18-May-2016

Hormel Foods Corp. (HRL)

Q2 2016 Earnings Call

Copyright © 2001-2016 FactSet CallStreet, LLC

CORPORATE PARTICIPANTS

Jana L. Haynes
Director-Investor Relations

Jeffrey M. Ettinger
Chairman & Chief Executive Officer

James P. Snee
President, Chief Operating Officer & Director

Jody H. Feragen
Chief Financial Officer, Executive Vice President & Director

OTHER PARTICIPANTS

Adam L. Samuelson
Goldman Sachs & Co.

Farha Aslam
Stephens, Inc.

Akshay Jagdale
Jefferies LLC

Heather Lynn Jones
BB&T Capital Markets

Mario Contreras
Deutsche Bank Securities, Inc.

Jeremy Scott
CLSA Americas LLC

Eric Larson
The Buckingham Research Group, Inc.

Robert Moskow
Credit Suisse Securities (USA) LLC (Broker)

MANAGEMENT DISCUSSION SECTION

Operator: Good day and welcome to the Hormel Foods Second Quarter 2016 Earnings Conference Call. All participants are in a listen-only mode. Today's conference is being recorded.

At this time, I would like to turn the conference over to Jana Haynes, Director of Investor Relations. Please go ahead.

Jana L. Haynes
Director-Investor Relations

Thank you. Good morning. Welcome to the Hormel Foods conference call for the second quarter of fiscal 2016. We released our results this morning before the market opened around 6:30 AM Eastern Time. In addition, we issued a separate press release announcing the acquisition of Justin's, LLC. If you did not receive the copy of the releases, you can find them on our website at hormelfoods.com under the Investors section.

On our call today is Jeff Ettinger, Chairman of the Board and Chief Executive Officer; Jim Snee, President and Chief Operating Officer; and Jody Feragen, Executive Vice President and Chief Financial Officer. Jeff will provide an overview of the quarter, and then Jim will comment on the Justin's acquisition, a review of the operating results, outlook and guidance for fiscal 2016. Jody will provide detailed financial results for the quarter. The line will open for questions following Jody's remarks.

As a courtesy to the other analysts, please limit yourself to one question with one follow-up. If you have additional queries, you are welcome to get back into the queue. An audio replay of this call will be available beginning at

Copyright © 2001-2016 FactSet CallStreet, LLC

10:00 AM Central Time today, May 18, 2016. The dial-in number is 800-346-0976, and the access code is 2194984. 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 statements. 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.

Factors that may affect actual results of the acquisition include, but are not limited to, whether and when the required regulatory approvals will be obtained, whether and when the company will be able to realize the expected financial results, and accretive effect of the transaction, and how customers, competitors and suppliers and employees will react to the transaction.

Please refer to pages 30 through 35 in the company's Form 10-Q for the quarter ended January 24, 2016 for more details. It can be accessed on our website.

Now, I will turn the call over to Jeff.

Jeffrey M. Ettinger

Chairman & Chief Executive Officer

Thank you, Jana, and good morning, everyone. We are pleased to report record results for our second quarter of fiscal 2016. Earnings in the second quarter were $0.40 per share, up a robust 21% from last year. Sales for the quarter were $2.3 billion, a 1% increase despite lower turkey volumes at Jennie-O Turkey Store and soft export demand in our International segment.

We reached an agreement to sell Diamond Crystal Brands in the second quarter and completed the transaction in recent days. This business, which was part of our Specialty Foods segment, represented approximately $260 million of annual sales. While Diamond Crystal Brands performed acceptably, it did not fit our long-term strategic priorities. As a result of the transaction, there was a small goodwill impairment recorded this quarter to reflect the final sales price.

Our Specialty Foods group will retain Hormel Health Labs, a provider of nutritional foods and beverages developed specifically for individuals with special dietary needs, which was previously a part of Diamond Crystal Brands. We continue to ensure a smooth transition for the customers and employees of Diamond Crystal Brands.

In addition to our earnings release this morning, we also announced the acquisition of Justin's, LLC, a pioneer in the specialty nut butter category. The acquisition comes with the fast growing JUSTIN'S brand of natural and organic products, a strong management team, access to new customers and several manufacturing agreements. The deal is subject to the customary closing conditions, including regulatory approvals in the United States, and is expected to close within 60 days.

I will now turn the call over to Jim Snee, who will provide additional details about the Justin's acquisition and also take you through each segment.

James P. Snee

President, Chief Operating Officer & Director

Copyright © 2001-2016 FactSet CallStreet, LLC

Thank you, Jeff, and good morning, everyone. Since Justin's was founded in 2004, the business has experienced tremendous growth. Looking forward, we expect Justin's to grow at low-double-digit rate from a starting point of approximately $100 million in fiscal 2017 net sales. Justin's will report into the Grocery Products segment.

Justin's enhances our scale in the nut butter category, complementing our SKIPPY brand positioning very nicely. The JUSTIN'S brand gives us a great platform in natural and organic specialty nut butter spreads, the fastest growing portion of the nut butter category. Justin's also further balances our portfolio of brands towards younger, more health conscious and on-the-go consumers with their pioneering squeeze packs, affordable snack that comes in all seven of JUSTIN'S nut butter flavors.

We intend to leverage key Hormel Foods resources and supply chain, finance and R&D, while leaving their mission and vision unchanged. We look forward to working with the Justin's team in Boulder, Colorado, and finalizing the acquisition in the coming weeks.

I will now take you through each segment. Grocery Products segment profit was up 21% for the quarter. Input cost tailwinds and improved plant efficiencies drove the gains. Sales were up 1% led by SKIPPY peanut butter, HORMEL chili and WHOLLY GUACAMOLE and our HERDEZ line of authentic Mexican products. Sales for our chunk meats business and COMPLEATS microwave meals were down this quarter.

Our SKIPPY peanut butter products had a great quarter. Our traditional jarred peanut butter continues to capture share in the marketplace as our sales team gains additional distribution. Our most recent innovation SKIPPY P.B. Bites has had many early successes and key measures such as trial and repeat are meeting our internal targets. The company continues to leverage its iconic brands in new and innovative ways. In this past April, we opened the new 14,000 square foot SPAM Museum located in downtown Austin, Minnesota. We invite you to come and visit our new family-friendly museum.

Refrigerated Foods second quarter operating profit increased 13%, with sales up 7% and volume up 3%. Refrigerated Foods benefited from strong pork operating margins, the addition of the Applegate business and great results from our foodservice business.

We saw growth from many of our value-added products, including retail sales of HORMEL NATURAL CHOICE lunch meat, HORMEL pepperoni, HORMEL party trays. Our foodservice value-added products experienced solid growth led by brands such as the AUSTIN BLUES line of products, HORMEL BACON 1 fully cooked bacon, and HORMEL FIRE BRAISED meats.

When we announced the Applegate acquisition in 2015, one of our top priorities was to tackle the supply constraints we identified during the acquisition. While staying true to Applegate's mission of Changing the Meat We Eat, we have secured additional supplies and the team is working to gain back distribution that was lost when supplies were pressured. Applegate remains on track to deliver earnings results consistent with our initial guidance for this business.

Jennie-O Turkey Store's second quarter segment profit increased 20%, while sales decreased 4%. Results were impacted by the lingering effects of avian influenza as flocks lost in 2015 created shortfalls in operations and sales. Production volumes have now returned to normalized levels and we remain optimistic that avian influenza is behind us. However, the team continues to be diligent and heightened bio-security remains a top focus. We remain focused on gaining back distribution that was curtailed during the outbreak, but we did enjoy growth this quarter in our Jennie-O Lean Ground Turkey, retail bacon, and OVEN-READY product lines.

Copyright © 2001-2016 FactSet CallStreet, LLC

Our Specialty Foods segment reported an operating profit increase of 74%. The increase was aided in part by a favorable comparison to expenses last year related to the closure of the CytoSport production facility. Operational synergies captured in the current year within the CytoSport and Century Foods supply chain also contributed to the increase. MUSCLE MILK sports nutrition products posted excellent results in addition to launching many new innovative items such as MUSCLE MILK protein smoothies. The gains made by our CytoSport team were offset by lower contract packaging sales resulting in a 5% decrease in sales this quarter.

International's operating profit decreased 33% and sales declined 17%. Weak exports of our SPAM and SKIPPY family of products in addition to soft pork export markets contributed to the declines. Our China meat business had a difficult comparison to last year in addition to pressures from higher pork raw material cost. Our SKIPPY business in Mainland China experienced nice growth this quarter.

We expect input cost tailwinds to continue for Refrigerated Foods and Grocery Products. We look for these segments to continue driving year-over-year gains in sales and operating profit through increases in our value-added products.

Jennie-O Turkey Store production is now at normalized levels and we are positioned to deliver growth in the back half of the year provided there are no significant reoccurrences of avian influenza. The team is investing in their fourth Make The Switch advertising campaign, highlighting turkey as an alternative to beef. Lower grain input cost should continue to be a tailwind in the second half of the year.

The Specialty Foods segment may show year-over-year sales and earnings declines due to the sale of the Diamond Crystal Brands business. Positive sales trends in the MUSCLE MILK brand and incremental sales from new innovative MUSCLE MILK products will offset some of the sales declines.

With the sale of Diamond Crystal Brands and to reflect the enhanced margin profile of CytoSport, we are increasing our segment margin guidance for Specialty Foods to 11% to 14%, up from the previously guided 8% to 11%.

We look for the International segment to return to growth in the second half through increased export sales of our SPAM luncheon meat and SKIPPY peanut butter products, along with gradual improvement in our China retail meats business.

We continue to reinvest into our businesses through increased advertising and marketing support for brands such as HORMEL pepperoni, our SPAM family of products, SKIPPY peanut butter, MUSCLE MILK protein products, and Jennie-O Turkey.

As a result of the strong second quarter and continued confidence in our position heading into the back half of the year, we are raising our full year guidance from $1.50 to $1.56 per share to $1.56 to $1.60 per share.

At this time, I'll turn the call over to Jody Feragen to discuss the financial information relating to the second quarter.

Jody H. Feragen

Chief Financial Officer, Executive Vice President & Director

Thank you, Jim. Good morning, everyone. Net earnings for the second quarter of fiscal 2016 totaled $215.4 million, up 20% over last year. Diluted earnings per share were $0.40, a 21% increase. Sales for the second

Copyright © 2001-2016 FactSet CallStreet, LLC

quarter totaled $2.3 billion compared to $2.28 billion for the same period last year, a 1% increase. Turkey supply shortages and lower exports pressured sales during the quarter.

Volume for the second quarter was 1.28 billion pounds, down less than 1% from the same quarter last year. As Jeff and Jim mentioned, we have reached an agreement to acquire Justin's, LLC. The purchase price is $286 million. The transaction is structured to provide an ongoing cash flow benefit resulting from the tax amortization of the stepped-up basis of asset. The net present value of this tax cash flow benefit is estimated to be about $70 million.

We expect fiscal 2016 to include about four months of results from Justin's with a slightly negative impact to earnings after factoring in the expected transaction cost and fair value adjustment. We estimate accretion associated with the deal to be approximately $0.01 for fiscal 2017. We expect to gain supply chain synergies that will be implemented over the next several years. We plan to finance this transaction with cash on hand and a short-term draw from our credit facility. Following the close, we will remain in a strong financial position to fund any other capital needs.

Advertising expense for the quarter was $48.8 million compared to $39.5 million last year, as we continued to build on our brand investment. Our effective tax rate in the second quarter was 33.6% versus 34.6% in fiscal 2015. For the full year, we expect our effective tax rate to be between 33.5% and 34%.

The basic weighted average number of shares outstanding for the second quarter was 529.9 million compared to 528.1 million last year. The diluted weighted average number of shares outstanding for the second quarter was 543.8 million shares, compared to 540.9 million last year. We repurchased 160,000 shares of common stock spending $6.4 million in the second quarter. We have 15.4 million shares remaining to be purchased from the current authorization in place.

Long-term debt at the end of the quarter was $250 million, the same as last year. Capital expenditures for the quarter totaled $66.4 million compared to $27.3 million last year. For fiscal 2016, we expect capital expenditures to be approximately $250 million. Depreciation and amortization for the quarter was $32.1 million compared to $33 million last year.

As Jim mentioned earlier, we raised our fiscal 2016 earning guidance range to $1.56 to $1.60 per share. This guidance includes the sale of our Diamond Crystal business and the acquisition of Justin's, LLC. As a reminder, fiscal 2016 includes an extra week in the fourth quarter. We paid our 351st consecutive quarterly dividend, effective May 16, 2016 at the annual rate of $0.58 per share.

At this time, I will turn the call over to the operator for the question-and-answer portion of the call. Operator?

Copyright © 2001-2016 FactSet CallStreet, LLC

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] We'll go first to Adam Samuelson from Goldman Sachs. Please go ahead.

Adam L. Samuelson
Goldman Sachs & Co.

Q

Great. Thanks. Good morning, everyone. Maybe first, was hoping to get a little bit more color on volume trends in Refrigerated, I think you reported 3% volume growth. Do you have the organic number if you strip out Applegate? I would guess it actually be slightly negative, which would be a little bit of a deceleration versus last quarter and hoping to really understand kind of some of the mix there for where you're seeing the gains foodservice versus retail and some of the categories that are lagging?

Jeffrey M. Ettinger
Chairman & Chief Executive Officer

A

I think your overall – this is Jeff, Adam. Your overall math would be correct. It would have been slightly down absent the Applegate added sales. In terms of a differential between parts of the business, we did talk about that foodservice had a really very strong quarter. So, clearly, we're a little bit off on some of the retail brands. But it was a mixed bag. They had some nice success with some of their items such as NATURAL CHOICE and party trays and pepperoni, but they did have a couple of the franchises that were down somewhat.

Adam L. Samuelson
Goldman Sachs & Co.

Q

And as you look ahead, any visibility to an improving retail cadence going into the summer, and maybe a little bit more color, Jeff and team, on the margin mix implications of that stronger foodservice growth, is that actually benefiting the margins meaningfully at this point? Thanks.

Jeffrey M. Ettinger
Chairman & Chief Executive Officer

A

Yeah. I think, not just for Refrigerated, frankly, we're looking at a more favorable environment for net sales growth for multiple segments next quarter. This quarter was still not quite where we would like it to have been, but it was not at the level of declines that the last two or three quarters had been. So, we're seeing the sequential improvement in our outlook heading into the second half. For example, you got Jennie-O now with full volume, so that will be a much more favorable picture.

In terms of margins, we've talked before about that foodservice is a solid contributor to overall Refrigerated Foods returns. The greater volatility piece more recently had been the processing margins, which were still quite strong this quarter, although a little bit less than Q1.

Operator: We'll take our next question from Farha Aslam from Stephens, Incorporated. Please go ahead.

Farha Aslam
Stephens, Inc.

Q

Hi. Good morning.

Copyright © 2001-2016 FactSet CallStreet, LLC

Jeffrey M. Ettinger
Chairman & Chief Executive Officer

A

Hi, Farha.

Jody H. Feragen
Chief Financial Officer, Executive Vice President & Director

A

Good morning.

Farha Aslam
Stephens, Inc.

Q

First question is on turkey. As your volume comes back, how should we think about margins in that business and margins going into next year and longer term for turkey?

James P. Snee
President, Chief Operating Officer & Director

A

Yeah. Hi, Farha. Good morning. This is Jim. As we look into the future, with our more normalized levels of production, obviously, the team is working hard to regain the distribution that was lost while supply was gone. And clearly, they were able to take advantage of some higher margins during that time. But, as we look to the future, we would expect, because of a couple of reasons, because of market conditions, but then also now that we are going to be able or have to sell all of the parts and not be able to take advantage of specific mix opportunities, that our margins will return to the more normalized ranges, the guidance that we had provided. And I think we'll start to see that in the back half of this year and into next year.

Farha Aslam
Stephens, Inc.

Q

And then, also, your margin outlook for your Refrigerated Foods division longer term, do you anticipate the increased processing capacity that's coming on in the U.S. hog and pork processing sector to impact margins for Hormel and how do you plan to kind of work around that?

Jeffrey M. Ettinger
Chairman & Chief Executive Officer

A

Farha, this is Jeff. That will clearly be one of the pieces we assess when we create our business plan for 2017. And we're sticking with our margin guidance that we provided for each of the segments at the beginning of the year, with the one exception being, obviously, we did update the Specialty Foods segment as we said we would once we had visibility of the Diamond Crystal transaction being completed. But we recognized that, at this point, a number of our segments are performing quite strongly against the guidance ranges we provided, and when we have a more clear outlook for 2017 and beyond, we would provide an update to that.

Operator: And we'll go next to Akshay Jagdale from Jefferies. Please go ahead.

Akshay Jagdale
Jefferies LLC

Q

Good morning.

Copyright © 2001-2016 FactSet CallStreet, LLC

Jeffrey M. Ettinger
Chairman & Chief Executive Officer
A

Hi, Akshay.

Jody H. Feragen
Chief Financial Officer, Executive Vice President & Director
A

Good morning.

Akshay Jagdale
Jefferies LLC
Q

Hi. First question is on Refrigerated Foods. So, the pork operating margins that everybody tracks in May were even lower than what you saw in the second quarter. Can you help us – I know it's difficult to look at those numbers and translate them to yours, but just generally speaking, what have you factored in into your guidance for the back half as far as pork operating margins go? Should they be similar to what we're seeing in the month of May? Is that what's factored in or how should we think about that?

Jody H. Feragen
Chief Financial Officer, Executive Vice President & Director
A

Sure. I'll take that one, Akshay. Yes, you're right. Pork operating margins for May have been down about 40% from the averages in April. And that's probably a little bit faster decline than we originally anticipated. But, as we stated on our first quarter call, we really do expect pork operating margins to be higher for the full year because of the strong start we've had in the first half, but moderating in the back half. So, predicting exactly where that's going to go is not an easy task, as you know.

Akshay Jagdale
Jefferies LLC
Q

Okay. And then can you talk a little bit more about Justin's, the sales number you quoted is much higher than what we see in the measured channels. So, clearly, they seem to have a big presence in the non-measured channel. Can you give us a sense of the channel mix and maybe, more importantly, talk about why sort of buy this brand when you already have a good brand equity in the whole nut butter category? Why couldn't you take that and extend it into some of the categories that Justin's is in for example? Thanks. I'll pass it on.

Jeffrey M. Ettinger
Chairman & Chief Executive Officer
A

Okay. Thanks, Akshay. This is Jeff and I'll start with the question related to the sales number, and then Jim is going to talk to the strategy piece. What we described for our anticipated sales for next year for our full fiscal year was in the $100 million range, but that's for next year and the brand is growing at a nice clip. They clearly do have sales outside of the reported channels. I don't have a precise quantification for you at this time in terms of the percentages, but clearly, that captures a good portion of what's been in the reported sales, but we should enjoy the growth next year.

James P. Snee
President, Chief Operating Officer & Director
A

And then, Akshay, in terms of the strategy of the brand, we've had a lot of success since the acquisition of the SKIPPY brand. We've been able to, obviously, gain share, drive innovation, but also a lot of the research that we've done around the brand tells us that it's not extendable into the space where Justin plays today. And so, Justin's

Copyright © 2001-2016 FactSet CallStreet, LLC

affords us that opportunity to really be more complementary to the SKIPPY brand in a category that's a rapidly growing category.

We know that it attracts a younger, more health conscious, on-the-go millennial consumer, and the growth that the business has seen over the last several years, clearly, we are earlier on the growth curve than we've been with some other acquisitions, which we're quite frankly excited about.

Operator: And we'll go next to Heather Jones from BB&T Capital. Please go ahead.

Heather Lynn Jones
BB&T Capital Markets

Q

Good morning and thank you for taking my question. On Jennie-O, you guys are adding capacity there this year, is that correct?

Jeffrey M. Ettinger
Chairman & Chief Executive Officer

A

So, we have the Faribault announced capital addition last year that was going to enable us to have more ground turkey capabilities. We suspended that last year when the avian influenza outbreak occurred and now we have turned that back on. So, it's not head capacity change, but it does enable us to support what's been a really nice growing franchise for us, the lean ground products.

Heather Lynn Jones
BB&T Capital Markets

Q

So, could you help us understand how much that new value-added capacity could add to your growth rate? And thinking about 2017, you're comparing against an extra week, however, you'll have a full year of – well, assuming AI doesn't recur, you have a full year of normalized volume. So just wondering how we should think about 2017 volume growth for Jennie-O.

Jeffrey M. Ettinger
Chairman & Chief Executive Officer

A

Heather, we really don't have any 2017 projections on either the top or bottom line at this point. But I would point out and we've talked in past presentations that that ground turkey line is not a flash in the pan. That's been a long-term strong, superior CAGR deliverer vehicle for us. That was why we went ahead and made the investment in the capital. And we're comfortable that now that we can guarantee supply on a broad basis. And frankly, the Make The Switch campaign that Jim mentioned in his remark, that's the product line it's featuring, so that how easy that is to use in tacos and in burgers for consumers. And so, we do think that'll be part of the growth story for Jennie-O, but we won't be able to give you a quantification of that until we talk 2017 in November.

Operator: And we'll go next to Mario Contreras from Deutsche Bank. Please go ahead.

Mario Contreras
Deutsche Bank Securities, Inc.

Q

Hi. Good morning. I wanted to ask, first in International, if you can just give a little bit of detail around what drove the challenges in brands like SKIPPY and SPAM, and then what gives you the confidence that those will recover in the second half here?

Copyright © 2001-2016 FactSet CallStreet, LLC

James P. Snee
President, Chief Operating Officer & Director

A

Yeah. Good morning, Mario. This is Jim. The biggest issue that we face is we finally have felt the impact of the strong dollar in some of our export markets. It's not something that we've talked about in previous calls. But that really did impact both SKIPPY and SPAM. There have been other supply issues that impacted our fresh pork business in terms of EU pork now flooding the Asian markets.

So, it's really been a combination of things. But, obviously, we've seen moderation in the strength of the dollar. We feel like we're positioned in terms of our branding, our advertising, our pricing, that the second half will shape up to be a much better half on a comparable basis versus 2015.

Mario Contreras
Deutsche Bank Securities, Inc.

Q

Okay. Thanks. And then one other question with respect to Justin's; do they own any of their own manufacturing facilities? And then, beyond that, can you just give a little bit of additional details around where you see potential synergies coming from there?

James P. Snee
President, Chief Operating Officer & Director

A

Sure. They've actually done a great job of building the brand and building the business since 2004 with a network of co-manufacturers and our team is very comfortable with that approach. And as we think about where synergies will come from, having already worked with them on due diligence, we believe supply chain, finance, R&D, there's a number of opportunities to gain synergies and really leverage the capabilities of our organization. And as I mentioned in my comments, we do plan to still run the business out of Boulder, Colorado.

Operator: We will go next to Jeremy Scott from CLSA. Please go ahead.

Jeremy Scott
CLSA Americas LLC

Q

Hi. Good morning.

Jeffrey M. Ettinger
Chairman & Chief Executive Officer

A

Hi.

Jeremy Scott
CLSA Americas LLC

Q

Can you refresh us on your current mix of value-added versus commodity within Refrigerated Foods?

Jeffrey M. Ettinger
Chairman & Chief Executive Officer

A

It's in the 70% range. Frankly, it's been in that range for a while. I think the bigger effort in recent years has been moving products even further up the value ladder. So there's raw bacon, there's flavored bacon, there's microwavable bacon, now we have BACON 1 for our foodservice group, and each case provide an added element of convenience or unique flavors that also enable us to attain a better margin return for our efforts in creating those products.

Copyright © 2001-2016 FactSet CallStreet, LLC

Jeremy Scott
CLSA Americas LLC

Q

Okay. And just on – the resilience in the Refrigerated Foods business has been exceptional. I was hoping you could share how you expect, given where processing margins have come down, how you expect the back half to trend relative to the front half?

Jeffrey M. Ettinger
Chairman & Chief Executive Officer

A

The back half should trend a little bit lower than what the first half was on an operating margin basis, but still very strong versus historical averages for the group.

Operator: We'll take our next question from Eric Larson from Buckingham Research. Please go ahead.

Eric Larson
The Buckingham Research Group, Inc.

Q

Yeah. Good morning, everyone.

Jeffrey M. Ettinger
Chairman & Chief Executive Officer

A

Hi, Eric.

Jody H. Feragen
Chief Financial Officer, Executive Vice President & Director

A

Good morning.

Eric Larson
The Buckingham Research Group, Inc.

Q

Just a couple of questions back – one back on Jennie-O, Jeff and Jim. It's kind of related to Heather's question, and adding some capacity to some of your individual product lines at Jennie-O, i.e., the growing turkey product lines, et cetera, will you move into a net buying position for your raw materials for that division eventually? Is that part of your strategy? And does that make sense to be diversified on that front rather than adding head count?

And then as kind of a follow-on, Jeff, and I think we talked a little bit about this maybe about a year ago. Obviously, with your operation so concentrated right in this Upper Midwest area, when you had the flu impact it obviously had a bigger impact on you as opposed to having more diversified potential operations in other parts of the country. Strategically, does it make sense to diversify your sourcing and maybe part of this is with more third-party sourcing to supply your specialty products?

Jeffrey M. Ettinger
Chairman & Chief Executive Officer

A

So, on your first question, realistically, we were probably a couple of years away from having to address adequate meat supplies before the AI hit and, of course, that put us in a completely different mode for the past year. And the team's done just a great job of surviving through that and positioning the brand well. So that will come again in the future where, at some point, we would have to assess, okay, do we engage in a more expanded program of buying in meat or do we look for further capacity capabilities of our own? And we'll cross that bridge as that heads forward.

Copyright © 2001-2016 FactSet CallStreet, LLC

On your second question, we did make an assessment of that. At this point, we've chosen to redouble our efforts within the region that we do operate to make sure that we're kind of on the front lines of understanding how disease issues like that might spread and what you can do to combat them. Ultimately, we feel we have a really nice position being within a four-hour concentric circle of our operating plants and our production lines. It allows for the maximum freshness of product. In general, absent last year's AI outbreak, this is a very favorable grain market with [ph] positive basis (33:55) situation in most cases. And so, overall, we like our position of being where we are. But, clearly, if we were starting to have repeated incidence, we might have to reassess that at some point.

Operator: [Operator Instructions] We'll go next to Robert Moskow from Credit Suisse. Please go ahead.

Robert Moskow
Credit Suisse Securities (USA) LLC (Broker)

Q

Hi. Thanks.

Jeffrey M. Ettinger
Chairman & Chief Executive Officer

A

Hi, Rob.

Robert Moskow
Credit Suisse Securities (USA) LLC (Broker)

Q

Couple of questions. Hi. First one is you said pork processing margins down 40%. By my tracking, they're still up versus historical levels though. And I think, versus year ago, if you factor in like overhead or shipping cost being down, transportation costs are lower, that's also a benefit. We have a service that does that for us. So , I want to know if you're seeing a similar thing.

And then, secondly, on turkey, I continue to underestimate the profitability of turkey during AI, and I just was hoping to get just a little more color on, once you get your volume back, do you think you go back to kind of a normal margin environment, could it be well above normal margin environment as a result of maybe some continued tight supplies out there? It's just a little hard to figure out what it's going to look like. Maybe you're having the same challenge when you get back to normal.

Jody H. Feragen
Chief Financial Officer, Executive Vice President & Director

A

Okay. I think may have misled you by saying down 40%. That was just the average so far in May versus the average in April. So, that was sequential. You're absolutely right. We do expect pork operating margins to be above last year in the back half of the year and somewhat higher than the historical averages.

Robert Moskow
Credit Suisse Securities (USA) LLC (Broker)

Q

Right.

James P. Snee
President, Chief Operating Officer & Director

A

Yeah. And then Rob, to your second question, our expectation is as the production level returns to normal at Jennie-O Turkey Store that these margins will fall in line with our normalized margin range. And it's a

Copyright © 2001-2016 FactSet CallStreet, LLC

combination of now that supply is back we've seen some break in markets that we were able to capitalize on. And then, clearly, the mix, where we were perhaps being opportunistic in some of our buys, now we're going to have the supply of the birds and it's going to be our responsibility to make sure that we're clearing all of that volume, which changes the margin structure of the business slightly. So, we really do expect that it'll be more normalized range as we head into the future.

Operator: [Operator Instructions] We'll go next to Jeremy Scott from CLSA. Please go ahead.

Jeremy Scott
CLSA Americas LLC

Q

Hi. Thanks for taking the follow-up. I was wondering if you could – I was going to try again on Applegate, if you can share the run rate of that business and if there's been any success in moving some of that into foodservice?

Jeffrey M. Ettinger
Chairman & Chief Executive Officer

A

Yeah. This is Jeff. What we mentioned was that the business is performing consistently with the kind of earnings guidance projection that we provided on the business early on. We're looking forward to having that additional supply available and being able to start seeing the sales successes in the team of placing items and utilize that supply. But, overall, the Applegate brand still is connecting very well with the consumer that we're seeking to partner with that kind of a brand and we're very pleased with where Applegate sits today.

James P. Snee
President, Chief Operating Officer & Director

A

And as we think about opportunities in the future for foodservice, clearly, we're working on making sure that we regain the space with the retail business first. And then as supply opportunities present themselves over time, certainly, foodservice would be an opportunity.

Operator: And we'll take a follow-up question from Akshay Jagdale. Please go ahead.

Akshay Jagdale
Jefferies LLC

Q

Thank you. So, just following up on Jennie-O Turkey, just as a modeling question, so how should we be thinking of the volume growth for the back half? There were some pretty massive declines last year, right? The strong double digits, so should we be expecting double-digit increases in volume in the back half as we're lapping those? Can you help us with that?

Jeffrey M. Ettinger
Chairman & Chief Executive Officer

A

Yeah. I don't have the precise volume for you. But, definitely, when it comes to on a net sales basis, it will be solidly double digit for both of the upcoming quarters.

Akshay Jagdale
Jefferies LLC

Q

Okay. And in terms of your guidance, can you remind us how much the divested business was contributing to EBIT, so how much of your guidance change includes negative impact on EBIT from the business that you're selling? And do you have any sense as to what Justin's might be accretive or dilutive in a full fiscal year?

Copyright © 2001-2016 FactSet CallStreet, LLC

Jody H. Feragen
Chief Financial Officer, Executive Vice President & Director

A

So, Akshay, as a reminder, our annualized sales for the divested portion of Diamond Crystal Brands was estimated around $260 million and we've never given guidance for sub-divisions of our segments. But I think the comment that our $1.56 to $1.60 outlook for the full year includes not having the benefit of Diamond Crystal in the back half of the year as well as a slightly negative impact from Justin's and that's mostly driven because we'll have transaction costs that we recognize currently as well as an estimated step-up in some fair value of the inventory. So, the $1.56 to $1.60 is all in.

Jeffrey M. Ettinger
Chairman & Chief Executive Officer

A

And then on Justin's, we did provide that for our first full year operating the business, we're looking at $0.01 a share and, clearly, the business with the double-digit growth expectations and what we think is going to be an ability to attain synergies that we think we'll be able to move up from there over time.

Operator: We'll take our next question from Robert Moskow. Please go ahead.

Robert Moskow
Credit Suisse Securities (USA) LLC (Broker)

Q

We've got a lot of time, so I'm following up. I think you said there's a $70 million tax credit for Justin's. How is that factored in to your accretion guidance and how quickly can you realize the benefits from that? And then, the second question, Jeff, I think you mentioned some declines on certain products within the Refrigerated Foods segment. Can you elaborate on which products those are and maybe the circumstances – are you seeing competitors discounting or is it just some products just need to be revived a bit?

Jody H. Feragen
Chief Financial Officer, Executive Vice President & Director

A

So, I'll take the tax benefit. That's just a reflection of the purchase price. It has no P&L impact going forward. So, we'll get the benefit from a tax perspective, but it will not impact us on the P&L. But if you think about what we paid for the business, I would look at it as the $286 million less the $70 million tax shield to get to kind of the price, but no P&L impact, and that's a cash flow that's generated over the next 10 years to 15 years.

James P. Snee
President, Chief Operating Officer & Director

A

And then, Rob, on the volume question, a couple of the categories that were impacted, we've got some – what we would consider to be more commodity deli business that is a more of an intentional decline, if you will, and we're okay with that. The second category that has become very competitive is the bacon category. And over the last several years, our team has done a great job really driving our share, really developing our brand. And, most recently, we are facing some competitive activity. And so we did see some short-term declines, but we remain very confident in the category and our ability to continue to drive our share and brand over time.

Jody H. Feragen
Chief Financial Officer, Executive Vice President & Director

A

I'd like to follow up on a response we gave earlier too about the volumes in Refrigerated Foods without Applegate, they were slightly positive. So, tonnage was up for the quarter in Refrigerated under 1%, but up.

Copyright © 2001-2016 FactSet CallStreet, LLC

Operator: [Operator Instructions] Looks like we do have another follow up from Akshay Jagdale. Please go ahead.

Akshay Jagdale
Jefferies LLC

Q

Sorry, just one last one. This is for Jody. Can you talk a little bit about the free cash flow? It looks like working capital has been a little bit of a drag and so as the sort of the other line. I'm guessing that has to do with the acquisitions, but can you – because it's a deflationary commodity environment, so you'd expect maybe working capital to be a source of cash. But can you just help us give us a little bit more color on what might be going on there?

Jody H. Feragen
Chief Financial Officer, Executive Vice President & Director

A

So we've had some – and I think you said free cash flow so that includes stepped-up capital expenditure base as well as, as we bring turkeys back into the barn, remember, those animals go on inventory the minute they're an egg. So, those will be the two biggest drivers.

Operator: [Operator Instructions] And currently, there are no further questions in the queue.

Jody H. Feragen
Chief Financial Officer, Executive Vice President & Director

So, thanks, everyone, for participating on the call today. And this is Jana Haynes last call as Director of Investor Relations, and we'd like to thank her for her leadership of the investor relations function and wish her well in her new position as Vice President and Controller. And at the same time, we welcome Nathan Annis as the new Director of Investor Relations and look forward to working with him. Have a great day.

Operator: And this does conclude your teleconference for today. Thank you for your participation. You may disconnect at any time.

Copyright © 2001-2016 FactSet CallStreet, LLC

Disclaimer

The information herein is based on sources we believe to be reliable but is not guaranteed by us and does not purport to be a complete or error-free statement or summary of the available data. As such, we do not warrant, endorse or guarantee the completeness, accuracy, integrity, or timeliness of the information. You must evaluate, and bear all risks associated with, the use of any information provided hereunder, including any reliance on the accuracy, completeness, safety or usefulness of such information. This information is not intended to be used as the primary basis of investment decisions. It should not be construed as advice designed to meet the particular investment needs of any investor. This report is published solely for information purposes, and is not to be construed as financial or other advice or as an offer to sell or the solicitation of an offer to buy any security in any state where such an offer or solicitation would be illegal. Any information expressed herein on this date is subject to change without notice. Any opinions or assertions contained in this information do not represent the opinions or beliefs of FactSet CallStreet, LLC. FactSet CallStreet, LLC, or one or more of its employees, including the writer of this report, may have a position in any of the securities discussed herein.

THE INFORMATION PROVIDED TO YOU HEREUNDER IS PROVIDED "AS IS," AND TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, FactSet CallStreet, LLC AND ITS LICENSORS, BUSINESS ASSOCIATES AND SUPPLIERS DISCLAIM ALL WARRANTIES WITH RESPECT TO THE SAME, EXPRESS, IMPLIED AND STATUTORY, INCLUDING WITHOUT LIMITATION ANY IMPLIED WARRANTIES OF MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE, ACCURACY, COMPLETENESS, AND NON-INFRINGEMENT. TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, NEITHER FACTSET CALLSTREET, LLC NOR ITS OFFICERS, MEMBERS, DIRECTORS, PARTNERS, AFFILIATES, BUSINESS ASSOCIATES, LICENSORS OR SUPPLIERS WILL BE LIABLE FOR ANY INDIRECT, INCIDENTAL, SPECIAL, CONSEQUENTIAL OR PUNITIVE DAMAGES, INCLUDING WITHOUT LIMITATION DAMAGES FOR LOST PROFITS OR REVENUES, GOODWILL, WORK STOPPAGE, SECURITY BREACHES, VIRUSES, COMPUTER FAILURE OR MALFUNCTION, USE, DATA OR OTHER INTANGIBLE LOSSES OR COMMERCIAL DAMAGES, EVEN IF ANY OF SUCH PARTIES IS ADVISED OF THE POSSIBILITY OF SUCH LOSSES, ARISING UNDER OR IN CONNECTION WITH THE INFORMATION PROVIDED HEREIN OR ANY OTHER SUBJECT MATTER HEREOF.

The contents and appearance of this report are Copyrighted FactSet CallStreet, LLC 2016 CallStreet and FactSet CallStreet, LLC are trademarks and service marks of FactSet CallStreet, LLC. All other trademarks mentioned are trademarks of their respective companies. All rights reserved.