The Hershey Company

Third Quarter 2022 Earnings Q&A Session

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CORPORATE PARTICIPANTS

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CONFERENCE CALL PARTICIPANTS

Andrew Lazar, *Barclays*

Bryan Spillane, *Bank of America*

Michael Lavery, *Piper Sandler*

Robert Moskow, *Credit Suisse*

Ken Goldman, *JP Morgan*

Alexia Howard, *Bernstein*

Pamela Kaufman, *Morgan Stanley*

Nik Modi, *RBC Capital Markets*

Jason English, *Goldman Sachs*

Chris Growe, *Stifel*

Cody Ross, *UBS*

Jonathan Feeney, *Consumer Edge*

David Palmer, *Evercore ISI*

PRESENTATION

Operator

Greetings and welcome to the Hershey Company's Third Quarter 2022 Question-and-Answer Session.

At this time, all participants are in listen-only mode. As a reminder, this conference is being recorded.

I'd now like to turn the call over to your host, Ms. Melissa Poole, Vice President of Investor Relations for The Hershey Company. Thank you, you may now begin.

Melissa Poole

Good morning, everyone. Thank you for joining us today for The Hershey Company's third quarter 2022 earnings Q&A session. I hope everyone has had the chance to read our press release and listen to our pre-recorded Management remarks, both of which are available on our website. In addition, we have posted a transcript of the pre-recorded remarks. At the conclusion of today's live Q&A session, we will also post a transcript and audio replay of this call.

Please note that during today's Q&A session, we may 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 we may 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.

Joining me today are Hershey's Chairman and CEO, Michele Buck, and Hershey's Senior Vice President and CFO, Steve Voskuil.

With that, I will turn it over to the Operator for the first question.

Operator

Thank you. Our first question is coming from the line of Andrew Lazar with Barclays. Please proceed with your question.

Andrew Lazar

Great, thanks so much. Good morning, everybody.

Michele Buck

Good morning, Andrew.

Andrew Lazar

Morning. Maybe first off, you discussed in the prepared remarks how you expect a strong top and bottom line performance in '23. Given where the markets are, it seems like items like pension and interest expense will be incremental headwinds, obviously, for the group as a whole next year. I was wondering if you'd be able to help level set us a little bit on where some of these items at least that you do have visibility to might sit for next year, and if they are material enough to derail the earnings performance in the year.

Michele Buck

Sure. Andrew, let me start with a little bit of an overview and then I'll let Steve dive into a few more of the specifics.

Overall, we believe we can deliver an on-algorithm year next year. We believe our sales will be slightly ahead of algorithm, pricing will be about comparable to 2021. We anticipate that our gross margins will be stable. We will have a step-up in investment as we reinvest, reinstate some of the DME spend now that we have more capacity available to really be able to take advantage of that, and also to invest in capabilities to secure a profitable, sustainable future. We think all of that will net down to strong earnings performance that will likely be at the high end of our algorithm, so that's a little bit of an overview.

Steve, I'll let you go a little bit deeper.

Steve Voskuil

Yes, just on the discrete items, to answer your question at a summary first, we don't see any derailers in terms of those discrete areas. We will have more pension expense - our estimate today would probably be $5 million more year-over-year for next year. On the pension side this year, we picked up about $10 million of incremental pension expense. Next year, I would—again, markets can change, but today I would probably estimate that at probably twice that number for next year, but neither of those are material enough to shift the needle.

Michele Buck

Yes, sorry - just to clarify, that first $5 million was interest for the year.

Steve Voskuil

Yes, sorry.

Michele Buck

Then the pension, probably about $20 million.

Steve Voskuil

Yes.

Andrew Lazar

Really helpful, very helpful. Just lastly, as you mentioned, you've got incremental pricing on tap for '23, and I appreciate you're planning for greater elasticity than you've seen thus far, which is prudent. Obviously you delivered strong volume this year in the face of high single digit pricing. You've got more capacity coming online. I think A&C is expected to grow faster than sales next year. Dot's entering, I think, the organic calculation to start the year, and obviously strong underlying momentum, so at a minimum, shouldn't these help at least mitigate the potential for building elasticities in '23? I'm just trying to make sure I'm not missing anything else on either side of the ledger. Thanks so much.

Steve Voskuil

Yes, I think that's the right way to think about it. As Michele said at the top, I think we've got a lot of positives in the story for next year as some of the things you mentioned roll through, and I'm sure we'll have challenges but we don't see anything yet that is a derailing factor.

Andrew Lazar

Thank you very much.

Michele Buck

Thanks.

Operator

Thank you. Our next question comes from the line of Bryan Spillane with Bank of America. Please proceed with your questions.

Bryan Spillane

Hey, thanks, Operator. Good morning, everyone.

Michele, in the prepared remarks you referenced consumer behavior and maybe seeing some changes in where people shop, channels and pack types. Could you just elaborate a little bit more on that and maybe how Hershey is adjusting to that?

Michele Buck

Yes, absolutely. We are seeing some of those changes in how they're spending. Fortunately, we are seeing them continue to spend, but there is some reprioritization, so specifically value channels and value packs are selling well. We are also seeing some improvements in private label performance, and really we're seeing this across the board, slightly more noticeable with lower income consumers, but really across all different income levels.

Within our categories, the trends have really remained very strong as the consumer continues to prioritize snacking and particularly sweet treats, and obviously we have minimal private label presence, so we continue to see that our products remain an affordable treat for families and for consumers, and we know that part of that is they want to reward themselves when times are tough. They also use these products to relieve stress, and we think that those trends will continue.

I think on a class of trade basis, just to augment relative to the channel piece, we have seen particular strength in mass, in club and in dollar, so certainly in channels that represent strong value.

Bryan Spillane

Okay, thank you.

Michele Buck

Sure.

Steve Voskuil

Thank you.

Operator

Our next question is from the line of Michael Lavery with Piper Sandler. Please proceed with your questions.

Michael Lavery

Thank you, good morning.

Michele Buck

Good morning.

Michael Lavery

You've got strong momentum on Reese's, obviously up, I think it was 16% in the quarter, and certainly adding capacity is paying off. Even Payday, which we don't hear too much about typically, is up very strongly behind some new capacity. Can you just maybe give us a little bit more specifics looking ahead in terms of how some of the capacity unfolds? I think you've given maybe a five-year outlook, but in terms of, say, next year, would it be—is it about a fifth comes over the next five years, do we have to wait longer, is there a bigger bump near term? Just help us maybe think about some of the pacing, because capacity certainly is working when you can add it.

Michele Buck

We certainly have a, I would say, a continuous effort against broadening our capacity, certainly focused only on where we see those really strong returns. Next year for example, we are planning for five new manufacturing lines to start up throughout the year, and that includes three new Reese's lines, so we do expect a pretty nice increase in capacity. However, some of the investment that we have in 2023 will also be for production that doesn't come online until 2024, so not all of the incremental spend directly relates to '23 but we do have continuous capacity coming online into the future years, with a big focus on '23 and '24.

Michael Lavery

Okay, that's helpful. It's a little bit more near term skewed, it sounds like.

Just on Dot's, if I could follow up there, very strong momentum. It looks like it came in about 40% ahead of what we had thought the run rate was when you bought that business. Can you just point to what some of the drivers are and how to think about the sustainability of that kind of momentum?

Michele Buck

Yes, absolutely. On Dot's, a big piece of our gains has been continuing to grow distribution. As we purchased the business, there was significant opportunity, particularly on the east coast and with certain customers. We were somewhat underdeveloped with Wal-Mart, so Wal-Mart was a big gainer on distribution, obviously - that's a huge customer. At the same time, we're also focused on optimizing the consumer model and all of the spend to maximize impact and starting to drive incremental investment in brand building, which is our model across our entire portfolio, which we think will give us further upside beyond the distribution going forward.

The other thing I want to just clarify on the capacity piece is while we have significant effort in ’23 and ’24, there will be continued—if you look across our entire portfolio, continued capacity coming online into the future years beyond that as well, if you look at confection snacks, etc., across the board.

Michael Lavery

Really helpful color, thank you.

Operator

Thank you. Our next question is from the line of Robert Moskow with Credit Suisse. Please proceed with your questions.

Robert Moskow

Hi, thanks. Two very different questions. Are there any initial efforts being made to try to consolidate your snack brands together in either route to market or any other operating functions? My understanding is that they get to market in very different ways. Then also, for Steve, just wanted to know if you can help us with seasonality in 2023. First half looks like a tough comparison, but maybe that’s just optics.

Michele Buck

Yes, so relative to our snack brands, to date we have been running those businesses separately as we have had a dedicated focus on continuing to drive ahead the Amplify business and also to really integrate the Dot’s business as we just took it over in December. Going forward, we are now starting to take a much more holistic look across all of salty with a focus as we go into 2023 on really how we integrate those businesses together across the board to really capture and leverage scale and synergy across everything - supply chain, marketing, go-to-market, etc. That’s really the phase that we are entering now, and I think we believe that’s how we will also begin to unlock some of the gross margin expansion that we need to go after on that business.

Steve?

Steve Voskuil

Yes, very good, nothing to add to that.

On the seasonality, I don’t think there’s a big story. We’ve got a big year to lap, full stop, first and second half, and so I don’t think it’s—we’re not thinking about a big nuance right now first half versus second half. I don’t know if that’s helpful.

Robert Moskow

It’s simple. Thank you, I’ll take it.

Steve Voskuil

Thank you.

Operator

The next question comes from the line of Ken Goldman with JP Morgan. Please proceed with your questions.

Ken Goldman

Hi. Just a very quick clarification. First Michele, I think in response to Andrew's question, if I heard correctly, you said that pricing in '23 will be similar to '21. I assume you meant similar to '22, unless I heard you wrong.

Michele Buck

Yes, sorry about that.

Ken Goldman

That's okay. Time has lost all meaning to me post-COVID, so I understand.

Then really, just a quick summary of next year to make sure I heard you correctly there. You're talking about sales growth being very strong. You don't have an EBIT algorithm, I think, but is it fair to assume, just to summarize, that you're expecting very strong sales growth, maybe a little bit higher than EBIT growth, which in turn is a little bit higher than EPS growth, but EPS growth still closer to maybe that 8% organic range with a small haircut from FX. Am I summarizing that correctly?

Steve Voskuil

Yes, I think you're in the right zip code. Yes.

Ken Goldman

Perfect, that's all I had. Thank you.

Steve Voskuil

All right.

Michele Buck

Thanks.

Operator

Our next question is from the line of Alexia Howard with Bernstein. Please proceed with your question.

Alexia Howard

Good morning, everyone.

Michele Buck

Good morning.

Alexia Howard

Can I ask about the high single digit increase in costs in 2023? I think, generally, we've been expecting that things might get a little bit easier - obviously that is easier than what we've seen in 2022, but it's still a pretty big hurdle to get over. Specifically, where are the pain points, what's continuing to go up? How much of it is locked in, do you have good visibility into that, and is it likely to moderate through the course of the year, so maybe higher in the first half versus the second half? Thank you and I'll pass it on.

Steve Voskuil

Sure. Yes, as you said, it's high, it's not as high as this year, and to that extent I'd like to be in a position, when we give more guidance, to say we're stabilizing gross margins overall. But nonetheless, still expecting high single digit inflation, and where is it coming from? On the commodity side, we still have some commodity pressure in some commodities where we don't have complete hedging coverage. Packaging costs, logistics, still seeing inflation in people costs, some energy costs, and I would also say technology is probably another one that's starting to be a bigger component. Across that basket, we're still seeing high single digit inflation.

I would hope by the time we get to the back half of next year, you're again starting to see more moderation as we start to lap more of those inflationary costs, but still expecting a pretty significant lift next year. Our visibility is pretty good with our hedging and longer term contracts. I think we do have pretty good perspective on that number today.

Alexia Howard

Great, thank you very much. I'll pass it on.

Operator

Our next question is from the line of Pamela Kaufman with Morgan Stanley. Please proceed with your questions.

Pamela Kaufman

Good morning.

Michele Buck

Good morning.

Pamela Kaufman

Can you discuss the shipment timing dynamics that impacted Q3 results? You pointed to earlier seasonal shipments and inventory replenishment benefiting top line in the quarter, so where are retailer inventory levels now, and are there any additional timing shifts that we should be aware of over the coming quarters?

Then just on the Q4 implied guidance, which points to deceleration to low single digit growth, is that largely a reflection of the inventory dynamics, or are there other factors contributing to the outlook?

Steve Voskuil

Sure. On the inventory timing for Q3, the two big factors that we talked about were, one, some inventory build, as you mentioned. We didn't expect as much inventory build as we saw in Q3. Again, what we did see wasn't as big as we saw earlier in the year, but it was a factor, about a point. Then we also saw some seasonal pull forward, and this continues a little bit of a trend of retailers pulling seasons in earlier and earlier, and so we saw about a two-point benefit in the third quarter from that.

As we look to the fourth quarter, we also expect we'll see some seasonal pull forward with Valentine's and Easter, so that will have some impact potentially on Q4, but probably the biggest factor in the Q4 guidance is really just the assumptions around elasticity, and again being a little bit prudent as we think about what's happening with the consumer and not being quite as aggressive as maybe the more recent elasticities we've seen.

Pamela Kaufman

Great, and can you comment on current promotional levels? You indicated that they are back to more normalized levels. Can you address what types of promotions you are implementing and how you are balancing higher promotions with the capacity constraints, and then do you expect promotions to continue to step up next year?

Michele Buck

Yes, so our promotions are pretty much in line with historical. When we do promotion in this category, it's always our first objective to get display because these can drive—this category can drive a lot of impulse, so a focus on featuring display, display where possible, and as usual, we always put a big focus on our core brands, so we may use news to create some excitement on a display but we know that or core brands are the strongest mover, and that's really where the bulk of the focus will be. That's a bit where we are on promotions.

If we think about next year, we think we'll be at about the same level as we've been. There might be some shifts across the quarters, but pretty much in line.

Pamela Kaufman

Great, thanks. I'll pass it on.

Operator

The next question is from the line of Nik Modi with RBC. Please proceed with your questions.

Nik Modi

Yes, thank you. Good morning, everyone.

Michele Buck

Hi Nik.

Nik Modi

Hi Michele. I was just wondering in terms of growth drivers, we've been getting a lot of good feedback on the pantry pack, especially in the online channel, so I was just hoping you could talk a little bit about that and what your insights are saying, and maybe where you can take that strategy going forward.

Then the second thing would be just on alternate channels. Obviously FDM has been a very strong area for Hershey, but there seems to be a lot of pockets of opportunity in other channels not measured, and I just wanted to get your thoughts on that strategy as you move forward.

Michele Buck

Yes, absolutely. As we approach innovation, we've really evolved our strategy over time to continue to provide product news, but also really to look at packaging as a big unlock because packaging enables us to provide consumers with our core brands, which they love, but in a different packaging format that tends to open up a new occasion. That can be very powerful and very sustainable, and that's really what the pantry pack did. As consumers are spending more time at home, it's almost the ability to have their own single serve dispenser in their pantry or in their refrigerator if they so desire, so we're really pleased with how it's doing to date. We still have some distribution upside opportunity to further capture, but it's done what we were hoping to and we'll continue to focus on packaging for new occasions.

Relative to non-measured and alternate channels, yes, this has always been a focus for us. I would say as capacity got tight, we pulled back a little bit, de-prioritized a little bit during COVID, but we are really leaning back in now and the team is aggressively focused on really trying to get our products everywhere that they possibly can.

Nik Modi

Thank you, I'll pass it on.

Operator

Our next question comes from the line of Jason English with Goldman Sachs. Please proceed with your questions.

Jason English

Hey folks, good morning. Thanks for slotting me in.

Michele Buck

Good morning.

Jason English

A couple questions. First, in the prepared remarks, I think you noted that you're expecting growth trends on everyday products to moderate. Can you elaborate on what you're seeing and also comment on how this influences your view of, I guess, how much more capacity you have to push price on everyday and whether or not you should be looking to layer on a bit more promotion to counter whatever trend you're seeing.

Michele Buck

We've been pretty happy with the strong trends that we have seen on retail takeaway, and certainly throughout the year, we've been trying to balance the seasonal sell-through with everyday business and really look at the two somewhat holistically. I think we've been held back a little bit, as you mentioned, through capacity. We're excited that next year, we open up a bit more capacity which then allows us to reinstate some of the spending that we had pulled back on, which we think will also provide some momentum for us going forward.

Jason English

Okay. Switching gears, M&A, your track record of late has been pretty successful. Your balance sheet certainly suggests you have capacity for more. Do you have organizational bandwidth to do more anytime soon, or is all eyes of attention focused on integrating Dot's, and also, it sounds like not just integrating Dot's but addressing the whole structure of salty snacks as you look to combine those businesses and leverage the synergies you discussed.

Michele Buck

Certainly I would say job one for us is the integration and continued growth and acceleration of the entire salty portfolio, so we do really have scale there now and a lot of opportunity ahead of us, great top line momentum and then opportunity to leverage that scale to improve the margin structure. That's clearly job one.

That said, we are always looking and evaluating the marketplace and, given the health of our balance sheet, we certainly would consider something that made sense for us, that we believe we could execute well.

Jason English

Understood, thank you. I'll pass it on.

Operator

The next question comes from the line of Chris Growe with Stifel. Please proceed with your questions.

Chris Growe

Hi, good morning.

Michele Buck

Good morning.

Chris Growe

Hi. I just wanted to ask a little more of a near term question around the fourth quarter. You had—it sounds like you're going to have some further pull forward of next year's season—2023's seasons, and then I also think you have an easy shipping—comparison with the previous year, where you had less shipping days in the fourth quarter of '21. I just want to get a sense of what that means for volume in the fourth quarter, a little extra seasons and then a little extra benefit from the shipping day factor.

Steve Voskuil

Yes, on the seasons side, it's not a net benefit because we pulled some of the Q4 into the Q3 season, so we've got a little bit of a deficit that will be potentially partly made up by pull forward of '23 seasons. That's probably the biggest piece.

In terms of calendar days, it's really not a big factor for shipping days.

Chris Growe

You had two less shipping days on the fourth quarter of '21. Does that not compare beneficially to this year, or no?

Steve Voskuil

Not …

Michele Buck

I think the calendar only shifts by maybe one day this year, so it shouldn't have a material impact.

Chris Growe

Okay, got you. Then just a quick question around the gross margin. As I look at the gross margin decline year-over-year and look at the margins by division, I'm just curious, is there more of a gross margin kind of lag or shortfall, basically a pricing versus cost inflation shortfall in salty snacks versus confectionary? I'm just trying to get a sense of the pricing coming through in confectionary, should that benefit the margin and would that therefore benefit the overall gross margin more so, or is it salty snacks that needs more pricing here to offset the inflation?

Steve Voskuil

Yes, so there's a lot in there. I think pricing on confections is great, it's in the plan. We will see the full effect of that in the fourth quarter and it will be a big factor in the '23 outlook. On salty, we have taken price, it probably hasn't come to the market quite as fast, and as Michele said, as we look at strengthening that business and the gross margins, and at the same time continuing the rapid growth on the top line, pricing is a lever like it is for all our businesses that we'll continue to look at.

What I'm pleased with is as we look at the progression of the salty margins even this year, we started out the first quarter order of magnitude, I think, 1,200 basis points down year-over-year, that's improved sequentially and we'd expect that to improve again the fourth quarter. As we get to next year, continuing to drive margin improvement in that business through all levers available is going to be a high priority.

Chris Growe

Thank you.

Operator

The next question is from the line of Cody Ross with UBS. Please proceed with your questions.

Cody Ross

Good morning. Thank you for taking our questions.

Based on the prepared remarks, it sounds like your underlying volume, excluding the seasonal shipments and retailer inventory replenishment, was down. Is that correct, and how did that compare to your expectations?

Steve Voskuil

Q3 was roughly flat overall, and I'm saying it was line with expectations. Like we said, we probably put in a little more inventory than we expected, but where we landed on base volume was more or less in line with what we expected.

Cody Ross

Thank you for that, and then I think you mentioned your chocolate market share was up versus pre-pandemic. I assume that's dollar share. Can you just comment on how that compares from a volume share perspective? Thank you.

Michele Buck

Yes, that was dollar share, and it is similar from a volume share perspective.

Cody Ross

Okay, great. I'll pass it on, thank you.

Operator

The next question is from the line of Jonathan Feeney with Consumer Edge. Please proceed with your questions.

Jonathan Feeney

Good morning, thank you. Michele, you mentioned in your prepared remarks, but a lot of food industry leaders had mentioned reporting pretty good numbers in the past couple weeks. A sense of, I think it was concern about the stress that inflation was bringing to consumers, and I think that's certainly true and it's certainly an impact on retailers. But if I just dive into the data you have, where are you seeing that, if anywhere? Is trade-down behavior happening, and how—when you think about prior periods where—I mean, there's nothing quite like this period, but, say, consumer distress accompanied by rising inflation, I think we had something like that dynamic in 2010. How did consumers behave, and as you look forward, how is this go-round with the consumer reacting to a tougher environment driven by crowding out factors from other costs, how does this compare?

Michele Buck

Yes, so we remain very focused on the consumer, and certainly we're aware of the pressures that are on them. What I would say is overall, it has not impacted our total performance and overall product performance to a large degree. Yes, there are some shifts in terms of seeing more consumers buying value packs, purchasing in value channels, and then certainly in other categories where private label has really dialed up. But I would say overall, we need to continue to be always focused on the consumer and when they could hit a breaking point, but to date as we look at our elasticities, we really aren't seeing signs of that impacting our business.

That said, we're going to be very focused on it going forward because we don't want to miss a trend. I would say historically, our category has tended to fare pretty well during these times because it is an affordable indulgence when consumers can't afford a lot of other things.

Jonathan Feeney

Very clear, thank you.

Operator

Our next question is from the line of David Palmer with Evercore ISI. Please proceed with your questions.

David Palmer

Thanks, good morning. You mentioned in the prepared remarks that capacity was added for Reese's and gummies in 3Q. How much of a capacity increase was that, and were you in any way constrained on these platforms before this or is this just simply anticipatory of ongoing growth?

Michele Buck

Yes, we're not going to get into a lot of the specifics around specific brand capacity, just for overall competitive reasons, but yes, we were constrained on both and this capacity did allow us to unlock, whether it was broader distribution, reinstating of promotions, upping our marketing spend selectively, etc.

David Palmer

Understood on that. I wanted to ask on convenience channels and single serve packaging, I've heard certain retail measures in food service, like convenience store food service, have gotten stronger lately. I wonder, where is your volume in convenience and single serve packaging, and if you look at checkout counters too, how does that compare versus pre-COVID? Are you all the way back? Is that ramping more quickly than some of your other packaging?

Michele Buck

I would say that overall for convenience stores in total, not specific to our business, some of the trends have moderated, particularly with regards to unit purchase, those I'd say snacking and confection products continue to outpace the overall store and they are growing double digits, so certainly we had seen a pretty significant decline when consumers were not mobile, and now that consumers are much more mobile than they were previously, we've seen that business really come back.

David Palmer

Is that going to be a meaningful help to profitability mix, or is it not a big deal?

Michele Buck

No, not really. Overall we sell single serve in other units—or in other channels as well, so no.

David Palmer

Thank you.

Operator

Thank you. At this time, I'll turn the call back to Melissa Poole for closing remarks.

Melissa Poole

Thank you for joining us this morning. We look forward to catching up with you throughout the day to answer any other questions you may have. Have a great day.

Operator

Thank you. This will conclude today's conference. You may disconnect your lines at this time. Thank you for your participation.