The Hershey Company

Third Quarter 2020 Earnings Conference Call
(Prepared Remarks)

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CORPORATE PARTICIPANTS

Melissa Poole, *Vice President, Investor Relations*

Michele Buck, *Chairman of the Board, President, and Chief Executive Officer*

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

PRESENTATION

Melissa Poole

Good morning, everyone, and welcome to the Pre-Recorded Discussion of The Hershey Company's Third Quarter 2020 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 November 6. 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. We hope you, your colleagues, and your loved ones are continuing to stay safe and healthy.

We had a strong third quarter, with accelerated reported net sales growth of 4%, adjusted EPS growth of more than 15%, and confectionery share gains across markets, including an almost 190 basis point gain in the U.S. Our core U.S. business remains healthy, as consumers reach for small treats during the pandemic and they continue to celebrate important rituals in their lives. We also saw sequential improvement in the areas of our business hit hardest by COVID-19, including our International markets, owned retail locations, and food service business.

Our decision to lean into Halloween ahead of the season supported consumers' desires to find new and creative ways to celebrate safely. Our team, advantaged brands, capabilities, and execution enabled us to deliver Halloween net sales slightly above prior year and estimated category seasonal share gains of over 400 basis points.

We are continuing to focus on executing with excellence, investing in the business, and advancing our strategic priorities to deliver a strong fourth quarter and position us well for 2021. None of this would be possible without the hard work and commitment from our teams around the globe. I want to extend a sincere and heartfelt thank you to all of our employees for the care and the concern that they have for each other, for their agility in adapting to this environment, for their passion to make sure consumers can still have moments of Hershey goodness during these difficult times, and for operating safely, both in and out of work.

The COVID-19 pandemic has had a meaningful impact on the Company, from how we work, to the way consumers interact with our brands, to our relationships with customers, to the value that we are delivering to our shareholders.

We made two very important calls at the beginning of COVID-19 that shaped everything that followed. The first was to focus our organization on safely making and selling our products. The second was to play to win. We knew that taking quick action to help support the physical, emotional, and economic well-being of our employees would allow us to continue to safely operate our supply chain and sales organization. This was critical to keeping the engine running.

We quickly implemented new procedures around manufacturing personnel movement and enhanced flexible schedules for our retail team to improve safety and accommodate new needs from our customers. We enhanced cleaning protocols and PPE, partnered closely with local and federal governments, transitioned nearly all meetings to virtual, and asked corporate functions to work remotely.

While these steps added higher near-term costs and impacted productivity, they were an imperative for creating a safer work environment and ensuring that our business continued operating effectively as we pressed forward to support customers and consumers. These measures, along with other factors, have helped us maintain a global infection rate of less than 2% and a U.S. rate of less than 1%, despite having over 10,000 front line employees.

Additionally, our employee net promoter scores have increased significantly during the pandemic, which speaks to our strong culture and the passion, engagement, and commitment from our employees. While some of our competitors pulled back, we did the opposite because we knew we had the team, the brands, the financial strength, and the capabilities to lean in. We took action to capture share and enhance our customer relationships while continuing to provide consumers with the treats they wanted during this difficult time.

Within North America, COVID-19 has had a slight positive impact on overall consumer chocolate and sweets consumption despite significant shifts in where consumers are shopping, and what products they are buying. Hershey has been able to significantly outperform the category, with chocolate category share gains of 160 basis points and sweets share gains of 30 basis points since the pandemic began.

We have focused on the areas of our portfolio that are resonating most with consumers during the pandemic, such as S'mores, Candy Dish, and Twizzlers for movie night and road trips. Importantly, our best-in-class capabilities in sales, supply chain, and media, just to name a few, have enabled us to capture this incremental growth by quickly identifying trends, predicting demand spikes, ramping up production, adjusting media copy and targeting, and deploying our retail sales team.

A great example of this has been our S'mores activation. Early on, our category management teams identified that zip codes with high COVID-19 cases were seeing a 40% to 50% increase in demand for our Milk Chocolate bars. Consumers were looking for safe, fun ways to spend time together outdoors, and S'mores met that need. Our teams quickly created a model that combined actual and projected COVID-19 cases by zip code with store level traffic and sales trends. We were able to predict spikes in demand, adjust our manufacturing schedules, and proactively get the right amount of inventory into the right stores to capture this strong demand.

We adjusted our media copy to reflect the changes our consumers were experiencing, we elevated our e-commerce activation, and leveraged our retail sales teams to merchandise that inventory in store. This is a great example of how the breadth of our capabilities enabled us to quickly capitalize on consumer opportunities in a dynamic environment. We also leveraged these same capabilities as we planned for and executed our largest season, Halloween.

Our early decision to lead and drive this season was critical to shaping our customers' buying decisions. As always, we led with deep consumer insights, a strong portfolio, and a highly collaborative approach to help consumers find creative solutions to safely participate in their favorite season and drive category sales for our retailers. We surveyed our consumers weekly, and we leveraged real time media insights to identify additional early signals around sentiment, enhanced our public and private partnerships to promote safe Halloween guidelines, we created our Hershey Happiness Hub to be a central resource for inspiration and for ideas for celebrating Halloween, and we accelerated our omni-channel activation.

I can't say enough about the passion and energy our entire organization brought down to execute down the stretch. Our retail teams showed once again what an incredible competitive advantage they are, as they operated with safety protocols to build amazing displays and stock shelves. Our supply chain teams worked tirelessly, and our office employees volunteered in stores and at our plants to make sure consumers could still have the products they desired to celebrate the season.

As expected, we saw strength early in the season for at-home consumption as well as baking and crafts, and we saw lower participation in trick or treat in the final two weeks, but overall, the category showed resilience in a very volatile environment with COVID-19 case counts rising significantly across the country during the final week. While we saw differences across the country and by channel, many consumers found new and different ways to enjoy the season. From candy slides, to contactless trick or treat and individual bags, to candy graveyards and booing, everyone, including us, got more creative this year, and we believe many of these creative ways to celebrate will become a part of people's new traditions in the future.

Preliminary results indicate that confectionery category sales were down mid-single digits for the season, ahead of many other Halloween categories. As expected, we were able to leverage our brands, insights, and capabilities to outpace the category and grow sales slightly versus prior year, significantly expanding our share leadership. Both the category and our sell through was strong, and we believe we are well-positioned to keep the momentum going into the holiday season. Given the different nature of occasions at holiday, we expect less volatility for this season than we saw for Halloween. Our sell-in was solid, and product is on shelf and merchandised in many stores already. We expect our strong execution, great brands, and innovative new products will enable us to gain share of the holiday season.

In our non-measured channels, we saw trends continue to sequentially improve in the third quarter. Sales in movie theaters, vending machines, and specialty stores declined at half the rate that we saw in the second quarter. While we expect these channels to be volatile and slower to recover, we have been able to leverage our strength in traditional channels and ecommerce to convert many of these consumers as their shopping habits shift.

Our e-commerce business grew 80% in the third quarter. This deceleration versus Q2 was driven by a key retailer de-emphasizing ship-to-home chocolate during the hot summer months as they prioritized other high demand categories. Meltables began shipping again in October, and as a result, we expect Q4 growth to be stronger than Q3. Our click-and-collect and local store delivery growth has continued to perform very well, with growth of over 140% in the third quarter, and we expect continued strength to close the year. While the impact on overall chocolate and sweets category consumption has been slightly positive, COVID-19 has had a more material impact on the consumption of a few of our products including baking, refreshment, and nutrition bars.

Within our baking lineup, we have seen strong growth in our syrup, cocoa, and chips products as consumers spend more time cooking at home with their families. In measured channels, sales of our baking products have consistently grown 15% to 20% over the past several months. We are excited to build on this momentum in the key November and December months with strong omni-channel activation and in-store execution. This strong at-home consumption has more than offset declines in our food service baking business. Within refreshment, the category has experienced declines of 20% to 25% as the functional need for breath freshening has lessened as consumers spend more time at home and social distancing.

These trends have sustained for several months, and we expect them to continue until consumer mobility increases and social distancing declines. Hershey's results have been relatively in line with the category. Similarly, the nutrition bar category has declined as the need for on-the-go protein and meal replacement has reduced as consumers spend more time at home cooking. Despite difficult category pressures, ONE is performing well relative to the category, gaining 30 basis points of share this year. While we expect category trends to remain pressured, we are continuing to invest in the business and innovate.

Our Mini Bars and plant-based line are performing well and adding incremental distribution and households to the portfolio. Within salty snacks, we have not really seen a material impact in overall consumption despite large swings in where consumers are purchasing and eating. SkinnyPop and Pirate's Booty sales and share performance both accelerated in the third quarter as we added capacity and resolved some of the COVID-19 related disruptions within our co-manufacturing network. Per IRI, SkinnyPop retail sales grew 10% in the third quarter behind strength in both our ready-to-eat and microwave offerings.

During this same period, Pirate's Booty retail sales grew 8.3%. We expect to finish the year strong, ahead of both our operating and strategic plans for the year.

Within our International segment, category sales have declined as COVID-19 has had an impact on retail operations as well as consumer mobility and economic security. While drivers of category declined differed slightly by region, we saw improvement across markets in the third quarter versus the second quarter.

In China, the key chocolate occasion of gifting has continued to be pressured by fewer gatherings and social distancing. While trends have improved over the course of the year, we do expect category sales declines to persist in the fourth quarter. While results have been challenged, we are pleased with the improvement in sales trends this quarter versus the first half and our year-to-date share gains of approximately 40 basis points.

In India, significant government restrictions and GDP declines have impacted consumers' ability to purchase premium priced chocolates, resulting in category declines of approximately 20% this year.

While these challenges temporarily impacted our ability to launch our Hershey Kisses products nationally, our team made great progress in the third quarter securing new distribution. Year-to-date, we've gained approximately 50 basis points of chocolate marketplace share, and we hope to build on that momentum in 2021. Like the U.S., our baking portfolio has seen strong performance. This has more than offset chocolate category pressures and helped contribute to a net sales increase of 6% in the quarter, a meaningful improvement versus our second quarter results.

Finally, in Mexico, supply chain disruptions and retail closures, in addition to large GDP contractions, have resulted in category declines. While Hershey's net sales were down 36% for the quarter, we have consistently outperformed the chocolate category in modern trade channels this year, gaining 90 basis points of share.

While trends have improved slightly over the past several months, we expect this market to remain challenged in the fourth quarter due to both COVID-19 as well as the implementation of new packaging requirements. As market conditions continue to evolve around the world, we will continue to evaluate our business operations and make any necessary adjustments to help ensure we have the right strategies to make International a growing and profitable contributor to our Company's performance.

In summary, we expect to deliver adjusted earnings in the top half of our original guidance for the year. While there was an approximate two-point negative impact on sales driven by COVID-19 challenges within our International and Other segment, we were able to mitigate these pressures with strength in our North American segment, prudent cost management, and commodity favorability.

Our core U.S. business is pacing ahead of plan expectations driven by increased at-home consumption, as well as strong instant consumable pricing conversion and innovation. Importantly, we have continued to advance work on the largest priorities we believe are most critical to achieving our long-term strategies and delivering top quarter financial performance in the future. By executing with excellence today, and remaining focused on the future, we believe we are well-positioned to drive advantaged performance and shareholder returns in the coming years.

Now, let me turn it over to Steve to provide some more details of our financial results.

Steve Voskuil

Thank you, Michele, and good morning, everyone.

To start, I want to also express how proud I am of the way Hershey has performed in this unprecedented operating environment.

Our third quarter results are a true testament to our team's ability to adapt and execute during a period of volatility. In the third quarter, we delivered solid top-line growth of 4% from a balance of core brand strength, price realization, and improving results in business areas highly impacted by COVID-19. This strong sales performance, in addition to our relentless cost management and agile decision-making, drove double-digit EPS growth in the quarter. Just as important as our current results is the momentum we have entering the fourth quarter.

As Michele mentioned, our North America segment had a strong quarter with organic, constant currency sales growth of 5.5%. Price realization contributed 3.3 points of benefit to the quarter driven by our July 2019 price increase. We will begin to fully lap this price increase in the fourth quarter, and therefore, expect pricing benefits of approximately 50 basis points versus year ago.

We remain committed to our current pricing strategy of smaller, more frequent price increases, and it will remain one of many levers we deploy to grow our business over the long-term. Volume contributed 2.2

points of growth in the third quarter, as inventory replenishment and strength within our core chocolate and baking products more than offset softness in our non-measured channels. Inventory replenishment contributed approximately 1.5 points of growth in the quarter, and we expect a similar benefit in the fourth quarter.

Last quarter we shared that foodservice, specialty retail, and refreshment in the North America segment were particularly challenged as a result of COVID-19. While these businesses remained negatively impacted, we saw incremental improvements in each, from down 40% in the second quarter to down roughly 20% in the third quarter. We expect our third quarter trends to sustain until social distancing subsides and consumer mobility begins to recover.

As Michele shared with you, COVID-19 has impacted where and how consumers are enjoying confection but has had minimal impact on overall consumption in North America. The mid-single digit growth that the North America segment achieved in the third quarter was due to our significant outperformance in the category.

As we look ahead to the fourth quarter, we expect a similar level of organic net sales growth, as we benefit from continued strength in our core brands, share gains, net price realization, and replenishment of retail and distributor inventory levels.

As a reminder, we will begin to lap the acquisition of ONE Brands beginning in October, so this will minimize the net acquisitions and divestures benefit in the fourth quarter.

Gross margin for the North America segment expanded 100 basic points to 46.3% for the third quarter driven by strong price realization, which more than offset increased warehouse cost from elevated demand and unfavorable commodities. North America advertising and related consumer marketing spend decreased 3.1% in the third quarter driven by media cost efficiencies and optimized brand investment related to COVID-19. As we shared in July, we began to selectively reinvest these savings into brands, occasions, and channels that align with consumer behavior and trends amidst the pandemic.

Looking to the fourth quarter, we expect advertising spend to grow in line with sales as we continue to increase our marketing investment to sustain the topline momentum achieved in the third quarter. In our International and Other segment, organic, constant currency net sales declined 9.3% in the third quarter versus prior year, due to softness in our owned Chocolate World retail locations and large declines in air travel. While owned retail locations reopened during the quarter, foot traffic remained suppressed given reduced consumer travel and capacity restrictions imposed by government regulations. Michele shared a detailed update on each of our International markets.

Overall, we are pleased with the incremental improvement reported in the third quarter. Combined constant currency net sales in Mexico, Brazil, India, and China declined 2.3% versus the third quarter in 2019, compared to a decline of 31.8% in the second quarter. Consistent with the second quarter, we continue to take a disciplined approach to cost management to minimize the profit lost from volume declines in the segment.

Optimization in advertising and related consumer marketing spend, along with savings in travel, resulted in an additional $8.5 million of savings in the quarter. The segment reported operating income of $24 million for third quarter, a decline of $15 million versus the third quarter of 2019. We estimate COVID-19 will negatively impact full year sales by approximately two points, driven by our International and Other segment.

The business areas within this segment are vast and varied, but overall have been more volatile and slower to recover from the pandemic.

Furthermore, sales volume is typically higher in the second half of the year for this segment given increased traffic in our owned retail location in the third quarter and purchases related to Chinese New Year in the fourth quarter. Both of these trip drivers have been severely impacted by COVID-19.

With that in mind, we do not expect a material change in trends in the fourth quarter versus what we saw in the third quarter. Despite COVID-19 headwinds, we remain committed to the importance of our International and Other segment to our overall business, and to our long-term growth algorithm.

Third quarter adjusted operating profit of $543.3 million resulted in an adjusted operating profit margin of 24.5%, an increase of 220 basis points versus the third quarter of 2019. Gross margin gains, along with efficiencies in marketing and general and administrative expenses, drove operating profit expansion in the quarter.

As we look forward to the fourth quarter, we expect modest gross margin gains as we begin to lap the pricing action from July 2019. Consistent with our previous commentary, we anticipate fourth quarter incentive compensation to be favorable versus the prior year. However, given the strength in our U.S. business this year, we now expect incentive compensation to be a $20 million tailwind versus the $30-$40 million tailwind we shared earlier. The adjusted tax rate for the third quarter was 21.5%, an increase of 140 basis points versus the year-ago period. This increase was primarily driven by lower excess tax benefits from stock-based compensation.

Third quarter other expense was $12 million, a decrease of $6 million versus the prior year due to higher non-service-related pension expense in the year-ago period. We do not expect any material changes to the full-year tax or Other Expense outlook provided in January, but recall we estimated a significant increase to other expense resulting from additional tax credits in 2020. The full year adjusted tax rate is estimated at 16% to 17%, and Other Expense is estimated at $100 million to $110 million.

We are resuming guidance for Fiscal Year 2020 given our visibility into seasonal and promotional orders for the balance of the year. We expect full year net sales growth of around 1%, and adjusted earnings per share growth of 7% to 8%, the high end of our original plan guidance at the beginning of 2020. We remain committed to our capital allocation priorities, reinvestment for growth, dividends, and share repurchases. Let's briefly talk about each in turn, beginning with reinvestment.

In the third quarter, total capital additions, including software, were approximately $106 million, with year-to-date investment of $292 million.

In the fourth quarter, we have significant spend planned for several projects related to our supply chain initiative including expansion of capacity at Stuart's Draft, Virginia, and construction of our new fulfillment center in Annville, Pennsylvania, both projects announced earlier this year.

Additionally, we have a new project we would like to share with you today, which is the construction of a distribution center in Canada. While we currently have a shared Canadian site, we have outgrown this space, and believe our strength and projected growth in this market warrants a larger, more innovative distribution center. For the full year, we expect capital expenditures to be between $400 million and $450 million, consistent with our prior guidance. Overall costs for these projects remain in line with original estimates, therefore we expect 2021 and 2022 Capex to remain elevated as we complete these strategic programs. We look forward to sharing further details with you on our fourth quarter earnings call.

Now, to dividends and share repurchases. Over the past 90 years, we have remained steadfast in our commitment to return cash to our shareholders by consistently paying quarterly dividends. Despite a global pandemic, our strong financial profile and adaptive operating model has enabled us to continue to return cash to shareholders this year. In the third quarter, we paid $164 million in cash dividends reflecting the 4% increase communicated in July.

During the third quarter, we did not complete any repurchases related to stock option replenishment, nor did we repurchase any shares against the $500 million authorization. Approximately $260 million remain available under this repurchase program. As a result, we are in a strong cash position exiting the year, with balance sheet flexibility to continue investing in our business, pay our dividend, and advance our M&A agenda.

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

Michele Buck

Thanks, Steve.

While we have experienced a lot of change this year, we have embraced the opportunity it has presented to re-think what's possible, to be even more creative, and to bring out the best in each other. The strength and resiliency of our category and our brands, along with our incredible talent, makes us excited about what lies ahead.

Thank you so much 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.