The Hershey Company

Second Quarter 2022 Earnings Question-and-Answer Session

July 28, 2022

CORPORATE PARTICIPANTS

Michele Buck, *Chairman and Chief Executive Officer*

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

CONFERENCE CALL PARTICIPANTS

Andrew Lazar, *Barclays*

Alexia Howard, *Bernstein*

Robert Moskow, *Credit Suisse*

Ken Goldman, *JP Morgan*

Jason English, *Goldman Sachs*

Bryan Spillane, *Bank of America*

Michael Lavery, *Piper Sandler*

Chris Growe, *Stifel Institutional*

Simon Neagan, *UBS*

Jonathan Feeney, *Consumer Edge*

PRESENTATION

Operator

Greetings and welcome to the Hershey Company Second Quarter 2022 Question-and-Answer Session.

At this time, all participants are in a listen-only mode. 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

Good morning, everyone. Thank you for joining us today for the Hershey Company's Second Quarter 2022 Earnings Q&A Session.

I hope everyone has had the chance to read our press release and listen to our pre-recorded management remarks, 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 session, we may make forward-looking statements that are subject to various risks and uncertainties. These statements include expectations and assumptions, regarding the Company's future operations and financial performance. Actual results could differ materially from those projected. The Company undertakes, no obligation to update these statements based on subsequent events. A detailed listing of such risks and uncertainties can be found in today's press release and the Company's SEC filings.

Finally, please note that 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. Reconciliation 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. We’ll now be conducting the question-and-answer session.

Thank you. Our first question is from Andrew Lazar with Barclays. Please proceed with your question.

Andrew Lazar

Great. Thanks so much. Good morning, everybody.

Multiple Speakers

Good morning.

Andrew Lazar

As you discussed in the prepared remarks, inventory refill has certainly been nicely additive to volume growth through the first half of the year. Where do you think retailers are at this stage and how much more of a benefit, I guess, can this be in the second half? From the prepared remarks from reading it right, seems to suggest maybe the bulk of that inventory refill is sort of behind you at this point and maybe no longer enough to necessarily offset what volume elasticity you are seeing. So, just some clarity there would be helpful.

Steve Voskuil

Yes, that's exactly right, Andrew. We saw pretty strong inventory replenishment in the second quarter, as we commented. A portion of that was a pull forward from the second half to really a timing move. But as we look at the back half, we're really not seeing any additional meaningful inventory replenishment in the second half guidance.

Andrew Lazar

Then sort of following on that, As you and others sort of slowly start to get back to a sort of a better inventory position and some of the supply constraints slowly ease, I guess not surprisingly we're starting to hear from, I think, from Hershey and others that they'll be in a better position maybe for the first time in a while to begin to kind of ramp back up merchandising activity to sort of drive volume and traffic.

I can understand why in this environment, some might simply see that as sort of retailer concessions given all the pricing that's come through in the industry, and with commodity starting to roll over. I assume you see this as more getting back to a maybe a more normal cadence of spending and really looking just to drive volumes and traffic and protect elasticities that I still think can be, in many cases, incremental to the business. But I was hoping, Michele, you could kind of comment a little bit on that, if you could. Thank you so much.

Michele Buck

Yes, absolutely. As we have always talked about our investment model or model running the businesses, we strongly believe in investing to drive the top line, and with our strong margins that enables us on the bottom line. We always want to be sending to the consumer, advertising our brands, having the right levels of promotion, the right levels of innovation, and as we mentioned earlier, given some of those supply constraints, we did have to pull off on that a bit just because it didn't make sense to make those investments given some of those constraints. But we very much look forward to re-upping the investments as we look at the second half, we have always planned an increase both in DMEs as well as incremental merchandising coming back online.

Andrew Lazar

Thank you.

Operator

Thank you. Our next question is from Alexia Howard with Bernstein. Please proceed with your question.

Alexia Howard

Good morning, everyone.

Michele Buck

Hi, Alexia.

Alexia Howard

Hi there. You talked about the general supply chain disruption that you're still experiencing. Can you talk about exactly where the pain points are? I'm thinking, you know, across raw materials, packaging labor, where are the things that you're really wrestling with at the moment, and are you seeing light at the end of the tunnel at this point? It sounds as though things are getting little easier. Then I have a follow-up.

Michele Buck

I think generally we continue to see struggles across the supply chain. How I would characterize it is what those are have evolved. Where we are now, I would say early on it was some of the basic logistics issues largely driven by labor, and as we've evolved, I'd say we're now starting to see bigger concerns relative to scarcity of ingredients needing to leverage different suppliers at higher cost and price points in order to secure production.

Then also the geopolitical environment has put certain strains on the business. Certainly, the Ukraine/Russia issue created some scarcity and issue with ingredients. More recently there have been additional restrictions from Russia on the EU relative to natural gas. Germany will be impacted. That's an area where we source a lot of equipment, supplies as do many of our suppliers. So, I would say that that's kind of evolved.

Steve, would you add anything…

Steve Voskuil

The only thing I would add is that we're also starting to see more cost flow through from third-parties, co-packers co-manufacturers. A lot of those are a lot of those are under contract, and so it sort of happens as those contracts renew, but they're facing the same cost pressures and disruptions that we're facing. And so, we're starting to see more of that impact to P&L as well.

Michele Buck

I guess I'll also just add we have made significant progress in investments in capacity, significant investments, and so part of our short-term pain was once you make those investments and take some time to get them up and running to get the lines actually in place. And so, part of some of the relief we're seeing is the gradual coming online of those capabilities as well, which is helpful.

Alexia Howard

That's super helpful. Thank you so much for the color there. Just as a follow-up, how big is India these days? You called it out in the prepared remarks. haven't seen much news on India for a while, and I'm just wondering how do you avoid the same problems coming up that you had in China several years ago? I know you've moved—backed off from China and doing it more arm's length these days. Why is India are different market? Why can that work over the longer term? Thank you, and I'll pass it on.

Michele Buck

India is still relatively very small for us, growing high double digits. But back when we really made our decisions on China and India, for me, the key difference in India is the cost of doing business in that market is very different. So, media costs, labor costs. In both markets we thought we had the potential to drive top line, but as we really did the assessment and looked at the NPV of our investment, India is a market that we feel good about our prospects of getting to profitable growth. Frankly, we're already in a place that we like relative to where gross margins are on that business, very different than where we ever were in China.

Alexia Howard

Great. Thank you very much. I'll pass it on. Appreciate the color. Thank you.

Operator

Thank you. Our next question is from Robert Moskow with Credit Suisse. Please proceed with your question.

Robert Moskow

Hi, Michele. Hi, Steve

Steve Voskuil

Morning.

Michele Buck

Hi.

Robert Moskow

Morning. I thought the comments about 2023 were pretty encouraging, albeit at a pretty early stage. You said that you expect your pricing actions to be partially offset by high single digit inflation, and then you also have productivity. Do you expect the pricing lap to offset inflation, COGS inflation, in 2023, because you've had lags in 2022? So, I guess that's a positive. Then maybe you could talk about the advertising increase that you're thinking you need to do. How much of that is just restoring what's kind of lagged so far? How do you think about how much investment's needed?

Steve Voskuil

Sure. Yes, for 2023 we're still talking at a pretty high level, we'll get a lot more fine tuned as we get through the third quarter and get more picture for next year. But we are seeing high single digit price is the expectation to come through. Volume wise, we'll watch and see how consumers behave. We'll know more about elasticity's as we come out of this year. As we said, overall inflation we're still seeing high single digits. You know, when you peel into that we'll have some—I expect some commodity impact still as will be rolling off some more favorable hedges, into hedges were struck at prices that look more like recent times. We still see logistics and third-party cost impact in there.

I think it's too soon yet to say whether the price is going to fully offset all of those inflationary impacts. We'll know more again as we get through the third quarter towards the end of the year, but we do want to increase advertising and we called that out in the remarks. We see that growing faster than the rate of sales. And as you said, it's really—as Michelle said just a few minutes ago, making sure that we continue to reinvest in brands, reinvest in consumers, and have a healthy level of investment once we have supportability.

Robert Moskow

Did you say, Steve, that you expect your pricing to be up high single digit next year because of the flow through?

Steve Voskuil

That's correct.

Robert Moskow

Okay. All right. Thank you.

Operator

Thank you. Our next question is from Ken Goldman, with JP Morgan, please proceed with your question.

Ken Goldman

Hi. Thank you. One quick one and then a longer one on Halloween. I just wanted to get a sense, if possible, for the North America Salty Snacks business, the margin going forward. We've seen some volatility there. Just wanted to kind of get a sense for how to sort of model that in the next couple quarters given you know some of the cloudiness we have in our model, at least our (phon) model on that one.

Steve Voskuil

Sure. Be happy to take that one. So, as you saw in Q2 looked a lot like Q1. We continue to see higher raw material costs and logistics costs for these two quarters are more than offsetting the price that we've taken so far. That said, we've announced more price increase in the second quarter. So, as we roll forward through the next two quarters, we do expect to see some stability and release there.

We're also going to begin to lapin the back half some of the higher logistics costs that we've been talking about. So, that will provide a little bit of relief there as well. Then longer term as we talked about on last quarter's call, we continue to advance the structural changes that we need to do for that division. Things like setting up or formalizing the supply chain, some of the back-office efficiencies that we need to put in place, and longer term that will drive more structural improvement there, but right now it's kind of fighting the balance between pricing in inflation and commodities still.

Ken Goldman

Thank you for that. Then I wanted to ask about Halloween, and it's early to be precise, but you got it to high single digit sales growth. And you said that part of the reason is you're still capacity constrained. I was a little curious why the guidance wasn't higher.

Maybe it's just that it was a very difficult comp or you're facing a difficult comp from last year. Maybe it's just a little bit of conservatism because it's still early, but I would have expected maybe capacity to be less of an issue, just given how important the holiday is. And maybe you could sort of be rather in an all-hands-on-deck mode writing producing as much seasonal candy as possible, but maybe that's just an overly simplistic view of your supply chain. I was just curious why that guidance wasn't a little bit higher.

Michele Buck

Ken, as we look at the business, we have a strategy of prioritizing everyday on shelf availability. It was a tough decision to balance that with the seasons, but we thought that was really important. That was a choice that we needed to make. We had opportunity to deliver more Halloween, but we weren't able to supply that. We were really producing—we begin producing Halloween back in the Spring, and that's really when we needed to make these key decisions on what we were going to produce.

So, trade-off to make, we feel really good about having high single digit growth, but we also feel good about as we get into the future, being able to have more capacity to really fulfill more of the demand that we see during the seasons.

Steve Voskuil

Yes, it's definitely all hands-on deck. Make no mistake.

Ken Goldman

Understood. Thank you so much.

Operator

Thank you. Our next question is from Jason English with Goldman Sachs. Please proceed with your question.

Jason English

Good morning, folks. Thanks for slotting me in.

Michele Buck

Hi, Jason.

Jason English

I guess I want to start on capacity because there's a little bit of conflicting messages here. On one side, you've got enough capacity to be refill inventory levels, but on the other side you don't have enough capacity to meet demand for some products. Can you help me foot (phon) those two conflicting things? Also, give me a little bit better understanding of where the bottlenecks are, and what the pathway and timeline is to relieve those bottlenecks.

Michele Buck

Yes. So, capacity is constrained, but obviously in certain parts of the portfolio more than others. There are certain places we have no constraints, and there are other places that we are more constrained. We've shared previously that Reese is one of the areas where we have seen high double-digit growth for extended periods of time. It's our very largest brand, so that's certainly been a pressure point, and then there are a few other places that have been pressure points and where we've needed to make trade-off in order to prioritize some parts of the portfolio.

We've continued to work through a capacity investment plan to address where the soft areas are and bring capacity online. That might be part of the mixed messaging, is there are certain places were not constrained; others that that we are.

Refreshments, specifically, Icebreakers Mints is one area where we had some production difficulties as we ramped up production back up after the COVID softness, so that's one place as well that we're continuing to work to get more supply available. Does that help?

Jason English

It does. It doesn't shed a lot of light on when you think the issues will be behind you, but it certainly helps in understanding where the issues are.

Michele Buck

As we get through the issues, I would say we're making—I would characterize it as gradual improvement. Certainly, we are, I would say, quite constrained this year, we see that gradually improving as we get through '23. And as we get to '24, we feel much better about our ability to be able to fully meet demand. That's how I would characterize it.

Steve, anything…

Steve Voskuil

Just the color around, you know, in the last three years we've invested on the order of $800 million on capacity, mostly in the core. And so, we've got, 13 new lines in place coming online, we've refurbished 11. As Michelle said, over the next year or two we're going to start to see more significant capacity available.

Michele Buck

If it helps, the investments that we made will result in about a 15% increase in our internal volume production capability. That should allow us to catch up, but also to deliver some of that future growth.

Jason English

For sure. That's helpful. I want to come back to Rob Moskow's question real quick. I was surprised that you are offering color on 2023 this early. It's uncharacteristic of you, and it begs the question of why? I guess, Rob showed one interpretation of, hey, you have inflation but your price above it, don't worry, gross, margins are weak now, but they'll come back to growth next year, I guess that's one way to interpret it.

The other is your emphasis on we're going to lean into spending next year so don't get out over your tips in terms of how much margin flow through is going to drop to the bottom line. Which of those two interpretations do you think we should be leaning towards?

Steve Voskuil

I would just say it's still pretty early. We're trying to just give some broad movements on the top line and inflation. That's really the part that we could share. As we're learning more every month and quarter that goes by, we'll have a lot more to share as we get to the end of the year. So, really not trying to get up ahead of our skis (phon), just extending some of the color we see right now.

Michele Buck

Jason, if I could just add a little bit, was just related to some of the pricing that's in the marketplace and expecting to come, trying to put that in perspective around how much '23 factored into that choice and just trying to make sure that everybody was understanding some of the inflation that we see coming in '23 to help put some of that pricing in perspective as well.

Jason English

For sure, for sure. Alright, thank you.

Operator

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

Bryan Spillane

Thanks Operator. Good morning, everyone.

Michele Buck

Good morning.

Steve Voskuil

Hi, Bryan

Bryan Spillane

I wanted to follow-up on just the commentary around inflation, and I guess two things, Steve. One, it's been mentioned in the call that some of the pressure is like scarcity of ingredients, and you know more than just like market-based type things. So, I guess what I was trying to understand is just how much of the sort of increase in COGS that you're experiencing now is maybe a more permanent shift and how much of it is still sort of a function of just that the current environment and maybe there will be some relief, like disinflation at some point in time.

So, just trying to understand how much do you think is really just, hey look, this is our now are kind of permanently re-based higher costs, or do you think some of this could be more variable and you get some disinflation in the future?

Steve Voskuil

Yes, it's a really good question, and it's hard to answer that one with precision. You look at all the moving pieces. There are clearly some that we would see as temporary, you know, the scarcity issues. Hopefully some of the commodity's pressures that are being influenced by events in Eastern Europe, things like that. On the other side we've seen more labor inflation and other things that could prove to be more structural.

So, again, if we get to the end of the year and we get some guidance for next year I'll probably give some more color on that, but it is a mix, some are temporary, and some at least have the potential to be longer lasting. That said, we also focus on productivity and continuous improvement every year and it's been a goal of that program is to be able to more than offset over time some of those structural costs. So, that also has to continue to advance.

Bryan Spillane

Right, right. Okay. All right. That's all I had. Thank you.

Michele Buck

Thanks.

Steve Voskuil

Thank you.

Operator

Thank you. Our next question is from Michael Lavery with Piper Sandler. Please proceed with your question.

Michael Lavery

Thank you. Good morning.

Multiple Speakers

Good morning.

Michael Lavery

I just wanted to come back to Dots, which obviously is up very strongly. I would love to understand a little bit more some of the dynamic there. How much is distribution driven and maybe more importantly, how much distribution upside runway do you still have left?

Michele Buck

Sure. We are absolutely very pleased with Dots performance in the marketplace and the momentum that we see. I think what we're really happy about is we continue to gain distribution, but we are maintaining our velocities as we continue to broaden reach, and that can be a challenge to do as you continue to broaden reach into sometimes some of the smaller accounts.

All the trends are in line with our expectations; retail sales growing about 50% over the past 12 weeks, share up about 370 basis points. We are right now lapping some large distribution increases from prior year, so we do expect to see a little bit of softening in trend as we overlap that, but we do have continued distribution upside. As we took over the business, the distribution was really concentrated primarily in the center of the country and the West, and we're really still filling out the East and importantly just making sure that we have the right placement in stores. Then of course, beginning to actually market and drive consumer messaging to the brand, which we hope, think will further drive upside in velocities,

Michael Lavery

Okay, that's helpful. Thank you. Just a quick follow-up on the pricing. I know you've said you've got at least most, if maybe not all of it that's announced. Is there any of that that's sort of TBD, or to be negotiated? Or is it all locked and loaded and just a question of on the clock, ready to go out the door?

Michele Buck

Our recent announced pricing action is being executed. It is going as planned and we're starting to see some of the new retails in the market already. We feel good that we really took a consumer-focused approach for the right retail price points, and we're also beginning to reset some of the promotional points. Overall, the prices are moving in line with our recommendations and our expected ranges, and we are pleased about that as we want to really move ahead with further investments in the business and capacity and consumer spending, new capabilities, and the right programming. All of this will allow us to do that to drive profitable category growth.

Michael Lavery

Okay, great. Thanks so much.

Operator

Thank you. Our next question is from Chris Growe with Stifel. Please proceed with your question.

Chris Growe

Thank you. Good morning.

Multiple Speakers

Good morning.

Chris Growe

I just have a question first on the recent price increases you put into place, in particular across confectionery, I guess to understand, you see very little of that coming through this year, it would seem like some would come through but very little. Then just to what degree that's caused you to build in a higher degree of elasticity into your second half assumption. Just want to get a better feel for that.

Steve Voskuil

Sure. Yes. I mean it's right, most of it will impact next year. We will get a benefit in the fourth quarter, but even a portion of that benefit we're reinvesting in with the trade to drive merchandising and so forth, but most of it will impact next year.

In terms of elasticity assumptions, we do have in the back half in elasticity that is a little bit better than what we've seen historically, but a little bit worse than what we saw in the first half. It actually looks a lot like the second quarter if you adjust it for the volume replenishment, that level of elasticity of the assumption for the back half. Then, of course, the range on guidance kind of goes up and down from there.

Chris Growe

Okay. Then one related question that would be do you expect pricing just to sequentially accelerate in the second quarter? I'm sorry in the third quarter from the second quarter, or maybe more Q4 with the confectionery pricing coming through. Then do you believe you can grow volume in the second half of the year? You’ve got some really strong volume trends to date.

Steve Voskuil

Yes. So, we don't see sequential improvement in the third quarter, we do in the fourth quarter, and that's when we'll see the beginning effects of the price increase. And we don't expect to see volume growth, you know, again with that last elasticity impact combined with pull forward of the inventory replenishment from the second half into the second quarter.

Chris Growe

Okay. That's all I had. Thanks so much.

Steve Voskuil

Thank you.

Operator

Thank you. Our next question is from Cody Ross with UBS. Pease proceed with your question.

Simon Neagan

Good morning. This is Simon Neagan (phon) filling for Cody Ross. Could you give some additional detail into the delays and capacity coming online next year? Is this only impacting Reese, and how much of an impact is expected?

Steve Voskuil

Most of the capacity that will be coming online is focused on the core, Reese is one significant component of that. I don't think we're going to be specific about exactly how much is coming on when, but that is the focus of the capacity.

Simon Neagan

Got it. Just one smaller question. Obviously, Dots is demonstrating incredible growth, largely by distribution gains. Moving forward, do you expect to change and consumers trialing new brands and products when budgets are squeezed more in this environment? Perhaps sticking to what they're comfortable with?

Michele Buck

It's a good question. I think across snacking, what we tend to see is consumers very much like their brands. So, if you look across total foods, as budgets are tighter, certainly private label brands have grown share versus, across snacking, private label has not, and consumers tend to like their brand. I think that I think that consumers will continue to try new brands given that they have a (inaudible) focus on brands within snacking. We will closely monitor that, but at this point, we haven't seen any concerns around a slowdown in trial, as a result of that.

Simon Neagan

Thanks so much.

Operator

Thank you. Our next question is from Jonathan Feeney with Consumer Edge. Proceed with your question.

Jonathan Feeney

Good morning and thanks for taking the question and great quarter. As far as pricing over the next 6 to 12 months. Assuming we have—if we did have a moderating cost environment, and Michele you've lived through a lot of ups and downs in costs in this business. If there's been so much conversation, so much acceleration in pricing, much of that headline cost-driven, how does it work if—what changed about the conversation if costs moved sharply in the other direction like they did in grains, for example, at least so far off their peak. If costs moderate, how do you handle that to people? Does it typically play out that it's increased promotion? Do you see decreased list prices, or do you see no impact in just a significant increase in gross margin? Thanks.

Michele Buck

Yes. Our focus is always on driving profitable category growth and looking at how we can invest to do so. We have a deep list of investment priorities and growth driving opportunities. And so, we believe that this enables us to really invest to unlock, whether that is in capacity, whether that is in the right consumer marketing support, whether that is in more impactful promotion investments, in innovation, technology, etc. We like to invest back in the business, and I would say that's the overall approach and strategy that we take.

Jonathan Feeney

Okay, thank you.

Operator

Thank you. There are no further questions at this time.

I would like to pass the floor back over to Michele Buck for any closing comments.

Michele Buck

Thank you very much for your time today. We appreciate all the questions, and I know that many of you will have follow-ups with Melissa throughout the day. So, thanks.

Operator

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