin expectations, have you factored that in based off kind of the current spot rates? Or do you build in a little -- anticipated an inflation just so we can kind of gauge the conservatism?

Michele Gross Buck - *The Hershey Company - President, CEO & Director*

So relative to Easter, yes, about 0.5 point is how you should think about it. And Patricia, do you want to handle the...

Patricia A. Little - *The Hershey Company - Senior VP & CFO*

Yes. On our key commodities, because we hedge, one of the things that, that gives us is a lot of good cost visibility. So definitely included in our plan. We have those pretty -- since we hedge 24 months out, we have good visibility into that. We also stay very close touch with the market on things like packaging, freight, wages that allow us to, I think, do very good at estimating the impact of those.

Operator

And we will take our final question from Rob Dickerson with Deutsche Bank.

Robert Frederick Dickerson - *Deutsche Bank AG, Research Division - Research Analyst*

So Michele, I just have a broader question with respect to the, I guess, the 22% to 23% margin, operating margin target you put out a couple of years ago. So I hear for '19 gross margin should be up modestly if I salvage some of that smart commodity-driven non-SLA off of restructuring spend or ERP efficiency, et cetera. And then you said also that on the operating margin side, that will be up a little bit more than what we've seen historically. But frankly, over the past, call it, 3 years, we haven't seen that much. So I'm just wondering, like if we think about what this implied up margin expectation would then need to be for 2020, is that still rational given what I'm hearing as increased efficiency, increased velocity probability for SKU rationalization and more targeted spend. But I'm also hearing that maybe there's some need, given the competitive environment, that if you're more efficient, you might need to reinvest more, which therefore could maybe increase the probability to accelerate top line growth but not as much margin expansion at the company, which might not be a bad thing. So I'm just curious, updated thoughts around kind of the top line growth relative to profitability expansion platform.

Michele Gross Buck - *The Hershey Company - President, CEO & Director*

Sure. Our target, when we set the target, it was really set to ensure that we will be in the top quartile amongst our sector, and that's really the goal and the intent of that EBIT margin target. We will always take a balanced approach to expanding margins and growing the top line. And we know that sometimes, we will shift in one direction versus the other, but we think that balanced approach is critically important. 2018 overall was a pretty tough year for the industry from a margin perspective. But we're confident in our plans to make that progress in 2019 that you referenced, both in terms of on the gross margin line and a little bit below. So we think there's always opportunity there, and we need to continue to evolve and attack each line item in the P&L to go after margin improvement, and we'll continue to do that going forward.

Operator

And this concludes our Q&A session. I'd like to turn the program back over to our presenters for any additional remarks.

Melissa Poole - *The Hershey Company - Senior Director of IR*

Thank you for joining us this morning. We'll be around today for any follow-up questions you may have.

Operator

Thank you for your participation. This does conclude today's program. You may disconnect at any time.
