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Hormel Foods Corp. (HRL)

Q2 2017 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, ladies and gentlemen, and thank you for standing by. Welcome to the Hormel Foods Second Quarter 2017 Conference Call. At this time, all participants are in a listen-only mode. As a reminder, this conference is being recorded Thursday, May 25, 2017.

I would like to turn the conference over to Nathan Annis, Director of Investor Relations. Please go ahead, Mr. Annis.

Nathan P. Annis

Director-Investor Relations, Hormel Foods Corp.

Good morning. Welcome to the Hormel Foods conference call for the second quarter of fiscal 2017. We released our results this morning before the market opened around 6:30 AM Eastern. If you did not receive a copy of the release, you can find it on our website at www.hormelfoods.com under the Investors section.

On our call today is Jim Snee, President and Chief Executive Officer; and Jim Sheehan, Senior Vice President and Chief Financial Officer. Jim Snee will review each segment's performance for the quarter and also provide outlook for the remainder of fiscal 2017. Jim Sheehan will provide detailed financial results for the quarter and further assumptions relating to our fiscal 2017 outlook.

The line will be opened for questions following Jim Sheehan's remarks. As a courtesy to the other analysts, please limit yourself to one question with one follow-up. If you have additional questions, you are welcome to get back in the queue. An audio replay of this call will be available beginning at 11:00 am today Central Standard Time. The dial-in number is 877-681-3367 and the access code is 2874950. It will also be posted to our website and archived for one year.

Before we get started with the results of the quarter, I need to reference the Safe Harbor statement. Some of the comments made today will be forward-looking, and are made under the Private Securities Litigation Reform Act of 1995. Actual results may differ materially from those expressed in or implied by the statements we will be making. Among the factors that may affect the operating results of the company are fluctuations in the cost and availability of raw materials and market conditions for finished products. Please refer to pages 30 through 37 in the company's Form 10-Q for the quarter ended January 29, 2017 for more details. It can be accessed on our website.

Additionally, please note the company uses non-GAAP results to provide investors with a better understanding of the company's operating performance by excluding sales and volume impact of the divestiture of the Diamond Crystal Brands business, the divestiture of the Farmer John business, and the acquisition of Justin's specialty nut butters. Discussion on non-GAAP information is detailed in our press release located on our corporate website. Please note that during our call today, we will refer to these non-GAAP results as adjusted sales and volume.

I will now turn the call over to Jim Snee.

James P. Snee

President, Chief Executive Officer & Director, Hormel Foods Corp.

Thank you, Nathan. Good morning, everyone. Earlier today, we announced second quarter results of $0.39 per share, down 2.5% from last year. Sales for the quarter were down 5% on an 11% decrease in volume. Adjusted sales grew 2% while adjusted volume grew 1%. For the quarter, three of our five segments reported earnings growth. Refrigerated Foods, International, and Grocery Products grew earnings, while specialty products earnings were down 16%.

We frequently talk about the intentional balance we've built into our business, and this quarter demonstrates the value of our balanced model. Even though we had double-digit declines in our very important business at Jennie-O Turkey Store and divested two profitable but non strategic businesses, we delivered earnings within $0.01 of last year's results. We were able to do this through impressive results from our meat products, foodservice, grocery products, and international teams. In addition, all of our teams proactively managed expenses.

Now, I would like to talk through each of our segments. Jennie-O Turkey Store had another difficult quarter compared to last year, with earnings down 29%. Sales were down 8%, and volumes were down 6%. Segment profit margins declined from over 21% in the second quarter last year to 16% this year, similar to the first quarter.

Three main issues affected Jennie-O Turkey Store's profitability this quarter versus the same time last year: declining turkey prices, increased competition, and increased expenses. First, turkey prices, such as breast meat, have maintained their seven-year lows and, in some cases, declined further since the first quarter as the industry continues to be in an oversupply situation. History suggests the turkey industry will balance supply and demand, and market conditions will improve in the coming months.

In turn, we have made additional adjustments to our production levels and would expect volumes slightly under 2014 levels. The impact to our business continues as commodity sales pricing and whole bird pricing is much lower than last year. Lower turkey prices are also pressuring prices in Jennie-O Turkey Store's three sales divisions: retail, deli, and foodservice.

Second, increased competitive activity from other turkey suppliers and competing proteins, such as beef, continue to pressure Jennie-O's results. Third, we incurred higher operating expenses primarily related to bird performance issues with both our conventional flocks and those raised without antibiotics. We continue to make investments into consumer trends such as our raised-without-antibiotics products.

Despite the market conditions and operating challenges, the Jennie-O Turkey store team grew value-added volumes 1% this quarter and also grew lean ground turkey tray pack volume by double-digits. Recent 12-week scan data shows positive sales trends as the Jennie-O brand continues to outperform the category.

This week, we announced plans to build a new production facility in Melrose, Minnesota, primarily to process whole birds. This new facility will replace the current aged Melrose facility and is expected to cost over $130 million. While our emphasis at Jennie-O Turkey store is on value-added products, whole birds are an important part of the turkey supply chain.

The new plant will increase operational efficiency through an improved layout and will also automate some of the most difficult production jobs. Construction begins this year, and we expect the plant to be operational in early 2019.

Grocery Products operating profit was up 15%, volume was up 2%, and sales were up 8%. The inclusion of Justin's specialty nut butters and brands such as WHOLLY GUACAMOLE, SPAM, and HERDEZ all contributed to growth.

International operating profit increased 38% on volume growth of 17% and sales growth of 19%. Fresh pork exports and branded exports such as SPAM had excellent results this quarter. Our SKIPPY peanut butter business in China also performed well.

Refrigerated Foods second quarter operating profit was flat, with sales down 6% and volume down 14%. The decreases reflect the divestiture of the Farmer John business in January of this year. Excluding the divestiture, adjusted sales were up 5%, and adjusted volume was up 1%.

Growth continues to come from retail and foodservice value-added products. In foodservice, items such as Hormel BACON 1 fully cooked bacon and Hormel pepperoni delivered excellent growth during the quarter. In our retail business, Hormel Black Label bacon, Hormel Natural Choice meats, and Applegate bacon and dinner sausage delivered nice growth.

Specialty Foods operating profit declined 16%, sales declined 24%, and volume declined 33%. Excluding the divestiture of Diamond Crystal Brands, adjusted volume was up 3% while adjusted sales were flat. Muscle Milk ready-to-drink protein beverages performed well especially in the food, drug, and mass channels. Our Muscle Milk powder business was softer this quarter which is line with the category dynamics. In addition, our new Muscle Milk bars have been well received in the marketplace.

Given our current operating environment, we have made some short-term reductions to SG&A expenses. One such area is advertising. Advertising expense this quarter was $30 million compared to $49 million in 2016. This level of advertising is comparable to our fiscal 2015 spend. The majority of the advertising reductions came from the Jennie-O Turkey Store segment. To maintain our advertising and promotional spend efficiency, some of these advertising dollars have shifted to in-store promotions, but we still remain the price leader.

Looking to the balance of fiscal 2017, the only change to our outlook is for Jennie-O Turkey Store. We now expect percentage declines in earnings for Jennie-O Turkey Store to be in the high-teens for the second half of the year with the pressure not abating until the entire industry starts to reduce production levels.

For Refrigerated Foods, we expect growth in many of our retail brands, particularly Hormel Black Label bacon and Hormel Natural Choice meats. We expect growth in the food service channel to remain strong with growth coming from many of our brands such as Hormel Bacon 1 and Hormel Fire Braised meats. We see continued sales and earnings growth from Grocery Products, Justin's specialty nut butters, WHOLLY GUACAMOLE dips, HERDEZ salsas, and SKIPPY peanut butter are all expected to be strong contributors to this growth.

The full-year outlook for the International segment is for growth in line with their long-term goals of 10% top line and 15% bottom line. We expect strong exports of both branded and fresh pork products. Our new manufacturing facility in Jiaxing, China will start producing products early in the third quarter, and we also expect relief for China pork prices in the second half of the fiscal year, which will improve the operating environment for our China retail meat business.

We look to Specialty Foods to deliver double-digit earnings growth in the second half of the year, driven by CytoSport and the Muscle Milk brand. As a reminder, we will annualize the divestiture of Diamond Crystal Brands early in the third quarter.

Based on our updated outlook for Jennie-O Turkey Store, we are maintaining our full-year earnings per share guidance of $1.65 to $1.71 and expect earnings to be at the lower end of the range.

At this time, I will turn the call over to Jim Sheehan to discuss the financial information relating to the quarter and additional key drivers for the remainder of 2017.

James N. Sheehan

Senior Vice President & Chief Financial Officer, Hormel Foods Corp.

Thank you, Jim. Good morning, everyone. Volume for the second quarter was 1.1 billion pounds, an 11% decrease compared to last year. Sales for the second quarter were $2.2 billion, a 5% decrease. Excluding the acquisition of Justin's and the sale of Diamond Crystal and Farmer John, adjusted volume increased 1% and adjusted sales increased 2%.

Net earnings for the quarter were $211 million, down 2% compared to last year. General corporate expenses were lower in the second quarter primarily due to reduced employee-related expenses and higher allocations to the business units. We expect general corporate expenses to be below last year for the remainder of the year.

Depreciation and amortization for the quarter was $32 million, unchanged from last year. We expect depreciation and amortization to be approximately $125 million for 2017. Equity and earnings for the quarter was $10 million, up 6% compared to last year. Strong results for MegaMex including the HERDEZ and WHOLLY GUACAMOLE brands drove the increase.

Our effective tax rate in the second quarter was 33.2% compared to 33.6% last year. We expect our full year effective tax rate to be between 33% and 33.5%. As a reminder, we experienced an unusually low tax rate in the third quarter of last year, which was a result of international restructuring. Cash flow from operations was $84 million, down from $130 million last year. The decrease was primarily related to changes in working capital.

Capital expenditures totaled $39 million compared to $66 million last year. We expect capital expenditures to be approximately $190 million this year. Projects include completion of our plant in China, the new plant in Melrose, capacity expansion for value-added product lines, and ongoing investments for food and employee safety.

We paid our 355th consecutive quarterly dividend effective May 15, at the annual rate of $0.68 per share. We repurchased 547,000 shares of common stocks spending $19 million. We have 12 million shares remaining from the current authorization and will continue to repurchase stock to offset dilution from stock option exercises and based on the internal valuation of the stock.

Operating margins were 14.5%, a 40-basis point increase compared to last year. Four of our five segments increased operating margins. Input costs for the second quarter were mixed. Feed costs were slightly higher compared to last year. Barring any unforeseen weather events, we expect feed costs to trend below last year in the second half. Breast meat and other turkey commodity prices remain at seven-year lows. Based on inventory and production levels, we do not expect material changes in prices until the industry starts to cut back production.

Hog prices in the second quarter were similar to last year. We expect to see some short-term volatility in the hog markets in the second half. Overall, hog prices are expected to be higher than last year. Belly prices increased sharply in the first part of the quarter but are now comparable to last year. On average, belly prices were approximately 10% higher than last year. We expect belly prices to be above last year as the industry continues to experience lower cold storage levels and high demand for bacon. 72% pork trim prices were 10% above last year. We expect trim markets to remain above last year for the second half.

Prices for 50% beef trim were over 20% higher for the quarter. We expect beef prices to remain high for the second half with a possible downward trend in our fourth quarter. The new hog harvest capacity is coming online. Two plants recently began production, and two additional plants are expected to start production by late summer. The additional capacity represents an increase of about 6%. We believe hog supplies are positioned to closely match this increase as the USDA projects a 4% to 5% increase in the hog supply for 2017.

As we assess the long-term future of the hog industry, we see three areas of focus: export demand, domestic consumption, and total U.S. harvest capacity. Year-to-date, export demand has been strong. The USDA expects exports to be up 10% in 2017. Domestic consumption also remained strong. For example, pork feature activity has increased significantly and pricing has been stable. Depending on the long-term export and domestic consumption trends, we believe rationalization of less efficient harvest operations may need to occur. We remain confident we are well positioned to make the necessary adjustments in our business to address changes in pork capacity.

At this time, I'll turn the call over to the operator for the question-and-answer portion of the call.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from Rupesh Parikh with Oppenheimer.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.

Q

Thanks for taking my question. So, I want to discuss the Jennie-O segment in a little more detail. I was just curious, when you look historically, how long does it typically take for the industry to reduce production levels?

James P. Snee
President, Chief Executive Officer & Director, Hormel Foods Corp.

A

Good morning, Rupesh. What we've said is – I mean, we believe the cycle is a 12 to 18-month cycle. We don't know, we can't predict exactly when others in the industry will make production cuts. Now, I do think one of the things that we have to remember is that there still are improvements that can happen along the way in that 12 to 18 months in terms of commodity pricing, competitive activity. So, I mean, that's how we're looking at it and thinking about it.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.

Q

Okay. Great. And then my related follow-up question, as we look at your guidance for the back half of the year, what do you assume for Turkey prices? Do you assume we bottomed out or do you assume that they continue to get worse?

James P. Snee
President, Chief Executive Officer & Director, Hormel Foods Corp.

A

Yeah. I mean, so from our perspective, I mean, we've built in the downside that we think can occur. But from our perspective, we believe that there could be some improvements in the back half of the year. But again, as far as timing, when that happens, that's really hard to predict.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.

Q

Okay. Great. Thank you for all the color.

Operator: Our next question comes from Ken Zaslow with Bank of Montreal.

Kenneth Bryan Zaslow
Analyst, BMO Capital Markets (United States)

Q

Hi. Good morning, everyone.

James P. Snee
President, Chief Executive Officer & Director, Hormel Foods Corp.

A

Morning, Ken.

Kenneth Bryan Zaslow
Analyst, BMO Capital Markets (United States)

Q

Just continuing on the turkey side, there's two questions I have. One is the short term and one is the longer term. So, on the short term, what prompted you to change – I mean, I get the profitability, but you guys totally reversed course on your volume side of it, is my understanding. So, you do – how much was that just because, hey, look, the environment is that bad that we're just going to cut so, we're going to change that?

And then my second question, which is actually probably more important is, okay, so with seven-year low turkey prices, 2017 will probably be your fourth best year ever in turkey still. So, how does this change your longer-term view of the turkey operation in terms of 2018 and 2019? Does this change your margin structure? Is this something that we should – there's a structural issue here. Can you talk about that as well?

James P. Snee
President, Chief Executive Officer & Director, Hormel Foods Corp.

A

Sure. Thanks, Ken. From our perspective, the shorter term issue, as we looked at the business, starting with production, we have planned reductions before our fiscal year, some mid single-digit reductions that really allow us to be a net buyer of breast meats. We did take further reductions and have won in response to the market conditions. You could say those are probably low single digits and that would put us for the full year slightly lower than 2014.

Beyond that for the short term, I don't know that I would say we've changed course. And what we have seen is continued low commodity prices, and others in the industry have not cut back yet. And we haven't seen a change in competitive activity, still very strong. And this is unique to us but clearly we've still seen some increased expenses in terms of bird performance, our investments that we're making which we believe are on trend with RWOA and, of course, the ongoing investment in bio-security. So, I mean, that's the short-term view.

From our perspective, on the long-term side, I mean, there is nothing structurally wrong with this business. I mean, these changes are – they are market-based. They are not fundamental issues to the business. And we said this on our first quarter call is whether good or bad, we've been here before and we have emerged stronger as an organization. So, we feel really good with our ability to deliver long-term growth in this business, and it's still about being able to drive value-added sales, so we've been very pleased with the growth in our lean ground turkey, up double-digit this quarter, scan data that shows we're outperforming the category. So lots of good positive trends that set us up really well for the long term.

Kenneth Bryan Zaslow
Analyst, BMO Capital Markets (United States)

Q

Thank you.

Operator: We'll go next to Adam Samuelson with Goldman Sachs.

Adam Samuelson
Analyst, Goldman Sachs & Co.

Q

Yeah. Thanks. Good morning, everyone. Maybe first at the corporate level, just trying to get a sense. Last quarter, I think that you talked to a full-year outlook of about 5% organic growth for the year. Year-to-date, you're running a little bit under 3%, a little bit around 2% for the quarter, and you've got – and you're lapping an extra week in your fiscal fourth quarter. With the Jennie-O reductions that you have outlined for the back half, do you have an updated thought on the sales view? And any color by business would be helpful.

James P. Snee
President, Chief Executive Officer & Director, Hormel Foods Corp.

A

Sure, Adam. Obviously, the driver has been the JOTS performance. As we go around the horn and we think about all of our businesses for the back half of the year, we believe our Grocery Products sales will stay in line with their long-term growth goal of plus 3% and then plus the addition of the acquired Justin's business.

Refrigerated Foods on an adjusted basis would be in the low single-digit range. For JOTS, we are calling continued decreases in that mid-single-digit range. Specialty Foods group will be positive mid-single-digits and International will be on track to deliver their long-term stated growth goal of 10% sales growth. So, really aside from the JOTS business, we feel really good about the other four segments.

Adam Samuelson
Analyst, Goldman Sachs & Co.

Q

Okay. That's helpful. And then I want to go back to some comments in the prepared remarks that you made about pork harvesting capacity on the packing side and maybe the industry actually needing to rationalize the capacity long-term and you even alluded to you might need to reevaluate your own capacity there. Maybe elaborate on that view a little bit and do you view your pork packing capacity at higher cost relative to the industry or do you see less of a need for that vertical integration in your own business? Maybe a little bit more thought on how the pork harvest capacity fits in with the Hormel strategy relative to some of the increases in the industry capacity that's going on.

James N. Sheehan
Senior Vice President & Chief Financial Officer, Hormel Foods Corp.

A

Well, we constantly review our capacity. We've recently sold Farmer John which, obviously, reduced our capacity in the harvest level. We make changes to our harvest capacity on a regular basis. We look at it on a daily basis. We increase and decrease our harvest levels. We harvest hogs to provide a supply of raw materials for our value-added products. We do that because of the consistency of the products that we attain by harvesting the hogs themselves. And honestly, we do it on a very economic basis.

We purchase hogs that are very focused to be used in value-added products, which sometimes are slightly different than what you might see in the open market. We do purchase bellies, trims and, at times, ribs in the open market. We've been successful with that in the past. So, I guess, the answer to your question is, is that we look at our harvest levels on a daily basis. Both short-term and long-term we're looking at our harvest levels.

Adam Samuelson
Analyst, Goldman Sachs & Co.

Q

Okay. It's helpful color. I'll pass it on.

Operator: We'll go next to Rob Moskow with Credit Suisse.

Robert Moskow
Analyst, Credit Suisse Securities (USA) LLC

Q

Hi. I guess just a technical question on the cash flow in the quarter. If I'm not mistaken, it was pretty far below last year. Can you give us some color on the factors driving that and what do you expect cash flow to look like this year?

James N. Sheehan
Senior Vice President & Chief Financial Officer, Hormel Foods Corp.

A

Certainly. In the quarter, there are a couple of things that drove the change. There were tax payments, about $30 million in additional tax payment, and that's really just a timing issue. It has to do with how we make our estimated federal income tax payments. We expect that that'll come back to us in both the third and the fourth quarter. So, that, again, is more of a timing issue.

We also saw some variation in our accruals around some of our expenses, again more of a timing issue as to when they're paid during the year as opposed to the level of expense. We saw increases in dividends and share repurchase. That was about $25 million. But we also saw a lower CapEx expense. CapEx was supposed to come in at about – we expect it to come in at about $190 million. That is the primary driver of what would change the CapEx. As we get later in the year, we start to understand what projects are going to get completed in the year, what projects you're going to have investments in. So, we don't see any significant change to our cash flow. We still see the company is having a very strong cash flow.

Robert Moskow
Analyst, Credit Suisse Securities (USA) LLC

Q

And just a follow up, Jim and Jim. It just sounded a little inconsistent to hear the company talk about reducing Jennie-O production in the back half but then also talk about the renovation at Melrose and $130 million of CapEx to build – I know it's a further processing facility, so I guess it's different. But do you view this as – I don't know, how do I reconcile these two things? Is this a bet on 2019 being a much better year from a turkey perspective when you're fully operational?

And then secondly, the industry experts I talked to think that it's not going to be a 2018 recovery for turkey. It probably will be 2019 based on the fact that everyone seems to continue to increase production this year. Why are they increasing production even though results are that bad? And that's a lot of questions, but maybe you can help me out.

James P. Snee
President, Chief Executive Officer & Director, Hormel Foods Corp.

A

It is, but we'll try to get to all of them. I think as far as starting with the facility, and so, what we've said here is we are replacing a very aged facility in Melrose, and it is more for whole birds, and that is a very – I guess, we are focused on the value-added business. I mean, that's our long-term growth driver. But whole birds are still an integral part of the business. And so, this isn't a bet that we're making. I mean, this is an investment to update the facility, to modernize the facility, make it more efficient. So, we do feel like it sets us up well for the future. And I mean, the other thing to consider is that there is a positive NPV even though this is a replacement facility.

As you think about the production side of the business, there is increased production because you had a lot of people who were uncertain about avian influenza. So, there was a chance throughout the year that you could have another outbreak. So, you had people ramping up on production as we move further in the year and we never say never. But obviously and plus likely, I think that's when you could see some production cuts.

The other thing that I would say, Rob, is that there will be improvements along the way. If you want to think about when does it get back to more normalized or historical levels entirely, that will be hard to predict. We've set 12 to 18 months. But I do think that the other piece to consider is that there will be improvements along the way as commodity prices improved. You see some more rational competitive activity. We've seen what's happened in some of the beef markets already. So, I think, all of those things will impact it. And for us, it's the right long-term on-trend business to be in and there is nothing structurally wrong with the business. These are all market-based issues, not fundamental issues.

Robert Moskow
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. One last question, you filed a shelf placement recently. Can you tell us the rationale for that?

James N. Sheehan
Senior Vice President & Chief Financial Officer, Hormel Foods Corp.

A

That was just a routine extension of the debt.

Robert Moskow
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay.

James N. Sheehan
Senior Vice President & Chief Financial Officer, Hormel Foods Corp.

A

That was expired and we renewed it.

Robert Moskow
Analyst, Credit Suisse Securities (USA) LLC

Q

Thank you.

Operator: Our next question comes from Akshay Jagdale with Jefferies.

Akshay Jagdale
Analyst, Jefferies LLC

Q

Good morning. I wanted to ask about the Refrigerated Foods. Thanks for the update on the capacity. So, you mentioned 6% increase, can you clarify if that's one shift for all floor plans and when exactly expect that sort of 6% increased to be effective? Because you mentioned couple of plants are open now and couple are going to open later. Do you have a sense roughly as to when that 6% will be sort of effective and I have a follow up to that?

James N. Sheehan
Senior Vice President & Chief Financial Officer, Hormel Foods Corp.

A

Thank you, Akshay. 6% is for 2017 and I don't have any insight information about how those plants are operating or how fast they'll come up to speed. So, there will be additional capacity that'll come online in 2018, but the 6% addresses the capacity that – the stated capacity that will come online in 2016. So, I can't provide any further information on the ramp up. The USDA is stating that there will be enough hogs to provide that production at that production level. It is part of the reason that we told you we might see some short-term volatility in the hog prices as if the plants are delayed or if they start up faster than they thought, that can create some very short-term volatility in the market. We've seen that as some other plants have come online. But, again, we see those as very short term and not real trends.

Akshay Jagdale
Analyst, Jefferies LLC

Q

Right. So, just so I understand your math, you're just saying the daily capacity of these plants is X. If you look at that relative to what the daily capacity was before, it's a 6% increase. You're not doing any sort of weighted average calculation there because it's coming on...

James N. Sheehan
Senior Vice President & Chief Financial Officer, Hormel Foods Corp.

A

No, we are not. That is correct. And the information that we're using is the stated information from those groups building the plants.

Akshay Jagdale
Analyst, Jefferies LLC

Q

Perfect. And so as it relates to that expansion, we understand the difficulty of modeling any of that. But can you just help us understand your base case for 2017 is that hog prices sort of for the rest of the year remain flattish year-over-year because, I mean, they've moved up but they are somewhat still below a year ago? So, with the capacity coming online, what's your expectation for the next two quarters in terms of the hog prices? Is it sort of flattish year-over-year or it's...

James N. Sheehan
Senior Vice President & Chief Financial Officer, Hormel Foods Corp.

A

Slightly higher. We don't believe that the plants coming online will have any long-term impact on the price of some hogs.

Akshay Jagdale
Analyst, Jefferies LLC

Q

Okay.

James N. Sheehan
Senior Vice President & Chief Financial Officer, Hormel Foods Corp.

A

We, again, we believe that there could be some short-term volatility, but that's going to be very short term based on daily or weekly needs of hogs.

Akshay Jagdale
Analyst, Jefferies LLC

Q

Okay. And just one last one on turkey, and I know we have discussed this in private as well, but just overall the turkey business that you have is value-added, right? And so, there's a lot of conversation today in the last couple of quarters on commodity prices. I know there's three factors that are impacting the performance there, but I mean over time because you're so value-added shouldn't you be more and more insulated from commodity moves? Can you just address that sort of broader question? I mean, I understand that quarter-to-quarter over a six-month period there can be some disconnects, but one of the major issues you have is your cost to raising turkeys is much higher and you have less pounds. But the price itself long term you should be able to manage through that, right?

James P. Snee
President, Chief Executive Officer & Director, Hormel Foods Corp.

A

Yeah. I think, Akshay, in a nutshell what you're saying is correct. I mean, over the long term I mean we are a value-added business. Once again, we demonstrated that in a face of a tough operating quarter by being able to deliver double-digit growth for lean ground and positive scan data, and still a very, very profitable business. But, I mean, that doesn't mean we're immune to market conditions and competitive activity. So, you've got situation where we've got competing proteins. We know the first half of the year what the market was like for beef. So, there certainly is market pressure that comes into play. But through it all, I mean, we remain the price leader in the categories where we compete. It's a very profitable business that's focused on long-term, value-added growth, and again these are short-term, market-based issues, not structural or fundamental issues to the long-term viability of the business.

Akshay Jagdale
Analyst, Jefferies LLC

Q

Perfect. I'll pass it on. Thank you.

Operator: Our next question comes from Farha Aslam with Stephens, Incorporated.

Farha Aslam
Analyst, Stephens, Inc.

Q

Hi. Good morning.

James P. Snee
President, Chief Executive Officer & Director, Hormel Foods Corp.

A

Hi, Farha. Good morning.

Farha Aslam
Analyst, Stephens, Inc.

Q

So, again, on Jennie-O for my first kind of questions around there, we've seen turkey egg sets come down. In the calendar first quarter of this year, turkey egg sets were up 9%. And here, so far, in the second calendar quarter, we're down to flat. I mean, so the industry is cutting. How much do you think turkey egg sets need to go down for this recovery to happen? And your 12 to 18-month kind of target, when is the start date that we should use for the 12 to 18 months in your mind?

James N. Sheehan
Senior Vice President & Chief Financial Officer, Hormel Foods Corp.
A

Right. So, as we look at the net poult placement, it looks like it's down 3% to 5%. So, we expect it to be down, I guess, I should say, 3% to 5%. If you looked at the inventory levels that just came out, the freezer inventories that just came out this week, freezer inventories of breast meat are up over 50% above last year. So, there still needs to be some clearing through the market of this excess inventory.

James P. Snee
President, Chief Executive Officer & Director, Hormel Foods Corp.
A

And, I think, in terms of the 12 to 18 months part of it, the bigger issue there, and what I've said several times already is this idea that we'll see improvements along the way, both in the market and, of course, in our own business. And so we don't have today, I would say, a starting line in terms of when that clock will set. But for us, it's more about the improvements that we know we'll see. And, I think, we've done the right things in terms of how we had planned reductions at the beginning of the year, proactively managing our own business by taking further reductions in half one. So, we're doing the right things to set ourselves up for improvement. And clearly, that could be accelerated by others in the industry doing the same.

Farha Aslam
Analyst, Stephens, Inc.
Q

Yeah. Clearly, the industry is already responding. But then, if we look at your earnings for this year, they're essentially coming in plus or minus flat to last year. When you look out into 2018 and with all the puts and takes, do you anticipate earnings growth? Do you anticipate being able to get back to your historical targeted algorithm of 5% top line growth and 10% EPS growth?

James P. Snee
President, Chief Executive Officer & Director, Hormel Foods Corp.
A

In terms of specific guidance for 2018, it's obviously too early. As we think about our business just in real general terms, our business is solid. I mean, we've got market impacts, market-based impacts impacting Jennie-O. But there is a solid foundation, this intentional balance that we've built throughout our portfolio has allowed us to offset some of the devastating impact to JOTS. This is the what-if scenario, but if JOTS is flat with year ago, our business is up double-digit on the bottom line. So, that doesn't do anything to the results but it just shows how solid our business is and how strong that balance is. But I mean, we do believe that we'll get through this and we'll be able to deliver our long-term growth algorithm of 5% and 10%.

Farha Aslam
Analyst, Stephens, Inc.
Q

Great. Thank you.

Operator: Our next question comes from Benjamin Theurer with Barclays.

Benjamin M. Theurer
Analyst, Barclays Capital Casa de Bolsa SA de CV Q

Hi. Good morning and thank you very much for the opportunity. Just I have a follow-up question on your SG&A expenses. So you mentioned that basically there was a huge reduction in advertising from roughly $50 million last year to $30 million. So, that's about $20 million. Taking a look at what you've reported on SG&A, there is a decrease by about $30 million on a quarter-over-quarter but also on a year-over-year basis.

So, my question is, I understand that you're likely to be a little more cautious on advertising especially on the Jennie-O side for the remainder of the year, but can we assume that more for the long run that that roughly $10 million savings is something recurring. Do you think there is an opportunity to further save on and what's your expectation in terms of SG&A expenses for the back half of the year? If you want to express it as percentage of sales or more in absolute terms, so just to get a little bit of a sense of how much more savings potentially you might have on the SG&A side? Thank you.

James N. Sheehan
Senior Vice President & Chief Financial Officer, Hormel Foods Corp. A

Thanks for the question. You're right. Our SG&A is down $30 million year-over-year, $19 million of that is advertising. We also experienced lower employee-related expenses including the loss of the expenses related to the businesses that have been sold. But we've made other cuts around employee-related expenses. We're very tight. We're looking at any changes in inventory levels or in employee levels very closely. We've taken a very proactive approach to expense management due to the market conditions. We've focused on reductions that will not harm long-term growth.

There are many examples of things that we've done that have managed expenses in this market condition. We've had sales meetings that have been held on conference calls instead of the big meetings. We've looked at how many people are going to conferences. We've reduced travel. Now, those things are going to be needle movers, but I think it's just the sense of attention to every expense that's going through the system.

And it's not only going on now, but it's something that we [ph] play in (44:21) to continue in the future. So, we're very focused on expenses, and I think this is a good time to refocus the staff about making sure that every dime has been spent wisely and efficiently.

Benjamin M. Theurer
Analyst, Barclays Capital Casa de Bolsa SA de CV Q

Okay. And you have the $19 million that was related to the advertising as of now, but is that something towards the end of the year, i.e., 4Q into what's usually a more – the strongest quarter throughout the year, do you expect advertising to pick up by then again just to, well, not lose market share in the different segments or is that something you would try to maintain in terms of spending what we had 2Q throughout the rest of the year?

James P. Snee
President, Chief Executive Officer & Director, Hormel Foods Corp. A

Yeah. So, Benjamin, just to reiterate, I mean, the advertising reductions that we've made are short-term reductions. I mean, we've been again very public and intentional about how we do support our brands and how important that is to us. But in the short-term reductions, the majority, again, have come from JOTS and not all of them have translated through to the bottom line. Some of the JOTS, in particular, have shifted to [ph] tray (45:35) to maintain on-shelf competitiveness, on-shelf positions, but remember even with that we are still the price leader.

Benjamin M. Theurer
Analyst, Barclays Capital Casa de Bolsa SA de CV
Q

Yes.

James P. Snee
President, Chief Executive Officer & Director, Hormel Foods Corp.
A

So, we're – and these levels are comparable to 2015. And we have flexed our advertising dollars before. So, this has happened. We are committed to long-term growth and long-term brand building. And I just want to reiterate that we are absolutely committed to our brands and the short-term reduction is not putting them at risk.

Benjamin M. Theurer
Analyst, Barclays Capital Casa de Bolsa SA de CV
Q

Okay. Perfect. Very clear. Thank you very much.

James P. Snee
President, Chief Executive Officer & Director, Hormel Foods Corp.
A

Yes.

Operator: Our next question comes from Heather Jones with The Vertical Group.

Heather Jones
Analyst, Vertical Trading Group LLC
Q

Good morning. I hate to beat a dead horse, but I have a question on Jennie-O. And I was just wondering if you could give us a sense of how much of the profitability pressure you experience right now is due to things like your livability issues with NAE, et cetera, because from what I understand most of the industry is still making money, and I understand you all are, if not the best producer in the industry, among the best, and your margins are still strong. So, it doesn't seem like anyone's in dire straits right now. So, I was just wondering if you could give us a sense of how much things like your operating expenses being higher and then once you regain some of the shelf space lost during the AI, how much that could help your earnings as opposed to the industry cutting production?

James P. Snee
President, Chief Executive Officer & Director, Hormel Foods Corp.
A

Yeah. I think, Heather, you're correct. I mean, our earnings are still there and are still strong. We are a very – Jennie-O is still a very profitable business for us. Without getting too specific, probably just more along the order of magnitude in terms of what's having the greatest impact, the first one would be market conditions, second would be pricing pressure, and then third would be our own increased expenses.

So, we're battling. It's a battle for JOTS to maintain price competitiveness, to maintain their shelf space. But those are all the right fundamental things that when these market conditions change, that are going to set us up for the continued growth. I think the perfect example of that is that we continue to make investments in our raised-without-antibiotic program. That is on trend with consumers, and rather than make the cut this year – we know that it's something that's going to set us up for the long term, so we'll continue to invest in that.

Heather Jones
Analyst, Vertical Trading Group LLC
Q

Okay. And going back to an earlier question on the Refrigerated Foods side, so you guys are net short bellies, trim, and to a lesser extent, ribs. From my understanding of the industry, your plants, as you have remaining, I believe it's two, they're pretty efficient plants. And so they don't seem to be two of the candidates to be shuttered when you were mentioning less efficient facilities. However, would you ever entertain the idea of simply just moving to buying primals for our value-added business as opposed to being in the hog slaughter part of the business?

James P. Snee
President, Chief Executive Officer & Director, Hormel Foods Corp.

A

Yeah. Heather, we – I mean, we really value the control and the process, the quality control that we get. And you're right, I mean, we harvest hogs as a source of raw materials for our value-added business. And so, I mean, we see great value in being able to harvest those hogs ourselves gives us a level of control, as I said earlier. And so that's a business that we plan to remain in.

Heather Jones
Analyst, Vertical Trading Group LLC

Q

Okay. Perfect. Thank you so much.

Operator: Our next question comes from Eric Larson with Buckingham Research Group.

Eric Larson
Analyst, The Buckingham Research Group, Inc.

Q

Yes. Good morning, everyone, and thanks for squeezing me in here. Jim, I want to go back to really the pork markets. And we all know how important the export markets are for keeping a favorable balance in the U.S. market particularly given the amount of pork that we've been seeing coming into the market the last few years. We are now – looks like we are going to be negotiating NAFTA. Mexico is a huge partner for us on pork products particularly hams. I'm not really sure it makes much difference. I mean, Mexico has already moved to get corn from Argentina, Brazil not much, but they're moving. I'm not sure it makes much difference, but I'm interested in your perspective on the export markets in general and if NAFTA can have any kind of an impact on the dynamics of those export markets.

James P. Snee
President, Chief Executive Officer & Director, Hormel Foods Corp.

A

Eric, NAFTA is certainly an interesting agreement. And the large driver of the whole agreement is agricultural products. I mean, that's the benefit that the U.S. gets from those agreements with Mexico and Canada. So, again, I'm not going to make a prediction now to what that's going to look like in the future. But I have a hard time believing that it's going to go away entirely. I think we'll some renegotiation, but we'll still be able to benefit from those neighboring markets.

Eric Larson
Analyst, The Buckingham Research Group, Inc.

Q

Yeah. I agree. Thanks. Thanks for the comments.

James P. Snee
President, Chief Executive Officer & Director, Hormel Foods Corp.

A

All right. Thanks, Eric.

Operator: Our next question comes from Brett Andress with KeyBanc Capital Markets.

Brett Andress
Analyst, KeyBanc Capital Markets, Inc.
Q

Hey, good morning.

James P. Snee
President, Chief Executive Officer & Director, Hormel Foods Corp.
A

Good morning.

James N. Sheehan
Senior Vice President & Chief Financial Officer, Hormel Foods Corp.
A

Brett.

Brett Andress
Analyst, KeyBanc Capital Markets, Inc.
Q

I wanted to go back to turkey real quick. Could you comment a little bit more on the bird performance this quarter? I mean, did it come in worse than you were expecting and maybe what's happening now here in May? And I guess, how long do you think it would take you to get these issues corrected?

James N. Sheehan
Senior Vice President & Chief Financial Officer, Hormel Foods Corp.
A

Thanks, Brett. The turkey performance was about where we thought it would be and improved a little bit close to the end of the quarter. So, we're seeing some improvement in the performance. It's a slow process and it takes time to determine what you need to do to improve the turkey performance. There's a bit of a learning curve here and I think that we're – we think that we are getting close to turning the quarter on us.

Brett Andress
Analyst, KeyBanc Capital Markets, Inc.
Q

Got it. Thank you. And last one on the driver of the grocery margin, I think it was close to a record for the second quarter. So, I just kind of want to understand some of the put-and-takes? Maybe how much was advertising and maybe what were some of the largest input benefits or maybe some of the largest pressures? Because I think avocados are spiking recently and it seems like your expectations for beef and pork inputs are also up. So, maybe if you can kind of clarify maybe some of the expectations going forward.

James P. Snee
President, Chief Executive Officer & Director, Hormel Foods Corp.
A

Sure, Brett. In the second quarter, I mean, clearly, we saw a strong growth from SPAM, WHOLLY, HERDEZ and SKIPPY which are great margining businesses for us. Clearly, we've had the inclusion of our Justin's business which has been a great acquisition. And then, of course, we've talked about our recent innovations like SKIPPY P.B. Bites and HERDEZ Guacamole Salsa, and those are all accretive innovations to the grocery products group.

In terms of advertising, I would tell you it's a small portion of that improvement. And we did have some offsets for the quarter. Chili had a difficult quarter. and a large part of that was just some promotional activity that didn't play out the way that we thought we would. But remember, I mean, we're coming off of banner 2016 for our chili business. So, again, we feel really good about where that's heading.

And so, for the back half of the year, I mean, we're thinking about GP as more of the same. So, strong growth from SPAM, WHOLLY, HERDEZ, SKIPPY. Justin's continues to ramp-up. And then, of course, these accretive innovations are going to continue to be very important to that business. So, we feel really good about our ability to deliver the long-term stated goals for GP.

James P. Snee
President, Chief Executive Officer & Director, Hormel Foods Corp. A

Thank you.

Operator: Our next question comes from Jeremy Scott with Mizuho.

Jeremy Scott
Analyst, Mizuho Securities Q

Hey. Good morning.

James P. Snee
President, Chief Executive Officer & Director, Hormel Foods Corp. A

Jeremy.

Jeremy Scott
Analyst, Mizuho Securities Q

So, I just wanted to get a sense of the retail and food service landscape and how that's changing given the impact of labor cost. Clearly, we've seen the growth in the retail perimeter and on site food preparation over the past 10 years in grocery and what that has done to the center of the store volumes. But given that it's a much more labor intensive process, it seems like the natural progression would be to outsource more of those perimeter goods to Hormel and others and you could be the preferred providers. Now, I would assume that would translate to foodservice as well. What's the opportunity here? What are you hearing from your customers with regards to this business and what could that mean for the sustainability of Refrigerated Foods margins?

James P. Snee
President, Chief Executive Officer & Director, Hormel Foods Corp. A

Jeremy, that's a great question. I mean, there's certainly is a retail focus on that area of prepared foods. It's not new focus, but I would tell you it feels like retailers are really starting to finally figure it out and fell for it and you're exactly right. I mean, the business is more closely aligning with the traditional foodservice business.

And that bodes really, really well for us. I mean, our ability to work with operators, and so if you consider retail prepared foods an operator, our ability to help them take out labor is second to none. I mean, we're able to develop customized solutions to meet their needs and a variety of different ways that with ease of preparation, taking out labor, but still very, very high quality products that consumers believe are prepared in the back of the house. So, it is going to – it's an area of focus for us because it's an area of focus for the retailers, and sets up really well for how we run our food service business.

Jeremy Scott
Analyst, Mizuho Securities

Q

I guess from that same leg, there's a lot of regionalized specialty vendors that provide these goods to the retail perimeter. I mean, what's your take on, is the next – or the M&A pipeline is consolidating maybe some of that opportunity?

James P. Snee
President, Chief Executive Officer & Director, Hormel Foods Corp.

A

I don't – I mean, I don't want to speculate on that. I mean, as we think about it, certainly, we've got our own criteria. We're looking for number one, number two brands opportunity become more global, accretive margins. So, we've got our own criteria when we think about how we're going to approach the M& market.

Jeremy Scott
Analyst, Mizuho Securities

Q

Okay. Thank you.

James P. Snee
President, Chief Executive Officer & Director, Hormel Foods Corp.

A

Yes.

Operator: Next. We have an additional question from Robert Moskow with Credit Suisse.

Robert Moskow
Analyst, Credit Suisse Securities (USA) LLC

Q

Hi. Just a follow-up on party trays, normally, that shows up in your prepared comments as demonstrating growth in the quarter. I certainly saw a lot of growth in the Nielsen data but you didn't mention it today. Have you lost any distribution on party trays?

James P. Snee
President, Chief Executive Officer & Director, Hormel Foods Corp.

A

No, Rob. I'm sorry. We actually – party trays are doing well. I mean, as you go across the entire meat products platform, we didn't get too specific with it, but the growth in IRI data was very strong across many, many categories. So, we just didn't list it there and party trays continue to do really well for us and we do all have only some space in the press release. But you're right, party trays are very important to our meat products business and continue to be doing really well.

Robert Moskow
Analyst, Credit Suisse Securities (USA) LLC

Q

Great. Thank you.

James P. Snee
President, Chief Executive Officer & Director, Hormel Foods Corp.

A

Yes.

Operator: It appears there are no further questions at this time, sir. I'd like to turn the conference back to your for any additional or closing remarks.

James P. Snee

President, Chief Executive Officer & Director, Hormel Foods Corp.

Well, thank you all very much for your participation today. While we're proud of the results for many of our businesses, we clearly understand that our mission is to deliver growth. Our team knows what needs to be done this year and is fighting to deliver our key results. On behalf of the team here at Hormel Foods, thank you for joining us today and have an enjoyable long weekend.

Operator: This concludes today's conference. Thank you for your participation. You may now disconnect.