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The Hershey Company

First Quarter 2021 Earnings Q&A Session

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C O R P O R A T E P A R T I C I P A N T S

Melissa Poole, *Vice President, Investor Relations*

Michele Buck, *Chairman, President, and Chief Executive Officer*

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

C O N F E R E N C E C A L L P A R T I C I P A N T S

Rob Moskow, *Credit Suisse First Boston*

Michael Lavery, *Piper Sandler*

Nik Modi, *RBC Capital Markets*

Jason English, *Goldman Sachs*

Ken Goldman, *JPMorgan*

Alexia Howard, *Bernstein & Co.*

Andrew Lazar, *Barclays*

Rob Dickerson, *Jefferies*

Morgan Fletcher, *Bank of America*

P R E S E N T A T I O N

Operator

Greetings and welcome to The Hershey Company First 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 now begin.

Melissa Poole

Thanks, Rob. Good morning, everyone. Thank you for joining us today for The Hershey's First Quarter 2021 Earnings Q&A session.

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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 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 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 Rob Moskow with Credit Suisse. Please proceed with your questions.

Rob Moskow

Hi. Thank you for the question, and obviously, really great results. I just wanted to get a little more color on your gross margin expectations for the year. You talked about transitory reasons for why gross margin would be down in first quarter. Are you still guiding to gross margin expansion? To what extent do you need the incremental pricing to get that gross margin to turn the other way? I would think some of these higher costs that you're talking about, like freight, co-packing, it sounds like you'll need to keep doing those things beyond just first quarter. Maybe a little more color there.

Michele Buck

Let me have Steve take that one.

Steve Voskuil

Sure, happy to. Yes, we are still calling for modest gross margin expansion on a full year basis. As you noted and we haven't remarked, there were some transitory impacts in the first quarter, some lapping from last year, some also costs in response to the higher volume. As we look forward for the rest of the year, some of the things that are strengths for us, the productivity gains, the additional volume, the pricing that you referenced, all of that will be part of building that gross margin.

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So far, for the first quarter, and even as we look out for the year, I would say our inflation assumptions are largely tracking to what we had in plan. The one exception that we noted was package, and I think that is one we'll watch. Our expectation is that inflation will moderate some as the year plays out, impacted a bit by weather in Texas for the first quarter. So that's one we're watching. And then any carry-forwards of incremental cost to support the higher volume. With more runway here in the balance of the year we'll have more opportunities to optimize between customer service and manufacturing capacity and the cost of support.

So we're keeping a close watch on all those, but yes at this point we still see some gross margin expansion over the course of the year.

Rob Moskow

Okay. One follow-up. The new price increase on grocery and non-chocolate, can you give us a sense of what it represents both in absolute terms and also on an annualized basis once it fully flows through?

Steve Voskuil

Yes. We see total pricing for this year across all the price increases order of magnitude about a hundred basis points, about half of that is the non-chocolate piece. Again, reference there is we haven't priced that part of the portfolio since 2014, so this is in line with our broader strategy we talked about of rotating and refreshing pricing in parts of the portfolio.

Rob Moskow

Okay. So on an annualized basis does that mean it's 1%, 2% to the total business, or...?

Steve Voskuil

Yes, annualized it's about a point for that, it's about 50 basis points.

Rob Moskow

Okay. All right. Thank you very much.

Operator

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

Michael Lavery

Good morning. Thank you.

Michele Buck

Good morning.

Michael Lavery

Just following on pricing a little bit. You said the point to point and a half expectations for the year and mentioned that a lot of that reflects the pricing you just took and some of the promotional benefit in the

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first quarter. You also just mentioned that the packaging inflation should moderate. You've got some relatively benign things like cocoa cost and dairy, at least so far. But if you were to look for more pricing, say if packaging didn't come in the way you're expecting, how nimble can you be and what sort of timing does it take to flow some of this through? How much upside to the one to one and a half could we end up seeing?

Steve Voskuil

Yes, it depends on which parts of the portfolio that we would price up to the seasonal part. It takes a pretty long lead time and so really that's not something that would be in the cards for this year. On an everyday basis, we probably need at least three to four months of lead time. So you could say there's still some optionality there if we were to see some worse case scenario from a cost standpoint. Right now, that's not in the plan. I think we feel good about the plan that we have for pricing. But as I said, we'll monitor what's happening from a cost standpoint.

Michael Lavery

Okay, that's great. Thanks. Just a follow-up on the e-commerce side. I believe you've said that those margins might be somewhere around 100 to 150 basis points lower but as it scales that should improve. How have you seen that change over this past year with the benefit of the surge and obviously a bigger scaled base now?

Steve Voskuil

Yes, from a dilution standpoint, I mean, you're in the right zip code. It's a bit dilutive to the overall margin. Obviously, that piece of the business as we've talked about in prior calls has gotten bigger, but at the same time we continue to look for ways to drive efficiency there and optimize inside that business to bring those margins closer in line with the rest of the portfolio.

Michael Lavery

Do you have a sense of just the timing for what that might take? Is that a multiyear process or would some of this surge that's kind of still sticking now be a big help towards narrowing that gap?

Steve Voskuil

Sure. It's a multiyear process, for sure. I mean, the scale does help. We get more scale across some of the investments and capabilities that we've put there. So, there's some benefit there in the present, but really to address the full dilution it's going to be a multiyear process.

Michael Lavery

Okay, great. Thanks so much.

Operator

The next question is coming from the line of Nik Modi with RBC. Please proceed with your question.

Nik Modi

Yes, thank you. Good morning everyone. I had two questions. First is on just shelf space. Clearly, Hershey's done a phenomenal job on execution. Gains in 2020. Gains in early 2021. I'm just curious

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given how your momentum continues, if you would expect to see or have discussions with retailers regarding more space later this year but also in 2022. That's the first question. Second question is just on—given the online momentum that you've been seeing and the clear stickiness that we've seen, how are you thinking about the supply chain and kind of reorienting the supply chain and make sure that you can continue to effectively execute as the online business continues to grow? Thank you.

Michele Buck

Good morning, Nik. Let me first go to the space question. As we started out for the year, we always have a focused plan focused on balanced growth across all levers - driving base velocity, using media to accelerate growth, growth in season, distribution gains. So that's always a focus for us and we are fortunate that we have been able to, given the strength of the performance of our supply chain, particularly overall but also during COVID and some of the needs of our customers, to be able to provide some incremental SKUs that were very viable that our customers were looking for and we gained about five incremental SKUs for the year. So, certainly, with that comes some shelf space gains. That's something we've been focused on. As we get that distribution and we get shelf space now, that certainly has some staying power as long as the SKUs perform, which we anticipate that they will.

So, we are continuing to be focused on that and as we look throughout the year believe—we feel pretty good about our ability to continue to drive distribution as well as shelf space gains and certainly that kind of coincides with some of the share gains that we have seen on the business have been driven by that.

As we look at online momentum as it relates to our supply chain, we've talked before about supply chain 2.0, a big initiative that we have to really prepare our business and enable our manufacturing and supply chain for the future, and certainly as we built that program and that initiative, one of the key legs that we were focused on was the agility to enable us to adapt to the changing retail environment and specifically e-commerce being one of those areas because a lot of the packs still in e-commerce are slightly different than those sold across the business.

So, some of those investments that we're making there enable us to more efficiently at a better margin develop the right packs that enable us to win in e-commerce. So, big focus in supply chain 2.0 against that and in all of our new capacity builds.

Nik Modi

Great. Thank you, Michele.

Michele Buck

Sure.

Operator

Our next question comes from the line of Jason English with Goldman Sachs. Please proceed with your question.

Jason English

Hey, good morning folks. Thank you for sliding me in. I want to come back to the question on pricing but from a slightly different angle. Michele, if we look back in history, usually you move, Mars follows, or Mars moves, you follow, and you follow in similar order of magnitude on some of the products and that consistency has obviously helped investors build confidence in the pricing architecture or the pricing

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discipline or the pricing power in the category. We're in a bit of a unique circumstance right now where Mars is moving one direction with—start with a higher magnitude and you're moving a different direction with a much lower magnitude and it strikes me as quite a unique moment in time where you guys are diverging. I guess, I'd love a little more clarity to try to understand the motivation for you to go in a different direction and what if any implications this may have in terms of that pricing discipline we've historically seen in the category?

Michele Buck

Yes. I continue to feel really good about this being a very rational category from a pricing perspective and there being strong discipline from that perspective. our recent announcements regarding increasing price on seasons and also non-chocolate and grocery are very consistent with the strategy we've been executing over the past couple of years of realizing price through different levers and on different parts of the portfolio. We think that that's proven effective for us to drive profitable growth and also able to reinvest in the business, both for us and also for our retailers. But we do know that across competitors in the category we each do have unique portfolios with different SKUs to our business across pack types and across brands. We have some different capabilities in terms of what we are good at executing and perhaps even different business needs at different points in time.

So, while all the pricing isn't exactly pack to pack exactly the same, what we think is important is while those tactics and products might differ overall category price realization is pretty consistent. So, if you look at us and you look at the largest player in the—the second largest player in the category, the magnitude and difference in terms of what we each are getting from price is probably a point or in that range. So it's not a significant difference between.

Jason English

Got it. Thank you. That's helpful. I'll pass it on.

Operator

The next question comes from the line of Ken Goldman with JPMorgan. Please proceed with your question.

Ken Goldman

Hi. Thank you. You highlighted some recurring headwinds to your gross margin. I think there were some incentive payments, some (inaudible) and warehousing costs. Is there any color, Steve, that you can provide on how much these may have added to your COGS or I guess took away from your margin? And do any of those incentive payments bleed into 2Q?

Steve Voskuil

Yes. Maybe just taking the incentive piece. Yes, we will see some additional incentives (inaudible) versus prior in second quarter, as well as as we get to the back half of the year it's going to get a little bit narrower year-on-year, but we'll definitely see some impact in the second quarter. We also have some year-over-year investments in capabilities. I think we touched on these a little bit in our last call. Still some comps going through op ex to support supply chain 2.0 that Michele mentioned and also the ERP program.

So those would be, if I kind of look between the lines, some of the pieces year-over-year that'll be different.

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Ken Goldman

Okay. And then as my follow-up, I may be pushing you a little harder here than what you're willing to talk about, but it's hard to not to notice that cocoa is one of the only commodities that hasn't (inaudible) lately, has come down actually sequentially in the last couple of months. So I know you don't talk about your specific commodity buys, but can you just walk us through a little bit about how you're looking to lock in maybe some of your favorable inputs a bit longer than you otherwise might have, just given how everything else has risen so much higher it really could help you in terms of protecting your 2022 numbers at this point.

Steve Voskuil

Sure. Yes, I mean, you're right, Ken, we're not going to get too specific. Our hedging horizons vary. We kind of said in the past three months up to two years depending on what's available in the market, liquidity, pricing. I will say our commodities team is very good at interpreting the signals and trying to make smart moves with respect to that hedging program.

Beyond that, we're probably not going to comment. As I said, cocoa's moved around, it's down a little bit. All else equal you might interpret that as some opportunity if you were to be a little bit longer from a hedging standpoint. But we really don't want to say any more than that yet about '22.

Ken Goldman

Understood. Thank you.

Operator

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

Alexia Howard

Good morning everyone. Hope you can hear me okay.

Michele Buck

Yes, we can.

Alexia Howard

Perfect. Okay. I guess my first question is, I wondered if you can give us a little bit more detail and granularity around the away from home recovery, particularly in North America, which regions, which channels, what exactly is playing out there that you're seeing that's so encouraging? And then my second follow-up question, I know you're not giving quarterly guidance but obviously 2020 was such an unusual year and we're going to be lapping some interesting developments in the year-ago period as we go into Q2. I think you mentioned that ad spend was going to be up materially in the second quarter. I'm just wondering whether you can give us any other pointers on how the top and the bottom line might be expected to develop or what the pluses and minuses are as we think about next quarter? Thank you and I'll pass it on.

Michele Buck

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Sure. So, relative to the away from home strength, I would say it is across the board. So, first of all, we did see stronger foot traffic and consumer mobility in North America, and that was really I believe from the accelerated vaccine distribution as well as from the stimulus funds that were allocated. And that not only drove strength in what we would call our core channels, kind of the more traditional channels - food, drug, masks, and even some pickup in convenience in Q1, it also had—there was also a very strong positive impact on our non-measured channels as well. So, foodservice, our own retail stores, world travel retail, some of those businesses that were really big decliners for us last year came back faster than we anticipated.

So, I would say it was pretty much across the board in terms of all of those venues improving a bit more than we had anticipated. Some of it was due to the consumer traffic. And then of course we were able to also capture incremental distribution and merchandising in our U.S. confection business, and given the strong sell through that we saw driven by mobility and foot traffic, strong sell through Easter then led to accelerated shipments of some of our summer programs, which also helped us across the board. And then even beyond North America, we actually saw increased mobility in the international market as well a bit more than we had expected.

So, with that, I think those were unplanned for us in Q1. We certainly had planned to see those mobility improvements later in the year and had that in our plan but not in Q1.

With that, I'll turn it over to Steve to talk a little bit about the quarters.

Steve Voskuil

Yes. From a quarterly standpoint, as we look at Q2, building on what Michele said, we've got a lot of momentum on the top line coming into Q2. We're able to merchandise early some of the summer season. That'll get us off to a good, strong start. As we go forward from there on the top line, you're going to see sales growth moderate, the last (phon) get tougher. You'll see pricing start to make a contribution more in the back half. As Michele said, our plan assumed mobility would begin to recover as we got to the back half. So that's less of a new piece of the story as we turn the corner on midyear. And then we'll see some margin improvement as the year progresses. You mentioned ad spending for Q2. It's going to be up pretty big year-over-year. That was the quarter last year where we made some adjustments. Some pricing advantage because it was cheaper to buy and some adjustments in how much we spent just in response to COVID.

So, hopefully that gives you a little bit of color on the balance of the quarter.

Alexia Howard

Very helpful. Thank you so much. I'll pass it on.

Operator

The next question is coming from the line of Andrew Lazar from Barclays. Please proceed with your question.

Andrew Lazar

Good morning everybody.

Michele Buck

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Good morning.

Andrew Lazar

Michele, I know this can be a little hard to parse out sometimes, but as you think about how much of the gains that you've made in the last couple of quarters, right, in distribution and shelf space, merchandising gains you've talked about, how do you think about how much of those might be structural based on a lot of the good stuff that you're doing around innovation and everything else, versus a product of what's been clearly a more accommodative sort of competitive environment from the perspective of some others, whether it be supply chain missteps and things of that nature? I'm just trying to get a sense, it's a hard one to answer I know, but how sticky do you think some of those gains in market that you've seen can be over time?

Michele Buck

Yes. So I think you're right. It is a little bit tough to parse all of that out. I would say we came into the year feeling really good about our strategies and many of those we had laid out pre-COVID relative to really focus on we've got to win at the top line with balanced growth, which is driving against distribution, the core innovation, seasons, pricing and volume growth. I think what we're seeing on the businesses that we are delivering on each of those elements. So certainly, that is a piece that I think has staying power that some of the strategies we've put in place relative to pre-COVID optimizing our balanced focus on the core and on innovation, not over rotating on innovation too much. Not over rotating on any one factor. Balancing pricing, volume, one of those things.

So I think that there's some underlying strength there as well as a lot of the investments that we've made in our core capabilities in our manufacturing and our supply chain over the year that have enabled us to deliver perhaps at stronger levels than perhaps some others in the marketplace.

So some of that strength that we're seeing in terms of impact of media, those types of things, they're there without the COVID impact. We tend to always—as you know, strong category managers, so we tend to do well when it comes to winning at retail. We have our proprietary retail sales force that enable us to do that.

At the same time I'd say I guess if I was going to parse out some places where some of the current dynamics may be a little bit more transitory, certainly we have one more distribution than I would say is probably at the historic level in terms of number of new items because of our strength in being able to operate in this environment and our agility. We have one, some incremental merch (phon) associated with the competitive situation as well.

So for me, I guess, I narrow into probably those two factors being probably the biggest one that are the most unique. And of course, the other one is that right now in Q1 - you asked more about a couple of quarters - in Q1, in particular, we've got that unique duality where we're seeing that we're benefitting both from away from home and from at-home behaviors both being strong and certainly I think that that can't sustain at the level that it did in Q1. So we do think that that's going to moderate a bit.

Does that help?

Andrew Lazar

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Yes, that's very helpful. It'll be really interesting to see how much of the at-home moderates as mobility does return for the industry. as a whole, obviously, will be really interesting. But I hear your point about how strong both of those really were at the same time in Q1. So, yes, that's very helpful. Thanks so much.

Michele Buck

Thank you.

Operator

The next question is coming from the line of Rob Dickerson with Jefferies. Please proceed with your question.

Rob Dickerson

Great. Thanks so much. I just wanted to touch on the international segment for a minute. I mean, obviously, performance for Q1 was extremely strong. I think originally the expectation was essentially for somewhat modest growth. Guidance now is up for the full year for the total Company. I know you have comments in your prepared remarks just around basically playing it safe, right. There's some incremental lockdowns occurring. The visibility's not strong. I guess, kind of overall big question is, could it be actually a lot stronger than we would expect as we go through the year because it would seem as if kind of relative to what we're thinking about for North America that international piece does continue to play out and obviously given those compares are so much easier it would seem as if the volume driven year could actually be even more volume driven off of that international piece as we progress through the year.

So kind of simplistically I'm just asking, I realize you don't have the visibility, but if things were to kind of self-correct and momentum were to continue in international, could you just not do much better on the top line than you're already currently guided? That's all. Thanks.

Michele Buck

First of all, I'd say, hey, we feel great that we are seeing strength across every piece of our business, in North America, in every component of North America including U.S. confection and amplified as well as in international. So that's great to see. Certainly, we did have a strong first quarter in international that was significantly ahead of our expectation.

I think what was interesting for us was that despite the fact that COVID cases were high in many of those markets, consumer mobility still increased and that drove demand for our category that was stronger than we anticipated. I think the potential concern is, certainly as you look at the news you see this everywhere is, there certainly are some pretty dire situations and especially in some of the markets that we're in, but certainly India being one of those, where case counts are risking. There are other markets where the vaccination dissemination is going quite slowly and as new lockdowns are implemented we expect that those could hamper mobility and that these trends could moderate.

So, we know in international things are always volatile but they certainly are even more volatile during this time and those markets are not going to have linear behavior. We expect that we'll see continued volatility. What we're trying to do is to drive what's within our control and our teams are responding with tremendous agility and adapting the plans based on the state and the status in each market.

So we feel good that all of our key initiatives, whether it's our China transition to the new business model, a restart or upping again our focus in India on our chocolate initiative. All of those things are going well,

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but there's just a lot outside of our control and we'll have to see how the year plays out. If things are positive, certainly there could be upside, however we also know that there could be downsides as well.

Rob Dickerson

Got it. Great. Thanks so much.

Operator

Our next question is from the line of Morgan Fletcher with Bank of America. Please proceed with your question.

Morgan Fletcher

Hi. Good morning. Thank you for the question. I guess, my question is on how COVID may have changed your perspective on the portfolio, maybe in an organic but also an inorganic way. We touched on e-commerce and supply chain earlier but maybe if we could just go through more how you're looking at categories differently. Like baking mix has had very strong growth, while refreshments have seen declines. So just how you may be thinking about your portfolio on a category basis going forward. Thank you.

Michele Buck

Yes, absolutely. I think one of the things that we feel good about that COVID just reinforced was the strength of the breadth of our portfolio to be able to participate in different occasions. So I would start first within core confections and say, we have—our business splits a third, a third, a third. Instant consumables, which are all about people being out and about on the go. Take home, which is all about people being at home and consuming the product there. And then seasons, which is all about celebration.

So, within confection, what we saw was, wow. Normally we might focus a bit more of our efforts on instant consumable and when COVID hit we were able to immediately shift media, in-store, merchandising, etc. more to our take home portfolio. We also saw that during a time like COVID consumers were just hungry for connection. So the role that our brand played during seasons to create that connectivity and traditions and rituals were something consumers just were so hungry for.

So, really leveraging the full breadth of that within confection was important. You raised baking and certainly consumers were baking more and we were able to leverage that as part of our portfolio. So I think what it really taught us was this ability to pivot to follow the consumer and to focus on the parts of our portfolio that were most relevant to them at that time. If we think about organic and inorganic, likewise, we were able to take advantage of SkinnyPop, which has done incredibly well during COVID, and certainly we know that categories like nutrition bars haven't done quite as well.

So it's really playing on the pieces of your portfolio at the right piece of time, but having the options and the breadth across the portfolio to be able to meet those needs.

Morgan Fletcher

Thank you.

Operator

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Thank you. We've reached the end of the question-and-answer session. I'll now turn the call over to Michele Buck for closing remarks.

Michele Buck

I'll turn it over to Melissa for closing remarks.

Melissa Poole

Thank you for joining us this morning. I know it's a busy day of earnings. As always, I will be available to answer any additional questions you may have. Thank you.

Operator

Thank you. This concludes today's conference. You may disconnect your lines at this time and thank you for your participation.

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