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The Hershey Company

First Quarter 2021 Earnings Conference Call

April 29, 2021

CORPORATE PARTICIPANTS

Melissa Poole, *Vice President, Investor Relations*

Michele Buck, *Chairman, 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 First 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 April 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 first quarter results were outstanding, with broad-based growth across the portfolio leading to double-digit sales and earnings growth. We entered the year with strong plans to deliver accelerated top and bottom-line growth with balanced activation of our brands through advertising, innovation, distribution, and pricing. We are delivering against these plans, and at the same time, external conditions have been more favorable than we anticipated. Our strategies, capabilities, and agility have enabled us to respond to these rapidly changing trends and capture incremental growth for the year.

As COVID-19 vaccines roll out across the globe, consumers are more optimistic about the future and looking forward to spending more time with their family, friends, and community. As we have seen over our 127-year history, our brands play an important role in these special moments of connection, comfort, and happiness.

Over the past few months, families continued to embrace the at-home lifestyle and our brands were part of many game and movie nights, seasonal celebrations, and baking creations. At the same time, consumer mobility is improving in the U.S., and our away-from-home businesses performed better than expected. Despite challenging COVID conditions across the globe, sales in our international markets exceeded expectations.

Our teams have done a fantastic job responding to these trends in a volatile operating environment. Without their passion, agility, and dedication to making more moments of goodness for our consumers, none of this would be possible. Thank you to our employees across the globe for their countless contributions to these results.

In the first quarter we delivered net sales growth of 12.7% and adjusted earnings per share growth of 17.8%. We expected a strong start to the year behind continued elevated take home chocolate and seasonal sales, category share gains, and inventory replenishment. We were able to exceed these high expectations by converting more shoppers as trips increased during the quarter and capitalizing on the competitive environment to capture incremental merchandising and distribution opportunities. This resulted in year-to-date total U.S. retail takeaway of 7.1% through April 18 and U.S. confectionery share gains of nearly 80 basis points.

While some of these trends are planned to moderate as the year progresses, we expect to deliver sales and earnings growth above our long-term algorithm for the full year. Importantly, we are taking strategic actions and investing in the business to drive long-term value from the opportunities we are capturing today.

We believe balanced growth and business reinvestment in our brands and capabilities are critical for delivering sustainable, advantaged financial results. Our strategies and investments over the past several years positioned us well to capitalize on COVID-19 tailwinds and execute with agility in a volatile operating environment.

In the first quarter, all key pillars of our strategy contributed to our performance. We delivered growth in both our everyday and seasonal products, in measured channels and non-measured channels, confection and snacking products, and North America and International markets. We grew volume and price, across both our core products and innovation, and through base velocity and distribution gains.

As we enter the recovery phase of COVID, we know the journey will not be linear. We are closely monitoring consumer trends and pivoting quickly to adjust as the environment changes.

We expect certain pre-pandemic behaviors to rebound, including in-person schooling, restaurant dining and in-store shopping. As those levels rebound, we will focus on our confection and better-for-you snack packs, food service business, single-serve products, and non-traditional channel distribution opportunities. We saw a significant improvement in our sales in these channels in the first quarter. Our food service and specialty retail business grew high-single digits in the first quarter of 2021 after declining high single digits in the fourth quarter of 2020. Sales in our retail store and world travel retail locations also improved notably, with low single digit growth in Q1 4.5% versus 50% declined in the fourth quarter of 2020.

Importantly, while these businesses rebounded, we saw continued strength in our core portfolio in traditional channels. While we don't expect trends to permanently stay this elevated in both at-home and away-from-home channels, our teams are capitalizing on this unique window of dual strength as consumer behaviors change during the COVID recovery.

Consumers tell us that they value some of the new traditions that they've created this past year, and they intend to continue them in the future even when the pandemic ends. This is particularly true for occasions spent connecting with loved ones, and this represents a wonderful opportunity for our brands.

To share some examples, 43% of parents are having more movie nights this year compared to last, and 36% claim that they will increase movie nights in the coming months. While we had a record S'mores season last year, 14% of households who did not make S'mores last year plan to do so this year, and those who did make S'mores last year are excited to make more this year as they re-connect with close friends, families, and neighbors.

Another area where we have seen increased participation and new traditions is in seasons. Consumer participation in Valentines and Seasons was strong and ahead of expectations. Consumers have settled into their pandemic holiday routines, and they are finding ways to create special moments for their families at home.

At Easter, this included candy dishes filled with chocolate eggs, Easter baskets filled with bunnies, and treats to fill eggs for hunts. While backyard egg hunts became a COVID necessity as community hunts were canceled, many consumers indicate that they plan to continue backyard hunts in the years to come as their kids seem to enjoy them more.

A significant amount of candy continues to be purchased in store; however, a sizable number of consumers did purchase their seasonal and everyday candy online in the first quarter. E-Commerce represented approximately 15% of confection trips in the first quarter, an increase of approximately 60% versus the same period last year. Our team was prepared with strong omni-channel activation and cross category promotion to inspire consumers as they got ready for the season.

While this year was a shorter season, the category grew 9.5% versus 2020. Hershey grew 9.7% resulting in a share gain of 11 basis points. Given 2020 was impacted by the onset of COVID-19, the two-year trend is perhaps more telling. Despite 2021 being a two-week shorter season than 2019, category sales were down approximately 3.5% versus 2019. This is above historical declines of approximately 10% during a two-week shorter season, and it's a testament to the importance of seasons and confection's role in consumers' traditions during these holidays.

Hershey's results for that two-year period were slightly up, resulting in a category share gain of almost 170 basis points. Our sell through was stronger than anticipated this year, partially driven by elevated foot traffic and robust retail spending as vaccinations paced ahead of expectations and stimulus checks were issued. These great results will set us up for a fast start on our summer activations and position us well for a strong sell-in for 2022.

As we head into summer, we are excited about the plans we have in place. We will continue to support our brands with strong media, and we have great merchandising lined up to support summer S'mores, Twizzlers, and our Olympic sponsorship.

Our innovation is on track, and many of our take home items, including Kit Kat Thins and our Zero Sugar items, are hitting shelves now. In addition, our category management teams have been able to capitalize on our strong performance and the competitive environment to secure incremental distribution during planogram changes. In Q1 alone, our teams gained approximately five new everyday items through front end strategies like queuing and take-home aisle space optimization. We expect this strength to continue as we progress through the year.

Finally, let me share an update on our confection pricing strategy. Earlier this year, we announced changes to our seasonal pricing that go into effect with our Holiday products this year. Two weeks ago, we communicated additional pricing changes to our retailers. This most recent change primarily affects our non-chocolate and grocery products, which had not been priced since 2014. These actions are consistent with our previously stated pricing strategy, one that we believe plays an important role in enabling business investment and driving profitable category growth. Steve will share some additional details as it relates to the impact on our financial outlook.

Now, let me shift gears and provide an update on our snacking and grocery products. Our Amplify business is off to a great start, with retail sales growth of 9% for the year-to-date period ending April 18. This strength was driven by SkinnyPop, which grew 14.6% and gained 180 basis points of share in the ready to eat popcorn category. While we expect growth to moderate as laps become more difficult, we do expect to grow and gain share in the coming quarters behind strong media support, distribution gains, and incremental merchandising.

Pirate's Booty declined in Q1, as multi-pack sales were pressured by virtual school and key promotional activity was shifted to Q2. We expect trends to improve as more students return to in-person schooling and promotional activity increases in the second quarter.

The ONE business continued to be impacted by reduced consumer mobility in the first quarter, but trends subsequently improved and have turned positive over the past several weeks. We expect category and ONE trends to continue to improve as the year progresses.

Finally, let me spend a few minutes on our International and Other segment before turning it over to Steve. Net sales grew 11.2% with strong results across markets.

In Mexico, chocolate category sales remained pressured, but we did see improvement in the traditional trade in Q1 as consumer mobility increased. We were able to take advantage of incremental capacity to capitalize on this improvement and deliver net sales relatively in line with the prior year despite continued COVID-19 challenges. A big thank you to the teams who were able to bring this capacity online ahead of plan to be able to capture this demand.

Similarly, in India we saw mobility improve ahead of expectations in the first quarter driving better than anticipated results across our portfolio. Our chocolate distribution expansion initiatives resumed late last year, and they remain on track.

In Brazil, our performance accelerated in the first quarter as the chocolate category gained incremental merchandising opportunities due to the cancellation of Carnival this year, and in China, our transition to the new distributor go to market model is going well and remains on track.

As many of you know, the state of COVID-19 across the globe is different from what we are seeing in the U.S., and the environment remains uncertain and volatile. Recently, we have seen new lockdowns implemented across the globe as variants spread and cases rise. During the past year, we have seen these strategies to limit mobility have a negative impact on confectionery category sales. However, despite these challenges, we believe we can grow both sales and profitability in our International markets this year.

Now, let me turn it over to Steve to provide more details on our Q1 financial results and full year outlook.

Steve Voskuil

Thank you, Michele, and good morning, everyone.

As Michele shared, our first quarter results were exceptional, well-exceeding our expectations by delivering double-digit sales and adjusted earnings growth. Strength in our core confection and seasonal products, complemented by the accelerated recovery of our COVID-19 impacted businesses, drove significant net sales and operating income growth, despite higher input costs and capability investments.

These results showcase our focus on balanced and profitable growth, providing the financial flexibility to meet current business needs, invest for the future, and return cash to our shareholders. While the environment remains highly volatile due to the pandemic, we see incremental opportunities based on our first quarter performance and growth momentum that is reflected in our increased outlook.

The North America segment continued to show momentum with reported net sales growth of 12.8%. As expected, we saw strength in our take-home chocolate portfolio, in addition to solid seasonal performance for Valentine's Day and Easter, which drove category share gains in the quarter. We also benefitted from inventory replenishment, which was relatively in line with expectations, and two additional selling days in the quarter.

Accelerated orders for some of our key summer programs drove incremental shipments for the quarter given our strong Easter sell through. Additionally, the teams captured incremental distribution and merchandising opportunities that further contributed to our outperformance in Q1. We do see additional distribution and merchandising opportunity in the coming quarters, particularly the second quarter, which is reflected in our raised full-year outlook.

Despite elevated COVID case counts throughout much of the quarter, mobility increased ahead of our expectations as consumers anticipated the distribution of the vaccine, and discretionary income increased with the receipt of two rounds of stimulus checks in January and March. As Michele shared, this created a unique window of dual-strength as both our at-home and away-from-home businesses benefited in the quarter.

Our away-from-home businesses including food service and specialty had a strong quarter, growing high-single digits versus the prior year period. While away-from-home businesses improved, we also saw continued strength in chocolate take-home and seasonal products, growing 9.9% year-to-date. As the year progresses, we expect our away-from-home business to continue to rebound and our at-home business to moderate as we start to lap higher growth and share gains in the second half of the year.

This benefit was compounded as base volume gains and channel mix generated trade favorability and net price realization of approximately 130 basis points in the first quarter. Additionally, we generated approximately 40 basis points of price realization from list price increases, in line with expectations. On a full-year basis, we now expect net price realization of 1 to 1.5 points, reflecting modest trade favorability largely realized in the first quarter, along with the pricing on our seasonal, non-chocolate, and grocery products benefiting the back half of the year.

Within our International and Other Segment, reported net sales increased 11.2% in the first quarter. FX was a 370-basis point headwind. First quarter results were ahead of expectations due to stronger than expected consumer mobility that benefited confectionary category sales. Michele shared a detailed update on each of our key international markets, and we are pleased with the strength we saw in Q1 and the team's ability to react to these significant demand changes. Given that our original outlook anticipated improving mobility over the course of the year, we do not expect this plan over-delivery to sustain in future quarters. Furthermore, the international environment remains volatile, and the rising case counts and new lockdowns implemented in April bring additional uncertainty to the continued recovery of the confectionary category in these markets.

Our strong top-line delivery generated over $1 billion of gross profit for the quarter, reflecting a dollar increase of 10.8% versus the prior year period. While gross profit increased double-digits, we did see a slight contraction in gross margin in the quarter driven by the North America segment.

In North America, adjusted gross margin decreased by 110 basis points, to 46.4% in the first quarter driven by raw material and packaging cost inflation as well as increased supply chain costs related to higher than anticipated demand, which were partially offset by higher volume and net price realization.

As our net sales exceeded expectations in the quarter, we incurred higher co-manufacturing and co-packaging costs to service this demand, in addition to warehousing and transposition costs. We expect these cost pressures to subside as volume begins to moderate throughout the year and as new capacity comes online early next year. We also provided additional one-time incentives to our manufacturing employees in the first quarter to recognize and reward them for their tremendous efforts keeping our plants running safely at high capacity to service this strong demand.

Gross margin in our International and Other segment expanded by 180 points to 39.4% for the first quarter, driven primarily by strong volume growth and fixed cost absorption.

Overall, we continue to expect modest gross margin expansion this year driven by productivity, volume gains, the lapping of incremental COVID-19 incentive costs in 2020, and net price realization. This multi-lever approach to gross margin expansion has been successful for us in the past, and we are confident that we can deliver our profitability targets for the full-year, barring any significant changes to our internal assumptions or new external pressures.

In North America, advertising and related consumer marketing spend increased 3.4%, consistent with our expectations. This increase was driven by investments in our core brands and innovation, in addition to the sponsorship of NCAA March Madness that was canceled in the prior year due to COVID-19. For the full-year, we expect advertising to grow roughly in line with sales, however, we do expect growth to vary by quarter. Specifically, we expect a significant increase in advertising in the second quarter as we lap a deflated base in the prior year due to COVID-19 driven market price efficiencies and brand support reductions.

In our International and Other segment, advertising and related consumer marketing spend decreased by 2.9% in the first quarter. We continue to have an agile yet disciplined approach to deploying brand investment based on the sales trends and recovery of the confectionery category by market.

Divisional and corporate expenses increase 4.4% for the first quarter, driven by salary and benefit inflation, incentive compensation, and capability and technology investments. These investments were partially offset by reduced travel and meeting expenses.

First quarter adjusted operating profit of $556 million resulted in an adjusted operating profit margin of 24.2%, an increase of 110 basis points versus the first quarter of 2020. Strong volume gains in both the North America and International and Other segments more than offset product cost pressures and increased SG&A costs.

The adjusted tax rate for the first quarter was 22.5%, an increase of almost 340 basis points versus the year-ago period, driven by the timing of lower tax credits and lower benefits related to employee share-based payments versus the year-ago period. First quarter other expense was $2 million, a decrease of $9 million versus the prior-year period.

Our first quarter results are a testament to our balanced top and bottom-line approach, which provided for healthy cash flow and a strong balance sheet. At the end of the first quarter, we had approximately $1.1 billion in cash and cash equivalents on the balance sheet and $610 million in operating cash flow in the quarter. This strong cash flow allowed us to simultaneously execute nearly every lever in our capital allocation framework during the quarter. We funded investments to fuel growth, returned a significant portion of cash to our shareholders through dividends and share buybacks, and paid down debt.

In the first quarter, total capital additions, including software, were approximately $114 million. As we shared in January, and last year, we have several key capital projects over the next few years including capacity expansion, ERP, and supply chain modernization initiatives. We expect capital expenditures to be around $550 million for the full year, consistent with prior guidance.

In the first quarter, we paid $163 million in cash dividends, and we resumed share buybacks by completing $240 million of repurchases related to stock option replenishment. Finally, we repaid $85 million of bonds in February, with an additional payment scheduled for May.

We had a strong start to the year, benefiting from some unique benefits in the first quarter, and as a result, expect a stronger full-year outlook. As the year progresses, we expect our performance to moderate as we lap higher prior-year growth and share gains, and take-home chocolate sales growth moderates as away-from-home sales rebound.

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

Michele Buck

Thanks, Steve.

I am so proud of how our teams continue to respond with agility and execute well against many factors out of our control during these extraordinary times. We are continuing to execute our strategies and make investments to not only deliver today but secure our future as well.

Last month we announced an ambitious commitment to reduce our greenhouse gas emissions based on the latest climate science by partnering with the Science Based Target Initiative. This includes goals to reduce our Scope 1 and 2 emissions by more than 50% and our absolute Scope 3 emissions by 25% by 2030. As part of these commitments, we signed two power purchase agreements that will enable the construction of two new utility-scale solar farms. Additionally, we set a new goal to reduce packaging weight by 25 million pounds, and target 100% of our plastic packaging to be recyclable, reusable, or compostable, by 2030. Finally, we announced a new Company-wide deforestation policy to end deforestation across our supply chain by 2030.

This work is important, it's ambitious, and it's what the world needs from leading companies like Hershey. It will take all of us, working together to achieve our goals, and we are excited by the journey we are on, and the impact that we can make. We look forward to sharing more details with you in our 2020 sustainability report, which will be published on June 1st.

Thank you for your time this morning, and 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.