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Pinnacle Foods, Inc. (PF)

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MANAGEMENT DISCUSSION SECTION

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We are delighted to welcome Pinnacle Foods back to the Back to School and Global Consumer Conference Stage. It's hard to believe that it's only been four years since the company's IPO, at which point Pinnacle stock priced at $20 a share. Today, the company's stock is triple that, closer to $60. In our view, this reflects Pinnacle's consistent fundamental performance, discipline around M&A and reputation for placing shareholder value creation as a top priority. Important is, as we look ahead, the company stands out for its multiple paths to value creation, including visibility to significant gross margin expansion in 2018 and ongoing strategic optionality.

Against this backdrop, we welcome CEO, Mark Clouse; CFO, Craig Steeneck; EVP and Chief Commercial Officer, Mark Schiller; and Head of IR, Maria Sceppaguercio. It's now my pleasure to turn it over to Mark and thanks for being here.

Mark A. Clouse
Chief Executive Officer & Director, Pinnacle Foods, Inc.

Thank you, Andrew. I've got the enviable position of coming right after lunch, always a great spot to be, but we're thrilled to be here today and we're looking forward to sharing with you, how we're going to continue to drive our business and leadership in the industry. Presenting with me today, let's see if we can get the slides moving in the right direction, my illustrious team members in the back. Here we go.

So presenting with me today is going to be our Chief Commercial Officer, Mark Schiller, and our CFO, Craig Steeneck. Before getting started, I'd like to direct your attention to the forward-looking statements and non-GAAP financial measures slide on the screen. This information along with the reconciliation to GAAP measures is included in the presentation that's posted on our website. All right [indiscernible] (02:12). Good.

In terms of the agenda for today, we're going to start with the foundation of our business, including how the team successfully navigates a challenging consumer and industry environment. Then we're going to focus on how we're unleashing brand potential. Mark Schiller will share how we're driving profitable top-line growth and our focus on strengthening capabilities and creating value through M&A. Craig will then discuss where we're in 2017 from a financial perspective, which is shaping up to be another very strong year. All right, we're going to [indiscernible] (02:44).

What you're going to hear today is a familiar strategy with some new initiatives. We continue to make great progress on the plans we shared a year ago and are even more excited about the future. So, with that, let's get started.

Today, we have a broad $3 billion portfolio that has evolved significantly over the last several years. The business has strong positions in both Frozen and Dry Grocery, with Boulder contributing to and benefiting from our scale in both areas. A key strength of this portfolio is that for the majority of the categories in which we compete, we're the leader or strong number two.

As the portfolio has evolved, we've seen a significant expansion of our health and wellness offerings, through innovation and acquisition. In fact, we've added seven additional health and wellness brands over the last four years, growing our health and wellness presence to over 55% of the portfolio.

The other key area of progress in this portfolio is our growing leadership position in Frozen. We've grown our Frozen sales 37% over the past three years, adding nearly 4 points of market share and a 67% increase in distribution, while improving profitability for Pinnacle and retailers. The best news is, we're just getting started. I believe we're in a unique position to really lead the continued transformation in Frozen, given our brands, our commitment, and our track record of performance.

This has all resulted in a formidable operation with the scale and assets to continue to drive growth on the top and bottom-line, even in an ever changing and tougher consumer and industry environment. Certainly, it's not new news to the folks in this room that the environment is tough. Nevertheless, companies that are nimble, that focused on execution, can still create opportunities even in challenging times.

A great example is health and wellness, and how it's changing the way consumers eat and what they're demanding from food companies, both big and small. In particular, consumers are selecting food that matches their lifestyle with demands that include specific benefits or elimination of certain ingredients. In fact, about a third of the population is trying to live a healthier lifestyle with the focus on plant based and gluten free diets, as two of the top three life styles.

Although navigating health and wellness, sometimes it feels like it requires a Ph.D. At the heart of the entire health and wellness movement, is fundamentally the consumer demand for less processed foods or what I call kitchen logic. If I can find an ingredient in my own kitchen, then it's okay to be on the ingredient line of the food I buy. 43% of the population is actively reducing processed food consumption across all categories. This creates opportunity beyond just health and wellness brands to simplify ingredients and offer less processed foods.

One way consumers are trying to achieve this is by increasing the presence of ingredients that are good for them such as vegetables. Two-thirds of the population is actively trying to get more veggies and that is good news for Birds Eye, but not only our consumer behavior is changing, but who the consumer actually is, is also evolving.

Imagine this, 75% of the purchasing power in food will be millennials by 2025 with more than half of the U.S. households currently being only one to two people and those dynamics paired with an ever expanding diversity of our population, require our products, packaging, marketing and where we're for sale to evolve with it.

The industry is responding to these consumer trends in a variety of ways. One of the areas of concern that has been front and center this year is the overall slowdown in packaged food consumption, while at times it does seem like a mystery as to where the sales have gone. I believe it's less mystery and more a reaction to the consumer trends I mentioned earlier.

Consumers aren't ultimately eating less. They are simply buying and consuming it in different ways. This includes a shift to channels like online, club and discounters that are not in the traditionally measured channel summaries, where value focus and quality of the outlets continue to grow in attractiveness. In addition, as more fresh and store perimeter products are purchased, that's also having an effect on packaged foods.

Finally, the emergence of additional in-home eating solution, such as in-store prepared foods and meal kits are additional culprits, combine that with improving away-from-home trends and it's putting even more pressure on packaged food maintaining its share-of-stomach.

In terms of channels, online is growing the fastest albeit from a smaller but expanding base. The increasing number of e-commerce choices and the relevance of online shopping to a growing consumer audience, demands the attention of manufacturers. And with the share of online food purchases expected to double over the next five years and likely representing about 10% of total in-home food purchases, over time it is a compelling call to action.

The critical emphasis now needs to be on creating sustainable business model. Rising the simply sell products online is not the right answer. The landscape will continue to move, as we saw earlier this year with news of the Amazon and Whole Foods merger. So prioritizing partnering, learning and remaining focused on profitability will be critical across all formats and platforms in the online world, while of course not forgetting the 90% to 95% of our business that will remain in more traditional retail.

In response to some of these more price-driven channels, private label is reemerging as price leadership becomes a growing priority. I think at times, companies have borrowed against the heritage and equity of brands, seeing consumer loyalty more is a right than a privilege. In today's environment, you have to earn that loyalty every day. The reality is that it's up to us to create the value equation that drives consumer brand loyalty and competitive advantage over price alone.

So as you step back and look at all of these trends, health & wellness, consumer evolution, new channels and growing competition, it's understandable that some might chose to point to them as reasons for the lack of growth. Conversely, some might chose to see these as a call to action to move faster, to change paradigms and simply execute better than other companies, which in turn is likely to translate into winning in the market.

This is the attitude and approach we've been taking at Pinnacle, which has resulted in 13 consecutive quarters of market share growth, overcoming challenging categories and reinventing brands that have been seen as out of date and out of touch. If I would have told you that the Baking category would be growing 6% this year, and that one of the number one innovations in all of food was going to come from that category, you might have thought I was crazy. But finding the way to navigate these trends has been a critical component of our playbook. We've also demonstrated that we can grow share and consumption in a world where private label is growing, through consistent differentiation, strength of our brands, and highly relevant margin accretive innovation.

Even better news is that even with this share of growth, today we still only represent a 15% composite market share of the categories we are in, leaving us 85% of the categories we're in to source growth and share from. This success is also leading to improving profitability as we drive profitable growth and focus on price and mix, while also delivering a robust productivity and synergy agenda. In fact, we've added 430 basis points of margin over the last four years, but similar to market share, we still have quite a bit of room to continue to expand margins as we sit well below the industry average, gross margin which is in the mid-30s range. This unique ability to grow both top and bottom-line has differentiated our company, and that differentiation has translated into value creation with a TSR of 225% since the IPO.

This performance is fantastic, but standing still to admire our work is not in our DNA. So, where do we go from here? The formula is not complicated. It's continuing to drive this balanced attack of margin expansion and profitable growth. In doing so, we're moving from not only reinvigorating iconic brands, but also to truly unleashing brand potential.

Let's spend some time now talking about how we're going to do this. Well, the good news is, it starts with the Pinnacle playbook, four pillars, each with a proven track record and importantly a clear path to drive improvement and acceleration in each, simple, understood and effective. The fuel of this playbook begins with gross margins and cash flow. Craig will talk more about cash in a moment, but I want to spend a few minutes talking about gross margins.

First and foremost, despite in 2017, where the impact of some discrete items in investments have driven a more stable gross margin year versus a growth year, we remain confident and committed to delivering the 300 basis points to 400 basis points of margin expansion by the end of 2019. The areas of focus to deliver this margin expansion remain consistent with what we've shared previously; namely productivity, Boulder synergies and mix and net pricing.

Importantly, we now have even clear building blocks for each. Productivity in our MVP program will remain the most critical driver and as we've widened our scope to include both vertical savings, defined as doing what we do better and horizontal savings, levering the power of our scale, we now see the path to more than 4% productivity savings over the foreseeable future. A key productivity enabler moving forward is the clarity of our network optimization initiative. Focused primarily on our Frozen network and our company-wide Distribution network, this initiative is a key building block in our 300 basis point to 400 basis point gross margin roadmap.

The goals of network optimization are fairly straightforward; fuel margin expansion, support profitable growth, strengthen quality and capabilities, and ensure a Pay-As-You-Go program. So the costs are absorbed in our ongoing results versus the typical large-scale restructuring type program that can weigh on a company's performance.

There are three focus areas that will create value in our Network Optimization program. First, optimize and expand our Frozen Vegetables network. On Frozen Vegetables, we'll strengthen our existing facilities, starting with better design and layouts in existing plants. Selective asset upgrades and process improvements. For example, in our dairy and plants, we're optimizing the design and layout by segregating raw vegetable processing from the rest of the production, allowing us to keep the part of the operation running with the other half needs to go down for general maintenance or cleaning versus shutting everything down at the same time.

We'll also be working across the entire vegetable network to better optimize how our three facilities, now including Beaver Dam, and co-manufacturers work together to get to lower cost and better capabilities. We also see opportunities more broadly across the entire Frozen end-to-end supply chain. Adding facilities like Hagerstown, exploring consolidation ideas similar to closing our EVOL Colorado facility and moving production to our Frozen meal hub in Fayetteville, or simply improving facilities like we discussed during Q2 earnings, will add value and capabilities.

Finally, on our Distribution & Warehousing, seeing the full manufacturing and product plans over a longer period of time and aligning with those needs will allow us to optimize our Frozen and drive warehouse network, resulting in lower cost and better service.

The Beaver Dam acquisition is a great example of this plan in action as it will allow us to better balance outside suppliers, while significantly increasing our manufacturing capacities to support ongoing growth. Further, Beaver Dam provides a large amount of additional warehousing space, which will allow us to consolidate warehousing footprint and simplify our inventory management processes.

This plan is also structured to spread the impacts over the three-year strategic plan timeframe with a modest effect on our capital phasing and the benefits building over the plan timeframe. The great news is, we've been able to accelerate some of these initiatives and activities in the 2017. And although not incremental to our overall roadmap, certainly helpful as we manage more broadly across all of the drivers of gross margin.

The second contributor to our gross margin roadmap is Boulder synergy capture, with scale as a key enabler to unlocking value. We have executed the integration flawlessly and continued to generate synergies at or above plan. We've utilized our scale to drive down cost, whether it be through lower rates or more full truckloads, ingredient and packaging purchasing, simply sharing warehouses or bundling with our brokers for better rates.

This has resulted in $37 million in total synergies by the end of 2018, $7 million better than our original estimate and contributing $20 million to gross margins. This strong synergy, coupled with integrating Boulder into our MVP process, and implementing the Boulder SKU rationalization program have collectively contributed to significant margin growth for Boulder. In fact, the gross margin on our Boulder businesses are up 660 basis points.

Now as we turn our attention to driving growth on the Boulder businesses, these favorable margins will be even more impactful. This is a great segue to the final driver. Mix & net realized pricing is the third pillar of our gross margin roadmap. A key enabler is our portfolio roles, often copied in the industry, but not always translated into action.

While not the biggest driver of margins, pricing and mix will continue to contribute to our roadmap especially given our clear and committed approach to portfolio roles. Leadership and Foundation brands were the starting point with us further separating Leadership to address the needs of truly category leading accelerate brands versus our very large and profitable core brands.

We arrived at these roles through a fairly exhaustive assessment of current position and future outlook. Through that, we've ended up with two-thirds of our business in the margin advantage leadership bucket. But what you do with this portfolio segregation and strategy is the most critical aspect. As you will see it's driven trade-offs and choices on focus, we have the majority of our marketing investment and margin accretive innovation focus on our most profitable brands, all fueling our strongest growth potential.

Critical though is not to abandon the Foundation brands. Smart support models like we do on Armour canned meat has driven a three year growth CAGR on that business of around 2.5% with expanded share and margins. In the end, I would point out that although not immediately intuitive having role players versus having all of one type of brand is in fact an advantage. With brands that can translate investment into high ROI and others as cash and profit engines is a terrific dynamic, and one that will provide an inherent tailwind on margins going forward.

And now let me bring up Mark Schiller, who will discuss with you how we're accelerating profitable top-line growth, as well as our focus on strengthening capabilities and M&A.

Mark Schiller
Executive Vice President & Chief Commercial Officer, Pinnacle Foods, Inc.

Thank you.

Mark A. Clouse
Chief Executive Officer & Director, Pinnacle Foods, Inc.

Thank you Mark.

Mark Schiller
Executive Vice President & Chief Commercial Officer, Pinnacle Foods, Inc.

Thank you, Mark. From Mark to Mark. Now, let's talk a little bit about our brands, starting with how we're going to continue to create growth – leading growth across the industry using our powerful portfolio. So we have three primary building blocks that we're going to use to drive this growth agenda, and first is about strengthening our fundamentals, the second is about expanding our health and wellness presence, and the third is about enhancing our channels coverage.

Now let me start with the first one, strengthening fundamentals. And over the last several years, we've invested a lot of time and energy building a world-class organization that has consistently delivered at a high level. Among our accomplishments, we've delivered composite share growth in 49 out of the last 50 months, which is a pretty enviable record and one that we fully expect to continue going forward.

Share expansion has come in several ways, first being that we can leverage the strengths of our brands individually with things like world-class marketing, sharp pricing and margin accretive innovation, but we can also leverage the strength of our portfolio across brands to create growth.

Now, I'll give you some examples of this in a few minutes, but let me say upfront that you'll see, as I go into it, how Boulder plays a pretty critical role in that strategy.

Now when we talk about brand strength and unleashing the potential of our brands by satisfying consumers and customers, we need to do it in highly impactful ways and I can't think of a better example than Duncan Hines cake mix. Now, after years of trying to compete in the cake mix segment at a $1 price point to win key merchandising holidays, we learned that consumers will pay more money if we give them higher quality products and solve real dis-satisfiers in the category.

So in 2014, we launched a $3 price point with something called Decadent, which was a kit that gave consumers the ability to bake high-quality desserts at home similar to the things they were seeing on television and in the bakery down the street. In 2015, we expanded on this $3 margin accretive price tier with Perfect Size for two to four, which really just built on the simple insight that we were providing way too much cake for the 60% of households that only have one or two people within them.

And this year, we've built on that smaller household insight with Perfect Size for One, an 18 item line of mixes that you bake in the microwave in about a minute. It solves many of the category problems and dis-satisfiers like long prep time, long cleanup time, lack of skills to bake confidently and it brings in new benefits like personalization, customization and even provides more healthy and permissible indulgence.

Now this product has been an absolute blockbuster, and it is going to be one of the biggest new product launches in the entire center of store in any food category. It's the 90% incremental to the Duncan Hines franchise; and after three years of mid single-digit declines in the category, it is almost single handedly restored growth back to the baking aisle again.

Now if you haven't tried it yet, it's available across the hall. I'd encourage you to go try it. I think we've got six or seven flavors to sample, and I think you guys will really enjoy it and see why this is such a big idea.

So, in keeping with the promise of creating value for Pinnacle and for retailers and for consumers, our premium segment is now almost a third of our entire cake business. We've grown our TDP 6% and we've increased our market share by an impressive 7 points since 2013. And importantly, our margins have expanded by 600 basis points during that period of time, how's that for unleashing brand potential?

The second way in which we're going to drive growth is by leveraging the scale across our portfolio. And the first example I could give you is that we bundle brands together to drive key merchandising periods and win against the competitive environment, things like Easter and summer grilling season. The second way in which we do it is, we can also leverage the strength and scale of our portfolio to develop even stronger customer relationships within our categories. For example, with the addition of Boulder, we are now a major player in the Frozen meals category. We have a brand for every consumer and every need, which gives us a lot more influence when it comes to promotions and shelf space.

And the third way, in which we can do it is by bringing meaningful consumer solutions with our brands. For example, we can bundle together our offerings to address an important consumer need like heart health or we can use the billion-dollar Birds Eye franchise, which has almost 50% household penetration to drive awareness and trial of some of the other healthy Frozen offerings we have in our portfolio like Gardein, for people who are looking for plant-based alternatives.

Now let's shift gears and talk a little bit about the second building block of our agenda, which is expanding our health and wellness presence. Now, we've made some terrific progress here and we will continue to do so by putting a disproportionate share of our resources against healthier brands and healthier offerings, as Mark indicated. We fully expect at least 80% of our innovation is going to be healthy or healthier than the current offerings in the categories in which we compete.

Now we have three clear pillars in terms of how we're going to continue to be an even bigger force in health and wellness. The first is around lifestyle leadership with plant-based, gluten-free and clean convenient. The second is around helping consumers eat more vegetables. And the third is around creating a better center of store by making existing offerings healthier and by adding new ones that make the category more permissible.

Let's look at each one in a little bit of detail. Now when we think about lifestyle leadership, consumers have opted in either because they need to for medical reasons or because they're trying to eat healthier. But when you pursue a healthy lifestyle, consumers are often forced to make trade-offs. And as a result, many consumers become dissatisfied and go back to the less healthy offerings. The key to success here is to create offerings that require no compromise. No compromise in taste, in health, in convenience, no compromise in value.

And our biggest single opportunity in this area is with Udi's, the leader in gluten-free eating. Now there's been a proliferation of gluten-free offerings in the category as manufacturers are attracted by the high growth potential of this lifestyle, but the products that have been launched often fall very short on this no compromise goal, particularly in bread, the largest segment.

Now, Udi's is about to solve this significant consumer problem. In January of 2018, we plan to change the paradigm with the launch of a new gluten-free bread that is absolutely sensational, bigger slices, perfect for sandwiches, better texture and mouth feel and an absolutely delicious taste. It's a revolutionary product that's tested better than other gluten-free offerings and tested on par with gluten-full offerings, in essence no compromise. More details on this new product to come as we get closer to the launch, but rest assured we have a great offering that is going to restore significant growth in a very important category for us.

Now we can also contribute to healthier lifestyles by getting people to eat more vegetables. And only 1 in 10 people eats enough vegetables, yet everybody knows that they should be eating more. And we've spent a lot of time over the last several years trying to understand the barriers to this deficiency and creating new products that overcome those barriers. And in fact, over the last several years, we've launched over 50 new products behind multiple platforms including a significant slate of innovation this year. These products are off to a fantastic start led by the performance of our revolutionary Veggie Made platform, which includes cauliflower made rice and mashed potatoes, as well as pasta made from vegetables. These products offer full serving of vegetables, they have less carbs than their starchy counterparts and the taste is really resonating well with consumers.

Now since 2013, this billion-dollar franchise has grown more than 23%, our TDPs are up 35% and our share is up an incredible 7.2 points and importantly, our gross margin has expanded as well. Also importantly, the category is growing again, which gives retailers confidence to continue to invest in Birds Eye with space and merchandising support within the store.

Now you may be thinking to yourself where is all of the space for this stuff going to come from. And first of all, there are duplicative brands within the categories in which we compete. And second, there are many places within the Frozen aisle that are simply underperforming. Many have not addressed health and wellness sufficiently and are in need of renovation. Our Birds Eye and Boulder brands are well positioned to bring health benefits to many of these categories just as we've done with the Veggie Made start substitutes. We're uniquely positioned to leverage our brands, our scale and our innovation capabilities to help retailers reinvigorate this very important part of the store.

Now while I focused a lot on health and wellness in vegetable ubiquity, we have many other brands in our portfolio that don't compete in traditionally health and wellness categories. That said, consumers in those isles also want to eat better. So, we've launched healthier offerings in those categories as well, like Vlasic pickles with low sodium, low sugar and cleaner labels, or Log Cabin where we've eliminated high fructose corn syrup or recently launched the non-GMO formula.

In short, we see opportunities across the stores in the categories and we do not accept the fact that the center of store cannot grow. If we give consumers what they want, they will come back, they will buy more and our brands will flourish.

And the last building block on here is our channels growth and we're very well positioned outside of grocery and traditional mass merchandisers, and we fully expect our sales to double here led primarily by the growth of e-commerce. Now, e-commerce is rapidly growing, but it's still relatively small today. And in the future, we recognize that the key to success here is going to be to build a sustainable business model to drive profitable growth.

It's going to be important to understand how retailers and consumers want to receive products so we can build an efficient supply chain around it. We'll need to assess which products sell best in this channel, and we're going to need to put dedicated talents around this to manage this more like a freestanding business than one that's encumbered by the current paradigms of the core business. And lastly, we'll continue to optimize our marketing programs here.

Now to-date, we have made great progress, educating consumers about our products, putting our brands in prominent places on these sites and creating branded destinations that drive sales. In short, this is an exciting growth space and one where we're well positioned and a true Pinnacle fashion as soon as we saw the opportunity emerging, we resourced it, we partnered with customers and we built the model to capitalize it.

And as Mark mentioned, the final two pillars of our playbook are about strengthening capabilities and maintaining costs, and increasing our M&A potential. I'll take a moment to talk about each one briefly.

Now the acquisition of Boulder is a great example of strengthening our capabilities. As we started the integration, we realized we needed to create a balanced business model to ensure that we maintain what made Boulder special and unique in the first place, but also to quickly capitalize on synergies and growth potential. So, in some areas like innovation, marketing and planning, we have separate dedicated resources in each location as well as separate leadership, but one joint process that captures the best thinking across both the Boulder site and the New Jersey site. This ensures we create real expertise locally, but work within a best practices framework.

Other areas like marketing services, productivity and sales also have separate dedicated resources, but one leader who leads the entire function across the entire enterprise to ensure that we're making the right trade-offs real-time and we think portfolio wide.

And then the last one, there's groups like manufacturing and back office that are done centrally as one team to ensure consistency and efficiency. And this is an important part to why we're able to keep our G&A around 9% creating the right model for the right function.

Lastly, let me just say a word about acquisitions, and as we've said before, we believe this industry is right for consolidation and that we are well poised, well positioned to take advantage of the opportunities. However, we maintain our commitment to having a strong organic plan where M&A is an accelerator and not require to deliver our algorithm. As always, we're going to maintain an active approach looking at businesses in North America; once they're in adjacent categories with leading share positions; transactions that are synergy rich; and allow for fast and efficient integration. And given our portfolio, we believe we have great optionality, both in health and wellness and in center of store, particularly in Frozen.

With that, let me now turn it over to the last member of our team, who isn't named Mark, our CFO, Mr. Craig Steeneck. Craig?

Craig D. Steeneck

Chief Financial Officer & Executive Vice President, Pinnacle Foods, Inc.

Thank you, Mark. Good afternoon, everyone. Okay. So, just in closing, just to remind everyone of our first half reported results, adjusted results.

I mean, despite the issues that we had in the second quarter around the exit of Aunt Jemima, we still produced a pretty impressive 24% improvement year-on-year in diluted EPS. And when you strip out the discrete items, which I'll cover in a minute, we produced, what I recall, industry leading 1.3% growth in net sales, 80 basis points of margin improvement and even more impressive 37% year-on-year improvement in diluted EPS.

Just to decompose and remind everyone about the discrete items that were behind our adjusted results in the second quarter that had an adverse effect of about $20 million in terms of net sales, $7 million of that coming from the recall itself and $13 million from the loss sales associated with the exit. When you carry that down to gross profit, it's about a $21 million effect, $9 million for the recall, so a couple of incremental costs at gross margin for that, the AJ exit is again the loss sales associated with the exit plus some incremental costs at our Jackson facility. And then as we've articulated and Mark Clouse talked about, we had some accelerated manufacturing investments that we brought into the second quarter, which were carry forward or bring forward from future years that produced an adverse effect of about $5 million. So, all in, about $0.11 for the second quarter.

And as you carry that out into H2, you'll see $35 million as the loss sales effect of the exit in the back half, some incremental costs another $3 million associated with the profit on that and carryover costs associated with our Jackson facility, and then $10 million, again, mostly waterfall effect of the strategic investments that we made in Q2. Most of that $13 million adverse effect in gross profit will occur in Q3, and I think most important is a majority of these items will result in a tailwind as we approach 2018. So, all in, $0.17 in EPS.

Productivity is the hallmark of the Pinnacle portfolio. And over the last several years, you can see we've been averaging close to 4%. As we now sit here in 2017, we believe that productivity will be in excess of 4%, sort of a big water – high watermark for us. And as you look at the relationship between productivity and inflation, on average since the IPO in 2013, productivity has exceeded inflation by 125 basis points.

The effective tax rate, the tax line has been very much of a benefit for us in 2017. When you look at where we started in 2016, almost 100 basis points improvement from DPAD, state legislation, improvement of the Boulder state tax position that got the 2017 base rate in terms of the effective tax rate at around 35.5% and then the new accounting treatment for stock-based compensation has produced a significant windfall of 260 bps in 2017. So that that gets to our reiterated guidance of around 33% to 33.4%, so low 33% for 2017.

And different from what I just articulated relative to the gross margin effect. This, along with some additional investment we'll make in DTC and SG&A, will end up being a headwind as we move into 2018.

We remain very disciplined in terms of CapEx expenditures. So you can see over the last several years, we've made network investments first with the Wish-Bone acquisition, next with Gardein, and some of these strategic investments in Q2 that I just articulated. But all-in, even in absorbing all of those network investments, we're still keeping our overall CapEx in around 4% of net sales.

This portfolio remains and is highly cash generative. It's been something that we have always been quite proud of. Last year, we produced about $380 million, a little bit north of that in terms of free cash flow, which was a record year for us. And we believe we're going to be able to replicate that in 2017 through managing the cash conversion cycle, particularly DPO, continuing to defer cash taxes and a disciplined CapEx approach I just talked about. And that ultimately produces a free cash flow yield at around 6%, which is markedly better than the 4% of our peers.

We use that cash in particular to de-lever at the IPO. March of 2013 had a leverage ratio of about 4.5 times EBITDA. We levered up to do the Wish-Bone acquisition, committed that we would take half a point of leverage out per year and then indeed got that to below 4 times at the end of 2015, levered up again for the Boulder acquisition and again committed half a turn of de-levering for two years after that and we fully expect that will be down again to 3.8 times by the end of this year.

So, in closing, our outlook for 2017. So, again, at the time of the IPO, we committed to a long-term TSR of double-digits, 10% to 12%. SmartCloud showed we have delivered that for each of the last four years. We're reiterating our guidance at the low end of that $2.55 to $2.60 range. And even at that $2.55, which is where we're guiding folks, that's going to be a miraculous 19% year-on-year improvement, which obviously now incorporates the benefit of the accounting treatment for stock-based comp.

And then just in closing, just to reiterate a few of the items relative to our guidance, we do have a 53rd week this year, which will hit Q4, which will be 1% in net sales, $0.03 in the EPS. The discrete items I covered, $0.11 in the second quarter, $0.06 in the back half. The tax rate at 33% to 33.4%. Overall CapEx in the $115 million to $125 million range, and our outstanding shares at around 120 million shares.

So with that, I'll hand it back to Andrew to take any of your questions.

QUESTION AND ANSWER SECTION

Andrew Lazar
Analyst, Barclays Capital, Inc.

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Okay. Thanks. Maybe we've got time just for one quick one in here and then we'll head to the breakout. I guess to start off, Mark, I wanted to just give you an opportunity to talk a little bit more broadly about some of the broader concerns that have kind of cropped up more recently, I think in the space, particularly culminating last week with some concern over not being able to come to an agreement with a large customer for a different food company. And some of the pushback, maybe, that we're hearing more about these days at a little bit of a higher level. How you see that? Are those things affecting any of your particular categories right now? How do you see yourself handling that going forward?

Mark A. Clouse
Chief Executive Officer & Director, Pinnacle Foods, Inc.

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Yeah. So, I think as we laid out earlier today, there's no doubt that there is growing pressure in the industry. And I think the demand for value, whether that comes through price or whether that comes through other mechanisms, is very important. And I think one of the things that I like about how we've really built this business is, if you go back several years, we were faced with the challenge of creating value on brands and in categories that had already been challenged. And so in many cases, we were coming to retailers with ideas and options that added growth and improved profitability at times where they weren't seeing that from a lot of our peers.

And I think that playbook or that approach to building relationship and providing alternative strategies for how we create value is really the key now as well. As that pressure mounts and as more people are focused on price, there's still an opportunity to do things like we've done on Duncan Hines or Birds Eye where we've been able to create a further tier or more premium segment, helping customers create win-win solutions where we're able to benefit, drive profitability, they can, as well as bringing news for the consumer is really what the name of the game is.

And honestly, I don't think that has necessarily changed materially. I think it's becoming more pronounced in a world where there are alternative options, other channels, where price continues to be more important private label re-emerging, but I think the focus and the actions that we've been taking make us feel really good about the path forward and being able to translate that into continued success like we've been doing.

Andrew Lazar

Analyst, Barclays Capital, Inc.

Perfect. Okay. Let's take it over to the breakout and please join me in thanking Pinnacle for being here today.