The Hershey Company

Second Quarter 2022 Earnings Results
Prepared Remarks

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CORPORATE PARTICIPANTS

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Michele Buck, *Chief Executive Officer and Chairman*

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 2022 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 April 28. 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 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 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 momentum continued in the second quarter, with reported net sales growth of 19% and adjusted EPS growth of 22%. These results reflect the strength and resilience of our categories, consumers' love for our brands, the investments we are making in our business, and the excellent execution of our dedicated employees.

I want to take a minute to thank our teams across the globe for their resilience, hard work, and unwavering commitment to meeting the needs of all of our stakeholders each and every day.

Second quarter growth was broad-based, with each segment delivering double digit sales growth, resulting in strong earnings per share. Organic net sales growth of 14% was driven by both price and volume gains while acquisitions contributed another 5 points of growth. Despite persistent, broad-based supply chain disruptions, our teams were able to increase production output and inventory levels during the quarter. This not only bolstered sales growth, but also drove improvements in marketplace share performance and will enable us to more fully activate our portfolio in the second half of the year.

As a result of these incremental second half investments, our strong second quarter performance, and other strategies we are implementing to respond to marketplace changes, we are raising our full year net sales and earnings per share outlook.

We continue to closely monitor consumer behavior and the impact high inflation is having on shopping and purchasing patterns. Over the past several months, we have seen many consumers begin to cut back on discretionary spending including eating out less at restaurants.

As consumers spend more time and consume more at home, grocery purchases have remained strong. This is particularly true for snacks and confection products, which are experiencing less pricing elasticity and minimal impact from private label. Private label holds a 2% share of confection and a 9% share of snacks versus a 19% share of overall food. While overall private label share of food improved 70 to 80 basis points during the second quarter, it declined 30 to 40 basis points on average in confection and other snacking categories.

In the first half of the year, we saw minimal price elasticity across our portfolio, though we did see more of an impact in Q2 than in Q1. Given this and broader macroeconomic trends and changes in consumer spending, we continue to expect more elasticity in the second half of the year than what we have experienced year to date.

Given incremental cost pressures we have faced this year and our inflation outlook for next year, we are working closely with our retail partners to implement our announced pricing actions in the coming months to cover inflation and continue investing in our brands, our people, and our supply chains to drive future category growth. We recognize inflation is pressuring many Americans, and we remain committed to making sure our products remain an affordable treat. We expect approximately 20% of our products to continue to retail at $2 or less, and we will continue to bring innovative offerings at a wide range of price points to meet the needs of our consumers.

As we shared earlier this year, we have made significant investments in our supply chain to increase production and improve our inventory levels. While we continue to have areas of opportunity, we have made progress. Everyday, retail inventory levels are approximately 10% higher than the same time last year and 35% higher than the beginning of the year. Prioritizing and improving everyday on-shelf availability is critical to enable us to increase advertising and merchandising levels to drive category growth and improve our competitiveness at retail.

Over the past month, our chocolate category share has increased over 70 basis points versus prior year, resulting in a 3-year gain of over 100 basis points. While S'mores got off to a slower start with the longer Easter and select retail execution issues over Memorial Day, we are pleased by the trends we have seen in June and July. Sales for Hershey Milk six packs have increased approximately 11% over the past 4 weeks, and season to date sales remain 20% higher than pre-pandemic levels. We have additional advertising and merchandising planned to close out the summer season strong.

Jolly Rancher Gummies continues to perform exceptionally well, growing over 60% in the past 12 weeks. Growth is driven by velocity gains as well as our new Very Berry item. And despite our supply constraints on Reese, the teams did a fantastic job optimizing our capacity and merchandising to deliver 6% retail sales growth and 10 basis points of category share gains over the last 12 weeks.

While our chocolate, non-chocolate, and gum businesses are all performing well, our Ice Breaker Mint business is performing below expectations. Category demand was significantly impacted by lower mobility during COVID-19. As trends began to improve, and the labor market became increasingly difficult, we struggled to efficiently ramp up production back to our historical levels. We have taken a lot of action to address these issues, including deploying manufacturing expertise and lean teams to the plant, and streamlining the portfolio to reduce complexity and increase output. We are seeing improvement every week, and this will remain a key focus area for our supply chain teams until our production and service levels are optimized.

As we look to the second half, we expect our higher inventory levels and increased advertising and merchandising to drive strong everyday sales and share performance. Chocolate media spending is projected to grow double digits in the second half, and quality merchandising is also expected to increase.

Seasonal consumer engagement is expected to remain high, and we expect high single digit sales growth for both our Halloween and Holiday seasons. Despite this strong growth, we will not be able to fully meet consumer demand due to capacity constraints.

Given many of our everyday and seasonal products are made on the same line, we have needed to balance production over the past several months to improve everyday on-shelf availability and build seasonal inventory at the same time. While this will likely result in second half seasonal share pressures, we expect our everyday share trends to remain strong behind higher inventory levels and more advertising and merchandising. As we head into next year with healthier inventory levels and more capacity, we believe we will be well positioned to meet consumer demand across our everyday and seasonal portfolios.

Our salty snacks brands continue to deliver tremendous growth and share gains. Over the past 12 weeks, SkinnyPop retail sales grew 17% and share of the ready to eat popcorn segment increased 130 basis points to 24%. Growth is led by higher household penetration and stable buy rates as new pack sizes have enabled us to capture incremental occasions. Pirate's Booty also continues to gain households via distribution gains, while velocities remain strong resulting in 32% retail sales growth in the latest 12-week period. And Dot's Pretzels growth continues to significantly outpace the pretzel category, with 45% retail sales growth and 340 basis points of share gains over the past three months.

To support this sustained, elevated growth, we continue to advance our strategic planning to optimize our salty snacks supply chain for additional capacity and margin efficiencies. We will share more about this work later this year.

Finally, let me share some highlights from our international segment. In the second quarter, net sales growth of 21% was driven by balanced price and volume gains. Consumer demand has remained strong across markets, with distribution and innovation driving double digit growth in each market during the quarter. In India, velocities on our iconic Kisses brand are achieving our targets. We continue to expand our Visi-cooler footprint, enabling chocolate sales in higher temperature conditions, and we've doubled total distribution level since 2021.

In Mexico, better-for-you innovation and continued distribution expansion in traditional trade helped bolster growth in the second quarter. Our new dark and zero sugar products, along with a smaller instant consumable offering, are performing well and driving category share gains. This year, I Love Reese's became a truly global holistic campaign celebrating the love for the brand among enthusiasts and peanut butter lovers in more than seven global markets and activating it across different platforms. For the first time in years, sampling is back, and consumers were excited to connect face to face with the brand they love and enjoy a Reese's cup. The campaign exceeded all of our benchmarks, and we look forward to making it even bigger next year.

During a time of persistent disruption and volatility, our teams continue to respond with agility and execute well against factors within our control. We are balancing delivering today and making investments to position us for future success. I continue to believe our unique culture of togetherness, acting with integrity, making a difference in our business and in our communities, and executing with excellence is a differentiator for us in the marketplace.

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

Steve Voskuil

Thank you, Michele, and good morning, everyone.

I want to build on Michele's comments and convey how proud I am of our team's ability to continue to navigate a dynamic operating environment to deliver another quarter of differentiated net sales and earnings growth and strong operating cash flow. Like most companies, we are being impacted by broad-based cost inflation, supply chain disruptions, and changes in consumer behavior resulting from the current macroeconomic landscape. But our advantaged business model, consumer-led strategies, and dedicated, high-performing teams have allowed us to execute well and increase our full-year financial outlook.

In the second quarter, we delivered reported net sales growth of 19.3%. Organic, constant currency net sales growth was 14.1%, driven by both price and volume gains. Net price realization contributed 9.5 points of growth, driven by mid to high single-digit list price increases across all segments. We also benefitted from 2.5 points of price, driven by lower levels of promotional activity, as we navigated capacity constraints and prioritized everyday inventory replenishment.

Volume drove an additional 4.6 points of benefit, ahead of expectations, driven by favorable price elasticities across segments and accelerated replenishment of distributor inventory levels. Inventory replenishment was approximately a 6 point benefit in the quarter within the North America Confectionery segment. While we continue to have opportunities to improve on-shelf availability for key products, we are pleased with the progress we have made and do not expect material inventory contributions in the second half.

As Michele shared, we are increasing our full-year net sales outlook by two points versus the prior outlook, to approximately 12% to 14%, reflecting strength in both volume and price. The impact of pricing is now expected to be similar across the first and second half of the year, with second half price realization skewing slightly to the fourth quarter. We continue to expect volume elasticities to moderate in the second half versus our experience to date but remain better than historical levels. This, combined with the absence of the first half inventory replenishment tailwind, is expected to result in lower volumes in the second half of the year.

Now, turning to profitability. Second quarter adjusted gross margin was 43.9%, a decrease of 250 basis points versus the prior year. As expected, broad-based supply chain inflation and labor investments persisted, along with unfavorable mix driven by recent acquisitions. These pressures were partially offset by accelerating net price realization.

For the full year, we expect gross profit to increase approximately 2% versus our prior expectations, driven by higher sales growth, while gross margin is expected to decline approximately 120 to 140 basis points. While we expect an incremental benefit from higher pricing, we are also anticipating higher supply chain costs related to dairy inflation as well as ingredient scarcity and substitution costs as we leverage different ingredients and suppliers to service production. Additionally, higher supply chain costs related to distribution network expansion, particularly in the North America salty snacks segment, and higher co-manufacturing and co-packaging costs versus our prior expectations will continue to pressure margins for the year.

Advertising and related consumer marketing expenses increased 3.2% in the quarter versus the prior year. Moderate advertising increases across supportable brands and segments was largely offset by cost efficiencies related to new media partners. Adjusted operating expenses, excluding advertising spend, increased 11% in the second quarter. Higher operating expenses and amortization costs related to Lily's, Dot's, and Pretzels accounted for approximately 35% of this increase.

Additionally, we continue to invest differentially in enterprise capabilities and technologies, such as ERP and integrated demand planning, as well as partnering with our retailers to shape the future of the category to drive sustained, long-term growth. This, combined with salary and benefit inflation and higher travel and meeting expenses as pandemic restrictions eased, drove increases in the quarter.

As we look to the second half of the year, we expect our improved inventory and on-shelf availability to enable us to increase brand investment. We now expect full-year advertising spend to increase low-single-digits versus prior year, with a greater increase in consumer impressions, as new media partners and tools allow us to increase efficiency and effectiveness. Corporate expenses are also expected to increase slightly versus the prior outlook driven by higher accruals for incentive compensation and higher capability and technology investments.

Moving to earnings, strong sales growth drove adjusted EPS growth of 22.4% in the quarter. To reflect this strength in Q2 performance and expectations for the second half of the year, we are raising our full year adjusted earnings per share growth by 2 points to 12% to 14% versus prior year.

As we shared earlier this year, our capital allocation remains focused on core confection capacity, snacking scale and optimization, and supply chain resiliency. Total capital additions, including software, were approximately $100 million in the second quarter. Certain capital projects have experienced delays related to broader supply chain challenges, resulting in some shifts in capacity now coming online in 2024 versus 2023. These delays are anticipated to be temporary, and we expect capital project spending to accelerate in the second half of the year. We continue to expect spending of about $600 million for the full year.

Now, turning to net operating cash flow and capital return. We delivered operating cash flow of $457 million in the second quarter, and over $1 billion in the first half of the year, driven by strong operating results. We also returned $180 million to shareholders in terms of cash dividends, totaling over $360 million year-to-date.

Earlier today, we announced a 15% increase in our dividend starting in September. This increase reflects our commitment to maintaining a healthy dividend payout ratio and delivering strong returns for shareholders over the long term. We also completed $151.9 million of share repurchase related to stock option replenishment in the quarter.

Before we wrap up this morning, let me share some high-level perspectives on how our current actions impact 2023. As we've shared, incremental pricing actions across the portfolio were announced throughout the second quarter tied to inflation, which will primarily impact 2023 due to the timing lag and the seasonality of our business. These actions were informed by the step-up in cost pressures we are seeing across our commodity basket, packaging, and logistics and the need to continue to invest in our brands, our people, and our supply chain to support future growth.

As we look ahead, we expect price to be a large contributor to overall growth in 2023 and provide a tailwind to gross margin which will largely be offset by high-single-digit cost inflation. In addition, productivity improvements remain a critical lever to address rising costs, and we anticipate these initiatives to provide a tailwind in 2023.

To support price elasticities and drive consumer demand, we also plan to increase brand investment faster than our sales growth 2023. Given the continued volatile environment, we expect this outlook to continue to evolve as we get closer to 2023.

I could not be more pleased with the position we are in as we approach the second half of the year. I am confident in our ability to deliver another year of advantaged financial results, while investing in our future, which we expect to drive peer-leading shareholder returns.

With that, I will turn it back to Michele.

Michele Buck

Thanks, Steve.

Before we close today, I wanted to share a few highlights from our recently released 2021 ESG report. Our latest report reflects the evolution of our sustainability journey building on past efforts and initiatives to make a positive impact in our communities and the broader world. ESG is becoming integrated into the fabric of our Company with engagement and ownership from our board of directors to the operational business owners. These initiatives will help us deliver long-term sustainable growth and underpin our purpose so that consumers can feel proud about the moments of goodness they experience with our beloved brands.

In 2021, we made great progress in sourcing visibility, reducing greenhouse gas emission, and increasing our diversity equity and inclusion efforts. We are on track to achieve our goals in these important areas, and further increase transparency about our progress in the latest report. For more information, please go to the sustainability section of our website.

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.