Corrected Transcript

24-Aug-2017

Hormel Foods Corp. (HRL)

Q3 2017 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Please stand by, we are about to begin. Good morning, ladies and gentlemen, and thank you for standing by. Welcome to the Hormel Foods Third Quarter 2017 Conference Call. At this time, all participants are in a listen-only mode. As a reminder, this conference is being recorded Thursday, August 24, 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 third 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 provide a review of each segment's performance for the quarter, a strategic review of the acquisitions of Fontanini and Ceratti and our outlook for the remainder of fiscal 2017. Jim Sheehan will provide detailed financial results for the quarter, a financial review of the acquisitions, 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 800-263-0877 and the access code is 9221656. 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.

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

Please refer to pages 32 through 38 in the company's Form 10-Q for the quarter ended April 30, 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 the 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 Butter. 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 third quarter results of $0.34 per share, down 6% from last year. Sales for the quarter were down 4% on a 9% decrease in volume. Adjusted sales grew 1% while adjusted volume was down 1%. While the results are not where we expected them to be, there is a lot of good news to share. I will briefly touch on some positive news in our company and then address the areas that are challenged and what actions we are taking to address those challenges.

From a financial perspective, we posted record pre-tax earnings for the quarter as our two largest segments, Refrigerated Foods and Grocery Products more than offset declines in our three other segments. Adjusted net sales increased 1% even as Jennie-O Turkey Store sales declined 9% or $35 million. We also made progress towards many of our strategic initiatives since the second quarter conference call. We committed $130 million in capital towards an expansion of one of our bacon facilities in Wichita, Kansas.

We have experienced tremendous demand for bacon. And this expansion will give us much needed capacity for many of our premium pre-cooked bacon items, most notably BACON 1. We expect this expansion to be completed in December 2018. We also announced two acquisitions of family-owned businesses. Last week we acquired Fontanini Italian Meats and Sausages. Since 1960, the Fontanini family has done a wonderful job growing their authentic branded line of Italian meat and sausage items. Fontanini enhances our branded Hormel foodservice and pizza toppings businesses. This acquisition also gives us more production capacity and allows us to avoid major capital expenditures at our current facilities.

We intend to integrate Fontanini into the Refrigerated Foods group over the next six to nine months. We do not plan to operate Fontanini as a standalone subsidiary, but instead integrate the plant into our Refrigerated Foods operations group and their sales force into our Hormel foodservice division. The integration will allow us to attain significant synergies.

We also announced the acquisition of Ceratti, an authentic family-owned branded meats business located in Brazil. This acquisition is a great strategic fit for Hormel Foods as their retail and foodservice deli meats business closely mirrors our domestic portfolio. Ceratti will operate as a standalone business in Brazil and will serve as a platform for future acquisitions in South America.

Jim Sheehan will provide financial details related to the Fontanini and Ceratti acquisitions. As you will see, we once again maintained our financial discipline in the acquisition process.

As I mentioned, there were challenges this quarter. We saw two of our primary raw materials, pork bellies and beef trim reach all-time record high prices. Since late April, belly prices have more than doubled, and are currently trading around $2 per pound. While we generate bellies internally through the hog harvest process, we also procure a large quantity of bellies externally. The speed and magnitude of these increases pressure both our retail and foodservice bacon business.

We have implemented price increases with the majority being realized late in the fourth quarter.

We also saw 50% beef trim prices hit record levels this quarter. While beef trim prices have recently decreased, they are still at elevated levels relative to last year. As a reminder, we procure all our beef needs externally for products in Grocery Products and International such as Hormel Chili, Dinty Moore Beef Stew, and products in Refrigerated Foods such as Hormel pepperoni and dry sausage items. We have taken different pricing actions depending on the category channel and competitive activity, and expect the majority of pricing to be in effect late in the fourth quarter. Jim Sheehan will provide further details on the financial impact of commodity prices in his remarks.

Now turning to Jennie-O Turkey Store, as we anticipated and communicated in the second quarter call, Jennie-O Turkey Store had another difficult quarter compared to last year with earnings down 20%. Sales were down 9% and volume was down 7%, driven by the decision to reduce production levels. Similar to the first half, three main issues affected Jennie-O Turkey Store's profitability this quarter: low turkey markets, elevated competition, and increased expenses.

First, the turkey markets were relatively unchanged from last quarter. We continue to operate in markets where lower turkey prices year-over-year are affecting both our commodity sales prices and our value-added pricing. Second, increased competitive activity from other turkey suppliers and competing proteins such as beef continue to pressure results.

50% beef trim prices are up significantly compared to last year, but we have not seen this translate into meaningful increases in ground beef prices at retail. Third, we incurred higher operating expenses, primarily related to bird performance issues with both our conventional flocks and those raised without antibiotics. Our team continues to work to address this issue through changes in feed and other live production factors.

Despite the market conditions and operating challenges, the Jennie-O Turkey Store team grew lean ground turkey sales by high single-digits and recent 13-weeks scanner data shows positive sales trends. On our second quarter call, we indicated Specialty Foods would see double-digit growth for the back half of the year and that is not materializing. Part of the delta between our expectations and actual results is the increase in commodity prices for our contract packaging business.

Similar to our Grocery Products segment, it will take a few months for pricing to catch up with input costs. Beyond that, we are disappointed with the results from CytoSport. We experienced a sharp decline in Muscle Milk ready-to-drink protein beverages as investments in the brand did not drive the expected growth. We continue to see aggressive competitive activity especially in the convenience store channel. We are making numerous corrective actions including increased promotional support.

International had a difficult quarter, as our China meat business continues to experience high pork prices. While hog prices have decreased in China, key raw material such as bellies and hams have not decreased at the same pace.

We also incurred start-up costs for our Jiaxing facility and higher than expected closing expenses for our Shanghai facility. We are now producing product at the Jiaxing facility and expect our SPAM production line to be running later in the fourth quarter.

Grocery Products had a strong quarter for sales. Brands such as WHOLLY GUACAMOLE, HERDEZ, SKIPPY, SPAM and Dinty Moore stew all contributed to the sales growth. Profit for many of our brands such as WHOLLY GUACAMOLE, SPAM, Dinty Moore and Hormel Chili were adversely affected by higher input costs, which was offset by decreases in advertising expenses. Refrigerated Foods had an excellent quarter, as segment profit increased 15% primarily driven by high demand for fresh pork and operational improvements.

Demand for our branded value-added products in retail and foodservice remain very strong. Foodservice brands such as Hormel Bacon 1, Fully Cooked Bacon, Hormel Fire Braised meats and retail brands such as Hormel pepperoni and Hormel Natural Choice lunchmeats contributed to the excellent results.

Consistent with what we communicated on the second quarter conference call, we continue to make responsible reductions to advertising and marketing expenses. Advertising expense this quarter was $24 million compared to $53 million in 2016. As a reminder, we incurred double-digit increases to advertising spend over the last three years, and current advertising is comparable to our fiscal 2015 spend on an absolute basis and as a percentage of net sales.

To maintain our advertising and promotional spend efficiency, some advertising dollars have shifted to promotions in order to maintain our share of voice in the store. We are committed to growing our brands through effective advertising, but are trimming advertising expenses while we work through commodity input cost increases. We will continue to evaluate our marketing strategy as conditions change.

Looking towards the fourth quarter, we see continued earnings pressure from high raw material prices which will not be fully offset by price increases until late in the quarter. We indicated in earlier calls we have decreased our live production at Jennie-O Turkey Store by mid single-digits in order to procure more turkey meat externally. We have been anticipating a cutback in industry production and based on recent USDA reports are finally seeing some positive signs. July poult placements were down 5%, following minor decreases in the prior months. Although cold storage stocks continue to rise, the rate of gain is slowing.

While the industry is moving in the right direction, we need to see further signs of lower poult placements and lower cold storage. As such, we would expect turkey prices for the fourth quarter to be unchanged from current prices. We expect the fourth quarter performance to be similar to the previous quarters this year.

As I indicated earlier, Specialty Foods will not achieve double-digit earnings growth in the back half primarily due to lower sales trends at CytoSport. We now expect flat earnings in the fourth quarter. For Refrigerated Foods, our outlook has moderated due to rising input costs. Grocery Products expects a solid quarter of sales and earnings growth, even as they work to overcome higher commodity markets. Jim Sheehan will be discussing the market dynamics impacting these segments in his portion of the call. And we are tempering our outlook for the International segment, as high raw material prices continue to impact results in China.

Based on the underperformance in the third quarter, current market conditions and lower expectations for Specialty Foods and International, we are lowering our full-year earnings per share guidance to $1.54 to $1.58 from the low end of $1.65 to $1.71 per share. We have faced difficult market conditions this year. Commodity markets have been challenging to forecast based on both the volatility of the markets and the velocity of the change.

The lag between the input cost increases and when price changes are realized in the marketplace has pressured margins in the short term. We know it is our responsibility to address these shifts and find ways to move the business forward. We have a plan and are executing that plan to realize our long-term goals.

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. Volume for the third quarter was 1.1 billion pounds, a 9% decrease compared to last year. Sales for the third quarter were $2.2 billion, a 4% decrease. Excluding Justin's and the sale of Diamond Crystal Brands and Farmer John, adjusted volume decreased 1% and adjusted sales increased 1%.

We generated record earnings before income taxes of $278 million, up 1% from last year. Our effective tax rate in the third quarter was 34.3% compared to 28.6% last year. During the third quarter of last year, we experienced an unusually low tax rate which was a result of international restructuring. Our income taxes were 22% higher this quarter compared to last year. We expect our full year tax rate to be between 33.25% and 33.75%.

Net earnings for the third quarter were $183 million, down 7% compared to last year. General corporate expenses were lower primarily due to the continued focus on strategic cost management. We expect general corporate expenses to be below last year for the fourth quarter.

Depreciation and amortization for the quarter was $33 million, unchanged from last year. We expect depreciation and amortization to be $125 million for 2017.

Equity and earnings for the quarter was $4 million, down 38% compared to last year. High avocado cost offset strong sales for MegaMex. Cash flow from operations was $250 million in the third quarter, up from $213 million last year. The increase was primarily related to decreases in working capital.

Capital expenditures for the quarter totaled $42 million compared to $66 million last year.

We expect capital expenditures to be approximately $190 million this year. Projects include the completion of our plant in China, the replacement of a whole bird plant at Melrose, the bacon expansion in Wichita, and ongoing investments for food and employee safety. We paid our 356th consecutive quarterly dividend effective August 15 at an annual rate of $0.68 per share. This completes our 89th year of consecutive dividends.

We repurchased 1.3 million shares of common stock, spending $45 million in the quarter. 10 million shares remain from the current authorization. We will continue to repurchase stock to offset dilution from stock option exercises based on our internal valuation.

Operating margins were 12.7%, a 70 basis point increase compared to last year. Grocery Products and Refrigerated Foods increased operating margins during the quarter. As Jim Snee discussed, input costs for the third quarter were much higher than the previous quarter and the third quarter of last year with the exception of Jennie-O.

Belly prices sharply increased in the quarter. Bellies moved to record highs and remained at historically high levels. On average, belly prices were approximately 40% higher than last year. We expect belly prices to be well above last year as the industry continues to experience lower cold storage levels and high demand for bacon.

On average 72% pork trim prices were 20% above last year. We expect trim markets to remain well above last year for the fourth quarter.

Prices for 50% beef trim were 70% higher for the quarter compared to last year. We expect beef prices to remain higher than last year for the fourth quarter. As discussed at Investor Day, we purchased between $700 million and $900 million of meat annually. The 70% – the 20% to 70% increase in purchased meat cost has significantly affected the expectations for the second half of the year.

Hog prices in the quarter were similar to last year. We expect to see more short-term volatility in the hog market for the remainder of the year and into next year. During the fourth quarter, hog prices are expected to be higher than last year, but below the five-year average.

Year-to-date, export demand has been strong. The USDA forecasts exports to be up 10% in 2017 and up another 4% in 2018. Domestic consumption also remains very strong. For example, pork future activities has increased 120% in the last 13 weeks and pork pricing has materially increased since last quarter. Two new pork facilities are coming on line in September. Based on the strong international and domestic demand trends and high commodity markets, we feel the industry is not at risk for a short-term overcapacity condition.

We remain confident we are well positioned to utilize the internally generated commodities and purchase the externally sourced raw materials required to support our value-added products. Feed costs were lower compared to last year. We expect feed costs to trend in line with last year for the fourth quarter. 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 we see a few more months of declines in turkey poult placements. We are also working at the cold storage levels as a lead indicator for turkey prices. Currently, cold storage levels for breast meat are 18% higher than last year.

As Jim discussed, we acquired Fontanini last week. The purchase price was $425 million and includes the Fontanini brand, a large sales force, a fully staffed production facility in the Chicago area, and access to new customers. The transaction is structured as an asset deal. It will provide an ongoing cash flow benefit as a result of tax amortization of the adjusted asset basis. The net present value of this cash flow benefit is estimated to be $90 million.

Fontanini provides us much needed capacity and also allows us to avoid a major plant capital expenditure in 2018 of $150 million. The transition of production to the Fontanini facility will provide operational synergies. Annual sales were approximately $240 million and are expected to grow 5%. Fontanini's operating margins are accretive to both Refrigerated Foods and the total company. We estimate this deal will be slightly dilutive to 2017 and between $0.03 to $0.04 per share accretive without synergies in 2018.

With Fontanini producing and selling products similar to our existing foodservice business, we will have immediate synergies in supply chain, operations, finance, and sales. We also acquired the Ceratti brand, a value-added meat business in Brazil. The purchase price was $104 million. The acquisition comes with a sales and marketing team, fully staffed production facility, and professional management team.

Ceratti's annual sales were approximately $100 million and have been growing at mid-teen levels. We expect that trend to continue. We estimate this deal will be slightly dilutive in 2017 and $0.01 per share accretive in 2018. Ceratti's margins are dilutive to International's margins, but we expect to improve margins over time. Ceratti will not contain many synergies.

Onetime cost for the second half of the year for Fontanini, Ceratti, and other acquisition efforts totaled $0.01 per share. These costs include deal costs and estimated inventory step-up costs. We plan to finance these transactions with the combination of cash on hand and funds from our short-term revolver.

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] We'll take our first question from Adam Samuelson with Goldman Sachs.

Adam Samuelson
Analyst, Goldman Sachs & Co. LLC

Q

Yes. Thanks. Good morning, everyone.

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

A

Good morning, Adam.

Adam Samuelson
Analyst, Goldman Sachs & Co. LLC

Q

Maybe just on the outset, Jim and Jim, help me think about the performance in the quarter relative to the expectations you have on the May call and at the June Analyst Day, the bigger areas, the shortfall, and as you think about the guidance cut, just maybe any way to parse kind of the geography of where those cuts came from between raw materials and Refrigerated and Grocery and International and Specialty and the impact of the acquisitions in the short term and kind of where things really fell short of your own internal projections two and three months ago.

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

A

Okay. Sounds good, Adam. So, when you think about the guidance reduction, I guess, the first thing I would tell you is think about the reductions being spread equally across all the segments. And now that being said, there were a number of different factors in each of those segments. So, when you think about Grocery Products and Refrigerated Foods, a primary driver there, impacted by the record prices for the key inputs and as we mentioned, pricing really won't be in effect until late in Q4.

From a JOTS perspective, the recovery that we expected to see in Q4 does not appear to be materializing, and from an International perspective, the raw material impact in China combined with the additional Shanghai closing cost and then they are taking up a portion of the deal costs that Jim mentioned. And then really from Specialty Foods, we talked about again the raw material increase in contract packaging and then the miss on CytoSport. The sales didn't materialize the way we had anticipated. So, that's how you can think about them across the business segments. From a quarterly perspective, probably you want to think about them, about the majority of the reduction was in Q3. We do have pricing that takes hold in the back half of Q4.

Adam Samuelson
Analyst, Goldman Sachs & Co. LLC

Q

Okay. That's very helpful. And then thinking about the implications into 2018, I appreciate that it's early still, and then certainly, there's been a lot of volatility in the near term, but as you start penciling in pieces of 2018, can you talk about the confidence level on sustainability of Refrigerated margins, Jennie-O improvement, the accretion from the deals that you just alluded to, just the things that you're starting to get some line of sight to and where the thought is for next year?

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

A

Sure. We can do that for you, Adam. I will open it by saying we're not giving guidance into 2018, but again, as we go through the segments and you think about them, clearly, in Refrigerated Foods, we'll have the benefit of Fontanini which is a great addition to our portfolio. We'll certainly be watching the changes in the hog market and the volatility that could come. In Grocery Products, we know that we'll have our pricing in effect. We'd tell you that we are also watching volumes as a result of that pricing and any changes we may need to make, but I mean, we're very optimistic about the Grocery Products portfolio.

In terms of JOTS, we expect to see some of these unfavorable market conditions spill into 2018, but we – at some point, JOTS is going to get incrementally better. For Specialty Foods, we've had a lot of moving parts over the last couple of years, and we've got work to do, but we know that will get Muscle Milk back on track. And then from an International perspective, we're pleased with the addition of the Ceratti brand in Brazil. We do believe that will have improvements in the China meat business. And then of course, the full benefit of having our new Jiaxing facility up and running, in-country production of SPAM should have some really nice benefits there. So, that's how we're starting to think about 2018 and some of the color around that.

Adam Samuelson
Analyst, Goldman Sachs & Co. LLC

Q

I appreciate the color, very helpful. I'll pass it on.

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

Thanks.

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

Thanks.

Operator: We'll take our next question from Rupesh Parikh with Oppenheimer.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.
Q

Good morning and thanks for taking my question. So, I wanted to ask about the SG&A expense reduction during the quarter, if you can maybe provide more color in terms of the key drivers and how you're looking about the sustainability and the reduction that we saw.

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

Sure, Rupesh. As we talked about it in Investor Day, we're really focused on making strategic changes to our expense structure. We've been focused on supporting our critical initiatives, our long-term goals but reducing expenses in other areas. So, that has been the main focus of the group over the last six months. We did have an advertising reduction of $30 million in SG&A, but we're very pleased with the progress that we've seen around managing our expenses while supporting those long-term initiatives.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.
Q

And then as you look at the pullback in the advertising spending during the quarter and I guess, even going forward, do you believe that at all impacted your top line performance and do you expect it to impact your top line going forward?

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

Yeah. Rupesh, we don't. I mean, we are obviously strategically looking at our advertising spend, and we are committed to the long-term growth and health of our brands. This level that we're at is our 2015 level, which is still a very healthy level after several years of double-digit increases, and these are all prudent decreases. The other thing I would remind you of is that we are shifting some of the dollars to trade so that we're maintaining our in-store share of voice and – I mean, we're confident that we'll still be able to drive sales growth.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.
Q

Okay. Great. Thank you.

Operator: We'll take our next question from Robert Moskow with Credit Suisse.

Robert Moskow
Analyst, Credit Suisse Securities (USA) LLC

Q

Hi. Thank you. I guess, I just wanted to understand a little bit about why it is taking this long to pass through these higher costs in fourth quarter. You didn't mention bacon, I don't think, in terms of what that pass-through looks like. Can you be a little more specific about it because it's a big part of what you do? Are you passing it through? Has it passed through already at retail? Because I know that's kind of quick. Is it taking longer in foodservice or not? And secondly, I didn't hear you mention retail bacon as being part of the things that went well in the quarter. I mean, our Nielsen data would indicate that your sales are way up on retail bacon. Can you be more specific as to what's happening there, just to give us a sense of comfort that this is a temporary phenomenon?

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

A

Absolutely, Rob. I'll start with the pricing perspective, and we have been very aggressive in the pricing action that we've taken across our entire portfolio. And we frequently talked about from a retail perspective, you're going to have a 45- to 60-day lag. And we have taken pricing on retail bacon, retail pepperoni, and a whole slew of Grocery Products items.

From a foodservice perspective, we certainly get the benefit of the price increase sooner on our [indiscernible] (36:07) business, but we do have some contract business that can have a one to three months lag. So, it really is a mixed bag, but I think the key takeaway here is that we have been very aggressive with all of our pricing action. I mean, we're priced to the peak of the market that we've seen, and as a reminder, because of that lag, that's why we're seeing the pricing will take hold late in Q4.

From a retail bacon performance, I mean, you are correct. We had an absolutely great quarter on volumes and sales both in retail and foodservice. The challenge, of course, is that margins suffered due to the fast run-up in belly prices, and obviously, it's a competitive category, but our focus has been growing our premium Black Label bacon line in retail. And of course, we've talked to you at Investor Day about the investments that we've made in BACON 1. And as I started off my comments, we're very excited about the strategic investment that we're making down in Wichita, Kansas in our Dold facility to support the high demand for foodservice BACON 1. So, pricing action, very aggressive; bacon performance, very strong, sets us up really well for the future.

Robert Moskow
Analyst, Credit Suisse Securities (USA) LLC

Q

That's great. Thank you for the color. And if I could move you to the acquisition, the Fontanini acquisition.

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

A

Yeah.

Robert Moskow
Analyst, Credit Suisse Securities (USA) LLC

Q

It sounds like a big part of the logic was opportunity cost avoidance, I guess, or however you want to put it. You didn't have to build this new plant. But you are kind of holding out a number for synergies that could also help us in fiscal 2018. 5% of sales is a typical kind of number in the group, maybe 7% of sales for synergies. When do you think you'll give us some insight as to what those synergies could be?

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

A

Rob, this is Jim Snee. I'm going to start with the first part about the fit. So, your comment about, I guess, I'd call it capital avoidance, that was part of the equation. It wasn't a majority part of the equation. From our perspective and I've talked a lot about my desire to grow and accelerate our foodservice business, and so this is a perfect addition to our foodservice business. It's branded, it's high-margin business, and it's a growing business, a direct sales organization, which in this day and age becomes less and less common. It mirrors the sales organization that we have, and then we just see this as a great fit complementing our foodservice business. It also complements the Burke organization, and as I mentioned in my comments, we are up against some capacity constraints that we were going to have to spend some money, and this gives us tremendous relief in that respect.

Jim, I'll turn it over to you for the synergy portion.

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

A

Sure. And as you discussed, there was $150 million of capital avoidance but also the $90 million of tax cash flow that really equates to $240 million of the $425 million that was spent. We obviously have looked at the synergies as we were doing our valuation. We feel that the synergies will be at or slightly above what you would refer to as an average synergy. But that excludes the advantages that we have from both the capital avoidance and the benefit we have from the tax cash flow. We're working with the Fontanini team now to finalize the plans, and we think that the synergies will be gained very quickly.

Robert Moskow
Analyst, Credit Suisse Securities (USA) LLC

Q

Got you. Last question. You helped us shape a little bit fiscal 2018 by segment, Jim Snee. Are any of these segments do you look at vulnerable to declines in fiscal 2018? Is there one particular segment that might be more vulnerable than others? I mean, you kind of – I think the message was kind of like, well, they could kind of be flattish, maybe with a little bit of upside I thought, but we've seen some unusual things happen across your business, so I just want to know if there is one segment that appears more – that there's more that could go wrong, I guess.

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

A

Sure, Rob. Again, I'm going to qualify it by saying I'm not giving guidance into 2018, but we are clearly watching what's happening in the hog market in Refrigerated Foods and the volatility associated with that. As Jim Sheehan mentioned, we know that there is additional capacity coming on line, and we're watching the three factors that we've talked about in the past, international demand, domestic demand, and the corresponding capacity and where we sit right now after coming through a quarter where four of our top seven inputs experienced record prices because there was an adequate supply, I mean, that additional capacity is certainly needed in the short term. So, these are unprecedented changes in the hog industry. We're watching them closely. And so, I think to answer your question, we're watching Refrigerated as we head into 2018.

Robert Moskow
Analyst, Credit Suisse Securities (USA) LLC

Q

Because, if I could, like if there is more capacity coming on line and international demand is really, really strong, is there enough hogs out there to meet it all, like are you saying there is a risk that hog futures might spike?

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

A

The interesting thing that has happened through the cycle is that hog costs have been very flat to last year. So, it looks like there is really a balance in the hog supply and the demand right now. The other thing that we think is important to understand is that the groups that are bringing these processing plants on line are, in fact, hog producers. So, we certainly feel that they believe that there is adequate hog supplies to fill their plants.

Robert Moskow
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. Thank you.

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

A

Yeah.

Operator: We'll take our next question from Farha Aslam with Stephens.

Farha Aslam
Analyst, Stephens, Inc.

Q

Hi. Good morning.

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

A

Good morning, Farha.

Farha Aslam
Analyst, Stephens, Inc.

Q

It sounds like some of the disconnect between commodities and your margins is really on visibility. Could you share with us kind of how you establish visibility into your commodity markets and what are your pricing policies overall on pricing?

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

A

So far, I guess, our approach to pricing, we are looking at commodity markets on a very regular basis. We certainly have forecasts in place at the beginning of the year. We look at those throughout the year that helps us not only set the pricing at the beginning of the year, but what we think it might look like through the course of the year.

From our perspective, I mean the big disconnect in all of this is that we simply can't forecast record prices. We've taken the price action just as quickly as we could. We've priced these items to the peak of the markets that we've seen. And I would say, while the record high prices would be the disconnect, the connect would be that we have a proven ability to price in many market conditions, and it's really that short-term volatility that hurts us the most.

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

A

As we gave guidance into the back half of the year, we predicted the trends. As Jim said, we didn't predict that they would hit record highs, and we did not predict the velocity at which they would change. So, we saw the trends coming, we didn't see the magnitude and the speed in which we're seeing and the volatility of the markets at this level.

Farha Aslam
Analyst, Stephens, Inc.

Q

So, as commodities moderate – because it looks like belly prices are starting to moderate, avocados just start to come down, do you expect your margins to expand as you have pricing in place?

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

A

Yeah. I mean, certainly that's why we're saying with the pricing taking hold in the back half of Q4 and then as I referenced, as I gave some color into our 2018 outlook, you're going to have Grocery Products that will benefit from the pricing that's in effect.

Farha Aslam
Analyst, Stephens, Inc.

Q

So, that will be a positive for 2018. That's helpful.

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

A

Yeah.

Farha Aslam
Analyst, Stephens, Inc.

Q

And then going into your Brazil acquisition, this is your first entry down in South America. It's rather smaller in scale. Do you have the distribution you need in the Brazilian market to get your products into retail and how quickly do you anticipate building scale down in South America?

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

A

Sure. Well, first, Farha, I mean, now you have to believe me when I said the pipeline was full all those quarters, right?

Farha Aslam
Analyst, Stephens, Inc.

Q

I think...

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

A

And we finally got a couple across the finish line. But yes, you're correct, I mean Ceratti is our first entry into South America. They're premium branded items and it's a niche portfolio that we know very well, I mean, this is an established business. And so, they have distribution in the marketplace. They have a professional management team. It's an 85-year-old organization.

So, as we look at it, yes, I mean from a $100-million perspective, you could say it's a small acquisition. We look at it to say this is our first entry point into South America and we see this as a platform for future acquisitions in South America. Clearly, there are some learnings that we need to obtain along the way and this is a tremendous vehicle, a successful vehicle for us to be able to achieve those.

Farha Aslam
Analyst, Stephens, Inc.

Q

Helpful. Thank you.

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

A

Sure.

Operator: We'll take our next question from Ken Zaslow with Bank of Montreal.

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

Q

Hey. Good morning, everyone.

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

A

Good morning, Ken.

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

Q

I'm going to go at this a little differently. I get the commodity issues, I get the input cost, the pricing all that. But what I'm not fully understanding is I get the sense that there is increasing execution issues. And let me just kind of – and that to me I guess is more of my surprise than anything else. You got Applegate, you got CytoSport, you got China. Help me understand how you're addressing the execution issues and why they have risen? And that's kind of my first question, then I'll ask my follow-up.

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

A

Sure. The way you described it, Ken, probably the one that I would agree with you on is the CytoSport piece. We did give expectations of double-digit growth. And to be fully transparent, I mean, we missed that one. We're making some investments, got aggressive competition in that ready-to-drink C-store space and the results did not materialize the way we had anticipated. So, I would agree with you on that.

When you talk about Applegate, not much has changed from the last time we talked about it. But as part of Refrigerated Foods, clearly, the driver was record prices for key inputs. And so, had we not experienced those record prices, especially in Refrigerated Foods, I mean, we would have been fine in that space. So, I certainly understand your commentary but would say that the specialty area is the one where I can agree with you on.

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

Q

What about the China issue?

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

A

Well, I mean...

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

Q

In Shanghai, you closed a facility, there is increasing cost relative to expectations. Again, I'm not trying – you're going through a management change, you're obviously at the senior level. There's a couple times that you've missed [ph] consents (49:28), expectations. And again, I get the belly prices, all the prices we all get. But I feel like there is, around the perimeter, there seems to be more execution issues than I'm used to over the last decade or so, and I just didn't know if that's what you guys are seeing or it's just being exacerbated by the commodity outlook?

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

A

I mean I think that last part is right on, Ken. I mean, I think given the exacerbation of the commodity markets, I mean, combined with what's happening at JOTS with I mean historic issues there as well, the one part on the China piece was we're starting up a significant plant. And yes, we certainly had planned to have the Shanghai plant closed and items transitioned, and it took us a little longer in terms of quarters, not years, and so the cost spilled over. But this – and I appreciate your comment that the senior management team, but this is the same team that's been in place at very senior levels of our organization for the last 5 or 10 years. And so, I do think it's a situation that's exacerbated by the current market conditions. And hopefully that helps with some color.

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

Q

And then my second question is the outlook for 2018, help me out a little bit little bit, is it an earnings growth story or is it a re-basing of your earnings power? And there is a big distinction between the two, because now you're obviously taking your base down pretty considerably. So, is there a make-up in 2018 or you're just going to grow your 5%, 10% that algorithm? And again, I'm not looking for exact guidance, but I think there is a big difference between those two.

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

A

Again, I agree with you, Ken, there is a difference between the two, and we are not in a position at this point to give additional guidance. I gave, obviously, the color that hopefully is helpful. I guess some additional color around the 5% and 10% which is repetitive to what we've discussed. But clearly, we believe it's an all-in number, the 2% to 3% of organic top line growth that we've seen over the last several years, very achievable. Clearly, we need to leverage our balance sheet for accretive acquisitions for the other part of that 5% and 10%. We've demonstrated our ability to do that here recently. Jim talked about some of the strategic cost management, operational efficiencies. Clearly, gross margin improvements will help us get to that 10% bottom line.

And I do think, going back to some of our earlier conversations around these commodity markets, we've got a proven ability to price in these many market conditions and it's really that short-term volatility. So, I can't give you a specific guidance but, hopefully, the 2018 outlook color, a reminder on the 5% and 10% being a longer term all-in number is helpful.

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

Q

The 5% and 10% is a long-term number. That means that if you were under, you need to overachieve in some other distant year. Is that fair?

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

A

That's fair, over time. You are correct.

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

Q

Right. Thank you.

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

A

Thank you.

Operator: We'll take our next question from Benjamin Theurer with Barclays. Mr. Theurer, your line is open. You may want to depress your mute function.

Benjamin Theurer
Analyst, Barclays Capital

Q

Hello?

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

A

Good morning.

Benjamin Theurer
Analyst, Barclays Capital

Q

Can you hear me?

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

A

Yes, we can.

Benjamin Theurer
Analyst, Barclays Capital

Q

Okay. Kind of weird, didn't work out. Sorry for that. I wanted to ask a question in regards to the Fontanini acquisition you've mentioned. So, I clearly get it that the CapEx benefit you have going forward. But could you share a little bit more detail on the current profitability and what you think that business should be running up from an operating profit margin point of view? Is it similar as what you're having in the two categories or is it a little lower and you believe that through the synergies you can get it to the same levels? Thanks for sharing the sales number, but it would be good to get also a little bit detail on operating or EBITDA level if you can share that, that would be much appreciated. And then I have one other follow-up question.

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

A

Sure, Benjamin. I guess the best answer I can give you on Fontanini is that the margins for the business are accretive to both Refrigerated Foods and the total company which, obviously, is a very good thing. And just a reminder, in our comments we talked about it, the $0.03 or $0.04 impact going forward.

Benjamin Theurer
Analyst, Barclays Capital

Q

Okay. And on the Brazilian acquisition, just to stick with the M&A business. So, you've mentioned this is going to be basically a separated unit that's going to be completely separated run. Is that kind of business that you opportunistically purchased? I mean, clearly the price is a little lower as having like a food in the country to potentially further expand in the future and if it's not working out, it's not that much of a cost associated. Or how do we have to think about that tiny step into Brazil which tends to likely be a profiting and growing country in the comings years, after two years of very tough economic environment? So, just to understand a little bit more of the strategic part behind that.

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

A

Sure. Yes. So, this is a very strategic acquisition for us. It is not opportunistic. It provides a great opportunity for us, but it is very, very strategic. I mean, we have been working at acquiring this family-owned business for some time and those do take a little longer to get across the finish line. We see this as a platform for future growth in Brazil. We continue to look for opportunities – already looking for opportunities to expand. We've got a great professional management team that comes along with the Ceratti acquisition. And yes, it's $100 million business, but it's a very healthy $100 million business that's growing and will serve as a great platform for the future.

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

A

One thing, worth mentioning is that as we went into Brazil, we spent a great deal of time on due diligence and the deal also – the valuation of the deal included a discount based on the country risk.

Benjamin Theurer
Analyst, Barclays Capital

Q

Okay. Perfect. That's much appreciated comment. Thank you very much.

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

A

Yes.

Operator: We'll take our next question from Jeremy Scott with Mizuho.

Jeremy Scott
Analyst, Mizuho Securities

Q

Hi. Good morning.

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

A

Good morning.

Jeremy Scott
Analyst, Mizuho Securities

Q

So, the Refrigerated Foods margins, they came in actually nicely above where we were modeling and I was hoping if you could help break down some of the elements of the 230 bps expansion year-on-year. I mean, the reason why I ask is we have a relatively clean comparison on core commodity margins outside of the trim pricing. So, anything you can put a number on would be very helpful as we look to build out 2018 and 2019 maybe starting with Farmer John. We have been modeling it as a 40 bps to 50 bps ongoing tailwind but if it was something a little bit more in the quarter and then if there's a greater mix shift to Applegate, your value-add component, what will Fontanini build in 2018? Maybe just kind of help out with your core – the 230 bps, if you can break that down by piece would be very helpful.

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

A

Okay. Jeremy, I think your assessment of Farmer John, there is nothing dramatically different there. I mean, clearly the big driver for Refrigerated Foods is the improvements, the increases in the value-added sales. And as we think about what has happened there, we've seen really a great performance in the quarter both in our meat products which is our retail division across a number of different brands, the foodservice business continues to outperform the industry. And when we talk about the increases with BACON 1 in their portfolio, certainly those margins are accretive to the overall Refrigerated Foods organization. So, it's the increase in value-added, some of the mix shift even within the value-added. And so, again we remain very positive about the great work we're seeing in our Refrigerated Foods segment.

Jeremy Scott
Analyst, Mizuho Securities

Q

Okay. And then maybe just can you talk a little bit about what was the core reason for the Muscle Milk softness. Was it strictly competitive issues or where there something else going on in the quarter, whether it's the channel shift or maybe break that down a little bit for us?

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

A

Sure. So, we talked about the channel and certainly it was primarily in ready-to-drink in the c-store. And a year ago, would have been late summer, we had a voluntary recall on our ready-to-drink items. And as we progressed at the end of 2016 and 2017, I mean, it's clear to us that we underestimated the impact of that voluntary recall. So, we had some pipeline fill, certainly some favorable comps that gave us a positive feeling about the business.

What we've seen most recently is some of the aggressive competition in the ready-to-drink c-store space, really exposed that the business hadn't materialized the way we thought. The bigger thing for us is now what are the actions that we're going to take in terms of giving that business additional promotional support, working very aggressively with our distribution partner to gain back any lost distribution, and making sure that we're priced appropriately in key channels.

So, a number of different things there and we've got work to do as we head into 2018 with that brand.

Jeremy Scott
Analyst, Mizuho Securities

Q

Okay. Thank you.

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

A

Yeah.

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

Heather Jones
Analyst, Vertical Group

Q

Good morning. Thanks for taking the question. Just two quick questions. You've mentioned, I thought I caught a comment about pricing for the peak of these commodity input pressures. And so, like we've seen belly prices come down about 25%, pork trim is down about a third from its recent peak. So, as we're thinking about the pricing actions that you've taken, did you price assuming that bellies are going to go back to that $2-plus range and trim, how should we think about the magnitude of price?

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

A

Yeah. I mean, I think the key takeaway is we didn't think it was going to go up as fast as it did. And so, we didn't have a preconceived notion that it was going to moderate either. So, we've priced it to the peak of the market. We know that, obviously, we work through some inventory, which takes longer in GP, our Grocery Products division, than it does in some of the other divisions. So, I mean that is the way that we thought about pricing is that we are priced to the peak of the market.

Heather Jones
Analyst, Vertical Group

Q

Okay. And then on the turkey side, your volume declines, how much of that is purposeful declines to try to do your part to right size supply and demand and how much is related to the live production issues that – I don't know if you've mentioned on this call, but I remember you mentioned on the Q2 call. So, just how we could think about purposeful versus just an effect of health issues or whatever?

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

A

Yeah. I mean, from a business volume perspective, I mean it was all purposeful, very intentional and that's – you can model that at about a 7% decline.

Heather Jones
Analyst, Vertical Group

Q

Okay. Thank you so much.

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

A

Yeah. You're welcome.

Operator: We'll take our next question from Akshay Jagdale with Jefferies.

Akshay Jagdale
Analyst, Jefferies LLC

Q

Good morning. Thanks for taking the question. Just wanted to talk through the Refrigerated Foods outlook. And obviously, you've been – I've listened to everything you've said. We appreciate the color. I know it's hard to predict what's going to happen in an event like this. But even if the volume is there, right, so if the demand is there for the plants to run, I mean why wouldn't the profitability be lower? So, that's my question. The processers are operating at three, four times normal profitability. So, if one would venture to say that, okay, the demand is there, they're going to operate the plants, but there is no way they're going to operate those plants at these profitability levels, right. I mean, is it inherent in your sort of expectations that the sort of cut-out margin will normalize? That's my main question really is. I get that the hogs that will come to market will get slaughtered and there is significant supply out there, but we're really talking about what's going to happen with the cut-out margin and how it will impact your numbers. So, is your expectation that cut-out margins will remain well above normal levels like they are now?

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

A

Well, what...

Akshay Jagdale
Analyst, Jefferies LLC

Q

And then – yeah, go ahead.

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

A

Well, as we've discussed, what we focus on are our hog costs, our input costs primarily around bellies and 72% trim. We think the hogs will be slightly higher in the fourth quarter and even going into 2017, bellies remain well above last year as freezer inventories are low and demand for bacon is very high. 72% trim is – we expect to be above last year.

What we have seen again is this what seems to be very much a balance in the hog supply and demand that isn't driving up the cost of the hogs. What we've said before is the additional capacity is a benefit to us, and we continue to watch the international domestic demand and the additional capacity coming online. Based on our analysis, we believe that the additional capacity is needed.

Akshay Jagdale
Analyst, Jefferies LLC

Q

Right. So, net-net, you think that next year is a more or less favorable operating environment for Refrigerated Foods compared to what you've seen in last couple of years?

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

A

Well, we have the addition of Fontanini. We should be through – the changes in the hog supply should be clear as the additional plants become online. Hopefully, there is additional supply of the raw materials so that there is not the type of volatility and spikes that we've seen in the bellies and the 72% trim markets. Beef has been very hard to predict. So, I think that the color that Jim gave you is what we feel about the Refrigerated Foods outlook for 2018.

Akshay Jagdale
Analyst, Jefferies LLC

Q

Okay. And just to sort of summarize everything you've talked about in terms of commodity prices. So the best way to think about it is, I guess that you've seen a significant rise. I think you have given some numbers around how much you buy in the open market. But essentially, the fourth quarter guide down, if I may, is all related to the lag or significantly related to the lag between the commodity cost and price pass-through and that next year, that will normalize, so you literally get that back, right. It's not like you're just absorbing that. It's a timing issue and you'll get that margin back next year, but it's like a quarter and half lag.

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

A

Akshay, what I will tell you about Refrigerated Foods is, historically, and the way the business is structured, we do suffer on a short-term basis when we see spikes in commodity prices. It compresses our margins. The velocity that occurred in this cycle certainly added to that difficulty. But as prices decline, historically, we expand our operating margins at Refrigerated Foods. We hate to say this cycle is a good thing but, in the long-term, we would tell you that we will expand our operating margins as prices decline.

Akshay Jagdale
Analyst, Jefferies LLC

Q

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

Operator: And that does conclude today's question-and-answer session. I would now like to turn the call back over to Jim Snee for any additional or closing remarks.

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

Well, thank you all very much for participating in our call this morning. There is no doubt this year has been challenging for us. And I'm confident we are making the right long-term decisions to drive growth for our company while maintaining focus on delivering our key financial results. Our team is working as hard as ever to continue our long-term growth story. On behalf of the team here at Hormel Foods, thank you for joining us today.

Operator: And that does conclude today's conference. Thank you for your participation, and you may now disconnect.