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Hormel Foods Corp. (HRL)

Q3 2018 Earnings Call

CORPORATE PARTICIPANTS

Nathan P. Annis

Director-Investor Relations, Hormel Foods Corp.

James P. Snee

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

James N. Sheehan

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

OTHER PARTICIPANTS

Akshay Jagdale

Analyst, Jefferies LLC

Ken Zaslou

Analyst, BMO Capital Markets (United States)

Eric J. Larson

Analyst, The Buckingham Research Group, Inc.

Rupesh Parikh

Analyst, Oppenheimer & Co., Inc.

Michael S. Lavery

Analyst, Piper Jaffray & Co.

Jeremy Scott

Analyst, Mizuho Securities USA LLC

Adam Samuelson

Analyst, Goldman Sachs & Co. LLC

Robert Moskow

Analyst, Credit Suisse Securities (USA) LLC

Heather Jones

Analyst, The Vertical Trading Group LLC

Farha Aslam

Analyst, Stephens, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good morning, ladies and gentlemen, and thank you for standing by. Welcome to the Hormel Foods Third Quarter 2018 Earnings Release Conference Call. At this time, all participants are in a listen-only mode. As a reminder, this conference is being recorded, Thursday, 23rd of August, 2018.

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

Nathan P. Annis

Director-Investor Relations, Hormel Foods Corp.

Good morning. Welcome to the Hormel Foods conference call for the third quarter of fiscal 2018. 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 hormelfoods.com under the Investors section.

On our call today is Jim Snee, Chairman of the Board, 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 and our outlook for the remainder of 2018. Jim Sheehan will provide detailed financial results for the quarter and further assumptions relating to our 2018 outlook. The line will be open 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 into the queue. An audio replay of this call will be

available beginning at 11 AM today, Central Standard Time. The dial-in number is 888-220-8451, and the access code is 8905023. It will also be posted to our website and archived for one year.

Before we get started, I need to reference the safe harbor statement. Some of the comments made today will be forward-looking and actual results may differ materially from those expressed in or implied by the statements we will be making. Please refer to pages 34 through 40 in the company's Form 10-Q for the quarter ended April 29, 2018 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 third quarter operating performance by excluding the sales and volume impact of the acquisitions of Ceratti, Columbus Craft Meats, and Fontanini. Discussion on non-GAAP information is detailed in our press release located on our corporate website. Please note, during our call today, we will refer to these non-GAAP results as organic net sales and organic volume.

I will now turn the call over to Jim Snee.

James P. Snee

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

Thank you, Nathan. Good morning, everyone. We are pleased to report our team delivered record sales and earnings in the third quarter. Our company's long-term growth formula is anchored in building brands, innovation, strategic acquisitions, and achieving balance across our portfolio.

We take a consistent, long-term approach to our business decisions and strategy. Over the years, we have increased marketing investments in support of our brands. I'm pleased to report those investments are paying off with growth from both established brands such as SPAM and Skippy, and with the emerging brands such as Natural Choice, Applegate, Jennie-O, Wholly Guacamole, and Herdez.

We are also delivering innovation to the market place at a faster cadence than ever before. Foodservice innovation such as Bacon 1, Fire Braised meats and Austin Blues continue to generate growth. Retail innovations like Skippy P.B. Bites, Herdez Guacamole Salsa, and Natural Choice Snacks are also making meaningful contributions to our results.

Our recent disciplined and strategic acquisitions expand our presence in areas where we are a market leader such as deli and foodservice. While it is early, I am happy to report that Fontanini, Columbus and Ceratti acquisitions are meeting our expectations. The final component of our long-term formula is balance. This is why we made the decision last week to divest the Fremont harvest facility, which when complete, will decrease our earnings volatility.

Our long-term strategy is sound, and our experienced leadership team is executing that strategy. We achieved record sales and earnings in the third quarter as we managed through foreign trade uncertainty, increased freight costs and commodity market volatility. We generated record earnings per share of \$0.39, up 15% from last year. The benefit from tax reform also contributed to our record results.

Record third quarter sales were up 7% on a 5% volume increase. The increases were driven by the recent strategic additions of Ceratti, Columbus Craft Meats and Fontanini, as well as growth from many of our brands across our entire organization.

On an organic basis, volume was up 1% while sales were flat. Strength in key brands across our portfolio were offset by lower pork and turkey markets, which drove decreased pricing for the quarter.

Third-party consumption data continues to show growth across our portfolio in both center store and the perimeter of the store. We are pleased to see growth in household penetration this quarter from emerging brands such as Herdez, Natural Choice and Jennie-O, and also from established brands such as SPAM, Skippy and Dinty Moore.

Grocery Products had a solid quarter. We are pleased with the continued growth from our core Grocery Products portfolio as that team grew sales mid-single-digits. Brands such as Skippy, Hormel chili, Wholly Guacamole and Herdez all delivered excellent sales growth this quarter. Total Grocery Products sales were flat due to declines in CytoSport and our contract manufacturing business.

Earnings grew 4% as our core Grocery Products portfolio continue to deliver excellent results and were able to offset declines in contract manufacturing, increased advertising investments and increased freight costs. The team at CytoSport continues to work on improving their business results. While volume and sales declined, earnings grew for the quarter due to lower selling, general and administrative expenses.

Our International segment delivered sales growth of 11% on a volume increase of 9%. Sales increased on stronger exports of SPAM luncheon meat and Skippy peanut butter, favorable results in China, and the addition of the Ceratti business in Brazil. We continue to gain momentum in China as we grow distribution for our SPAM family of products.

International segment profit increased 9% despite lower fresh pork export earnings, higher advertising investments, and increased freight costs. Refrigerated Foods grew volume 5% and sales 10%. In addition to strong value-added sales growth, the inclusion of the Fontanini and Columbus acquisitions also contributed to improved sales. A reduction in hog harvest volume of 4% drove an organic volume decline of 2%, and an organic sales decline of 3%. Pricing declined due to lower pork markets year-over-year.

We continue to grow our branded value-added volume and sales in the retail foodservice and deli channels. Brands such as Austin Blues, Fire Braised meats, Café H, and Natural Choice all showed strong sales growth in the foodservice channel.

We have also successfully launched the Applegate brand into the foodservice channel as we work to introduce this leading brand to operators around the country. The Natural Choice and Applegate brands also generated excellent sales growth in the retail channel as consumers continue to search for brands that align with their lifestyles.

On a segment profit basis, Refrigerated Foods value-added increases were able to offset a dramatic decline in commodity pork profits, higher freight costs, and higher advertising investments. Commodity profits were down 88% to near breakeven levels. This accomplishment speaks to the team's ability to deliver results and to the long-term strategy of moving the portfolio away from commodity business toward branded value-added products.

Jennie-O Turkey Store delivered strong volume growth of 14%, and sales growth of 8%. Our three value-added businesses all grew volume and sales this quarter. Value-added sales growth was led by Jennie-O lean ground turkey, Jennie-O premium deli items, and the Jennie-O Oven Ready products. Sales also increased due to earlier shipments of whole birds to minimize cold storage expenses. Segment profit declined 23% due to lower whole bird and commodity prices.

As we look to our fourth quarter, we expect to remain on track with our previous earnings guidance. We expect a strong finish to the year from Refrigerated Foods as they continue to grow value-added sales and profits, while managing through commodity volatility. We anticipate the International segment to generate earnings growth in the fourth quarter given the positive momentum that team has with branded exports and improving business results in China.

We do see risk from tariffs, which could negatively impact fresh pork exports and the segment's results. We anticipate a slight decline in earnings for Grocery Products. We expect to generate ongoing growth in the core center store portfolio while managing through continued declines in contract manufacturing.

For Jennie-O Turkey Store, we still expect earnings to decline in the fourth quarter compared to last year. We see fundamentals slowly improving and are encouraged by trends in the turkey breast meat market. We will not lap the declines in the whole bird business until calendar 2019 but expect our successful Make The Switch campaign to drive branded sales growth including our lean ground turkey product line.

We continue to see double-digit increases in per unit freight costs. Our efforts to find mutually agreeable solutions with our customers are helping to offset a portion of this increase. Taking all these factors into account, we are reaffirming our earnings guidance of \$1.81 to \$1.95 per share. We have lowered our sales guidance to \$9.4 billion to \$9.6 billion from \$9.7 billion to \$10.1 billion due to lower pork commodity markets.

Last week, we announced an agreement to sell the Fremont processing facility to WholeStone Farms. This was not an easy decision. The Fremont facility has been an important part of our company for decades, and we are pleased to have found a home for this team and facility with WholeStone Farms.

Fremont is a single-shift operation. Given the changes in the pork industry, the facility will need additional investments to keep it competitive. I'm pleased to see that WholeStone Farms has committed to modernize the facility. This strategic decision rightsizes our pork supply chain, reduces our earnings volatility and is aligned with our vision as a global branded food company.

At this time, I will turn the call over to Jim Sheehan to discuss our financial information relating to the quarter, key assumptions for the remainder of fiscal 2018, and financial and operational details of the Fremont transaction.

James N. Sheehan

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

Thank you, Jim. Good morning, everyone. In the third quarter, we increased our investment into our business in the form of advertising, capital expenditures for our value-added products, and the universal stock option grant for 20,000 employees. The third quarter marked the completion of 90 consecutive years of quarterly dividends. Our financial strategy and capital allocation decisions support the long-term growth strategy that Jim discussed.

Volume for the third quarter was 1.2 billion pounds, a 5% increase compared to last year. We generated record sales for the third quarter of \$2.4 billion, a 7% increase. Net earnings were \$210 million, up 15% compared to last year. For the quarter, SG&A expenses excluding advertising were 7.2% of sales compared to 6.9% last year. The impact of acquisitions drove the increase.

Advertising investment was \$40 million compared to \$24 million last year. We're currently advertising key growth brands including Skippy, SPAM, Jennie-O, and Natural Choice. General corporate expenses increased primarily due to higher employee-related expenses, including the \$4 million expense related to universal stock options.

Expenses also increased \$2 million due to tax-related services. Operating margins were 11.1%, a 160 basis point decrease compared to last year. The decline is primarily a result of lower margins at Jennie-O and higher freight across the entire business.

Our effective tax rate was 18.4% compared to 34.3% last year. We engaged a third-party to review our deferred tax liabilities in light of changes from tax reform. As a result of this study, the quarter reflects reduced taxes of \$8 million. A \$2 million expense was recorded in general corporate to complete the study.

Considering this event, we now estimate our full year effective tax rate will be between 15% and 16%. This implies a fourth quarter tax rate between 21% and 24%. Year-to-date, we have generated operating cash flows of \$743 million, up 40%. The increase was related to higher earnings and improved working capital.

Capital expenditures for the quarter totaled \$103 million compared to \$42 million last year, as we continue to invest in new production facilities and manufacturing capacity for our value-added businesses. We expect capital expenditures to be approximately \$400 million in 2018. In the quarter, we paid \$99 million of dividends at the annual rate of \$0.75 per share. This marked our 360th consecutive quarterly dividend.

Total debt is \$720 million, this is split between long-term and short-term debt. We remain in a strong financial position to fund other investments. We did not repurchase any stock this quarter. We continue to focus on three factors in the hog industry: export demand, domestic demand, and industry capacity utilization.

Exports remain uncertain, impacted by multiple rounds of tariffs and recent animal health issues in China. The USDA forecasts export volume to be up 6% in 2018. Domestic consumption remains very high. However, pork pricing has come down since last year as the USDA composite value was 16% below year-ago levels in the third quarter. We expect hog supplies to increase 3% to 4% this year and expect continued hog supply growth into 2019.

The sale of the Fremont facility is the culmination of a multi-year assessment of the pork industry, as well as a detailed review of the capital required to modernize the Fremont facility. We concluded that running Fremont as a single-shift operation was not a viable option, and we would have to either spend the capital to modernize the facility, find a long-term supply partner, or close the facility over time.

We began discussions with WholeStone Farms after learning of their interest to enter the hog processing business. Our discussions resulted in the sale of the facility at terms that provide benefits to both parties. The purchase price of the transaction is \$30 million, and includes the Fremont processing facility and a multi-year agreement to provide pork and raw materials from the first shift of production at market-based prices.

The sale of the Fremont facility allows us to do a number of things. First, this transaction allows us to contractually secure a source of raw material for our value-added business at competitive market prices. Second, this deal reduces the number of hogs we purchase and related exposure to volatility to the hog markets.

Finally, the sale of the plant allows us to avoid significant capital to modernize the facility. For example, we recently invested \$80 million to modernize the Austin facility. A similar investment would be required for Fremont in addition to investments to double shift the facility.

We expect approximately \$15 million to \$20 million of expenses associated with this sale in fiscal 2019. These expenses include the cost to build value-added equipment out of the facility and various pension-related expenses. Fremont harvests 10,500 hogs per day and currently represents one-third of our harvest volume, and

less than one-third of Refrigerated Foods commodity pork earnings. We will provide further guidance on the impact to fiscal 2019 on our fourth quarter earnings call.

Input costs for the third quarter were generally lower. Hog prices were 10% lower than last year. We expect hog prices to be lower than last year in the fourth quarter. Belly prices were 20% lower than last year. We expect belly prices to remain volatile and below year-ago levels. 72% pork trim prices were 22% below last year. We expect trim markets to be modestly lower than 2017 levels.

As we look into the first half of fiscal 2019, we see flat to lower hog, belly and trim prices. We do expect volatility as new harvest plants and hog supplies come on line. 50% beef trim was 43% lower compared to last year. We expect beef trim prices to be similar to 2017 levels.

Market costs for feed were higher compared to last year. We expect feed costs to be higher year-over-year in the fourth quarter. We continue to see signs of a slow recovery in the turkey industry. All placements have shown low-single-digit declines in recent months, which indicates lower harvest levels in the coming quarters. Turkey breast meat and whole birds in cold storage are still well-above long-term average levels.

Breast meat prices increased during the quarter, breast meat averaged \$1.88 per pound compared to \$1.53 last year. We expect moderate increases in the coming quarters. Whole bird prices are 17% lower than 2017 levels, and we do not expect a material change in pricing until the first quarter of fiscal 2019.

Various market factors including tariffs, freight, supply levels, and demand have all created market volatility, yet we have demonstrated an ability to manage through this volatility, and deliver long-term value for our shareholders.

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

QUESTION AND ANSWER SECTION

Operator: Thank you, sir. Our first question is coming from Akshay Jagdale from Jefferies. Please go ahead. Your line is open.

Akshay Jagdale
Analyst, Jefferies LLC

Q

Hi, good morning. I wanted to get a sense on sort of Jennie-O Turkey profitability, and how you see it, like, what's the long-term sort of bridge to a more sustainable and higher level, right? So, we have low breast meat prices that seems to be moving off of a bottom, and then you've got a bunch of higher costs. So maybe you can help us just think through high level long-term, how we're going to regain sort of the profitability levels that we've seen in this business historically? Thank you.

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

A

Yeah. Good morning. The JOTS business, we still remain very pleased with that business, very pleased with the value-added growth that we're seeing, just like we did this most recent quarter. Over time, certainly, we need to make sure that the supply comes in balance in the marketplace. We've talked a lot about lower poult placements. We've talked a lot about the need for reduced inventory in cold storage.

And although we're seeing those trends, they're happening slower than we've expected. And you're correct, we are seeing higher breast meat pricing. We're seeing a stabilized whole bird market, which are very positive for the fundamentals of the business. But over the long-term for us, it's really about our ability to continue to grow the value-added business. And we believe the results that we've delivered in the third quarter are a very good indication that the business is healthy and will return to growth in 2019.

Akshay Jagdale
Analyst, Jefferies LLC

Q

That's helpful. And one follow up, I guess, would be on the Refrigerated Foods business. So obviously, the value-added business is doing exceptionally well and offsetting some of the weakness in the commodity markets.

I know, you gave a lot of information, so we'll have some time to digest it afterwards, but can you help us understand sort of where you think the commodity margins are? I mean, have they bottomed out or do you think things might get a little bit worse before they get better as it relates to industry capacity utilization rates? Thank you.

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

A

That's a number that's very, very hard to predict. I mean, clearly, we're dealing with a lot of projections that remain uncertain and volatile. There've been a number of announcements in terms of increased hog processing capacity. But in terms of what happens with the timing of that, that'll feed into projections and into that volatility. So at this point, it's really, really hard to say.

Akshay Jagdale

Analyst, Jefferies LLC

Q

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

Operator: The next question is coming from Ken Zaslow from Bank of Montreal. Please go ahead, your line is [audio gap] (26:57)

Ken Zaslow

Analyst, BMO Capital Markets (United States)

Q

Good morning, everyone.

James P. Snee

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

A

Good morning, Ken.

Ken Zaslow

Analyst, BMO Capital Markets (United States)

Q

Two questions, will you be able to grow your EBITDA in 2019?

James P. Snee

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

A

We're in the midst of a planning process for 2019, and our early look into fiscal 2019, I mean, shows pre-tax growth. Obviously, we'll have more precise guidance for everyone on our November call, but as we think about all the different businesses with Refrigerated Foods, we expect to see continued value-added growth. We'll have our deli division fully up and running, impact of the recent acquisitions. And I mean, clearly, we'll have the impact of the Fremont sale that we'll talk to you more about on the fourth quarter call as well.

Our GP business, the core business remains very, very strong. We're seeing growth from MegaMex, steady growth from nut butters on the core business, but also on the innovation front. The pipeline's very robust. We have work to do to continue to stabilize CytoSport and contract manufacturing in that portfolio, but we think the outlook is very positive.

We've talked a lot about the JOTS business, the slowly improving fundamentals to growth and value-added, especially lean ground. And our International business, we're pleased with what we're seeing in China. We know that we have some volatility in the fresh pork exports due to tariffs. So I mean, our early look into 2019, Ken, shows pre-tax growth, and we know that there's certainly some headwinds out there in unknowns in terms of the tariffs, and we're going to battle through that. But yeah, we do think we can grow pre-tax earnings in 2019.

Ken Zaslow

Analyst, BMO Capital Markets (United States)

Q

And my follow-up question just as a point of nuance is, in the quarter, how much was free in the higher hog, higher belly prices relative to lower [indiscernible] (29:06) margins. Can you give us some sort of relative so we can kind of understand the importance of different vectors in the quarter? And I'll leave it there.

James P. Snee

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

A

Sure. From a freight basis, it's still been a headwind in the quarter, and we expect it to be a headwind in 2019. We've said again, we're focused on finding those mutually agreeable solutions in terms of minimizing miles, maximizing weight, less internal freight. And we've seen that we've offset a majority of the cost increase on a go-forward basis. And, Nathan, you could have a follow-up conversation, perhaps on the quarter, but really for the full year, our freight costs are expected to be up \$0.06 to \$0.08 on an EPS basis for the full year.

Ken Zaslow

Analyst, BMO Capital Markets (United States)

Q

Great. Thank you very much.

James N. Sheehan

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

A

Yes. Thanks, Ken.

Operator: Next question is coming from Eric Larson from Buckingham Research Group. Please go ahead?

Eric J. Larson

Analyst, The Buckingham Research Group, Inc.

Q

Yeah. Good morning, everyone. Thanks for taking my question.

James P. Snee

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

A

Good morning, Eric.

Eric J. Larson

Analyst, The Buckingham Research Group, Inc.

Q

My question is on Fremont, and I'm kind of inferring that this is what your contractual obligations are going – what your supply contract is going forward. But are you contracting to take all of the output from Fremont going forward or just the needs that you have? In other words, are you moving away from some of the commodity-oriented products that would normally be produced, and you will not have an obligation to sell that?

James P. Snee

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

A

Yeah, Eric. So, in the short term, I mean, it's going to be essentially business as usual. So we're contracted to take all of the meat just like we do today for the first three years, and then, over time, we'll have the opportunity to evaluate the business and make those decisions. But in that first three years, we are taking all of the meat off of the first shift just like we do today.

Eric J. Larson

Analyst, The Buckingham Research Group, Inc.

Q

Yeah. Okay. And that makes sense, and I assume that that probably was the case. And then just – and maybe this is for Jim Sheehan and, Jim, probably you should know the answer to this because it's been an issue – it's been a big delta for the whole year. But your general corporate expenses were up, it was a big delta in the quarter

year-over-year. Can you explain what that is? You didn't highlight any one-time items that were in there. Can you just refresh us why your corporate expense is up so much in the quarter and for the full year?

James N. Sheehan

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

A

Certainly. First of all, we talked about the universal stock options. The universal stock options were issued in the third quarter, and that created a \$4 million dollar corporate expense. The other issue was that – that we referenced was the tax study that we did. The tax study reduced our taxes in the third quarter by \$8 million. There was a \$2 million fee that exists within the corporate expense for that. And then we had generally higher employee expenses in the quarter.

Eric J. Larson

Analyst, The Buckingham Research Group, Inc.

Q

Okay. Thank you. I appreciate it. I'll pass it on.

Operator: The next question is coming from Rupesh Parikh from Oppenheimer. Please go [audio gap] (32:49).

Rupesh Parikh

Analyst, Oppenheimer & Co., Inc.

Q

Good morning. Thanks for taking my questions. So, on your EPS guidance...

James P. Snee

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

A

Good morning.

Rupesh Parikh

Analyst, Oppenheimer & Co., Inc.

Q

So, on your EPS guidance for the full year, so it's still a pretty big range. So, I was curious what are the key factors driving that larger range. And any sense at this point whether you're trending towards the bottom or higher-end of that range?

James P. Snee

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

A

Hey. Good morning, Rupesh. Given what's happening in the marketplace, we're talking a lot obviously about the volatility, whether it's tariffs, market conditions. We felt it was appropriate to keep the range intact for the full year, obviously, reaffirming that guidance.

And then, as we think about some of the things that could take you either way on the high-end, if we see continued declines in input costs, if there's a sudden end to tariffs, if there's a rapid recovery in Turkey. On the lower-end, I mean, the flipside or the inverse would be true if we see a spike in input costs when you think about hogs, bellies, trim, brain or if the tariff situation worsens. But we believe that the midpoint is still very reasonable, and we thought it was very appropriate to keep the range where it is.

Rupesh Parikh

Analyst, Oppenheimer & Co., Inc.

Q

Okay, great. Then my follow-up question on tariffs, I know there's a lot of different tariffs out there, and I think some proposal is out there. So, I was curious if you can just help us understand the dynamics currently, and then what is this doing in your current guidance?

James P. Snee

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

A

Sure. So I mean, obviously, it's difficult since we're dealing with markets. For the back half of the year, it's about \$0.01 to \$0.02 primarily coming from our export business, our fresh pork exports. As we think about it on an annual basis, probably about \$0.04 to \$0.06, but clearly, there's a lot of uncertainty. And as you think across our business, the impact would be pork, steel, aluminum, but the majority of that really is being export related.

Rupesh Parikh

Analyst, Oppenheimer & Co., Inc.

Q

Okay, great. Thank you.

Operator: Our next question is coming from Michael Lavery from Piper Jaffray. Please go ahead.

Michael S. Lavery

Analyst, Piper Jaffray & Co.

Q

Thanks. Good morning. Could you just give an update on some of your supply chain reconfiguration? And I remember you mentioning that as a driver of 2019 earnings growth, is there – what do you expect for some of the savings opportunity? What's some of the timing? Can you just help – give us some more color on where that all stands?

James P. Snee

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

A

Sure. Good morning. We've put our supply chain in place earlier this year led by Glenn Leitch, and we have kept Glenn and his team incredibly busy since that time, obviously dealing with all of the freight issues in the industry, evaluating our total supply chain. He was really the point person for the Fremont transaction, and we have got a lot accomplished in 2018 doing a lot of work around insourcing production, asset utilization, some automation, efficiency projects.

And then, we can't forget the fact that we're in the midst of building a new facility in Melrose for our Jennie-O Turkey Store business, and then a significant expansion for our value-added capacity down in Dold. So we've kept that team busy. We are working for a perspective on 2019, and I will be able to provide you more detail on that in our fourth quarter call.

Michael S. Lavery

Analyst, Piper Jaffray & Co.

Q

And then, is it right to assume some of the freight efficiencies you're looking for are all integral to that work? And just related to freight, when you talk about some of that headwind continuing into next year, is that all on rates that – are you still seeing those going higher?

James P. Snee

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

A

I mean, I think it's a combination of things. So, you mean you're going to have – who knows what's going to happen with fuel prices, certainly, the shortage of drivers can impact rates. Now, what we're really focused on are the things that we can control. And I mentioned it is the minimizing miles, maximizing freight, and really making sure that we're doing the right things on an internal basis so that we can offset as much of that as possible, but we feel really good about the work that's been done.

Michael S. Lavery

Analyst, Piper Jaffray & Co.

Q

Okay. Thank you very much.

Operator: The next question is coming from Jeremy Scott from Mizuho. Please go ahead.

Jeremy Scott

Analyst, Mizuho Securities USA LLC

Q

Hey. Good morning. Just want to talk a little bit about the Fremont sale. I guess, it's one-third of processing, less than one-third of commodity sales, so that would imply that the value-add mix is somewhat higher than Austin; maybe you can elaborate on what you meant by that?

And then on the multi-purchase agreement, just the answer to the prior question on taking all the meat; so it sounds like your overall volume is not going to be impacted because you said business as usual. However, I guess, I'm a little bit confused as to what the margin structure on that looks like. I mean, presumably, there's commodity product that you're going to be buying and then reselling with other value-added component. Is that right?

James P. Snee

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

A

That is correct. So, if you think about the transaction, what we are losing is the spread between the hog costs and the USDA composite value. That's how I would look at it.

Jeremy Scott

Analyst, Mizuho Securities USA LLC

Q

Okay. But that's a pretty good margin today and then – but if you were to buy ham and then resell ham, that margin would effectively go to zero. Is that correct?

James P. Snee

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

A

Well, you're correct that the margin is pretty good today. And what we've talked about is that, historically, it's less than 5% of Refrigerated Foods earnings. In the current year, far less than that, we talked about a significant drop last quarter, about 25%, significant drop this quarter of 88%. And then really, what the future holds in terms of how much comes online, what the timing is. It's all projections, and that remains very uncertain and volatile.

James N. Sheehan

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

A

Yeah. So, as we've talked, we're giving up that spread, but the margins in retail, the margins in foodservice will still retain. We're taking out the volatility, and we still believe that this creates the right mix of internally-sourced primals and outside purchased primals.

And also, it also allows us to avoid a very significant capital allocation. If you think about the Austin plant, that was over \$80 million and did not include the cost to double shift this plant. So the capital investment into Fremont would have been very extensive.

Jeremy Scott

Analyst, Mizuho Securities USA LLC

Q

Okay. And then just on the \$30 million sale price, that's a good amount lower than what you were able to gain from Farmer John. I know, it's an older plant and it needed some capital work, but would that imply a lower normalized margin than Farmer John or is there something in the multi-year purchase agreement with WholeStone that we need to consider going forward or is it just as you said, you're going to take the market price plus? What do we need to consider going forward as we're mapping this out?

James P. Snee

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

A

Yeah. I think the first thing is that you can't look at the purchase price in a vacuum, right? So the first thing is Fremont was not a full business like Farmer John. And then the price does not include any of the value-added assets. So we've talked about some of the expenses that we'll have in 2019 as we relocate those assets, but the price does not include any of that because we will retain that.

As Jim mentioned, the facility really is in need of significant investment to remain competitive. And in fact, it couldn't support both a double-shift and value-added capacity. And so, it does have the supply agreement at market-based prices, which we believe is a mutually beneficial agreement, and it's consistent with our long-term strategy. And we're excited. I mean, we really look forward to a long successful partnership with WholeStone.

Jeremy Scott

Analyst, Mizuho Securities USA LLC

Q

Got it. I'll jump back in the queue. Thank you.

James P. Snee

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

A

Yeah.

Operator: The next question is coming from Adam Samuelson from Goldman Sachs. Please go ahead.

Adam Samuelson

Analyst, Goldman Sachs & Co. LLC

Q

Yes. Thanks. Good morning, everyone. Maybe first question on Refrigerated and the value-added side, so the organic – organic volumes in the quarter were down 2%. You talked about harvest levels down 4%. So – and what would – can you just talk about what the Ceratti and Columbus and Fontanini – or I guess, Fontanini and Columbus organic volume growth were in the period or are they still in M&A? Just trying to think about what that organic volume growth looks like prospectively as you get those locked into the base and you start comping some of the declines in harvest values that you've seen in the last few quarters?

James P. Snee

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

A

Yeah. Adam, I think it's safe to say, I mean, the value-added growth that we saw in the quarter was significant, I mean, to be able to offset that type of commodity profit decline of 88% tells a story of value-added growth. And when you think about what's happening with Columbus, I mean, we're putting that deli sales division together to really leverage the strengths of the organization, the Columbus business remains very healthy and is going to be integral to the foundation of the deli division.

The Fontanini business, also very healthy, and we're now able to really leverage what the acquisition thesis was in terms of taking our foodservice portfolio into the Fontanini organization, and taking that Fontanini portfolio into the foodservice organization, so that we really can – over time, we know that we're going to see a sequential acceleration in that foodservice business. So, I mean, we feel really good about what both of those businesses are bringing to the party, and they're going to be playing a key role as we continue to drive that value-added business over time.

James N. Sheehan

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

A

I would add that we...

Adam Samuelson

Analyst, Goldman Sachs & Co. LLC

Q

Yeah, go ahead.

James N. Sheehan

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

A

...we completed the integration of both Columbus and Fontanini. The other thing that we've talked about is that volatility in the market can create some noise between quarters. And if you take a look at the belly market, the belly markets increased all during the third quarter, and our pricing trails that increase, you saw a steep decline at the end of the third quarter in belly pricing. So that's one of the reasons why we feel that there will be a strong finish to Refrigerated Foods in Q4.

Adam Samuelson

Analyst, Goldman Sachs & Co. LLC

Q

Okay. And then just going back on Fremont, I just want to be clear on thinking about the sale price, the \$30 million for the asset, you guys internally would think that there's at least \$80 million of capital needed to go in. So effectively, it's \$110 million some capital foregone that you don't have to spend.

And from an earnings contribution of the plant, I mean, in the past, you've talked about commodity profits in Refrigerated being averaging about 15% of the segment, probably under that this year. And Fremont, you talked about being less than a third of that. So, the EBIT contribution of the plant, I'd guess, this year is somewhere in the \$10 million to \$20 million range. Is that a fair assessment? And then thinking about the sale price, effectively is \$110 million because of the capital that you'd otherwise have to spend?

James N. Sheehan

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

A

Right. The commodity profits were down 88% in the third quarter. And we discussed that they were near breakeven levels. The fact that Fremont is a single-shift plant, it's not as efficient as the Austin plant, which is a highly-efficient double-shift plant, that's why the profits are less than the volume at the plant. And I would say that it's closer to \$10 million a year than the numbers that you're throwing out.

Adam Samuelson

Analyst, Goldman Sachs & Co. LLC

Okay. That's very helpful. I'll pass it on.

Q

James P. Snee

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

Thank you.

A

Operator: The next question is coming from Robert Moskow from Credit Suisse. Please go ahead.

Robert Moskow

Analyst, Credit Suisse Securities (USA) LLC

Hi, thanks. I guess, a couple of questions. One is on bacon pricing versus bellies, the spreads in the quarter, were they favorable versus last year? I noticed that Bacon 1 was not mentioned in the press release as being a growth driver. It's the first time I've ever seen that in years. Bacon 1 has been a big driver of growth for you. So, I just want to know what the spread was whether it was good or bad.

Q

And then second, maybe we'd just take a step back at the big kind of drivers for fiscal 2019, the puts and takes. I imagine there's going to be – the headwind from the cost to transition Fremont, you mentioned it here \$20 million or so, maybe you could also help us on the commodity kind of bridge to fiscal 2019?

Are you close to zero this year in commodity profits in pork, and therefore, we don't have to think about another decline in fiscal 2019, because if you're close to breakeven this year, we don't have to worry about a tough comp in fiscal 2019 on the commodity side or maybe we do. Can you help me with that?

James P. Snee

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

Yeah. Good morning, Adam – or Rob. Sorry, Rob. Why don't I go ahead, I'll take the bacon part, and then we'll let Jim take the commodity part? So, from a – the bacon dynamics, we had a solid quarter on retail bacon. It's obviously very competitive category. I think the spreads have been have been positive, so really no issue there.

A

In terms of the foodservice bacon dynamics, there was no fundamental reason why it was omitted. We've seen strong demand for all of our bacon items, especially Bacon 1. And so, the bacon category is very healthy for us. We feel really good about where it's headed and are excited because we're in need of the capacity that's coming online at our Dold facility, so very, very healthy bacon dynamics.

James N. Sheehan

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

Yeah. I'll talk a little bit about the pork commodity. As we've talked about last quarter, profits were down 25%. This quarter, they're down 88%, almost to near break-even. As additional capacity comes online, and we've talked about the additional capacity for a number of months now, and knowing that WholeStone was also going to add additional capacity into this, it's likely that you will see lower pork margins going forward than what you've seen historically. Historically, those margins have run about 15% of Refrigerated Foods, and that was all of the analysis that we made, that lowering our harvest level and sourcing the meat externally would be a favorable outcome.

A

James P. Snee

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

A

And Rob, I would add that, we're still in Q4. And so, it's hard to get a full-year projection. We obviously saw a significant decline in Q2 and Q3, and the market's all different in Q4. So again, we'll be able to give you some better visibility as we wrap up the year. But I think, it just speaks volumes to the volatility that we've been talking about over the last couple of years.

Robert Moskow

Analyst, Credit Suisse Securities (USA) LLC

Q

As the follow-up, I think, Jim, you talked about the outlook for 2019 saying that you think you'll be driving some profitable growth in 2019. And I can see the logics, but the people I talk to are very worried about a protein glut overall in the market. The chicken companies are talking about it. There's too much beef on the market. Is it possible for your value-added business to benefit, I guess, from these lower input costs in this market? Is that what has to happen in order for profitable growth to occur in fiscal 2019, or you're worried that with all this protein coming on that even the value-added items might see some price pressure as well?

James P. Snee

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

A

I mean, we think, Rob, that we would benefit, obviously, from lower input prices on our business. And I think the other issue is really what happens on the tariff front. And so, there's rumblings out there about some progress that is being made. And when that – if that comes to resolution, that could change the dynamics. But for us, I mean, we do certainly benefit from lower input costs across the portfolio.

Robert Moskow

Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. Thank you.

James P. Snee

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

A

Thank you.

Operator: The next question is coming from Heather Jones from Vertical Group. Please go ahead.

Heather Jones

Analyst, The Vertical Trading Group LLC

Q

Good morning. Thanks for taking my question.

James P. Snee

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

A

Good morning, Heather.

Heather Jones

Analyst, The Vertical Trading Group LLC

Q

Good morning. Thinking about your tax guidance, so the review you did in the quarter, have you made any changes to where you think the 2019 tax rate will shake out, or should we still be thinking somewhere in the low-20s?

James N. Sheehan

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

A

Heather, I'd think about 21.5% to 24.5%.

Heather Jones

Analyst, The Vertical Trading Group LLC

Q

Okay. I'm sorry, go ahead.

James N. Sheehan

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

A

So, that's what we think Q4 will be, and we still think that we'll be in the low-20s in 2019, probably that same range in 2019.

Heather Jones

Analyst, The Vertical Trading Group LLC

Q

Okay. And then I just wanted to go back to the Fremont, and just, I'm sort of curious, you said \$10 million for that plant and – so, if I take your – how many hogs it was killing a day, it comes to about 2.5 million to 3 million hogs a year assuming no Saturday kills. And so, I just – I was hoping you could give us a better understanding of what you all are defining as commodity, because that would equate to only about \$3 a hog or \$3 to \$4 a hog, which I know you guys said it's not the most competitive plant, but that is well below, on a LTM basis, well below what we've seen from others in the industry and well below like industry margins. I'm just wondering if you could give us a sense of how you're defining commodity when you say that that is closer to the \$10 million number.

James N. Sheehan

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

A

So, we're defining the commodity as the spread, the pork profitability margin along with some profitability that would include our commodity sales into the excess market as what I would refer to.

Heather Jones

Analyst, The Vertical Trading Group LLC

Q

Commodity sales into the excess market is what you would call the commodity part?

James N. Sheehan

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

A

Yeah, the provision sales.

Heather Jones

Analyst, The Vertical Trading Group LLC

Q

Okay.

James N. Sheehan

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

A

And I think, Nathan can probably drill down into it deeper offline.

Heather Jones

Analyst, The Vertical Trading Group LLC

Q

Okay. That's very helpful. Thank you.

Operator: Next question is coming from Farha Aslam from Stephens. Please go ahead. Your line is open.

Farha Aslam

Analyst, Stephens, Inc.

Q

Hi, good morning.

James P. Snee

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

A

Good morning, Farha.

Farha Aslam

Analyst, Stephens, Inc.

Q

Just a quick follow-up on the tax question. What is the deferred taxes that you're including in your taxes for this year, kind of the deferred tax revaluation benefit, total overall?

James N. Sheehan

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

A

Certainly, if you're talking about the change in the tax rate because of the study, what we did was to reassess our fixed assets to see if we could accelerate depreciation into the time period that had a higher statutory rate.

Farha Aslam

Analyst, Stephens, Inc.

Q

Okay. But kind of, the revaluation of deferred assets, that was just completely in your first quarter, and we didn't add to that this quarter.

James N. Sheehan

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

A

Right. It's the – no, we reassessed that in the first quarter because as the tax law took impact – had impact in the first quarter, you lower the amount that you can deduct in future years. So, you reset that in the quarter. Your existing liability is reset at the time that the new tax rate is effective.

Farha Aslam

Analyst, Stephens, Inc.

Q

Okay. So...

James N. Sheehan

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

Deferred tax [ph] isn't (54:45) an ongoing change.

A

Farha Aslam

Analyst, Stephens, Inc.

Okay. And so, the – sort of the tax benefit for this year, is that about \$0.10?

Q

James N. Sheehan

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

About \$65 million.

A

Farha Aslam

Analyst, Stephens, Inc.

About \$65 million. Okay. That's roughly around \$0.10. Okay. And then my second question is really broader, on CytoSport, you highlighted that sales were down in the quarter, but earnings were actually up. Could you give us some color going into the fourth quarter and into 2019, how we should think about that business?

Q

James P. Snee

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

Yeah, I mean, Farha, the team is hard at work at stabilizing that business. The big thing is what's happening in terms of the C-store market in the ready-to-drink space. We need to gain back lost distribution. We've talked about getting that consumer message right, and the team is working hard on that. We also are pleased, though, with what's happening in the – really, the food, drug, and mass channel. Our take home tetra pack drinks are growing really, really well. Our innovation is doing well. And so, we expect in 2019 that we'll see some stabilization in the business, but there's still work to do around that brand.

A

Farha Aslam

Analyst, Stephens, Inc.

Okay. So we're not going to see the fourth quarter recovery? Because I think we had previously anticipated top line growth in the fourth quarter because we're comping against a pretty easy comp?

Q

James P. Snee

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

Yeah. We were – Farha, we were talking about earnings growth. We saw some of that in our third quarter like we said, and we would expect to see that again in the fourth quarter.

A

Farha Aslam

Analyst, Stephens, Inc.

Okay. That's helpful. Thank you.

Q

James P. Snee

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

Thank you.

A

Operator: Our final question is a follow-up coming from Jeremy Scott from Mizuho. Please go ahead. Your line is open.

Jeremy Scott

Analyst, Mizuho Securities USA LLC

Q

Hey. Thanks. I think that question was just answered, but the driver of Grocery Products margin decline in the fourth quarter, we would expect to see some benefit from lower commodity prices. So are we to assume that some of that's being reinvested in your advertising?

James P. Snee

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

A

Yeah. I mean, we're making significant advertising investments in the GP business. Jeremy, the GP core business remains very strong, very healthy across the entire portfolio. The difficulty, the headwind really is, we talked about contract manufacturing, and then also that continued recovery of CytoSport.

Jeremy Scott

Analyst, Mizuho Securities USA LLC

Q

Right. Maybe just one follow-up on Fremont. So the product that you're currently producing today and selling fresh at Fremont, you're now going to turn around to your customer of that product and you intend to produce it into value add, at least a portion of it. To what extent does that incremental demand for this new stream of value-added pork exists today, or should we assume that you're going to be pushing a lot of this product on to the marketplace?

James N. Sheehan

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

A

Well, as we've stated that we're a net buyer of bellies and trim, and we utilize all of our ribs. We utilize 100% of the product coming off of Austin for value-added products. There are some excess products coming off of Fremont. And we've had our stated goal, as we stated in the past, our goal is not to sell any commodity meat at all. So, as we expand our production in, for instance, at Dold, as we expand our Natural Choice product lines, those products will go into – those commodity products now will go into value-added products.

Jeremy Scott

Analyst, Mizuho Securities USA LLC

Q

Got it. Thank so much.

Operator: Thank you. That concludes today's question-and-answer session. At this time, I will turn the call back to our host for any additional or closing remarks.

James P. Snee

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

Thank you all for joining us today, and a special thanks to all of our team members for their efforts as we wrap up our fiscal year and successfully deliver on our key results. Thank you.

Operator: Ladies and gentlemen, that will conclude today's conference call. Thank you very much for your participation. You may now disconnect.

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