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The Hershey Company

Second Quarter 2020 Earnings Conference Call
(Prepared Remarks)

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C O R P O R A T E P A R T I C I P A N T S

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

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

P R E S E N T A T I O N

Melissa Poole

Good morning, everyone, and welcome to the prerecorded discussion of The Hershey Company's Second 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 July 23.

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, 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 risks and uncertainties can be found in today's press release and the Company's SEC filings.

Finally, please note that during today's discussions, 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. On behalf of the entire Company, we hope you, your colleagues and your loved ones are continuing to stay safe and healthy.

We have all experienced significant change and new challenges over these past several months. Things we never predicted are now realities that we are all adapting to. Things we thought would evolve over the course of several years have changed in weeks.

I could not be prouder of the Hershey organization for how they have responded. At the center of our culture is the shared believe that Hershey and its people stand for togetherness, integrity, excellence and making a difference. These values have shined even more brightly over the past several months. Our teams have worked together tirelessly to keep each other safe, our supply chain running, our customers' needs met, and our consumers stocked with snacks that make their lives a little more delicious during these very difficult times. Our teammates have done this with care and compassion for each other and the communities in which they live, and they are energized and inspired to leverage this moment to drive positive change for the future. I want to thank the entire organization, from retail to manufacturing, and across our corporate international and regional offices, for the hard work and commitment they bring every day.

The marketplace remains volatile as the virus and consumer behavior evolve. We saw significant changes as we progressed through the second quarter, but our teams did a fantastic job of adapting to these changes and continued to execute exceptionally well.

The first half of the quarter was particularly challenging, as global economic growth contracted and government-mandated restrictions and closures impacted consumer mobility and, in turn, our performance. We did see an improvement later in the quarter as economies began to reopen and consumers returned to more activities outside the home.

We continue to feel good about our long-term strategies and the strength we saw in our core products and channels during the quarter. Despite new challenges and increased complexities, we delivered profitable category-leading sales growth in North America. These gains were offset by sales declines in areas heavily impacted by the pandemic and related government restrictions and consumer mobility limitations. Our agile investment mindset enabled us to quickly pivot and mitigate sales declines in areas impacted by consumer mobility restrictions. In addition, our advantaged margin structure and strong cost management helped us to mitigate incremental COVID-19-related costs to enable us to deliver adjusted earnings per share in line with last year. We expect accelerated sales growth in the second half of the year, based on momentum exiting the quarter, assuming there's no significant disruption to current consumer trends. We also expect pricing and strong cost management to drive margin expansion and earnings growth in the second half of the year.

Now, let me share some details on our North American business.

While we have seen significant channel disruption and changes in consumer behavior, our brands and categories remain an important part of consumers' lives and have performed relatively well.

We saw strong performance in the food, mass, dollar and e-commerce classes of trade, consistent with broader channel trends. Our e-commerce sales growth remains significantly higher than our pre-COVID baseline, with year-over-year sales growth accelerating further in the second quarter to 200%. Category trends in drug, convenience and club channels were more pressured, though all sequentially improved as we progressed through the quarter as consumers returned to more normal activities away from home. While COVID-19 has impacted traffic to some key channels in the short-term, we continue to believe our channel diversification is a long-term strategic advantage.

Despite some of these pressures, our combined retail takeaway in measured channels was up over 4% in the quarter and it was up almost 9% in June.

Importantly, we are winning share in every channel this year, and our share growth is strongest in the largest channels that are experiencing the most growth.

We are leading not only through our portfolio of iconic brands, consumer relevant marketing and strong execution, but with our thought leadership, as well. Within confection, this has enabled us to drive growth that far exceeds the category and expand our number one share position in the U.S. Our category share grew 225 basis points in the second quarter, bringing our year-to-date share gain to 150 basis points.

The chocolate category is performing well, with growth of approximately 4% in measured channels for the first half of the year, despite a shorter Easter. Everyday chocolate sales have consistently grown 9% since the pandemic began. While take-home products are driving outsized growth, instant consumable products are also growing.

Hershey's has outperformed the category, with sales growth across brands that accelerated as we progressed through the quarter. In June, Hershey's chocolate portfolio grew 13%, with Reese's, Hershey's and Kit Kat brands each growing 14%. Key variety brands, such as PayDay, York, Almond Joy, Mounds, Heath and Rolo, also all grew during the month, resulting in a combined growth rate of over 11%.

Our key chocolate innovation is also performing well. As we discussed in April, much of our innovation was launched prior to the pandemic hitting the U.S. Despite softening convenience store trends in the quarter, our instant consumable innovation remains on track. Our Reese's Take 5 relaunch is set to double the size of the brand this year to approximately $70M of retail sales, and our Kit Kat flavor innovation is doing very well, with Kit Kat Duos and Kit Kat Birthday Cake both driving incremental brand household penetration and frequency. Distribution of our new THINS innovation was delayed slightly by the pandemic at several customers, but is now in full distribution and velocities are strong.

We have secured strong merchandising in-store for our key summer promotions, including Smores, Twizzlers and our Reese's Lovers In and Out Promotions. Our teams have shown great agility to adjust messaging and deliver consumer-relevant content to drive growth of 14% on these programs versus last year.

Our Twizzlers and Jolly Rancher brands grew a combined 6% in the second quarter, also ahead of the category. Our strong in-store merchandising on Twizzlers has been amplified by consumer-relevant marketing to drive accelerated growth this summer as consumers enjoy this classic treat while watching movies at home or in the car on their summer road trips.

As we mentioned in April, the refreshment category has been negatively impacted by social distancing, as the functional need for breath freshening has lessened. While trends have improved since April, the category continued to decline 20% to 25% in June. Our business has trended relatively in line with the category. We expect category trends to remain challenged until social distancing guidelines relax.

Sales for our baking items are performing exceptionally well, with growth of over 40% in the second quarter. This growth was across products, including syrup, baking chips, toppings and cocoa, as consumers spend more time at home together in the kitchen. We have capitalized on this trend to sustain momentum, increasing marketing spend and generating more content and recipes for our consumers. This is important for the second half of the year, when baking takes on an even bigger role in U.S. households.

Finally, let me touch on our better-for-you snack portfolio. Our salty snack brands have shown solid growth this year. As we shared on our call in April, we did experience some softness early in the second quarter, as our in-store presence and supply was negatively impacted by COVID-19. We worked quickly to improve our execution and in-store distribution and merchandising, resulting in accelerated performance in late May and June. In the month of June, our Skinny Pop and Pirate's Booty brands grew 8.4% and 3.7%, respectively, in measured channels, and total sales growth outpaced these levels, bolstered by strong growth in club and e-commerce.

While we saw strong sales growth in measured channels, as expected, this was partially offset by significant declines in our food service and specialty retail businesses. Trends improved as we progressed through the quarter as many locations re-opened; however, traffic and sales remained below prior year levels in June. While we expect the second half headwind in these channels to be less severe than the second quarter impact, uncertainty remains as consumer behaviors continue to evolve, COVID-19 cases rise and regions consider mitigating actions to control the spread of the virus.

Before I discuss our international segment, let me spend a few minutes providing an update on Halloween.

As many of you know, Halloween is our largest season and it represents approximately 10% of our annual sales. We begin manufacturing product in the second quarter and primarily ship product to stores in the third quarter.

Halloween celebrations are likely to be different this year, with an earlier start to the season and more geographic differences than in prior years. We expect that there will be more at-home activities, with families sharing timeless traditions and new ways for people to celebrate with neighbors. It is important to note that nearly 50% of Halloween candy spend is on “treat for me” and “candy bowl” occasions, which start early in the season. Trick or treating represents the other 50% of the season, with sales concentrated in the last two weeks of October. While research indicates trick-or-treating participation will likely be below prior year levels due to COVID-19 concerns, the expectation of this holiday tradition has been consistently improving over the past several weeks. We expect to outperform the category given our iconic brands, strong innovation and merchandising, and great execution.

While we have visibility to orders and current consumer intentions, we expect the virus and consumer sentiment to evolve in the months leading up to the season, which could present some risk to sell-through. We will continue to monitor consumer behavior and local guidelines and partner with our retailers to help consumers celebrate the season of Halloween during this uncertain time.

Now, let me shift gears and discuss our international and other segment. As anticipated, second quarter results were significantly impacted by COVID-19. As we shared in April, our owned retail Chocolate World locations were closed during the second quarter and we saw a meaningful impact on our travel retail business as air travel declined. While our locations have begun to reopen and air travel is beginning to improve, traffic remains well below historical levels and we anticipate a slower recovery in these channels.

In several of our key international markets—notably, Mexico, India and Brazil—we have seen a significant increase in coronavirus cases over the past several months. While measures to stem the spread of the virus have varied by country, we have consistently seen these measures and their associated economic impact pressure chocolate category sales. In many of these markets, chocolate consumption is not as embedded in the culture as it is in the United States, and it is premium priced versus other food and snacking options. Category trends did improve as the quarter progressed, but they remain below prior year levels. While we saw strength in some of our other items in key markets, such as cocoa powder, syrup and spreads, it wasn’t enough to offset the chocolate declines.

We have responded to these recent trends and scaled back investments accordingly to help mitigate the COVID-19 impact on our business. We remain committed to our international strategy over the long-term and we will maintain an appropriate level of investment to capture opportunities as the macroeconomic environment and pandemic improve.

Now, let me turn it over to Steve to provide some more details of our financial results, as well as our outlook for the rest of the year. Steve?

Steve Voskuil

Thanks, Michele, and good morning, everyone.

Before reviewing the detailed results for the second quarter, I want to build on Michele's remarks and commend our team's ability to adapt, execute and make smart decisions quickly during this unprecedented time. While our top line was challenged due to COVID-19-related softness in certain areas of the business, and we incurred incremental costs related to the pandemic, strong price realization in North America and proactive cost management allowed us to sustain profitability and deliver earnings in line with last year. As we look to the balance of the year, we anticipate incremental improvement to our top line, and feel good about the plans we have in place to continue to adapt and manage the opportunities and challenges that may arise in this dynamic operating environment.

During the second quarter, reported net sales decreased by 3.4% versus the same period a year ago, with an organic, constant currency decline of 3.5%. As Michele mentioned, these declines were driven by COVID-19-related pressures to our international and other segment, as well as non-traditional channels in the U.S., such as food service and specialty retail. These declines were partially offset by strength in our confection business in measured channels, which benefited from elevated at-home demand and strong price realization. Despite these top line challenges and incremental COVID-19-related manufacturing costs, price realization and productivity savings enabled us to maintain our peer-leading adjusted gross margin of 46.4% in the second quarter, relatively in line with prior year.

Adjusted operating profit increased 4.4% in the second quarter, resulting in a 170-basis-point improvement to operating profit margin versus the prior year period. Incremental incentives, cleaning and PPE costs were more than offset by travel and meeting expense favorability, as well as marketing spend optimization to align with consumer demand changes in the quarter.

In North America, organic, constant currency sales growth of 0.4% was driven by pricing and elevated at-home consumption of our chocolate and baking items. This was partially offset by sales declines in foodservice, specialty retail and our refreshment brands due to COVID-19. Price realization contributed 4.2 points in the quarter, which was slightly ahead of expectations, due to incremental trade efficiencies realized from revenue management and selective programming choices related to COVID-19. We continue to expect second half price realization to be approximately 1.5 to 2 points, driven primarily by our July 2019 price increase.

Food service, specialty retail and refreshment were each down approximately 40% during the second quarter. We continue to expect these businesses to be negatively impacted by COVID-19 during the balance of the year, but improve incrementally as the economy and consumer mobility continue to recover. In measured channels, retail takeaway for Hershey was 4.1% for the second quarter, driven by strength in demand for our take-home confection and baking businesses, and strong execution by our supply chain to ensure product was available and on-shelf. We did not see this fully flow through to net sales, as retailer inventory levels continued to be depleted to satisfy a portion of this demand. As a result, we expect these inventory levels to be replenished in the coming months, contributing approximately one to two points of growth in the second half the year.

Adjusted gross margin for the North America segment expanded 20 basis points to 47.5% for the second quarter, driven by strong price realization, which more than offset a challenging 2019 lap of favorable mix and incremental COVID-19-related costs for incentives, cleaning and PPE. Mix was a slight headwind for the quarter, driven primarily by lapping the significant mix benefit from Q2 of 2019, versus COVID-19-driven mix shifts this year. As Michele mentioned, our instant consumable business has continued to grow, which has helped maintain our margin strength. As a result, we do not anticipate mix being a material driver of earnings in the second half.

North America advertising and related consumer marketing spend decreased 10.8% in the second quarter, driven by media cost efficiencies and selective programming optimization related to COVID-19. Approximately half of our spend reduction was driven by favorable digital media costs in the marketplace, a portion of which we expect to sustain in the second half. The remaining declines were driven by reduced investment in brands negatively impacted by COVID-19 trends, including IceBreakers and select chocolate brands that are disproportionately sold in the convenience store class of trade. As consumer trends improved in May and June, we began reinvesting in these businesses. These actions are a testament to our capabilities and willingness to adapt quickly to changes in the marketplace. As we look to the balance of the year, we will continue to be mindful of the evolving operating environment, but plan to invest more in advertising and consumer marketing as sales trends improve.

In our international and other segment, organic, constant currency sales declined 33.4% in the second quarter, driven by COVID-19-related softness in our owned Chocolate World retail locations, large declines in air travel and performance in key international markets. Combined constant currency net sales in Mexico, Brazil, India and China declined 31.8% versus the second quarter in 2019.

As Michele mentioned, we expect our international business to be slower to recover and likely challenged for the balance of year because of both COVID-19-related restrictions and economic conditions impacting consumer participation in the chocolate category. Our owned retail businesses were closed for nearly the entire second quarter, though all have reopened on a limited basis with appropriate COVID-19-related precautions. While our stores have reopened, we do expect significantly decreased foot traffic during the second half of the year and, therefore, expect sales to remain below prior year levels.

Given these declines to the top line, we have taken a disciplined look at our variable cost base and optimized where feasible, while still maintaining the appropriate level of brand investment. This resulted in savings in advertising and related consumer marketing, along with travel expenses of approximately $15 million. The segment reported a slightly negative operating income of $4 million for the second quarter. We continue to expect gradual recovery throughout the second half of the year, but do not expect the segment to return to the same level as last year. While this segment has borne the greatest impact from COVID-19, we remain committed to the right balance of investment and support to ensure acceleration post COVID-19.

Shifting to items below operating profit, interest expense was $38 million for the second quarter, an increase of $4.3 million, versus the same period a year ago, due higher debt balances from debt issuances in October 2019. Other expense of $11.2 million represented a decline of $1.9 million, due to the purchase of fewer tax credits and lower non-service-related pension expense. The adjusted tax rate in the second quarter increased by 4.6% to 19.4%. This increase was due to the lapping of a prior period benefit related to the release of valuation allowances in select international markets. At this time, we do not anticipate any material changes to the tax and other income/expense outlook that we shared with you in January. We do, however, expect interest expense to marginally increase over the prior year due to the bond issuance in October 2019 and May 2020.

Despite any short-term challenges posed by COVID-19, we remain confident in our strong cash flow and healthy balance sheet to manage through the current crisis and beyond. At the end of the second quarter, we had approximately $1.2 billion in cash and cash equivalents on our balance sheet, an increase of $800 million versus last year, and $614 million in operating cash flow. To further mitigate potential risk and to take advantage of favorable rates in the capital markets, we issued $1 billion of bonds in the second quarter with staggered maturities, while paying long-term debt of $350 million that came due in May. We continue to have a peer-leading capital structure, providing agility to adapt to the dynamic environment we are operating in.

Given our strong free cash flow and liquidity, we remain committed to our long-term capital priorities, with a balanced approach to investing in the business and returning cash to our stockholders, all while managing through this volatile environment.

First, let's discuss our commitment to reinvestment. In the second quarter, total capital additions, including software, were approximately $87 million, bringing our-year-to date investment to $186 million. As discussed in April, our revised capital spending full year outlook of $400 million to $450 million reflects selectively pausing portions of our ERP transformation and supply chain capacity and capability initiative.

Both ERP and our supply chain initiative, while re-phased, remain on track and are critical capabilities to deliver our long-term strategic initiatives.

Now, shifting to returning cash to our stockholders, which remains a steadfast priority in our capital allocation strategy, earlier this morning, we announced our third quarter dividend, reflecting a 4% increase. While the Company did not repurchase any shares in the second quarter against the July 2018 $500 million authorization, we did repurchase $42 million of common stock in connection with replenishment of stock options. We remain confident that our balanced approach to business investment and returning cash to stockholders will continue to provide sustained stockholder returns now and in the future.

As you saw in the press release, we are not providing new 2020 fiscal guidance at this time. While the Company's performance improved over the course of the second quarter, the impact of recent spikes in coronavirus cases on consumer mobility, retail operations, governmental regulations and the macroeconomic environment remains unclear. With that being said, we do want to provide some visibility into our latest thinking for the balance of the year, which is based on our current understanding of the operating environment.

In the North America segment, the Company expects accelerated sales growth in the second half of the year driven by elevated at-home consumption, price realization and the replenishment of retailer and distributor inventory levels. These gains are anticipated to offset improving, but still pressured, sales in the food service and specialty retail channels. The Company does not currently expect seasonal performance to have a material impact on second half financial results, though the impact of a resurgence of COVID-19 cases on consumer participation in seasonal activities remains uncertain.

In the international and other segment, the Company expects demand to slowly rebound in the second half of the year, but remain below prior year levels as owned stores, travel retail and developing markets recover more slowly.

Finally, as it relates to sales, during the second quarter, we completed the planned divestitures of our Krave, Dagoba and Scharffenberger brands. These divestitures are expected to have a relatively small 20-basis-point impact to sales in the second half and an immaterial impact to earnings per share.

Solid price realization and strong cost management are anticipated to offset some of the incremental COVID-19 costs we are facing. COVID-19 costs are expected to be less in the second half of the year, mainly for increased plant sanitation and personal protective equipment for Manufacturing and Sales Teams.

We anticipate that price realization will continue to drive gross margin gains, though to a lesser extent than the first half of the year, as we begin to lap the announcement of the 2019 price increase.

Selling, general and administrative expenses should continue to show favorability in the back half of the year, behind lower travel and meeting expenses and favorable incentive compensation versus prior year.

Finally, as it relates to brand investment, we intend to continue investing in North America and further optimize spend in the international and other segment in accordance with expected sales trends.

While we have not issued new guidance today, we hope this additional perspective is helpful to understand our approach to managing through the crisis and our high level expectations for the next several months pending the continued evolution of the pandemic. We remain confident in our team, our plan and our agile operating model to deliver solid shareholder returns this year and in the future.

Now, I will turn it back to Michele.

Michele Buck

Thanks, Steve.

During a time of extraordinary changes and challenges this quarter, our teams responded with agility and executed well against factors within our control. We have balanced delivering today with making calculated investments that we believe will enable us to emerge even stronger after the pandemic. In times of risk and crisis, cultures are either strengthened or weakened. Hershey has come together and thrived as a team, committed to serving our consumers and our communities. Our purpose and commitment to operating sustainably and responsibly continues to move us forward.

Last month, we released our 2019 sustainability report that highlights some of the great progress we have made in this space, as well as some of our key priorities for the future. I encourage you to go to our website and take a look. In addition to the sustainability report, you will also find information on some of our more recent actions and pledges. Let me take a minute to discuss two that are top of mind related to recent events.

We have long supported our communities and, given the unprecedented need many are facing right now, we have amplified these efforts. In addition to increasing our product and monetary donations, we have invested in our own mask production line to service our employees, their families and our communities.

Second, for many years, we have pursued a vision of building a more diverse and inclusive company. We have been recognized for our progress, including being named the top food company for diversity by Diversity Inc. Recently, we initiated a company-wide dialogue to listen, learn and grow together. Through that dialogue, we have seen the very best of our Hershey culture, and a genuine desire to do more in the fight against systemic racism.

We announced a set of initiatives to support Black and Brown communities and accelerate increasing Black and Brown representation and internal development at Hershey and amongst our key partners to promote social and economic progress. We believe these initiatives will help address the need for meaningful, long-term change in our society, and include evolving our approach to recruiting, talent development, training and reporting, as well as pledging monetary donations to organizations to actively fight systematic racism.

To close, we believe Hershey is well positioned to adapt and succeed over the long term. We have scale brands in growing categories that consumers love and trust, we have a highly efficient, yet agile, supply chain that we are investing in for the future, we have advantaged capabilities in analytics, media, category management and sales, that we believe position us well to drive profitable growth in the future, and we have a team that is dedicated to our purpose of making more moments of goodness. We remain confident in and committed to our long-term strategies and financial targets.

With that, we conclude our prepared remarks this morning. 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.