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The Hershey Company

Third Quarter 2021 Earnings Conference Call
Prepared Remarks

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CORPORATE PARTICIPANTS

Melissa Poole, *Vice President, Investor Relations*

Michele Buck, *Chairman and Chief Executive Officer*

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 Third Quarter 2021 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 a.m. Eastern on the morning of October 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 risk and uncertainties. These statements include expectations and assumptions regarding the Company's future operations and financial performance, including expectations and assumptions related to the impact of the COVID-19 pandemic. Actual results could differ materially from those projected as a result of the COVID-19 pandemic as well as other factors. The Company undertakes no obligation to update these statements based on subsequent events. A detailed listing of such risk 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.

Consumer demand for our brands has remained robust on both a one and two-year basis. Our continued focus on operating with speed and flexibility has enabled us to respond quickly to changes in the marketplace and develop plans we believe will enable us to maintain elevated consumer demand, increase our supply chain output, and sustain our advantaged margin structure over the long-term.

We are raising both sales and earnings guidance for 2021 to reflect this strong consumer demand, an improved tax outlook and optimized brand investment, which collectively are expected to more than offset higher supply chain costs and inflation.

Our teams have done an outstanding job navigating a volatile and unpredictable environment over the past year and a half. Our manufacturing team is on track to deliver a record year of production volume and complete key capital investment projects to deliver an additional $500 million of sales capacity this year and next. We have also increased our manufacturing headcount and invested in our workforce to ensure a stable talent supply in 2021 and 2022, and our commercial teams have adjusted campaigns and reallocated investments in real time, optimized product mixes to capitalize on consumer and competitor trends, executed several pricing actions, and maintained a strong presence in store. Our purpose is to make more moments of goodness, and I could not be prouder of our employees' agility, dedication, and commitment to ensure our beloved brands are here for consumers when they need them.

Because of this focus, net sales grew 6.3% in the third quarter, and adjusted EPS increased 12.9%. Our market share remained well above pre-COVID-19 levels, with our confectionery share almost 100 basis points higher, and our snacking share 220 basis points higher in Q3 of 2021 versus Q3 of 2019.

Growth was broad-based, with both volume and price gains in North America confection, North America snacking, and our International and Other segment. New routines established during the pandemic have not only endured, but grown, over the past six months despite improving mobility. Areas negatively impacted by COVID-19, including away-from-home confection consumption and sales within our International and Other segment, have continued to rebound.

Within North America, net sales increased 5.5% during the third quarter. Consumer demand was even stronger in Q3, with measured channel retail takeaway growth of almost 9% and non-measured channel growth of over 10%. Changes in year-over-year inventory levels versus the prior-year period resulted in an approximate 6-point headwind to sales growth this quarter. While we expected inventories to contract in the third quarter, the contraction was larger than we anticipated as capacity constraints, labor shortages, and unprecedented levels of disruption in the broader supply chain network limited our ability to increase production commensurate with this significant increase in consumer demand. These same factors have also resulted in higher than anticipated supply chain costs.

As we progressed through the third quarter and observed strong consumer demand sustaining against more difficult laps and worsening supply chain disruptions and inflation, we took additional action to improve both our service levels and margins.

Within our manufacturing facilities, we have accelerated hiring and are adding headcount to not only increase production, but also provide employees with more scheduling flexibility and time off, which we believe will make our employee value proposition even stronger. Our board of directors approved an additional $200 million of capital in August to add more capacity on constrained brands, particularly Reese's. Our supply chain and commercial teams have partnered to further optimize and prioritize our SKUs to reduce complexity and maximize output while ensuring that we continue to support strategic initiatives for our long-term growth aspirations. We optimized our marketing investment to alleviate pressure on our capacity constrained brands, and last month we executed a high single digit price increase on approximately 60% of our U.S. confection products.

While not all of these actions will have immediate benefits, and we anticipate many supply chain pressures to persist well into next year, we expect to see gradual improvement in service levels in the coming quarters, and we are committed to continuing to invest in our brands and protect our advantaged margin structure over the long-term.

While we are spending a significant amount of time on execution, we are also advancing strategic initiatives to enhance our capabilities and drive sustained advantaged sales growth over the long-term.

We continue to collaborate with our retailers on macro space planning, particularly self-checkout solutions and queueing lines. These initiatives have become even more critical as the industry struggles with labor shortages. In the past year, we have partnered on more of these solutions than in the prior five years combined. Results have been terrific, with both accelerated category and Hershey sales growth, and we have many more opportunities in the pipeline for 2022 and beyond.

We have also expanded our presence in better-for-you confection and gummy sweets, two areas where we are under-shared and see meaningful incremental opportunity. Our Zero-Sugar chocolate and Jolly Rancher Gummies innovation are both performing well and bringing new consumers and occasions into our portfolio.

We are leveraging an agile approach to media to reallocate and adjust investment and content in real-time as consumer trends and supply chain pressures evolve. For Halloween this year, we are activating our first ever multi-brand advertisement for Reese's and Kit Kat, our two top selling brands of the season. This ad was created by our in-house design team, a key driver of our agility over the past year, and will enable us to more efficiently reach our consumers buying both brands, particularly in large assortments.

As we head into the final days of Halloween, sales and sell through are both looking strong. Category sales in early and mid-season are up 18% versus 2020, and up 12% versus 2019 levels and Trick or Treat participation is expected to rebound to pre-pandemic levels. Hershey Halloween sales for the same period are up 14% versus last year, resulting in two-year growth of 23%. Last year we gained approximately 500 basis points of Halloween share and heading into the final days, we have retained approximately 75% of those gains. We expect this strength to flow into the Holiday season as more family gatherings occur this year.

From a brand and occasion perspective, nearly all parts of our portfolio grew in the third quarter despite challenging laps from prior year.

Reese's continued to shine with another quarter of double-digit growth. Q3 2021 retail sales grew 10%, building on last year's Q3 growth of 25%. Two-year growth on this $2.5 billion dollar brand of approximately 20% was driven by media support, new packaging, seasonal gains, pricing, and innovation. Reese's Pretzel is the number one confection innovation item in the category this year, and Reese's Snack Cakes are the number two innovation item in convenience stores, where we focused our targeted launch.

As we shared on our last call, we have added three new manufacturing lines over the past four years as well as expanded peanut roasting capacity, but it has still has not been enough to keep pace with this significant increase in demand. New Reese's capacity is on track to come online throughout 2022 and 2023 to help support this tremendous growth.

Kisses has also seen incredibly strong growth as more consumer occasions occur at home, with gains of 13% in the third quarter of 2021 on top of 8% gains in Q3 of 2020. Jolly Ranchers grew 33% in the third quarter behind core item velocity growth as well as the expansion of last year's successful gummy launch to take home bags this past year. We have additional capacity coming online next year to drive even more growth in this on-trend business.

Overall, we have seen at-home chocolate consumption remain elevated while away-from-home consumption has rebounded. Sales for our everyday take home chocolate products grew 5% in the third quarter, building upon last year's 16% gains. Despite this sustained at-home consumption, category sales for chocolate instant consumables also grew almost 10% during the third quarter as consumer mobility improved. Sales for our refreshment business were up over 15% as social distancing and mask wearing were below 2020 levels.

This strong growth in our U.S. confection business was complemented by accelerated growth in our snacking products and markets within our International and Other segment.

Retail sales for our SkinnyPop and Pirate's Booty brands grew over 20% in the third quarter. Over the past year, household penetration has increased from 18% to 20%, with over 80% of new buyers also repeating. Growth has been broad-based across channels and occasions, with particular strength in our multi-pack offerings that have grown over 60% year-to-date. This multipack growth is driven by the resurgence of away-from-home consumption, including lunch boxes, as well as consumers' desire for self-sharing packs. Our family snack pack innovation featuring both SkinnyPop and Pirate's Booty is performing incredibly well and offers consumers a great variety for the entire family. Since our acquisition in late 2017, our teams have done a fantastic job fueling growth on the SkinnyPop brand with consistent double-digit growth. Over the past year we have reached an important milestone, delivering $500 million in retail sales. SkinnyPop is now our fifth largest brand, and we couldn't be more excited to continue driving growth on SkinnyPop and our other great snack brands in the coming years.

Strong recovery continued within our International and Other segment, with reported sales growth of 13.9% in Q3. In India, Brazil, and Mexico, reported net sales were above pre-pandemic levels with two-year growth of approximately 15%. Distribution expansion across markets, as well as new marketing activations such as our first-ever launch of Halloween in Brazil this year, are driving growth. In China, sales are in line with expectations and profitability continues to improve from the new go-to-market model we began implementing last year. While sales at Chocolate World and travel retail locations remain below pre-pandemic levels, we saw strong growth in Q3 this year as mobility improved.

Before I turn it over to Steve, I want to take a minute to recognize and thank our employees around the globe. Every day, they come to work with energy and passion to meet the new challenges awaiting us in this volatile environment. They have embraced the spirit of flexibility and are constantly adapting to the changes around us to make more moments of goodness for our consumers. These qualities are critical for successfully adapting and driving sustainable and advantaged results for all our stakeholders.

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

Steve Voskuil

Thanks, Michele. Good morning, everyone.

As Michele shared, we delivered 6.3% net sales growth and 12.9% adjusted EPS growth in the third quarter amidst a dynamic and evolving operating environment. Continued strong consumer demand, price realization, and favorable tax drove solid results despite higher supply chain costs and inflation. Additional pricing actions were announced in the quarter to address rising logistics, labor, and packaging costs. Looking ahead, continued investment in enterprise projects is critical for future success, including capacity, flexibility, and digital infrastructure. Our strong financial foundation and adaptive operating model continue to enable us to deliver balanced top and bottom-line growth in this environment.

The North America segment continues to perform well with reported net sales growth of 5.5% in the quarter, including a 1.5-point benefit from the acquisition of Lily's. Price realization contributed 2.4 points of growth driven by list price increases and lower seasonal markdown reserves versus the prior year. This was in line with expectations. The benefit from list price increases on our seasonal, non-chocolate, and grocery products will continue to build in Q4, while our most recent pricing action is expected to have minimal impact in the fourth quarter, with the majority realized in 2022. Favorability in seasonal reserves reflects an increase in Halloween visibility this year and will largely be offset in the fourth quarter. In total, we expect net price realization to be comparable to what we saw in the third quarter.

Volume also contributed an incremental 1.3 points of growth in the third quarter, though not fully reflective of the strong consumer demand as volume was constrained by capacity and industry-wide supply chain disruptions.

Changes in year-over-year retailer and distribution inventory levels helped meet that consumer demand in Q3. In the fourth quarter, we expect net sales growth to again lag U.S. retail takeaway, driven by less shipment days, which is expected to provide a two-point headwind in the quarter, and continued depletion of retail and distributor inventory. We now expect retailer and distributor inventory to be a one-point headwind for full-year net sales growth. As Michele mentioned, we have taken action to increase output and improve service levels as we move through the next several quarters and expect to begin replenishing inventory in 2022.

In the International and Other segment, constant-currency net sales grew 11.4% in the third quarter. This growth was in line with expectations, driven by both net price realization and volume in the third quarter. In the fourth quarter, we expect growth to moderate across International Markets due to depletion of retailer and distributor inventory related to our U.S. capacity constraints.

Adjusted gross margin declined by 110 basis points in the third quarter, driven by the North America segment. In North America, gross margins decreased 140 basis points to 44.9%, as higher supply chain costs and inflation, along with unfavorable mix, were partially offset by net price realization and lower seasonal markdown reserves versus the prior year. In July, we planned for demand to moderate and the broader supply chain to improve in the second half of the year. However, consumer demand has sustained, and industry-wide supply chain disruptions have impacted both our service levels and our costs. As we look to the fourth quarter, we anticipate these pressures to persist and therefore expect a comparable amount of gross margin contraction in the fourth quarter as we saw in third quarter. Given the disruption in the supply chain we've seen globally, I am proud of our team for rallying in the face of these challenges, and I'm confident in the plans we have put in place to improve and protect our advantaged margin structure in the long-term.

In the International and Other segment, gross margin was 38.9% in the third quarter, an increase of 230 basis points from the prior year. Net price realization and favorable fixed cost leverage drove margin expansion in the third quarter, partially offset by higher supply chain costs, mainly inflation and freight. We expect profitability to continue to improve in the fourth quarter as we complete the first full year following the change in operating model in China. I could not be more pleased with the tremendous work done by the International teams over the last several years to implement strategies across markets to structurally improve the profitability of this important segment.

In North America, advertising and related consumer marketing spend decreased 5.2% in the third quarter. We acted with agility, taking a disciplined approach to evaluate our marketing investments and optimize spending to align with consumer demand and available capacity in the quarter. Despite this optimization, we continued to invest nearly $150 million in our brands in the third quarter, with 20 brands and key occasions supported including S'mores and Halloween. We also increased investment by double-digits in salty snack brands, SkinnyPop, and Pirate's Booty. We anticipate a year-over-year decline in advertising spend in the fourth quarter as we saw in the third quarter.

In the International and Other segment, advertising and related consumer spending increased 11.4% as we continued to support the COVID-19 recovery across key international markets. Corporate expenses increased 10.5% in the third quarter driven by higher capability and technology investments, both project and people costs, against deflated 2020 levels due to COVID-19, along with elevated benefits costs and medical claims.

The adjusted effective income tax rate was 14.7% in the third quarter, a decrease of 6.8% versus the prior-year period. This rate decrease was driven by the utilization of certain capital losses, along with the timing of tax credits versus the prior year. We now expect the full-year adjusted effective tax rate to be in the range of 15% to 16%, and Other expense to be around $125 million. As we look to next year, we expect the overall tax expense to be comparable to 2021, absent any global or U.S. tax reform.

As I turn to capital deployment, I want to reiterate our priorities which have remained constant during the elevated volatility of the current environment. Our strong cash flow provides us with financial flexibility to maintain a dual focus on current and future growth. In the third quarter, we invested another $120 million in capital, bringing our year-to-date investment to $347 million. Of this investment, approximately 55% has been related to incremental capacity. We recently brought online an additional PAYDAY line in September and the agile fulfillment center came online just this week. Looking to 2022, we have additional Reese's and gummy capacity expected to come online along with the completion of the Canadian distribution center. Over the past few years, we've remained proactive in investing for growth, which has positioned us well during the pandemic. Our capital spending outlook for 2021 is slightly below our prior estimate largely due to project timing. Looking ahead, we expect a slightly higher level of capital investment in 2022 as we continue to invest for future growth.

Shifting to dividends and share repurchases; in the third quarter we paid $181 million in cash dividends, totaling over $505 million in cash returned to shareholders year-to-date. During the third quarter, we also completed $24 million of share repurchases related to stock option replenishment.

Before we wrap up this morning, let me share some high-level perspectives and expectations for 2022. While we expect the environment to remain dynamic next year, we are committed to delivering another year of top and bottom-line growth. From a top-line perspective, we expect price to be a larger contributor to overall growth in 2022, backed by several pricing actions announced this year, which will also provide a tailwind to gross margin. Supply chain costs, specifically logistics, labor, and packaging, are expected to remain elevated, at least through the first half of the year, while raw material inflation is expected to be higher relative to 2021, as we had minimal impact this year. As Michele shared, we are committed to maintaining our advantaged margin structure over the long-term and have robust plans in place to address challenges in capacity and the broader supply chain. While this is more than we typically share at this time of the year, we believe this additional perspective is helpful in the dynamic environment we're operating in.

We look forward to sharing more details with you in February. With that, I'll turn it back to Michele for closing remarks.

Michele Buck

Thanks, Steve.

As I wrap up, I do want to share continued progress on two of our most important enterprise initiatives.

First, on the environmental front, we have achieved a 24% reduction in our Scope 1 and 2 greenhouse gas emissions and 12.5% in Scope 3 compared to 2018. We are almost halfway to our goals, and we have operational plans underway to continue to reduce our impact to climate change.

Secondly, we know that diversity, equity, and inclusion are critical to our success. We have achieved pay equity in the aggregate for women and people of color for salaried employees in the U.S.

We have also focused our efforts to bring in a wider range of talent and perspectives and strengthen our development programs for underrepresented talent. I am proud of how inclusion starts at the top, with 58% board diversity that permeates our entire organization, with diverse leaders in some of our most important roles in the Company, our Chief Growth Officer, our Legal Counsel leadership, Investor Relations, and the head of our confection brand portfolio, just to name a few. We believe these areas of focus are fundamental for long-term sustainable growth.

Thank you for your time this morning, and 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.