The Hershey Company

Second 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 Second 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 July 29. 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.

Our business continued to excel in the second quarter with robust recovery in away-from-home consumption and international markets and sustained elevated at-home consumption. This strong consumer demand, coupled with our executional excellence, healthy balance sheet, and relentless focus on delivering against our strategic initiatives enabled us to support and expand our portfolio, invest in our people, and deliver strong shareholder returns during the second quarter. Net sales grew 16.5% in the second quarter, and adjusted EPS grew over 12%.

Our market share remains well above pre-COVID-19 levels, with our confectionery share 135 basis points higher, and our snacking share 200 basis points higher than the same period in 2019. We also added another fast growing, on-trend brand to the portfolio with the acquisition of Lily's. These great tasting, low sugar and premium priced products allow us to capture incremental consumers and occasions.

Our excellent business performance and financial strength also enabled us to increase capital expenditures supporting core brand capacity and IT infrastructure, pay down debt, buy back shares, and announce a 12% increase in our dividend.

While the environment remains volatile and post-COVID-19 trends are still evolving, we are confident in our ability to adapt with our consumers and retailers to meet their needs in the future and to continue to deliver advantaged financial results.

In the second quarter, we saw healthy one-year and two-year trends in our confection brands driven primarily by increases in chocolate consumption. Whether it's at-home or away-from-home, chocolate has provided consumers with comfort during stressful times and helped make time with family and friends even more special. NPD estimates chocolate per capita consumption increased 9% during the first year of the pandemic, and retail sales have remained elevated since that time.

As we enter the second half of the year and begin lapping our strongest performance from a year ago, we do expect sales growth to moderate. We will be closely monitoring consumer behavior to evaluate the sustainability of recent gains and implications to our performance in 2022 and beyond.

Let me share an update on some of the consumer trends we saw in the second quarter and our current expectations for the second half. I'll start with areas of sustained strength, brands, and occasions that are building on last year's gains.

Reese's retail sales grew over 10% during the latest 12 weeks, building upon last year's growth of 16% during the same period. This increase was across both core and innovation. Core velocities grew behind new packaging designs, higher levels of advertising, more effective media, and increased merchandising support including the return of NCAA events such as March Madness. Our Reese's innovation continues to be strong, leading with our instant consumable products, including the Reese's Pretzel and limited edition Peanut Butter Lovers items.

Over the past three years our Reese's brand solidified its leadership position in confection, becoming a $2.5 billion brand, growing at a CAGR of over 8%, and gaining 150 basis points of marketplace share. We have added three new manufacturing lines over the past four years and are adding another next year to further expand capacity and better service this strong growth. We expect continued strength in this franchise in the second half and beyond.

Our Twizzlers brand grew retail sales 2% in the second quarter, on top of 6% growth during the year-ago period. During COVID-19, consumers purchased more Twizzlers products to snack on during road trips, share with family members at home, and eat during screen time, which is the number one consumption occasion for this brand.

Last year, we not only added households, but also increased frequency and buy rate. To continue this momentum, the team took a holistic approach across all key levers including media, innovation, pricing, distribution, and merchandising. The team leveraged last year's strength to secure secondary placement this summer at key retailers to further bolster velocities.

Our mystery flavor limited edition drove 4.4 billion impressions and has had strong sell through. We partnered with Fandango to provide Twizzlers buyers a promotional code to watch a movie while enjoying their Twizzlers products, which also enabled us to partner with Universal Studios and highlight movie art on our merchandising units to bring even more consumer engagement in store. We expect growth to continue over the next several months despite difficult comparisons.

Within seasons, we saw high levels of consumer participation in the first half, and our second half seasonal sell-in has gone well. Consumers are excited to carry forward new traditions created last year and return to some old favorites. While the way consumers celebrate these occasions may continue to evolve, we know these rituals and memories made with family and friends remain incredibly important and our brands play a key role.

Halloween began shipping last month, and our retail teams have already created some fantastic displays to capitalize on the increased foot traffic we've seen in stores.

SkinnyPop has also continued to perform extremely well, with growth of over 25% over the last 12 weeks and share gains of 275 basis points within ready-to-eat popcorn. This is on top of growth of 5% during the same period last year, and has been driven by distribution gains on our multipack offerings and elevated base velocities from our increased media investment. Household penetration has increased 420 basis points since we purchased the brand, with gains coming in both at-home and on-the-go occasions, and we are excited to build on this momentum in the second half.

As I mentioned earlier, while at-home consumption remained higher than pre-COVID 19 levels in the second quarter, we also saw robust recovery in away-from-home consumption as we cycled the most severe decline in consumer mobility from last year. Net sales in our food service and specialty retail channels grew 40%, recovering most of last year's losses. Our chocolate instant consumables business grew 6% in measured channels, driven by increased trips to convenience stores. Recall that trends in these channels improved over the course of last year as consumer mobility increased; therefore, we do expect trends to moderate as we progress through the remainder of this year.

We also saw improvements within our refreshment business, with growth of over 25% in the last 12 weeks. While we are encouraged by the improvement in category sales, and our strong share gains of over 200 basis points in this period, the category remains below pre-COVID-19 levels as some consumers continue to work from home, wear masks, and practice social distancing. We expect trends to improve as we progress through the year but remain below pre-COVID-19 levels.

Our Pirate's Booty and ONE nutrition bar brands showed significant growth against challenged performance in Q2 of 2020. Pirate's Booty sales were impacted by the shift to remote schooling, and trends improved notably as we lapped last year's closures, and more students returned to the classroom. Retail sales grew approximately 25% in the last 12 weeks, resulting in a two-year share gain of over 20%.

ONE nutrition bars have also rebounded, with retail sales growth of 18% over the last 12 weeks, consistent with broader category trends. This more than offset last year's declines, with sales approximately 3% higher than Q2 of 2019.

Within our International and Other segment, we saw robust reported net sales growth of 70% in the second quarter against last year's second quarter declines of 38%, bringing two-year growth to approximately 6%. This sales growth, along with the changes we've made to our operating model in China, drove strong increases in segment profitability. While the teams have focused on managing COVID-19 volatility, they have also continued to drive progress against our strategies to increase brand awareness and distribution.

Let me share two great examples of this from the past quarter. The first is our I Love Reese's Day campaign, which was our first multi-country campaign and executed both in stores and online in Canada, the U.K., and Brazil. This activation provided messaging consistency and higher consumer reach within the same level of investment as a one-country campaign. The results were fantastic, driving double digit sales growth and tripling brand engagements.

Another great example was our HerShe campaign, which originated in Brazil and gained participation in all major markets this year. For the campaign, we changed the wrappers of our iconic Hershey's Milk Chocolate bars to feature important women who are making a difference and having a positive impact on our society. Hershey's bars became a canvas for the beautiful stories of unsung Sheroes and gave more voice and visibility to these deserving women. The campaign increased brand awareness by 300 basis points, and the teams plan to build on this year's success in 2022.

Finally, let me spend a few minutes on areas of the business that are below prior year levels, but significantly ahead of pre-COVID-19 levels.

Last summer we had a stellar S'mores season as consumers invested in their homes and spent more time together with close family and friends outside during the pandemic. Our teams did a fantastic job monitoring and responding to significant changes in consumer demand last year, and we are leveraging many of the same capabilities this year.

To date, sales for the season are slightly below last year but well-ahead of 2019 levels. As expected, increased mobility is having a slight negative impact. Additionally, high temperatures, particularly in the west, are also having a negative impact on performance. The teams are continuing to monitor trends and pivot both messaging and supply accordingly as these weather patterns evolve.

Sales for our baking products were down 18% in the latest 12 weeks, lapping 30% growth in the year-ago period. While we have seen some declines in at-home baking as consumer mobility has increased, sales for this part of our portfolio remain well-ahead of pre-COVID-19 levels. Sales for our cocoa, chip, and syrup products in the second quarter were approximately 10% higher than the same period in 2019.

We have also seen a shift back to in-store shopping over the past several months as consumer mobility improves. As a result, we did see a decline in our e-commerce sales during the quarter of approximately 30%, which was more than offset by growth in our brick-and-mortar channel as the teams did a fantastic job converting shoppers as they returned to stores. Despite the declines versus last year, e-commerce sales were still up significantly versus pre-COVID levels, with growth of over 100% versus the second quarter of 2019.

Our year-to-date growth in the channel is over 7%, and we continue to believe e-commerce will remain an important channel for consumers and retailers in the future.

While the U.S. has made tremendous progress recovering from COVID-19, the recent rise in cases in the U.S. and continued struggles in many International markets are a reminder that the world is not yet through the pandemic and business volatility and uncertainty is likely to persist. Change has become a constant, and our teams have shown tremendous adaptability at dealing with change and turning it into opportunity.

We will continue to invest in our people, our brands, and our capabilities, and we believe we have the right strategies to continue meeting our consumers' needs and delivering strong financial performance for years to come.

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

Steve Voskuil

Thanks, Michele, and good morning, everyone.

As Michele shared, second quarter results exceeded expectations, delivering a second consecutive quarter of double-digit net sales and adjusted earnings per share growth. Robust COVID-19 recovery, together with the continued strength of our take-home portfolio and retailer and distributor inventory replenishment, drove balanced top and bottom-line growth, despite cost pressures and incremental tax reserves in the quarter.

Strong delivery of our financial commitments was complemented by a balanced use of cash. In fact, in the quarter, we executed against every capital allocation lever, investing in future growth while providing returns to shareholders. With a consistent track record of delivering growth, profitability, and cash generation, we are confident in our ability to drive shareholder value creation now and into the future.

In the North America segment, reported net sales growth of 12.3% in the quarter was driven primarily by volume. Volume gains resulted from the dual-strength of away from home and at-home consumption, exceeding expectations, while retailer inventory replenishment contributed 130 basis points to growth, in line with expectations.

North America net sales growth outpaced U.S. Retail takeaway in the second quarter due to robust recovery of away-from-home consumption, U.S. retailer and distributor inventory replenishment, and strong performance in Canada.

As Michele shared, our Food Service and Specialty Retail businesses grew 40% in the second quarter, though both remain slightly below 2019 levels. In the second half of the year, we expect the growth in away-from-home consumption to moderate, as we lap improved mobility in the second half of 2020. As expected, Retail and Distributor inventory provided a tailwind in the first half of the year, as retailers and distributors carried elevated inventory across the store, though we do expect this to moderate in the second half as inventories return to more historical levels.

Canada also contributed nicely to net sales growth in the quarter. Canada's reported net sales were up double digits versus the year-ago period, and on a two-year basis. Similar to the U.S., Canada has benefited from strong at-home chocolate consumption and baking, as well as the recovery of away-from-home consumption. In the second half of the year, we expect net sales to continue to outpace U.S. retail takeaway, though to a lesser extent than the first half, driven by the continued recovery in non-measured channels.

In the International and Other segment, constant-currency net sales grew at 64.5% in the second quarter, and 14.9% on a two-year basis. Our International markets recovered ahead of our expectations, driven by volume in the quarter, complemented by net price realization.

Despite the rising case counts and lockdowns we saw in early April, stores largely remained open in the second quarter, minimizing business disruption. While some uncertainty related to COVID-19 remains in these markets, we are pleased with the teams' effort to manage both the recovery and our strategic growth imperatives.

We could not be more pleased with the exceptional start to the year with reported net sales growth of 14.4%, reported earnings per share growth of 29.8%, and adjusted earnings per share growth of 15.3% in the first half.

In the second half of the year, we expect net sales growth to moderate in each segment, and for the total Company.

In the North America segment, sales increases resulting from the continued away-from-home recovery, price realization, and the acquisition of Lily's are anticipated to be partially offset by declines in at-home chocolate consumption, retailer inventory depletion, and fewer shipping days.

In the International and Other segment, we expect COVID-19 recovery to continue though providing a smaller benefit as we lap improved mobility in the second half of last year.

Our strong volume gains in the second quarter, on top of our advantaged margin structure, allowed us to deliver a 16.4% increase in adjusted gross profit, while managing a challenging operating and inflationary environment.

Second quarter adjusted gross margin was flat versus the prior year at 46.4%, as higher fixed cost leverage in both segments offset higher supply chain costs due to both incremental demand and inflation in the North America segment.

In the North America segment, gross margin decreased 50 basis points to 47% in the second quarter. Higher volume in the second quarter drove an increase in supply chain costs including overtime at our manufacturing sites, higher volumes produced at contract manufacturing sites, freight and warehousing cost, higher labor costs, and packaging inflation. These pressures were partially offset by higher sales, productivity initiatives, and lower COVID-19 related costs versus the prior-year period.

In the second half of the year, we expect increased packaging and freight costs to continue. We also expect labor costs to remain elevated as higher levels of marketplace attrition contribute to more overtime and accelerated hiring to keep pace with demand. While we expect more price realization in the second half versus the first half, we also expect less sales volume benefits.

In the International and Other segment, gross margin was 41.4% in the second quarter, an increase of 850 basis points from the prior year, roughly in line with gross margin in 2019. Volume gains provided favorable fixed cost leverage in the second quarter, and we expect fixed cost leverage to continue to be a benefit in the second half of the year, though to a lesser extent, as sales growth moderates. Overall, full-year gross margin is expected to be slightly less than our previous estimates due to higher supply chain and labor costs to service demand in the North America segment.

In North America, advertising and related consumer marketing spend increased 8.4% in the second quarter. This was driven by a slight increase in advertising spend across our portfolio, including spend to support core chocolate innovation such as KIT KAT Thins, Zero Sugar and Organic, and snack brands, SkinnyPop and Pirate's Booty, along with reactivated sponsorship of NCAA March Madness and the Olympics.

In the International and Other segment, advertising and related consumer spending increased nearly 30% to support the COVID-19 related sales recovery we saw during the quarter.

Corporate expenses increased 38.2% in the second quarter driven by higher incentive compensation accruals and planned elevated capability investments and medical claims, against deflated 2020 levels due to COVID-19. The adjusted effective income tax rate was 27.4% in the second quarter, an increase of 8% or approximately $50 million versus the prior-year period. This rate increase was driven by incremental tax reserves incurred in connection with an adverse ruling on a non-U.S. tax litigation matter, as well as lower tax credits versus the year-ago period.

We now expect our full-year reported and adjusted effective tax rate to be in the range of 17% to 18%. Despite this tax headwind, Q2 adjusted EPS was $1.47 or 12.2% versus the prior year.

Strong sales performance and operating leverage drove strong cash flow in the quarter, enabling us to execute every lever of our capital allocation flywheel. Let's begin with the acquisition of Lily's. As Michele shared, we are excited to add this highly incremental, on-trend brand to our confection portfolio. The brand has net sales of roughly $100 million dollars with margins comparable to our recent acquisitions, and is expected it to be slightly accretive to earnings in year one.

Next, let's move to Capex. Total capital additions, including software, were approximately $113 million in the second quarter, and our full-year Capex outlook remains consistent with prior guidance at $550 million.

Our agile fulfilment center is on track to be operational in the fourth quarter, initially providing assortment bag capacity. We continue to invest in capacity across our portfolio to meet the demands of retailers and consumers with PAYDAY being brought online in Q4. Our ERP project is on track to be rolled out to our International markets next year, and the U.S. in 2023.

Now to dividends, share repurchases, and repayment of debt. In the second quarter, we paid $161 million in cash dividends, and as Michele shared, we announced a 12% increase in our dividends starting in September. This double-digit increase reinforces our commitment to return cash to our shareholders and to maintain a healthy payout ratio.

In addition to stock option replenishment, we deployed $150 million to repurchase shares related to our strategic buyback program. Approximately $110 million remain available under this repurchase program, and we received Board approval for an incremental $500 million repurchase program.

Finally, we repaid $350 million of bonds in May, with no additional long-term debt due until 2023.

I could not be more pleased with the position we are in as we approach the second half of the year. We have a strong outlook, balance sheet flexibility, and a plan to deliver an above algorithm year, while investing in our future.

With that, I'll turn it back to Michele for closing remarks.

Michele Buck

Thanks, Steve.

Before we close today, I want to take a moment to recognize our employees, especially our Manufacturing and Retail employees, whose passion and dedication to excellence and making snacks our consumers love is what enables us to deliver these results. They have shown amazing resilience and agility to not only deliver today but also develop and execute strategies to help ensure the Company's success for years to come. Thank you to all of our employees across the globe for your tremendous work.

Finally, as we shared on our last call, we published our 2020 Sustainability Report on June 1. This report not only highlights our sustainability strategies and progress against our goals, but also our commitment to transparency with incremental disclosures that we hope are helpful to all of our key stakeholders. We remain committed to advancing our strategies, progress, and disclosures in the years to come.

Thank you for your time this morning. 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.