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Hormel Foods Corp. (HRL)

Q1 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, ladies and gentlemen, and thank you for standing by. Welcome to the Hormel Foods First Quarter 2020 Earnings Release Conference Call. At this time, all participants are in a listen-only mode. As a reminder, this conference is being recorded Thursday, February 20, 2020.

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

Nathan P. Annis

Director of Investor Relations, Hormel Foods Corp.

Good morning. Welcome to the Hormel Foods conference call for the first quarter of fiscal 2020. We released our results this morning before the market opened around 6:30 a.m. 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, Executive Vice President and Chief Financial Officer. Jim Snee will provide an overview of the Sadler's Smokehouse acquisition, a review of each segment performance for the quarter, and our outlook for the remainder of 2020. Jim Sheehan will provide detailed financial results and further assumptions related to our 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're welcome to get back into the queue.

An audio replay of this call will be available beginning at 11 a.m. today, Central Standard Time. The dial-in number is 888-204-4368, and the access code is 4720526. 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 7 to 9 and 28 in the company's Form 10-K for the year ended October 27, 2019, 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 volume and sales impact of the CytoSport divestiture. Discussion on non-GAAP information is detailed in our press release located on our corporate website. Please note that during our call, we will refer to these non-GAAP results as organic volume and organic sales.

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. At our Investor Day last October, we outlined our 2020 Path Forward, which included growing our deli and foodservice brands as a top priority. This morning's announcement

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of an agreement to acquire Sadler's Smokehouse is another step forward on this initiative. Sadler's Smokehouse, based in Henderson, Texas, has been making authentic pit-smoked barbeque products since 1948. Hormel has been fortunate to have the Sadler organization as a key supplier for over two decades.

When the Sadler family decided it was time to sell the business, they knew Hormel Foods was the company to call. Over the past few months, we have been working on finalizing this deal, and I am personally excited to welcome their brand, products, and team members to the Hormel Foods family.

Authentic barbeque remains on-trend in the US. The number of menu mentions has increased at a strong pace over the past 10 years, and today, barbeque expands well beyond the traditional barbeque restaurant format. With Sadler's as a key supplier, we have been able to capture this favorable trend through our Austin Blues barbeque brand. Austin Blues is a line of genuine slow-smoked beef, pork, and chicken products for the foodservice and deli channels. As one of our premium prepared protein brands, Austin Blues has seen great success and growth. We are doing the difficult work of preparing the product so the operator doesn't have to. However, they still get the flexibility to customize the product with their own signature sauce.

We see similarities between this acquisition and the acquisitions of the Burke Corporation in 2008 and Fontanini Italian Meats and Sausages in 2017, both Burke and Fontanini have been very successful contributors to our foodservice growth and each has required capacity expansions to keep up with the growing demand. Sadler's will strengthen our position in foodservice, and we see a tremendous opportunity to further expand their authentic barbeque products into both the retail and deli channels with our dedicated sales forces, innovation capabilities, and track record of brand stewardship.

We expect to close the acquisition in March, and Jim Sheehan will provide more details relating to the financials in his prepared remarks.

Now, let's turn to our first quarter results, which were in line with our expectations as we delivered earnings per share of $0.45. Volume decreased 1%, while organic volume increased 2%. Sales increased 1%, and organic sales increased 4%. Three of our four segments, Refrigerated Foods, Jennie-O Turkey Store, and International delivered volume and sales growth. It is encouraging to see Jennie-O Turkey Store deliver a second consecutive quarter of volume, sales, and earnings growth.

We have made capital and marketing investments into many brands which are driving these results. These brands include, but are not limited to, SPAM, Hormel Black Label, Fontanini, Columbus, Hormel Bacon 1, and Hormel Fire Braised.

Looking at the segments, Refrigerated Foods grew volume 3% and sales 6%. We generated strong demand across many of our value-added businesses including retail and foodservice. In addition to some of the brands I just listed, Hormel Cure 81 and Hormel Gatherings also showed nice growth. A notable contributor this quarter was Applegate, which is doing really well in both the retail and foodservice channels with their line of natural and organic products. Their snacking platform is growing with products like the Applegate Charcuterie Plate made with their natural meats and cheeses. We also feel really good about Applegate's meat and plant-blend products and have seen success in the foodservice channel. We will continue to innovate in this space with new and exciting offerings for consumers.

Refrigerated Foods grew earnings 3% led by growth in our foodservice business and higher commodity profits. Refrigerated Foods benefited from lower belly prices during the quarter, but that benefit was offset by significantly

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higher pork and beef trim prices. While volatility and input costs negatively impacted our retail and deli divisions due to the longer lead times for pricing, our foodservice team reacted swiftly for the changing market conditions.

Our balanced pork supply chain is intentionally designed to take volatility out of our total pork costs during extreme market conditions, and that played out this quarter as expected. While hog market prices were lower during the quarter, the balanced mix of hog contracts and our long-term supply contract at Fremont, limited some of the upside profit potential that we may have captured 5 or 10 years ago. With our new structure to reduce volatility, we didn't capture the entire upside, but we also expect to minimize the downside when opposite market conditions occur. This supply chain is the right structure for our business, and Jim Sheehan will expand upon my comments.

Looking forward, the fundamentals in Refrigerated Foods continue to be very strong. The large categories we compete in such as pizza toppings and bacon continue to grow as consumer and operator demand remains favorable. Pizza and bacon are not only ubiquitous in both at-home and away-from-home eating occasions. They are also showing excellent growth.

Differentiated brands like Fire Braised, Bacon 1, Fontanini, Columbus, and Black Label are all outpacing industry growth, and we continue to make long term investments into those product lines. Jennie-O Turkey Store delivered a second consecutive quarter of volume, sales, and profit growth. Higher volumes and pricing for the commodity and whole-bird businesses drove the improved results. Operational improvements across their supply chain also contributed to growth. It is encouraging to see the efforts to realign our cost structure start to pay-off as we described at our recent Investor Day, and we do expect this trend to continue throughout the year.

The sales and marketing teams have done a good job regaining Jennie-O lean ground turkey distribution. In conjunction with these efforts, we have broadened our advertising campaign for Jennie-O and continue to see positive results from those investments. We are taking the necessary steps to fully restore our position in the lean ground turkey category, and with two consecutive quarters of growth at Jennie-O Turkey Store, we now have strong momentum across the business.

Grocery Products volume declined 14%, and sales declined 11%, primarily due to the divestiture of CytoSport. Organic volume decreased 4%, and organic sales decreased 1%. We continue to see growth in the SPAM family of products, Wholly Guacamole, and their [ph] best (11:40) salsas and sauces, and also expect this trend to continue. We saw lower organic volume during the quarter and attribute some of the decline to the timing of the SNAP disbursement last year. While hard to quantify the exact impact, higher shipments during late January in 2019 did not repeat with the same magnitude this year.

Earnings for Grocery Products declined 28% due to the divestiture of CytoSport, higher raw material costs, a decline in contract manufacturing profits, and lower volumes.

SKIPPY Peanut Butter continued to experience headwinds this quarter as the category was negatively impacted by a competitor's deflationary pricing action last year. We will lap the pricing declines after the second quarter, and we remain focused on building the SKIPPY brand through effective promotional strategies, advertising, and continued innovation.

Another dynamic in Grocery Products is our strategy shift on Hormel Chili. Historically, Chili was heavily promoted during the football season. Using revenue and growth management, we learned that many of the promotions during the timeframe drove volume but did not provide acceptable returns for us or our retail partners. This year, we made the strategic shift to reallocate some promotional expenses with advertising investments. This shift

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impacted results in the quarter, but we believe it will ultimately lead to a stronger and more profitable Hormel Chili brand for us and our retail partners.

International volume and sales increased for the quarter, primarily due to fresh pork exports and strong growth in China. However, segment profit declined by 20% as significantly higher pork prices negatively impacted our businesses in China and Brazil in addition to our affiliated businesses in South Korea and the Philippines. Our global team continues to take the necessary pricing actions to offset cost increases.

Like the rest of the world, we are monitoring the coronavirus outbreak in Asia. First and foremost, we are concerned for the safety of our employees in the region. We are working closely with our management team in China as the situation unfolds. Our team members across all functions of our business in China, from sales and marketing to plant professionals, observe the extended Lunar New Year holiday and started to return to work as of February 10. However, we still have a majority of our employees who have not returned to work due to self-quarantine and transportation restrictions.

Similar to other companies in China, all aspects of our in-country supply chain are operating more slowly and at higher cost than normal. From a sales perspective, the demand for our foodservice products, which represent the majority of our sales in China, has dropped off considerably as patrons are not eating out. On the other hand, we have seen a large uptick in retail sales of shelf-stable products like SPAM and SKIPPY as consumers dine at home.

We do expect a very difficult second quarter for international, primarily due to the impact of the coronavirus. However, if the outbreak is contained soon, the second half of the year could be more favorable as we refill the sales pipeline and get our plants back to running at full speed.

Taking all these factors into account, we are maintaining our full-year earnings guidance at $1.69 to $1.83 per share and our sales guidance at $9.5 billion to $10.3 billion.

At this time, I will turn the call over to Jim Sheehan to discuss our financial information relating to the quarter and key assumptions for fiscal 2020.

James N. Sheehan

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

Thanks, Jim. Good morning. Net sales for the quarter were $2.4 billion, up 1%. Organic net sales were up 4% with three of four segments showing growth. Pre-tax earnings were $290 million, down 5%. The decline was driven primarily by the sale of CytoSport. The effective tax rate was 16.3%, compared to 21.3% last year. The rate was impacted by the large volume of stock option exercises in the quarter. This is a timing issue and does not impact our expected full-year tax rate, which remains between 20.5% and 22.5%.

Earnings per share for the quarter was $0.45, $0.01 above last year and in-line with our expectations. For the quarter, SG&A excluding advertising, was 6.7% of sales, compared to 7.1% excluding the $0.02 legal settlement benefit in 2019. Net unallocated expense for the quarter decreased by $9.7 million. Last year, we incurred expenses associated with the Fremont sale. We expect net unallocated expense to be between $40 million and $60 million for the year. Advertising investments for the quarter were $35 million, up from $34 million excluding CytoSport.

Operating margins were 11.8%, compared to 13% last year. Lower gross margins for Grocery Products was the primary driver. We generated cash from operations of $188 million during the quarter, a 1% increase. We paid our

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366th consecutive quarterly dividend effective February 18 at an annual rate of $0.93 per share, an 11% increase over 2019.

Capital expenditures were $58 million. We expect capital expenditures for the year to be approximately $360 million. Large capital projects include the Burke facility expansion, which will be completed in the summer, our new Columbus dry-sausage facility, and Project Orion. Working capital increased as we continue to build inventory in the anticipation of the upcoming relocation of the value-added production lines from Fremont to other Hormel facilities and higher input costs due to African swine fever. The company did not repurchase stock in the first quarter.

As Jim mentioned, we announced the acquisition of Sadler's earlier this morning. The purchase price is $270 million with a $40 million cash tax benefit. This makes the effective purchase price $230 million. The deal includes the Sadler's brand and a production facility in Henderson, Texas. The acquisition will be funded with cash on hand and will report into the Refrigerated Foods segment. The transaction is an asset deal which results in the $40 million cash tax benefit from the asset valuation step-up.

Hormel is one of the largest customers of Sadler's, as they produce numerous items for our Austin Blues product line. Annual sales excluding Hormel, are approximately $140 million. Sadler's operating margins are in line with the total company average. We estimate this deal will be neutral to slightly dilutive in 2020 as we plan to make immediate investments into the business and production facility.

In total, raw material costs were up from last year with volatility across many commodities which can shift profitability between quarters. As a reminder, approximately half of our pork raw materials are sourced through the purchase of hogs and half are sourced externally based on primal values.

Our cost of hogs increased over last year, driven by two factors. Hogs purchased on the cutout formula were above last year and significantly exceeded the spot market. We also experienced higher costs for hogs purchased from future contracts. Hogs purchased on market-based formulas were down from last year, but not enough to offset the cutout formula and future contracted hogs. USDA composite value of hogs increased 4% over last year.

This was the valuation method for raw materials contracted through our former Fremont facility. Our strategic shift to purchase pork raw materials at market prices through a long-term partnership with Fremont was a key driver to the reduction in volatility. However, due to strength in the trim and ham markets, total pork costs through this partnership were higher than last year. Beef and trim markets were up from last year, bellies were down in the quarter.

We have previously discussed pricing action in Refrigerated Foods, retail, and deli lagged the market by 30 to 45 days. The outlook for the remainder of 2020 assumes higher protein prices for key inputs with periods of volatility. As we look at the fundamentals in the hog industry, the most recent USDA supply and demand report estimates a 4.5% increase in production and a-more-than 15% increase in exports. The forecasted additional supply of pork is in line with the increase in export demand.

Pork in cold storage was at record levels at the end of the year. African swine fever continues to impact global hog supply in China, Southeast Asia, and Europe. Worldwide demand for US pork remains high with the industry setting an all-time record for exports in December. Recently, we have seen downward pressure on domestic hog and pork prices. Since the start of our second quarter, market hogs in the USDA composite value have declined by more than 10%. Bellies and pork trim have been lowered by as much as 30%. The outbreak of the coronavirus in China may be a contributing factor.

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Turkey market conditions continue to improve as industry measures showed poult placement down 3% for 2019. Overall Turkey inventory in cold storage was down 23% compared to last year with breast meat inventory down 18%. Feed costs for the first quarter were flat to last year. We anticipate higher feed cost for the remainder of the year driven by lower levels of protein in the corn crop relative to prior years. This is requiring us to reformulate our feed with higher-cost ingredients.

We began the implementation of Project Orion in January with the global rollout of the Oracle Human Capital Management system which updates our payroll, benefits, talent management, and workforce management. Additional integrations for finance and supply chain are taking place throughout 2020. Incremental costs associated with the phased implementation are fully reflected in the guidance for the year.

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] And now we'll take our first question from Benjamin Theurer from Barclays. Ben, your line is open.

Benjamin M. Theurer
Analyst, Barclays Capital

Q

Okay. Perfect. Thank you. Good morning, Jim and Jim. So one question on the acquisition you've announced. Because clearly, you've laid out how this is going to fit in and what the financials are. Now you've also said you're going to immediately invest in the operation. Is that something we should consider from a CapEx point of view? Is that going to be meaningful with up to the $360 million you've announced prior? And where do you think you have most of the potential, within foodservice or actually taking those products into retail as you've mentioned in your prepared remarks? Then I have one quick follow-up.

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

A

Good morning, Ben. I mean there's a couple areas. As we go through facilities and the acquisition process, we usually find some opportunities to upgrade facilities. That's the case here. Also, perhaps some needed maintenance, that's not unusual. And as we look at our overall budget of the $360 million, we're holding that number the same because we have projects that ebb and flow throughout the year. So, we don't really see the need to modify that number at this point.

In terms of the opportunity, in the short term, this is definitely going to have a bigger impact in the foodservice space. And I think as we move further down the line, that's when we see the opportunity to really build out a bigger retail presence and expand it into the deli. And of course, it aligns well strategically with all those areas. And over the last several years, we've talked about at various times different strategies we have in place to expand all of those businesses. It stays on track with our foodservice strategy.

From a deli perspective, we talked a lot about how retailers are looking to expand and improve their prepared food offerings. This will be a great opportunity for us to do that. We already have a presence in the retail space with Lloyd's Barbeque, but we think this will be an opportunity for us to really improve the product offerings that we have. So as you go around the different businesses, there's a lot of boxes that it checks in a very positive way.

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Benjamin M. Theurer
Analyst, Barclays Capital

Q

Okay. Perfect. And then just one follow-up on ASF. I mean clearly, you've been in a situation where prices, for example, in your International operations, be it in Brazil, China have been significantly impacted already. And the US, it's more of a volatility thing. What measures have you taken to kind of reduce over that volatility? Is there anything you can do in terms of medium/long-term contracts to kind of lock-in some sort of pricing and then ultimately take the pricing action you need to do on the shelf to offset maybe that higher input cost on a year-over-year basis? Anything you've been doing on that hedging strategy?

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

A

Certainly, Ben. Thanks for the question. We have taken hedge positions. And in fact, we talked a little bit about the fact with the unusual market conditions that we experienced in this quarter as hog prices were down, the spot market was down as the primals carcass value was going up. I mean that's a very unusual market condition. In fact, it's only happened in three quarters of the last 21 quarters, where that market condition has existed.

Some of those future contracts [ph] we did (28:22) were negative to the P&L in the first quarter, but we are taking future contracts. We feel that our various approach with multiple formula pricing for our acquisition of hogs is a sound approach to the volatility that exists.

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

A

And Ben, I would add, I mean clearly, there's a level of uncertainty in the marketplace now that you got the impact of the coronavirus in China and the impact that's having on export markets in terms of reports of exports backing up and the idea of what happens to the hog supply here in the short term. So, there's still a lot of uncertainty because of ASF, because of the coronavirus. And as you would expect, we're watching all of the fundamentals very closely, and if we get to the point where we have to take pricing, and as we demonstrated last year, we're willing to do that.

Benjamin M. Theurer
Analyst, Barclays Capital

Q

Okay. Perfect. Thank you very much. I'll pass it on.

Operator: Thank you. And now we'll take our next question from Mr. Tom Palmer from JPMorgan. Please go ahead. Your line is open.

Thomas Palmer
Analyst, JPMorgan Securities LLC

Q

Good morning, and thanks for the question. I first wanted to clarify on your segment guidance, I think you previously expected organic EBIT, so excluding CytoSport, to be up in all four of your segments. If I interpreted the release correctly, I think you're still looking for Refrigerated and Jennie-O to be up year-over-year. It sounded like International down, and then I wasn't sure on the Grocery side. So, I guess, one, is that correct? And two, what is the Grocery outlook for the year?

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

A

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Yeah, Tom. Your assessment is correct. So Refrigerated Foods and Jennie-O up, uncertainty obviously in the International segment given what's happening in the marketplace. Ad then we did call out in our fourth quarter call, in fact, that net of CytoSport GP would be up. And so, we are still holding to those numbers and that comment.

Thomas Palmer
Analyst, JPMorgan Securities LLC
Q

Okay. Thank you. And just to follow up on the Grocery side, you did call out the headwinds from rising trim, and it sounds like that's come in a bit. But did you elect to take any pricing? Are we going to see any flow-through here as we look towards the second quarter of pricing on products that are exposed to trim? Or did it rollover fast enough that it was not needed?

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

That's exactly right. Although, the markets ran up, they didn't hold long enough for us to take any pricing activity, so we didn't take any in the first quarter. We don't have anything on the radar right now for the second quarter. And the point that you made in terms of it impacting the quarter is exactly right. We saw that in our Chili business. And of course, as we changed our strategy, we had kind of a double effect of the rising market, and then we made an intentional decision to change the strategy in how we went to market. So no pricing, and really nothing on the radar.

Thomas Palmer
Analyst, JPMorgan Securities LLC
Q

Okay. Thank you.

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

Okay.

Operator: And now we'll take our next question from Peter Galbo from Bank of America. Please go ahead. Your line is open.

Peter T. Galbo
Analyst, Bank of America Merrill Lynch
Q

Hey, guys. Good morning. Thanks for taking the question. Jim, I just wanted to get your higher-level thoughts on the announcement yesterday that you guys had been [indiscernible] (32:10). Should we read into that at all as maybe commodity is going to start making up a greater portion of the business again, because it just provides more export opportunities? Or just how should we be thinking about that at a high level?

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

I mean at a high level, this isn't new news to the industry. You've seen some other big players already make that move. We've had it on our radar for some time. Do we think that it makes us all of a sudden a huge export – a bigger export player? It won't be huge, but we do think there will be some opportunities.

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The other thing to consider that our ability to really make this shift is tied to the sale of the Fremont plant, our relationship with WholeStone, who has a vertically-integrated supply chain. And so, we're given that opportunity. We think that it's advantageous for us to do. And, yeah. There will be some opportunities on the export side, but in the short term, Peter, I wouldn't say that it's going to be a tremendous opportunity.

Peter T. Galbo Q
Analyst, Bank of America Merrill Lynch

Got it. Okay. That's helpful. And maybe just switching to Jennie-O, obviously the distribution gains are a positive, and volume is moving in the right direction. But pricing at least for the industry is still challenged. And, Jim Sheehan, I think you gave some statistics around cold storage and poult placement, but correct me, in Turkey in particular remains pretty weak. Just any thoughts there? And what's it really going to take to get that to accelerate?

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

I think it's really – it's more of a seasonal issue, seasonally lower. I think the market conditions or the fundamentals that we're describing are positive to the business. And so it's nice to have the market fundamentals positive in addition to the positive work being done in the business, really the things that we can control, as we talk about delivering excellent results across the supply chain by production manufacturing, the improvement in lean ground turkey sales, and continuing to gain back that distribution. So in my prepared remarks, Peter, really talked about the momentum that we're seeing in the business, and for us, that's really the key takeaway, as there's a lot of things moving in our direction and that's why we're optimistic.

Peter T. Galbo Q
Analyst, Bank of America Merrill Lynch

Great. Thanks very much.

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

Yep.

Operator: Thank you. And now we'll take our next question from Heather Jones from Heather Jones Research. Please go ahead. Your line is open.

Heather Jones Q
Analyst, Heather Jones Research, LLC

Thank you for the questions. Good morning.

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

Good morning.

Heather Jones Q
Analyst, Heather Jones Research, LLC

I wonder if we could talk about China a little bit. So you mentioned that the majority of your employees are still not back at work due to quarantines and transportation issues, but I was wondering if you could give us a closer look

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at like what have you seen over the last week or so? Has there been any improvement in that cadence and sales? Or does it seem like the country is still largely as it was a week or so ago?

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

A

Yeah. All of our reports, Heather, are that is as it was a week ago and probably and slightly before that. What we were describing – the largest portion of our sales in China are foodservice sales. And you've seen multiple reports, and we're no different, that the foodservice industry has essentially come to a halt in China. And so not only are we having the demand side in foodservice where there are opportunities. We're seeing some retail shelf-stable items – we talked about SPAM and SKIPPY Peanut Butter. The supply side in getting the plant to produce those products get that up and running has been an issue as well. So you've got it on on both sides of the supply and demand equation.

And again, as we said, we understand where we are today. The problem is really forecasting when do we see it start to change. And if it changes in the back half of the year and you get a pipeline fill, well, that can change the business in a hurry. But it's really too early to call.

Back to your original question, we haven't seen anything noticeably different here in the last week or two.

Heather Jones
Analyst, Heather Jones Research, LLC

Q

And as a follow-up to that, so I've read some things that were talking about restaurants like selling their inventory and all because they're not open, and they need to sell it or lease it. So you talked about the second half potentially having a pipeline sale. Is it correct to think that you would have not only the pipeline sale at the retail level but a pipeline sale at foodservice? Does that make sense to think of it that way?

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

A

Yeah. I think when we were talking about the pipeline sales, we are taking more of it from a foodservice perspective, since that is the bigger part of our business. If you've got people who are emerging from this quarantine, this lockdown. One of the things that they probably will want to do in resuming their normal day-to-day life is going back to eating out. So, yeah. I think that's a good way to think about it. It's just the uncertainty around timing.

Heather Jones
Analyst, Heather Jones Research, LLC

Q

Okay. Perfect. Thank you so much.

Operator: And now we'll take our next question from Ben Bienvenu from Stephens. Please go ahead. Your line is open.

Ben Bienvenu
Analyst, Stephens, Inc.

Q

Okay. Thanks. Good morning.

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

A

Good morning, Ben.

Ben Bienvenu
Analyst, Stephens, Inc.

Q

I want to ask on the inventory side, the last several quarters you guys have leaned into inventory a little bit and bought an advance of what you needed in light of opportunistic deflation and some of the primals that you typically buy. With bellies having been depressed as of late, what kind of opportunity does that give you? And when we look at the elevated – still elevated inventory in this quarter, could you just help us think about where your inventory sits today versus the comments you might have made a quarter ago? To the extent you can talk across the primals, that would be helpful.

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

A

Certainly, Ben. First of all, we have been building inventory because of the transfer of production from Fremont into other facilities. So part of that has been just a safety stock, if you will, to make sure that if there's any slowdown in the start-up on those lines, we have plenty of inventory. But you're right. We have been building inventory in anticipation of higher ASF costs.

In some cases, it has mitigated the cost, like for trim for SPAM. In other cases, it's actually hurting the decrease of the belly prices. The belly prices that closed at $140 at the end of the first quarter, are now down to $92. I mean, a $48 drop in those belly prices is not expected at this timeframe.

So, we'll continue to make decisions and determine case by case as to what we're seeing in the marketplace. This volatility that we're seeing is making it harder to time the market. About the time that you think that you – this is the time to build inventory on belly or bacon, for instance, you see this kind of drop in bellies. And it's a difficult task, but we're staying on top of it and trying to use our best knowledge as to what to build and when to build it.

Ben Bienvenu
Analyst, Stephens, Inc.

Q

Okay. Great. And then asking a follow-up on Sadler's, it seems like a nice fit in your portfolio. How representative would this deal be of the types of additional deals that you would like to do, given the additional balance sheet capacity that you have? And then how representative would it be from a purchase-price perspective, and/or valuation of what the landscape looks like, and/or the pipeline of deals that you would be looking at?

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

A

Yeah. That's a tough one, Ben, because we evaluate these deals, the pipeline on a deal-by-deal basis. We've talked about our ability to do a bigger deal, and that remains. And are we willing to do a bigger deal? Absolutely. But it's got to be the right deal, and we've got to have it come to market. And you've got to be able to get it to the finish line.

We like deals like the Sadler's deal just like we like the Burke deal, like we like the Fontanini deal. The beauty of those deals is it really is one-on-one negotiation, a relationship that we've built over time. They've been a supplier for over 20 years, so you really know the people. You know the business. They know us. So, is it representative of the deals we like to do? Absolutely. And we can put it into a very strategic part of our business in foodservice. And

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so, would we like to do a bigger deal? Sure. Could we do a bigger deal? Absolutely. But if we have deals like Sadler's, Fontanini, and Burke that come along on a regular basis, we'll take them all day every day.

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

The item that I would add on this, Ben, is it's not only the quality of the deals. But when you look at the purchase price net of the tax benefit, you're talking about a deal that was done at an EBITDA multiple of about nine. And once we get through purchase accounting, we see this as a $0.02 to $0.04 per share accretive to the business. So, it's not only a great strategic fit, but we're able to get this at a reasonable price.

Ben Bienvenu Q
Analyst, Stephens, Inc.

All right. Great. Thanks for the comments, and good luck with the rest of the year.

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

Great. Thank you.

Operator: Thank you. And now we'll take our next question from Ken Zaslow from Bank of Montreal. Ken, your line is open.

Kenneth B. Zaslow Q
Analyst, BMO Capital Markets (United States)

Hey. Good morning, everyone.

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

Hey, Ken.

Kenneth B. Zaslow Q
Analyst, BMO Capital Markets (United States)

Just an overarching question first. It seems like the commodity environment, though, volatile is lower than you would have expected. Does that mean that you'll get the timing benefit later in the year and generally, you should get a tailwind? It seems like if I go back to your original expectations across the board, you're in better shape than you started. Is that not a fair question, and is it a timing issue?

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

We talked about this before. When you're seeing this kind of volatility, it's going to move profitability between quarters. Even since the end of the first quarter, you've seen the carcass value drop $12 while hogs have only dropped $3. So we're getting into a more favorable market condition than we certainly had in the first quarter. Again, this was a very unusual market condition and especially with the structure in which we buy the majority of our raw materials off of basically the carcass value.

We didn't see the benefit of the lower spot market, because we do not buy a majority of our raw materials that way, but still, we were profitable in the pork operating area. I think our structure is sound. We have built the

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inventories. We're trying to take advantage of lower markets. So, we believe that we're in good shape going into the rest of the year.

Kenneth B. Zaslow
Analyst, BMO Capital Markets (United States)

Q

I just would have thought you would have been a little bit more positive given the environment. But my second question is on Grocery. Can you talk about – the profit came in lower than we would have expected. Can you talk about – are there trends within it? Is it the Peanut Butter side? What is really preventing this to regain its margin structure?

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

A

Yeah. So, Ken, I'll just tack on to the first question you asked, and I think Jim gave a great answer to how we're thinking about it. Your comment around you would have been more optimistic. I think the kicker in all of this is just that volatility that we saw in Q1, and how does that play out for the balance of the year. So, we're in a good position, but we really can't predict that volatility.

Leapfrog into the GP question, there's a lot of moving parts, as you can appreciate, and obviously SPAM is off to a great start. If the trend continues, it'll be our sixth consecutive record year of sales. We did make this shift in Chili where we moved some of the promotional activity into advertising to really support the brand, talk to consumers. And we believe it's going to be a longer-term benefit for us and the retailers. So that's a work in process.

MegaMex continues to perform well, and you mentioned SKIPPY. And, yeah, SKIPPY is having a dramatic impact on the profitability of Grocery Products, and it's all tied back to deflationary price action that was taken. And so that is still a work in process. Our team is focused on customer by customer revenue growth management, making sure that we're effectively spending those trade dollars and having advertising to support the brand, continuous innovation.

And then as we saw in the first quarter, we've got input costs, that volatility that can create noise in the year. But with all those moving pieces in GP, the fact is we have work to do, right? We've got work to do to make sure that we keep SKIPPY on track. We have work to do to make sure that we execute this shift in the Chili strategy. When we do that, we'll achieve the results that I talked about in the fourth quarter which was an increase year-over-year net of CytoSport.

Like I said, there's a lot of moving parts, but we know we have work to do. But the business still has a lot of favorable parts to think about.

Kenneth B. Zaslow
Analyst, BMO Capital Markets (United States)

Q

Great. I appreciate it. Thank you, guys.

Operator: And now we'll take our next question from Robert Moskow from Credit Suisse. Please go ahead. Your line is open.

Robert Moskow
Analyst, Credit Suisse Securities (USA) LLC

Q

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Yeah. Hi, there.

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

A

Hi, Rob.

Robert Moskow
Analyst, Credit Suisse Securities (USA) LLC

Q

I guess I'm a little confused as to how did the next few quarters shape up significantly well enough to offset what I think was an operating profit miss in first quarter? I don't see how Chili makes up for the – there's not going to be another Super Bowl for the rest of the year. It sounds like SKIPPY – it sounds like you're saying that even though you're lapping last years' price increase, Peanut Butter will still be down in terms of profitability for the rest of the year.

In Refrigerated, are you saying that just the commodity environment is much more favorable now? You have better visibility in it? First quarter was just – it looked good for a while, and then it didn't shape up the way you thought it would. But now, it does. So, is Refrigerated really carrying the day for the next few quarters?

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

A

Hey Robert, I think, going back to your opening comment, I mean, in total, our pre-tax earnings met our expectations for the first quarter. GP, clearly, did not meet our expectations. Refrigerated did, perhaps exceeded. International was slightly below what we thought. But as we think about the rest of the year, we do think – I get what you're saying about the Super Bowl, but the idea of making sure that that business is not entirely focused at one part of the year, we know that consumers are using Chili throughout the year. We need to make sure that we're reminding them, we're increasing that velocity and that frequency. So, we do believe that that's an opportunity, and that's why we shifted the strategy.

For Refrigerated Foods, it's going to be a critical piece for the balance of the year. Jennie-O Turkey Store remains a critical piece for the balance of the year, and we have nice momentum there. Just got to do what we said we would do in GP for the balance of the year to get the results that I talked about. And really the wild card, the uncertainty, is International. And what happens? When does it happen? a lot of timing issues.

So as we think about the rest of the year, we actually – we feel good about the business, the fundamentals in Refrigerated, the momentum in Jennie-O Turkey Store. And, Jim, I don't know if there's anything you would add?

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

A

No. I mean, you are right, Rob, that the market conditions have turned drastically in Refrigerated Foods. As you've seen, the cutout dropped $12. The spot market on hogs has only dropped $3. The market conditions that are unfavorable to the pure packer are favorable to us.

Robert Moskow
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay.

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

And I think that the important issue as we go into the future quarters, really this is the market that we're structured for.

Robert Moskow
Analyst, Credit Suisse Securities (USA) LLC
Q

Okay. I got it now. And in fresh pork, did you say that it was profitable in the quarter? Was that the commentary?

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

Yes.

Robert Moskow
Analyst, Credit Suisse Securities (USA) LLC
Q

Okay. Can you give us a rough estimate how much, or just profitable is fine?

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

It was profitable. And even in the market conditions that we were faced with, it was a very nice performance by the pork operating group.

Robert Moskow
Analyst, Credit Suisse Securities (USA) LLC
Q

Okay. All right. Well, if you need me to eat chili during this summer. I do, do that, so I'm happy to help. So, thank you.

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

Chili and Chili Dogs. So get them both, Rob.

Robert Moskow
Analyst, Credit Suisse Securities (USA) LLC
Q

You've got it half right there, but thanks.

Operator: Thank you. And now we'll take our next question from Michael Lavery from Piper Sandler. Please go ahead.

Michael S. Lavery
Analyst, Piper Sandler & Co.
Q

Good morning. Thank you.

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

Good morning.

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Michael S. Lavery
Analyst, Piper Sandler & Co.

Q

When you look at the International segment, you had such strong volume and sales growth, but obviously EBIT was down significantly. Can you just give a sense of how much that's a proxy for how a broader ASF outlook impact might look? And how would you compare and contrast what you expect in the business more broadly?

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

A

I think it's in line with what our ASF impact would be. If you know we saw a runup in raw material costs, and we took corresponding pricing actions which are always tough to get through as quickly as you'd like. And so, we saw that in our business in China. We've been seeing that in the business in Brazil as product has been exported out and markets have moved up there as well. So, I think Q1 is probably a good proxy for what we would expect. The key is going to be that we take pricing, and we all know that it takes time to get that pricing. And the pricing that we did take in China in retail and foodservice, as it has flowed through, up until the coronavirus, we didn't see a significant drop-off in volumes.

Michael S. Lavery
Analyst, Piper Sandler & Co.

Q

So I just want to make sure I understand your answer. So, in the quarter you're reporting, there's less coronavirus impact, or very little, and it's just that the pricing hadn't come in and the timing that covers the input cost pressure? So it's kind of the [ph] front-end of the lag (52:50)? Is that the right way to think about it?

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

A

That's exactly the way to think about it.

Michael S. Lavery
Analyst, Piper Sandler & Co.

Q

I guess. So, what's next? This is obviously a pretty steep decline. How quickly does that rebound? And maybe in the hypothetical ex-coronavirus view anyway, what would you expect? And maybe more importantly, tying it to your Refrigerated Foods segment, how should we think about the parallels if you see that cost pressure flowing back here? More broadly, would 20% EBIT decline be the right expectation for that first quarter before the pricing really gets in place?

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

A

I don't know, if you want to think about a direct correlation. I mean you've had a lot of moving parts in China, and there's still a lot of unanswered questions in terms of what's happening with their supply, their herd in China. I wouldn't use it as a direct proxy for the US at all. As we think about what we're seeing domestically with pork production. Our pork production is expected to be up 4.5% which essentially offsets the exports, which are covering down ASF implications, right? They're going to be up 15% for 2020. So I don't know that. I won't keep that isolated to China. I wouldn't carry it over to the US.

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

A

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No. This is isolated to China. As Jim said, they're watching the fundamentals very closely. The increase in supply is in balance with the amount of export that was expected. Now, I will point out that that level of export was really – earlier we don't know what it will look like based on the conditions in China. There's record cold storage levels. And so, we think the fundamentals are solid domestically for the pork industry and are improving significantly for the turkey industry.

Michael S. Lavery
Analyst, Piper Sandler & Co.

Q

Well then – and just a follow-up then. If you look at your description of unfavorable conditions for Refrigerated Foods now, but the profit growth there is up pretty modest. How much acceleration should we expect? Is it going to be more likely to be more similar to this quarter? Or what's the catalyst for fairly pushing that further in terms of, say, the balance of the year?

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

A

Again, here is what's difficult to forecast. Bellies were close to the – bellies at the beginning of the quarter and end of the quarter were close to the same price, but they moved $70 during the quarter. It's that volatility that is creating a difficult environment to really forecast what the change is and how solid the change is? We have seen a lot of volatility, we believe, based on ASF. What we haven't seen is a long-term trend? And until you see the trend really develop, it's tough to manage this through the volatility.

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

A

And Michael, just at a higher level, as we have talked about a couple of times already. For the full year, I mean, you think about Refrigerated Foods and JOTS delivering to offset the International downturn. And then GP is doing what we need to do. So Refrigerated Foods and JOTS will be important for us for the balance of the year.

Michael S. Lavery
Analyst, Piper Sandler & Co.

Q

Okay. Thank you very much.

Operator: Thank you. And now we'll take our next question from Rupesh Parikh from Oppenheimer. Please go ahead. Your line is open.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.

Q

Good morning. Thanks for taking my questions. I have two quick ones. So on the Jennie-O business, just wanted to get a sense in terms of where we are in terms of regaining some of the distribution you lost last year. And then on the SKIPPY side, I understand obviously you're still lapping some of the headwinds from last year, but wanted to understand if there's any change in the competitive dynamics in the Peanut Butter category?

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

A

Yeah. So, the distribution gains, Rupesh, are continue to be incremental, right? So, the team is doing a really nice job gaining back distribution retailer by retailer. One of the things that we've talked about a couple of quarters ago that continues to play out is that we are seeing a 4-percentage point better growth in retailers who were selling

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and distributing the Jennie-O brand. And so, as we're out telling the story to regain the distribution, there's a really good story to be told, and our team is doing that. And it's an incremental gain. We said it's going to take some time, but as you can see in the results, it's really playing out.

We haven't seen any additional change to competitive activity since the deflationary pricing action. As we said, we're lapping that coming at the end of Q2. And so, we're hopeful that we can return to a sense of normalcy and growing the business that we do in terms of innovating, brand-building, and driving the business the way we know how.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.

Q

Great. Thank you.

Operator: And now we'll take our next question from Eric Larson from Buckingham Research Group. Please go ahead. Your line is open.

Eric J. Larson
Analyst, The Buckingham Research Group, Inc.

Q

Yes. Thanks, everyone. I know we're running out of time, so I'll make it pretty quick. Thanks for sneaking me in here.

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

A

No problem here.

Eric J. Larson
Analyst, The Buckingham Research Group, Inc.

Q

The recovery in JOTS is actually really encouraging. I think it's been the longest down cycle in turkey that I've seen in a long time. So can you give us a little better flavor, just to dive a little deeper into the recovery? Have we seen actual capacity reductions by the industry? Obviously, we're seeing placements and egg sets and stuff going down, but is it for real? And are the competitors more rational than what we've seen maybe in the past year? Just a little more detail on that would be helpful.

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

A

Yeah. I think the key thing there, Eric, and you talked about it, is really the fundamentals, right? We're seeing favorable fundamentals which would be driven by the entire industry, so how they're doing, what they're do, when they're doing, what all feed into the fundamentals? That's what we're watching, and we do see those positive trends.

You add to that the excellent results across our supply chain and live production and manufacturing and combined with the incremental gains on regaining distribution, that's why we're a bit optimistic when we talked about the momentum that the business has.

Eric J. Larson
Analyst, The Buckingham Research Group, Inc.

Q

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Okay. And then I may have missed it. This is my follow-up. You may have already stated this, but when do you actually lap year-over-year the deflation that you saw in Peanut Butter pricing?

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

That's at the end of Q2.

Eric J. Larson
Analyst, The Buckingham Research Group, Inc.
Q

End of Q2. So Q3 will be at least apples-to-apples on that factor?

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

Exactly. We should start getting a clearer read on the business.

Eric J. Larson
Analyst, The Buckingham Research Group, Inc.
Q

Okay. Thank you.

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

Yep. Thanks, Eric.

Operator: Thank you. And now we'll take our next question from Adam Samuelson from Goldman Sachs. Please go ahead.

Adam Samuelson
Analyst, Goldman Sachs & Co. LLC
Q

Thanks for squeezing me in. Maybe a clarification question. In Refrigerated, you alluded to higher commodity profits. In the past, you've given some dimension to changes in commodity profits. Any way you could frame that this quarter? And also, you said you took some hedging losses on hogs, might come out in the Q, but is there any right way to frame kind of what the impact of that was?

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

Well, the commodity margins, the pork operating margins were in line with our long-term profile.

Adam Samuelson
Analyst, Goldman Sachs & Co. LLC
Q

Okay. And then just in the Refrigerated business and the commentary both in the press release and on the call today, didn't hear any mention of Columbus or Fontanini. Just characterization of how those businesses have been progressing?

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

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Thanks for bringing those up. We just had a lot of other things to talk about. [ph] They've been (62:11) really pleased with the work being done by our deli group, specifically with the Columbus brand. We had a great holiday season with Columbus. You probably saw the announcement that we're building a new facility in Omaha, Nebraska, to support the growth of that brand. So, things are going really well.

Same thing with Fontanini. We've put in a new line there last year because we needed the expanded capacity. Our foodservice team has really taken that business and run with it, just the way we designed the strategy. So, both those businesses are very healthy and in great shape.

Adam Samuelson
Analyst, Goldman Sachs & Co. LLC
Q

Okay. I appreciate the color. Thank you.

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

Thanks, Adam.

Operator: Thank you. And now we'll take our last question from Rebecca Scheuneman from Morningstar. Please go ahead.

Rebecca Scheuneman
Analyst, Morningstar, Inc. (Research)
Q

Good morning. Thanks for squeezing me in. So real quick on the lower profit margins in the Grocery Products segment, is there any way you can somewhat quantify the different factors that you talked about? The divestiture having an impact, lower volumes, lower contract manufacturing, higher raw material costs, et cetera? Is there any way you can kind of help quantify that?

And related to that, I believe that when you talked about the CytoSport divestiture, you said that the operating margins were slightly lower than the corporate average, which would mean that they're definitely lower than the segment. So I would think it would be margin accretive, the divestiture, unless you're talking about stranded overhead or something in that regard. So just some clarity there would be great. Thanks.

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

Yeah. The two biggest issues are the impact of the contract manufacturing business. That's [ph] packed in (64:07) a difficult business. And then the second part would be the run-up in the raw material costs for the segment. So those really are the two things.

Really in terms of your second part of your question, we can have Nathan follow up with you and give you a little more detail, but there's really not anything of any magnitude that are impacting it left over from the CytoSport divestiture. But we'll have him follow up with you, Rebecca.

Rebecca Scheuneman
Analyst, Morningstar, Inc. (Research)
Q

Okay. Sounds great. And just real quick then, so the contract manufacturing, is that something that's going to drag throughout the remainder of the year?

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

A

Yeah. We've seen that recently trend down. Just as a reminder, it's not a business that is of a strategic for us. It has been more of a capacity play, and so it does ebb and flow. But the key takeaway is that it has trended down, and it has been a difficult business.

Rebecca Scheuneman
Analyst, Morningstar, Inc. (Research)

Q

Okay. Thank you.

Operator: Thank you. It appears there are no further questions at this time. Mr. Snee, I'd like to turn the call back to you for any additional or closing remarks.

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

Great. Well, thank you, all, for joining us today. We are off to a solid start in Q1, and we know that we must continue to execute our plan for the balance of the year. To our key members online, my sincere thanks for everything all of you do to keep our company uncommon. Have a great day.

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

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