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The Hershey Company

Second Quarter 2021 Earnings Q&A Session

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CONFERENCECALLPARTICIPANTS

Andrew Lazar, *Barclays*

Ken Goldman, *JPMorgan*

Robert Moskow, *Credit Suisse*

Alexia Howard, *Bernstein & Co.*

Michael Lavery, *Piper Sandler*

Ken Zaslow, *BMO Capital Markets*

Bryan Spillane, *Bank of America Merrill Lynch*

PRESENTATION

Operator

Greetings, and welcome to The Hershey Company Second Quarter 2021 Question-and-Answer Session.

As a reminder, this conference is being recorded.

I'd now like to turn the call over to your host, Ms. Melissa Poole, Vice President of Investor Relations for The Hershey Company. Thank you. You may begin.

Melissa Poole

Thank you. Good morning, everyone. Thank you for joining us today for The Hershey Company Second Quarter 2021 Earnings Q&A session.

I hope everyone has had the chance to read our press release and listen to our pre-recorded Management presentation, both of which are available on our website. In addition, we have posted a

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transcript of the pre-recorded remarks. At the conclusion of today's live Q&A session, we will also post a transcript and audio replay of this call.

Please note that during today's Q&A session, we may 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 we may 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.

Joining me today are Hershey's Chairman and CEO, Michele Buck, and Hershey's Senior Vice President and CFO, Steve Voskuil.

With that, I will turn it over to the Operator for the first question.

Operator

Thank you. Our first question comes from the line of Andrew Lazar with Barclays. Please proceed with your question.

Andrew Lazar

Good morning, everybody.

Michele Buck

Good morning, Andrew.

Steve Voskuil

Good morning.

Andrew Lazar

Hi. First off, I guess, I wanted to dig in a little bit more on the cost to serve dynamic that you talk about in the prepared remark. I guess it should not come as a surprise that 15% organic sales growth in a given quarter would kind of stress any supply chain, no matter how efficient. My question is, are there any structural investments needed in the supply chain going forward or any capabilities that were exposed by the volume spike? Or is it simply, you sort of suck up the higher costs, as they're transitory, particularly the labor part, and not need to necessarily make any changes, as that sort of volume growth is really not likely sustainable at these extreme elevated levels.

Michele Buck

Andrew, let me start, and then let me ask Steve to give some more details. I would say at the highest level, there are certainly key parts of our portfolio that have had just extraordinary growth, and we cited

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some of the numbers, for example, on Reese's. One thing that we are very focused on is investigating capacity behind the brands and businesses that we know have demonstrated track records of strong growth over time and particularly where we've seen strong spikes that we think will have continued strength going forward.

Let me have Steve talk a little bit more about some of the other elements of cost and cost to serve.

Steve Voskuil

Yes, I would add on the structural side, one of the benefits is we've been working on our supply chain 2.0 program and the Annville fulfillment center comes online later this year, that'll provide some additional flexibility and agility, so that will certainly be helpful. As Michele said, continuing to invest where we need to on capacity, especially on those fast-growing core brands like Reese.

From a cost standpoint and getting into some of the pieces, clearly like you said, Andrew, putting that much pressure on the supply chain at one time pushed us in a number of spots. It pushed us from an overtime standpoint; it pushed us from getting to contract manufacturers and expanding some of their work off an onsite contract rate, and the same on the freight and warehousing side. I look at those as pressure points in particular on top of that, or as the result of the higher volumes.

Then in addition, I would say labor rates in general and labor availability in general are a pressure point, beyond just volume. The market for labor is challenging, so just like everyone, we want to make sure we are staying ahead of the curve on hiring, making sure our value proposition at our plants is attractive, and packaging inflation is similar. Packaging inflation we touched on a little bit on the last call; it's still a pressure point. I think we're still optimistic we're going to see that moderate as we go forward, but we haven't seen it yet. It is a combination of those transitory costs on the back of the higher volume, and a few things that are a little bit more sticky here as we look across the balance of the year.

Andrew Lazar

Thanks for that.

Then just using our back of the envelope math, it seems like the operating profit upside in the quarter maybe is roughly offset in equal parts by a higher full-year tax rate and some of the higher costs that you've talked about just now sort of leaving the full-year EPS guidance intact. I just wanted to see if I had the magnitude of each of those impacts for the full year more or less right. It seems like they're of equal magnitude, essentially.

Steve Voskuil

No, I would look at it as the tax piece was by far the biggest impact on us not taking up our earnings guidance alongside the top line. I think if it wasn't for the tax piece, we would've raised guidance. The cost to serve is a component, but think of that as the 10% or the 15% of the impact, where the majority really was the tax impact in the quarter.

Andrew Lazar

Really helpful, thank you.

Operator

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Thank you. Our next question comes from the line of Ken Goldman with JPMorgan. Please proceed with your question.

Ken Goldman

Hi, thanks.

Steve, you mentioned that there's 130 basis point tailwind from inventory loading this quarter, and you said there'll be a de-load in the back half. Two questions on this. First, what's your best estimate for how large the inventory reduction will be at retail in the back half? Number two, I know it's not always easy to forecast this, but how should we think about the cadence of that? Is the majority in the third quarter, or the fourth quarter, just for modeling purposes?

Steve Voskuil

Yes, I think in terms of total magnitude for the back half, I think 1.1 to 2.0 points of impact. I don't think we're clever enough to give you the precise quarter. I would say I'd look at it across both quarters, maybe a little bit of skew to the fourth quarter.

Ken Goldman

Okay, that's helpful, thank you.

Then, I think it's fair to say there's some frustration among investors this morning that you didn't raise your EPS guidance. I recognize the $0.04 beat wasn't huge in the second quarter, there's some uncertainty around the world in the back half of the year, but your business is doing great. I'm just curious, internally, was there any consideration of raising the bottom line guidance, or did you just feel it's a little early given some of the inflation and the macro risks?

Steve Voskuil

Yes, I think, again, but for the tax piece, we would've risen or taken up our guidance. Certainly, there's caution in the back half relative to the inflation and cost to serve. I think we have our hands around what that looks like and have a pretty good bead on that. If that were the only piece, we would've taken up our guidance, but tax was really the piece that we had to take into account. And we want to make sure we're not sacrificing investment in the back half of the year.

Michele Buck

Yes, for perspective, tax was $0.17 on EPS, so very meaningful.

Ken Goldman

Got it. Thanks so much.

Operator

Thank you. Our next question comes from the line of Robert Moskow with Credit Suisse. Please proceed with your question.

Robert Moskow

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Hi, thanks for the question.

What do you think about the tax rate going forward for 2022, Steve? This looks like a one-time impact, so do you think you'll have an easy comp in 2022?

Then secondly, you talk about some of the cost elements; some are structural, maybe some are short-term. Does any of this impact how you're thinking about pricing going forward for this year and for 2022?

Steve Voskuil

Sure. On the tax side, we look at it as a one-off, so if we were to reset next year—and again, we'll talk a lot more later in the year about 2022; but as a starting point, we wouldn't factor this into the starting point for 2022. I hope that's helpful.

Then from a pricing standpoint, and Michele can add on here, pricing is a key part of our strategy, maintaining and growing, our gross margin is a key part of our strategy. I'd say we execute against the trend. We are very aware of the dynamics at play from an inflation standpoint and so on, what competitors are doing, what retailers are doing. We are evaluating that environment all the time. And as always, we're not going to kind of tip our hand as we think through it, but pricing is and will remain a key part of our strategy going forward.

Michele Buck

Yes, as you recall, we did take two different price increases earlier this year on our Confection portfolio that will really just begin flowing through in the second half of the year, and we'll also have some upside from that in the first half of next year.

Robert Moskow

Okay, all right, well, thank you.

Operator

Thank you. Our next question comes from the line of Alexia Howard with Bernstein. Please proceed with your question.

Alexia Howard

Good morning, everyone.

Michele Buck

Good morning.

Steve Voskuil

Good morning.

Alexia Howard

Hi there. I guess the first question is whether you can give us any thoughts on the gross margin outlook from here. Obviously, a lot of other companies are seeing an awful lot of pressure. I remember back in

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2018 when there was freight cost inflation. I think you also saw some pressure. Input costs are going up, packaging costs are going up, and yet you held it pretty flat this time around. Just some thoughts on that, and then I have a follow-up.

Steve Voskuil

Sure. Yes, we were pleased with the Q2 gross margin. It was a little bit ahead of our plan, I think we managed it well, and of course implied inside our guidance for the balance of the year is a little softening of the gross margin outlook from being up slightly to being in line with last year. I think that performance in the face of the inflation that we've seen would be good. But our goal, again looking to next year, building on the last question a little bit, is we want to continue to grow gross margin over time. We want to do that through a pricing strategy, we want to do that through productivity, we want to do that through all the levers to manage inflation and commodity cost, so driving that forward remains an important goal.

We'll give more color on next year's gross margin as we get closer to the end of the year, but that goal remains firmly in our mind.

Alexia Howard

Okay, great. Then just a question on the Lily's acquisition. You recently sold Scharffen Berger and DAGOBA. The company's been trying to make premium work for quite some time. What's the difference about Lily's that makes you confident that you can actually make this work this time, versus some of the problems that you've had in the past? Thank you, and I'll pass it on.

Michele Buck

Yes, what we really like about Lily's is it is a scale business, so it is close to that $100 million in size, whereas Scharffen Berger and DAGOBA were much smaller, in the $30 million range. We've found over time, and I think we've shared this before that, for us, a good acquisition being around close to that $100 million mark has been built enough that we can really best apply our capabilities around distribution, manufacturing, synergies, additional marketing, kind of more broad-based marketing, etc., to really help to make the acquisition a success.

The other thing I would say is Lily's is single-mindedly focused on better-for-you; so while it is premium, it has a very distinct understandable benefit that those consumers understand, which is about the lack of sugar. That also gives us a lot of confidence that it fits very neatly into our operating model. As you know, we have already launched a broader portfolio of better-for-you on our core brands, and so that whole better-for-you area is a big point of focus for us. There's some nice synergy in terms of our focus there.

Alexia Howard

Great, thank you very much. I'll pass it on.

Operator

Thank you. Our next question comes from the line of Michael Lavery with Piper Sandler. Please proceed with your question.

Michael Lavery

Thank you, good morning.

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Steve Voskuil

Good morning.

Michele Buck

Good morning.

Michael Lavery

Just curious how you think about elasticity, and I know it can hard to measure. The ways we've tried to come at it, you tend to score quite well. Is that your sense as well? And how do you think about that in terms of your pricing, how aggressive you may try to be or not be, and just how you anticipate the consumer response to that?

Michele Buck

Yes. We have very complex and sophisticated price elasticity models where we look not only at price points within our own categories, price gaps, price thresholds, also around other snack items as well. I think over time, I think we've consistently seen that our business, our brands and our category tend to be on the less elastic side versus perhaps some other categories, which is what gives us confidence in pricing power and the ability to take price when we feel it is the right time.

Michael Lavery

Okay, that's helpful. Just a follow-up on Reese's. Can you give a sense for the organic Reese's launch, just how that might be tracking versus your expectations, and maybe a little bit of how it compares from a margin perspective? It looks like, with its price point, it's probably pretty nicely accretive. Is that directionally correct?

Michele Buck

It is performing in line with our expectations. It is early days, but it's absolutely in line with what we expected. It is really in kind of a test-and-learn phase as we move forward. It's not, I would say, a big material piece of our better-for-you launch at this point in time, as organic is a little bit more of a targeted offering than, say, zero sugar or sugar free.

Michael Lavery

Okay, great, thanks so much.

Michele Buck

To your second part of your question, from a margin perspective, we do charge a higher price point for it, but it also does cost more, obviously, so the margins are comparable to the core.

Michael Lavery

Okay, thank you.

Operator

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Thank you. Our next question comes from the line of Ken Zaslow with Bank of Montreal. Please proceed with your question.

Ken Zaslow

Hi, good morning, everyone. I had just two quick questions. One is the tax: is it a cash item or a noncash item?

Then the second thing I'll ask is, implicitly, you're actually raising the EBITDA, which is more cash oriented. Am I not understanding it correctly?

Steve Voskuil

The first question is for the second quarter, it's noncash, but a portion will become or could become cash in the balance of the year, and that portion will probably be noncash for the balance of the year, so it is a mix of both for the balance of the year.

On your second question, yes, you're thinking about it the right way from an EBITDA standpoint.

Ken Zaslow

Okay. Then just to follow-up on this. The magnitude of the increase on the EBITDA exceeds the amount of cash that will be needed to pay the taxes. Is that a fair way? Then I'll leave it there. I just want to make sure I understand the tax, because it just seems like it's more—if cash flow is actually coming up, not going down, based on what you're saying. I just want to make I'm understanding it correctly.

Steve Voskuil

Yes, that's true, but I'd say the caveat is time. If you're looking at a longer period of time, it's more possible that a portion of that reserve could become cash. If you're looking at next quarter or the balance of the year, that might lead to one answer. If you're looking at the next two years, it could be a different answer.

Ken Zaslow

Great, I appreciate it, thank you.

Operator

Thank you. Our next question comes from the line of Bryan Spillane with Bank of America. Please proceed with your question.

Bryan Spillane

Hi, good morning, everyone.

Steve Voskuil

Good morning.

Michele Buck

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Good morning.

Bryan Spillane

Hi. I guess I wanted to maybe follow-up a little bit on Andrew's questioning at the beginning. Michele, maybe just stepping back a little bit, in this environment where we're seeing not just higher cost inflation but in addition to that, what's effectively labor shortages, and we've seen this across a lot of the companies in our coverage universe. I guess I had two questions related to that. One is, if supply chains are kind of running all-out, just how you think about stimulating demand when there's some challenges just in terms of getting product on the shelf?

I guess the second is just, as you step back and you look at all these different dynamics in the economy and the environment in general, it's definitely a situation that is in some ways unique. Your perspective, have you seen some of this before? Maybe just how you're thinking about approaching planning for the business over the next, I don't know, 12 to 24 months if we continue to be in this type of environment.

Michele Buck

Yes, it's certainly something that we spend a lot of time thinking about and working on. I guess what I would say is, yes, we do realize that it is somewhat of a volatile time still, certainly with all the talk of the Delta variant and recent CDC guidance recently. It's all too much of a reminder that we clearly aren't fully out of the pandemic. And I personally believe, in September, we know that a lot of companies are implementing a return to office. It seems like a lot of companies are doing that then. Kids going back to school. There will be more for all of us to learn about consumer behaviors and what some of those changes mean for that.

The way that we think about the supply chain and managing where we are right now is, I guess in a couple ways. How do we efficiently maximize and profitably maximize revenue? One of the key things we do focus on is really looking across the portfolio and focusing on really maxing out where we have available capacity and leaning into some of those brands and businesses with greater investment, reallocating investment to those businesses so that we can really take full advantage of that.

If there are areas of the portfolio where we—like a Reese, for example, that I think we keep pointing out as an example because it's such a big piece of our business and growing at such a hefty rate. We have total confidence making big capacity investments on that one, just because of the track record and the dynamics around that. We'll invest in capacity as a piece of that.

Then there are parts of the portfolio where we're not going to lean in right away and invest in capacity because we want things to play out a bit here more. We really leverage the breadth; one of the strengths we have is the breadth of our portfolio. We've got our seasonal portfolio with the consumable, take-home. We have a range of different brands. We really try and leverage that as best possible to manage through. It's kind of a balance of investing to build supply chain even stronger, which we're always doing, but we're doing even more of that right now, doing what we need now, kind of no regret move, and then planning for the future from a contingency perspective depending on what the potential outcomes are.

Bryan Spillane

Okay, thanks for that.

If I could just follow-up with one quick one. Just as you've sold in merchandising for holidays in the back half of the year and maybe just more in general, have service levels come up more as a factor that

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retailers are focusing on? You can sell a program or they can take a program, but are they more sensitive to actually planning to be in stock? Is that becoming more of a factor in that decision making right now?

Michele Buck

Yes, I mean, I would say absolutely. Retailers were under tremendous pressure this past year with all of the huge shifts that COVID caused on many manufacturers' businesses. They had, as we all know, tremendous issues with out-of-stocks, so their goal is to make sure they remain in stock. In fact, right now, we've seen retailers really lean in a bit to inventory and carry a bit more inventory than they have in the past, because I think there's a little bit of a scarcity mentality. They want to make sure they have product. They also know that manufacturers are taking price, and so in some cases it may allow them to hedge a little bit there.

I think it is definitely a focal area and of course, something that we always focus on and are proud of how we've been able to deliver for retailers. They've continued to come to us, given how we were able to deliver during the worst of the pandemic last year, and have continued to rely on us this year.

Bryan Spillane

Okay. Thanks, Michele.

Michele Buck

Absolutely.

Operator

Thank you. It seems there are no other questions at this time. I'll turn the floor back to Ms. Poole for any final comments.

Melissa Poole

Thank you for joining us this morning and I'll be available throughout the day for any other follow-up questions you may have.

Operator

Thank you. This concludes today's conference. Thank you for your participation.

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