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Pinnacle Foods, Inc. (PF)

Q3 2015 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, ladies and gentlemen, and thank you for standing by. Welcome to the Pinnacle Foods, Inc. Earnings Call for the Third Quarter ended September 27, 2015. This conference is being recorded and there will be a question-and-answer session at the end of the call.

I would now like to introduce your host for today's conference, Pinnacle's Senior Vice President of Investor Relations, Ms. Maria Sceppaguercio. Ms. Sceppaguercio, please go ahead.

Maria A. Sceppaguercio

SVP-Investor Relations & External Communications

Thank you, and good morning, everyone. And thanks for dialing in. Here with me to discuss our results for the third quarter are Pinnacle's CEO, Bob Gamgort; and our CFO, Craig Steeneck. Earlier this morning, we issued our press release for the third quarter of 2015. If you haven't received a copy of the release you could get one on our website in the Investor center.

Our release and conversation this morning will include our results on an adjusted basis. The adjusted basis excludes acquisition, merger and other restructuring charges and other items affecting comparability. The company believes that the adjusted basis provides investors with additional insight into our business and operating performance trends.

While the exclusion of these items is not in accordance with GAAP, we believe that it is the most meaningful comparison and the most appropriate basis for discussion of our performance. Details of the items excluded are included in the reconciliation tables included in our press release and are discussed in detail in our 10-Q, which will be filed later today.

Also reconciled in our release and 10-Q is adjusted EBITDA, which is a non-GAAP measure. We define adjusted EBITDA as GAAP net earnings before interest expense, income taxes and depreciation and amortization, adjusted to exclude items affecting comparability. Other adjusted metrics discussed on the call are calculated using this methodology unless otherwise indicated.

Finally, I'd like to remind you that our discussion this morning may include forward-looking statements which are subject to the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995. These statements are subject to a number of risks and uncertainties that could cause actual results to differ materially and the Company undertakes no obligation to update these statements based upon subsequent events. A detailed discussion of these risks and uncertainties is contained in the Company's filings with the SEC.

With that, I'll hand it over to Bob.

Robert James Gamgort

Chief Executive Officer & Director

Thanks, Maria, and thanks to everyone for joining us today. The third quarter was another good one for us. Strong top and bottom line results were driven by our North American Retail business, reflecting growth of the base business, including strong innovation and the incremental benefit of the Gardein acquisition. As expected, our

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Specialty segment declined in the quarter. Our base business growth was driven by our Frozen segment, particularly our Birds Eye franchise, including very strong early results for our new innovation platform.

Our adjusted gross margin for the quarter expanded by 160 basis points which reflected the expected benefit of productivity exceeding inflation in the second half of this year, as well as favorable product mix and some net price realization. We continue to manage our expenses well and again benefited from lower net interest expense and a lower effective tax rate. Taken together, all of these factors drove adjusted EPS growth of 12% for the quarter.

Turning to the highlights of the quarter. We grew consolidated net sales 2% and North American Retail net sales 4.8%. The North America Retail growth reflected the benefit of the Gardein acquisition, higher volume mix on the base business, and net price realization, partially offset by unfavorable foreign currency translation. In terms of share, we again outpaced the performance of our categories with our dollar consumption in the quarter up 4.2% versus a category composite that was down slightly. As a result, we grew our composite market share by 80 basis points in the quarter with significant share growth again registered by our Frozen portfolio. For the quarter, we grew share for six of our eight leadership brands and for the year-to-date period we did so for seven of the eight.

The significant growth in gross margin was fueled by the favorable relationship in the quarter between productivity and inflation, coupled with favorable product mix and higher net realized price. Our strategy of innovating the trade consumers up to higher value offerings is a significant driver of our favorable mix, while improving promotional efficiencies and taking selective pricing to address specific inflationary input such as protein are benefiting net realized price.

Productivity for the quarter was a strong 4.3%, while our input cost inflation was 3%, consistent with our previous conversations on the timing of productivity and inflation being more favorable in the second half of 2015. Inflation continued to be driven by logistics and somewhat elevated costs in manufacturing. The manufacturing inflation, including incremental costs associated with the use of co-packing to satisfy strong demand for several of our new products. These inflationary costs were somewhat offset by deflationary input such as grains and oil.

SG&A expenses increased 10% for the quarter, driven by the inclusion of Gardein and higher administrative expense, reflecting in part the non-cash impact of the long-term stock-based compensation program we established following the IPO, which we have discussed with you previously. Net interest expense declined 10%, while our effective tax rate came in at 36.3% versus 38.2% last year. Finally, adjusted diluted EPS for the quarter totaled $0.46, a 12.2% increase versus year-ago.

Turning to our segments, starting with Birds Eye Frozen. Net sales were up 15% in the quarter due to 9% growth from the base business which was fueled by innovation and the benefit of the Gardein acquisition. The strong base business performance was driven by double-digit growth of the Birds Eye franchise with both core and new items performing well. In terms of market share, all four of our Frozen leadership brands grew share in the quarter with particular strength from Birds Eye Vegetables, Birds Eye Voila! and Gardein.

Our overall Frozen consumption for the quarter advanced 8% in a category composite that was down slightly, resulting in market share growth of 140 basis points with all four leadership brands registering share growth. We continue to capitalize on the growing popularity of plant-based nutrition by leveraging Birds Eye's health and wellness credentials and developing innovative new products that satisfy changing consumer needs.

Earlier this year, you'll recall that we launched two new Birds Eye platforms, namely Birds Eye Flavor Full and Birds Eye Protein Blends. Both new platforms were supported during the quarter with dedicated, high-scoring TV advertising along with digital and social media featuring our new spokesbirds. While still early, both new

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platforms are doing very well in the market with each achieving ACV distribution in excess of 75% and proving to be highly incremental to both the category and Birds Eye. Combined market share of the two new platforms approached 2.5% in the quarter, which fueled the 3.2 share points of growth registered by the total Birds Eye Vegetable business.

Another important area of focus for us has been making it easier and more enjoyable for kids to eat vegetables. Over the past few years, we've done this through multiple partnerships. In the third quarter we expanded our efforts with Disney with the introduction of a line of Disney-themed vegetable and pasta side dishes under the Birds Eye Steamfresh brand. The new line, initially launched into limited distribution, features great-tasting and nutritious flavor combinations with characters from key Disney properties. While still quite early, initial results are encouraging, with strong velocities registered to-date.

Birds Eye Voila! skillet meals posted another quarter of strong net sales and consumption growth due to continued distribution gains and the expansion of our Voila! Family Size line. Voila! is also benefiting from its first ever dedicated TV advertising combined with digital and social media support. Market share for the brand continued to advance with Voila! registering more than five full share points of growth in the quarter to 42%.

At the end of the quarter we introduced a new Voila! platform that offers consumers four non-chicken varieties such as beef, pork, and shrimp. The new platform is priced at a premium to the base Voila! Line, similar to the pricing architecture you'd find in a restaurant. We expect the new platform to expand the reach for our brand.

Turning to Gardein, which you will recall we acquired in mid-November last year, Gardein's unique portfolio of plant-based protein products builds upon our leadership in frozen vegetable. This business continues to grow a strong double-digit rate across both the traditional and natural and organic channels with retail consumption in the quarter up approximately 30% and our market share continuing to advance.

As we discussed last quarter, to keep up with Gardein's growing demand we are investing approximately $5 million this year to expand our capacity in our Vancouver manufacturing facility. This investment will help us meet growing consumer demand through 2016. In addition, during the quarter we purchased a new facility in Hagerstown, Maryland, that will further expand capacity for Gardein beginning in 2017. We continue to believe that plant-based proteins are at the tipping point of becoming mainstream and that Gardein is perfectly positioned to benefit from this trend, given its superior taste and texture.

Net sales for the Frozen Foundation brand portfolio declined modestly in the quarter, largely reflecting the volume elasticity impact of recent pricing actions on a number of brands. Adjusted EBIT for the Frozen segment grew 19.3%, reflecting the strong sales growth and productivity savings, partially offset by inflation and a higher consumer marketing principally behind new products.

Our Duncan Hines Grocery segment posted a 5% decline in net sales despite our share growth, largely reflecting continued challenging category dynamics in Baking as well as the impact of unfavorable foreign currency translation. Our Grocery segment foundation brands were essentially even with year-ago. In terms of market share, total Grocery segment share was even with year-ago, driven by share growth in baking, pickles, and pie fillings, offset by declines in syrups, canned meat, and salad dressing.

Turning to Baking, category volume continued to be under pressure, which drove our consumption decline despite growing our market share by 50 basis points. As we discussed last quarter, instead of battling strictly on price which tends to drag down the category, we are focusing on innovating to address some of the category's structural challenges and capitalize on opportunities resulting from changing consumer preferences. Our strategy is evident in the fact that our pricing was up 4% in the quarter, while the category pricing, excluding Pinnacle was down 3%.

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This focus is enabling us to continue to gain market share, which was up in both the quarter and the year-to-date period.

We know that Baking is a category with high consumer interest and we continue to reach consumers through our website, our Duncan Hines baker's club and social media channels, all of which provide cost efficient and highly effective ways to engage bakers. Earlier this year, Duncan Hines was named the number one CPG brand for total Facebook interactions. We also know that innovation is critical.

During the quarter we introduced Duncan Hines Perfect Size baking kits to address category challenges resulting from the decline in household size in America. Currently, one-person to two-person households have grown to represent 60% of all U.S. households, making baking a full-size cake less desirable. Perfect Size is a premium price, premium margin innovation that addresses this demographic shift by providing smaller households a baking option ideal for two to four people.

The baking kits come in five varieties and include the cake mix, frosting mix, as well as a disposable six-inch baking pan. The new line began shipping on July 1, and early results are very encouraging. ACV distribution has already reached 70% and velocities for all five varieties are performing well above the category average. In addition, Perfect Size is proving to be highly incremental to both Duncan Hines and the category with 25% of purchases made by consumers who had not purchased a Baking category in the past 12 months. And while we're still early in the launch, Perfect Size generated 5.1% of all category cake mix sales in the month of September.

Turning to Wish-Bone, the manufacturing startup is now complete and profit continues to track on plan despite some sales softness. While the category is down 1% year-to-date, it improved somewhat in the third quarter, but competitive activity within the category remained high. As we discussed previously, we are excited about the robust new product pipeline we've readied for early next year and the reaction from initial conversations with our retail customers has been quite positive. We look forward to sharing specifics of the innovation with you on our Q4 call in February.

Adjusted EBIT for the Grocery segment was down 1.5%, largely due to the sales decline and input cost inflation, partially offset by productivity and lower consumer marketing as we continue to shift marketing dollars to more efficient digital and social media campaigns. Duncan Hines is an excellent example of the strategy, as the brand enjoys a highly-engaged and interactive consumer base making these vehicles very effective and cost efficient.

Our Specialty Foods segment posted a 14% decline in net sales and a 24% decline in adjusted EBIT for the quarter. As we discussed with you last quarter, we expect big – Specialty to be down in the third quarter due to a very tough year-ago comp involving a government private label beef stew bid. Craig will discuss this in more detail. It's important to note that looking ahead we expect the top-line to stabilize in the fourth quarter and EBIT to post growth.

With that, I will hand it over to Craig.

Craig D. Steeneck

Chief Financial Officer & Executive Vice President

Thanks, Bob, and good morning, everyone. Starting with sales, our consolidated net sales increased 2% in the third quarter to $636 million reflecting a 2.6% benefit from the Gardein acquisition and approximately 1% from net realized pricing, partially offset by lower volume mix and unfavorable foreign currency translation. North American Retail net sales were up a strong 4.8% reflecting a 3% benefit from Gardein, higher volume mix of 1.4%,

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and higher net price realization of 1%. Partially offsetting this growth was unfavorable foreign currency translation of 0.6%.

Our Birds Eye Frozen segment delivered a particularly strong quarter with net sales up 15.3% driven by growth of 9.1% from the base business and a 6.2% benefit from Gardein. The strong base business performance reflected higher volume mix of 7.6% and higher net price realization of 1.5% with both existing and new products performing well. Net sales for our Duncan Hines Grocery segment declined 5.1% due to lower volume mix of 4.4% and unfavorable foreign currency translation of 1.2%, partially offset by higher net price realization of 0.5%.

Continued challenging category dynamics in both Baking and Salad Dressings, as well as the elasticity impact of selective pricing on several protein-related brands pressured our results for the segment as did unfavorable foreign currency translation associated with our Canadian business.

For our Specialty Food segment, net sales declined approximately 14% in the quarter, largely due to lower volume mix, primarily reflecting lower sales of private label canned meat.

As Bob mentioned, we expected both net sales and EBIT to be under pressure in Q3 due to comping against last year's exceptionally large USDA canned meat bid.

Turning to adjusted gross profit, as expected, the relationship between productivity and inflation turned positive in the third quarter. This benefit, along with the favorable product mix and higher net price realization drove a 7.8% increase in the adjusted gross profit dollars in the quarter. On a margin basis, this increase translated into a 160 basis point improvement in adjusted gross margin to 29%.

Productivity in Q3 totaled 4.3%, while input cost inflation totaled 3%. Inflation in the quarter was driven by logistics and somewhat elevated manufacturing costs, which reflected our use of co-packers for several new products and to meet continued strong demand for Birds Eye Voila! As we discussed last quarter, additional internal capacity is coming online during the fourth quarter to meet the demand for Voila!.

Turning to EBIT, excluding items affecting comparability, EBIT advanced approximately 6% to $108 million in the quarter, driven by the growth in gross profit, partially offset by higher SG&A expenses. The increase in SG&A was largely due to the inclusion of Gardein and higher administrative expenses, mainly reflecting increased non-cash stock-based compensation and higher depreciation largely related to IT investments.

Interest expense for the quarter declined 10% to $22.3 million, driven by the 25 basis point interest rate step-down on our term loans related to our deleveraging in 2014. Our effective tax rate for the quarter, excluding items affecting comparability, declined to 36.3% compared to 38.2% in the year-ago period. This decline was primarily due to qualifying in 2015 for the Domestic Production Activities Deduction and foreign tax credit associated with our Canadian operations.

Adjusted net earnings increased 14.6% in the quarter to $54.6 million or $0.46 per diluted share, compared to $47.6 million or $0.41 per diluted share in the year-ago period.

Now turning to cash flow, net cash provided by operating activities in the third quarter totaled $86 million compared to $226 million in the year-ago quarter which included a $151 million net benefit associated with the termination of the Company's merger agreement with Hillshire. Excluding this benefit, net cash provided by operating activities totaled $75 million in Q3 last year. Capital expenditures in the third quarter totaled $37 million compared to $26 million in the year-ago period. For the full year, we expect CapEx in the range of $110 million to $120 million including CapEx associated with our new Hagerstown facility.

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Turning to liquidity, at the end of the third quarter our total debt was $2.3 billion which includes $1.9 billion in term loans and $350 million in 4-7/8 senior notes. Cash totaled $73 million at quarter end, bringing our net debt to $2.2 billion and our net leverage ratio to just about four times at 4.03.

Finally, in terms of our outlook for the full year, we continue to expect diluted EPS in the range of $1.89 to $1.91. This implies Q4 EPS of $0.68 to $0.70, representing Q4 growth in the range of 6% to 9% versus year-ago. However, you will recall that in Q4 last year our results included the benefit of a one-time vacation policy change amounting to $6.5 million implying underlying Q4 growth this year in the range of 11% to 15%.

Included in our full year guidance are the following assumptions: Productivity at the high end of our 3% to 4% guidance range; input cost inflation of 3% to 3.5%; interest expense of approximately $90 million; an effective tax rate in the range of 36.5% to 37%; and a weighted average fully diluted share count of 117.3 million shares to 117.5 million shares for the full year.

With that, I'll turn the call back to the operator to open it up for your questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question comes from Andrew Lazar with Barclays.

Andrew Lazar
Barclays Capital, Inc.
Q

Morning, everybody.

Robert James Gamgort
Chief Executive Officer & Director
A

Morning, Andrew.

Maria A. Sceppaguercio
SVP-Investor Relations & External Communications
A

Morning, Andrew.

Andrew Lazar
Barclays Capital, Inc.
Q

I know that it's probably a little early to get into too many specifics right around 2016, but just as we think directionally about the balance between productivity and input costs going forward, I know you have a pretty significant pipeline going out a couple of years around the productivity side. So first off, maybe, how does that pipeline look for next year at this stage? – Because I know Pinnacle's been running at the high end of the 3% to 4% goal for the past couple years. And then on those things that are trackable, from an input standpoint, things look pretty benign, though I know we can't track some of the things that are input cost to you. So trying to get a sense of how that balance looks, even directionally at this stage.

Craig D. Steeneck
Chief Financial Officer & Executive Vice President
A

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Good morning, Andrew. It's Craig.

Andrew Lazar
Barclays Capital, Inc.
Q

Hi, Craig.

Craig D. Steeneck
Chief Financial Officer & Executive Vice President
A

Yes. So for this year, just to reiterate where we stand for this year before we move to 2016, we have productivity, our guidance range was 3% to 4%. We're clearly expecting that we're going to end up on the upper end of that guidance and input cost inflation at the 3% to 3.5%. And as you look to 2016, and you're exactly right, we have very good line of sight relative to what the productivity pipeline looks like. So you could assume that same 3% to 4% relative to next year in terms of productivity. And a good estimate would be in the midpoint of that range.

And inflation, as you know, there's pluses and minuses. Clearly, we've had a very good crop season. That's going to be a benefit in the first half. Corn sweeteners are going to be probably double digit inflation, but it only represents about 1% of the portfolio. So we're not seeing anything unusual inflation that would lead us to believe that, that same kind of 3% or so range wouldn't be appropriate for next year.

Andrew Lazar
Barclays Capital, Inc.
Q

Thanks for that. That's helpful. And then, Bob, some recent deals interestingly have traded maybe at multiples that are a little bit less robust than maybe what we've seen the previous couple of years. And there's one or two that are much-talked about deals that, frankly, have yet to even happen. I didn't know if you thought there was a growing disconnect maybe between buyers and sellers of assets to any great degree based on where multiples are more recently that might serve to further quiet the M&A environment at all. Just curious on your thoughts on that more broadly.

Robert James Gamgort
Chief Executive Officer & Director
A

Yes. I don't think that that's an issue, per se. I think that some of the multiples that you talk about on a relative basis with some previous deals are really I think more a representation of the quality of those assets more than any fundamental change in the mindset or valuation around these deals. I think they are just reflective of what the math was on that specific deal and nothing else. And so we continue to believe this industry will consolidate.

I think the news yesterday of Snyder's-Lance and Diamond is good evidence of that. And there are two other deals that have been announced – I mean a process I should say, that have been announced – Con Agra with their private brands and Boulder Brands Board saying that they are exploring sales. We know those are out there as well.

So there's lots of evidence that the industry is consolidating. And I think there's a tremendous appetite to make that happen, certainly on our part. And as I said before, the reason that certain deals have not gotten done on our part is nothing to do with valuation; it has really to do with motivation and the desire to transact. It's not over price. And I don't think that's changed at all out there.

Andrew Lazar
Barclays Capital, Inc.
Q

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Great. Thanks for that. Appreciate it.

Robert James Gamgort
Chief Executive Officer & Director
A

Okay.

Operator: Our next question comes from Bryan Spillane with Bank of America.

Bryan D. Spillane
Bank of America Merrill Lynch
Q

Hi. Good morning, everyone.

Robert James Gamgort
Chief Executive Officer & Director
A

Good morning.

Bryan D. Spillane
Bank of America Merrill Lynch
Q

Just two quick ones. First, in terms of Wish-Bone and I guess having the manufacturing plant up and running, are we now fully seeing the cost reduction or the efficiency benefits now of having transitioned the manufacturing? Or is there still more to come?

Craig D. Steeneck
Chief Financial Officer & Executive Vice President
A

No. Bryan, as we've said before, the manufacturing integration was 100% completed in the second quarter. We exited the co-pack arrangement with Unilever. We have our equipment fully functioning in our St. Elmo facility. So you'll start to see the run rate benefit of that manufacturing improvement layer itself through the P&L for the second half of this year. And then it should start to comp next year, in the first half of next year.

Bryan D. Spillane
Bank of America Merrill Lynch
Q

Okay. Okay. So we did see it [indiscernible] (27:20) after. In the third quarter there wasn't any sort of stranded cost or any other – anything that would have inhibited it from beginning to show up in the third quarter?

Craig D. Steeneck
Chief Financial Officer & Executive Vice President
A

It would not. I mean, you get a little bit of flow-through with the inventory, so that's maybe a slight delay as that comes into the third quarter. But nothing besides that.

Bryan D. Spillane
Bank of America Merrill Lynch
Q

Okay. And then, Bob, just in terms of – I guess following up on Andrew's question related to M&A, we've seen some pretty creative deal structures certainly in the beverage industry and even in the food industry over the last year or so. Can you just – in the past you've talked about reverse – RMTs and that being one way that Pinnacle might look to do deals. Can you just talk a little bit more broadly about your preference for RMT or doing a stock

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deal or a straight cash deal? Or is there any real difference from Pinnacle's perspective in terms of how a deal might be structured?

Robert James Gamgort
Chief Executive Officer & Director

A

From our standpoint, our priority is to get a accretive deal done, and one that's highly strategic over the long-term. And I'll just use accretive as a hurdle; there are many transactions that would meet that criteria – but a long-term strategic deal. And we've been very creative in proposing ideas that would alleviate some of the seller's concerns. And that's where an RMT or a stock deal or some other more creative transactions that we have proposed come into play because they are designed to eliminate tax leakage for the most part on the seller's side. And that's a good, legitimate concern by a lot of sellers. And we're able to alleviate that by offering creative deals. So you're right. There's a lot of deal structures that are out there that have been designed to get past those barriers and we certainly have made those same offers as well.

Bryan D. Spillane
Bank of America Merrill Lynch

Q

Thank you.

Robert James Gamgort
Chief Executive Officer & Director

A

Okay.

Operator: Our next question comes from Matthew Grainger with Morgan Stanley.

Matthew C. Grainger
Morgan Stanley & Co. LLC

Q

Hi. Good morning. Thanks.

Robert James Gamgort
Chief Executive Officer & Director

A

Good morning.

Matthew C. Grainger
Morgan Stanley & Co. LLC

Q

Thanks. Just two questions on the operating segments. Just first on Birds Eye and Frozen generally, volumes were incredibly strong here in the quarter. When we think about the sustainability of that growth in Frozen and on dinner mixes specifically, I guess you have a range of successful and ongoing innovation right now benefiting your share performance. But from a competitive standpoint, how much of this in the short term is perhaps a byproduct of trade or inventory disruptions at one of your key competitors? Is there some risk that this becomes a more difficult comp as we look into next year and there's more competitive reinvestment in the category?

Robert James Gamgort
Chief Executive Officer & Director

A

Yes. This is 100% driven by the strength of our core business and our innovation pipeline. I don't think we're benefiting from any disruption that you're kind of alluding to at all right now. We're really bullish on the delivery

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of the three platforms that we put out there; Flavor full, Protein Blends, and Disney, and we're very confident that we've got a strong innovation pipeline to follow that. So we really don't have concerns about the sustainability.

If anything, you would look at this and say, this is incredibly high quality growth; this isn't promotion driven. Our pricing is up because mix is higher. We're in the very early innings of these new innovations getting consumer acceptance and getting traction with consumers. We're really just promoting them on television advertising for the first time and so we think they have a long runway and some great innovation to follow that we will continually talk to you about.

So we've been talking about our desire to transform Birds Eye into a $1 billion plus health and wellness brand. I think that those three platforms and the strength that you're seeing in the marketplace are absolute evidence that we're being successful in making that happen. And I would also remind you, this is a very expandable category; less than one in ten Americans eats the right amount of fruits and vegetables per day – this is very expandable. And so we think the sky's the limit on this business.

Matthew C. Grainger
Morgan Stanley & Co. LLC

Q

Okay. Thanks. Thanks, Bob.

Robert James Gamgort
Chief Executive Officer & Director

A

Okay.

Matthew C. Grainger
Morgan Stanley & Co. LLC

Q

And one more, just to come back to the Baking category. You've been very transparent about your strategy, but just to talk a bit more about the promotional environment in the category right now. When we look at the measured channel data, it validates that you're gaining share, but it also kind of suggests that you're ceding some meaningful volume on the lower-priced products at the expense of pricing realization and positive mix and everything you're doing from an innovation standpoint. But I don't expect the promotional environment to last forever but is it feasible to continue pursuing this kind of pricing and mix-oriented strategy until the situation resolves itself?

Robert James Gamgort
Chief Executive Officer & Director

A

Oh yeah, very much. Because if you take a look at the year-to-date perspective here, as you point out, we gained market share in a category that's been really challenged. But as we've talked to you guys about before, we look at the business in three segments: Classic, Signature, and Premium. And Premium includes our Decadent mixes as well as Perfect Size right now. And if you look at it on a year-to-date basis, our absolute consumption – forget about share growth but our absolute consumption growth on Premium is 10% and our consumption growth on Premium in the third quarter is closer to 30%.

So it's a very viable strategy to not chase the [ph] 10 for $10 (32:40) price point on the Classic cake mix, and as a result, give up some share over there and then drive our innovation pipeline to much higher value-added segments that are good from a profit mix standpoint. But I would also point out, they're really good for the category, because as we talked about in the prepared remarks, the Perfect Size product is bringing in bakers to this category that haven't been there in over a year. And we've got a pipeline that's designed to chip away at a lot of the

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structural issues in there. So I think this is the strategy. It's really the only viable strategy in this category, and one that we will continue to follow with great success.

Matthew C. Grainger
Morgan Stanley & Co. LLC

Q

Okay. Thanks, Bob.

Robert James Gamgort
Chief Executive Officer & Director

A

Okay.

Operator: Our next question comes from Jason English with Goldman Sachs.

Jason M. English
Goldman Sachs & Co.

Q

Hey. Good morning, folks.

Robert James Gamgort
Chief Executive Officer & Director

A

Good morning.

Maria A. Sceppaguercio
SVP-Investor Relations & External Communications

A

Good morning, Jason.

Jason M. English
Goldman Sachs & Co.

Q

Thank you for the question. Baking, the competitive intensity. Have you seen it get sequentially worse than it was earlier this season?

Robert James Gamgort
Chief Executive Officer & Director

A

It's been about the same throughout the year. And you can see that in the syndicated data. If I take a look at the third quarter, third quarter pricing in the category excluding Pinnacle was down 3%. And you could see that the category certainly hasn't benefited from lower pricing.

And as we talked about a number of times, essentially you're just trading people down. The units don't move. Our pricing in that environment, an environment where the pricing for the competitors are minus 3%, we are up almost 4% in the quarter. And that's not because we're out taking less price increases, because we are mixing up our portfolio through higher value-added items. So it's about the same, which is intense. And we're staying the course and being competitive where we need to be, but really focused on higher margin, higher value items.

Jason M. English
Goldman Sachs & Co.

Q

All right. So at a minimum, the year-on-year pressure fades early next year when you start to lap it and fingers crossed, hopefully it goes the other way. Is that fair?

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Robert James Gamgort
Chief Executive Officer & Director

A

Well we're always hopeful that promotion moderates. When you're a competitor and you don't have any innovation, all you have left to play with is price. I think that's what you're seeing right now. And we're just not taking the bait. We're playing the game that's served us very well.

Jason M. English
Goldman Sachs & Co.

Q

And one last question, I'll pass it on. And I apologize if you gave this answer to Mr. Grainger's question. I got distracted over here. Really impressive results on innovation, congrats on that. Really impressive growth in Birds Eye. Is there any sort of pipeline fill or transitory benefit we should be aware of this quarter?

Robert James Gamgort
Chief Executive Officer & Director

A

You mean in terms of shipments of new products?

Jason M. English
Goldman Sachs & Co.

Q

Yeah. Yeah.

Robert James Gamgort
Chief Executive Officer & Director

A

No. I mean the numbers that you're looking at – the strength of numbers, you can see it in the consumption which is obviously at the transaction at the point of sale. And you see the consumption and shipments are very closely aligned. So, no, this is really consumption driven.

Jason M. English
Goldman Sachs & Co.

Q

Great. Congrats again. I'll pass it on.

Robert James Gamgort
Chief Executive Officer & Director

A

Thanks.

Operator: Our next question comes from Robert Moskow with Credit Suisse.

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

Q

Hi. Thank you.

Robert James Gamgort
Chief Executive Officer & Director

A

Morning.

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

Q

Hey. Good morning. Craig, you said it yourself that the fourth quarter forecast implies something like 17% operating income growth if you normalize for last year's vacation policy change. You might have provided a couple of details as to why it's so big, but maybe you could reiterate or give us a little more color on that.

Craig D. Steeneck
Chief Financial Officer & Executive Vice President

A

Yeah. So in the prepared remarks, Rob, I said the fourth quarter was going to show EPS growth of 6% to 9%; and then when you equalize it, and recognizing that we have that one-time benefit in last year which was $6.5 million for the vacation accrual adjustment, it would be 11% to 15% growth in EPS. So we feel comfortable based upon our line of sight relative to kind of the productivity and inflation and the top-line that we can make that and make the guidance. But clearly that recognized a pretty formidable year-on-year comp for the fourth quarter.

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

Q

Yeah. But Craig, it's very different from how the first three quarters laid out. So is there something specific that's enabling you to make fourth quarter look so different? Is there going to be another vacation policy change? What is it?

Craig D. Steeneck
Chief Financial Officer & Executive Vice President

A

No. It's really the timing that we've talked about all year, Rob. We have the highest level of productivity planned for the fourth quarter, a pretty comparable level to what we've just seen in Q3. And then we have the lowest level of inflation forecasted for the fourth quarter. We're generating right about 3%, 3.2% year-to-date, it was slightly below that a year ago. So really just the timing of the way the P&L flows, and that's been consistent with our initial guidance at the start of the year.

Robert James Gamgort
Chief Executive Officer & Director

A

Yeah. And Rob, that's not by design. That's just – as we talk about our annual guidance and we give you some indication of productivity versus inflation, we know that it doesn't flow through evenly quarter-by-quarter and has to do about our cycle of procurement, our crop cycle on how it actually hits the P&L. So from the very beginning we said the second half was going to be much more favorable than the first half. And as we move throughout the year, we've delivered against the numbers that we've put out there. And so it lines up for a fourth quarter that would show real strength versus year-ago, especially when you pull that one-time benefit out. But again, what you're hearing from us today is that we are confirming guidance and we feel like we've got good line of sight to all of that.

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

Q

Okay. Thank you.

Craig D. Steeneck
Chief Financial Officer & Executive Vice President

A

Sure.

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Operator: Our next question comes from Eric Katzman with Deutsche Bank.

Eric R. Katzman
Deutsche Bank Securities, Inc.

Q

Hi. Good morning, everybody.

Robert James Gamgort
Chief Executive Officer & Director

A

Hi, Eric.

Maria A. Sceppaguercio
SVP-Investor Relations & External Communications

A

Good morning, Eric.

Eric R. Katzman
Deutsche Bank Securities, Inc.

Q

I guess my question really is more a little industry-related, but it kind of connects to Wish-Bone. I think we're all anticipating and seeing what happens over at the new Kraft Heinz with their promotional cadence or lack thereof of promotion. How do you see that affecting the salad dressing category? And how, let's say the fourth quarter in 2016 play out for you if, in fact, they cut promotions significantly?

Robert James Gamgort
Chief Executive Officer & Director

A

Yes. So I think it's too early to tell how they're going to run that business. And as you know, promotions are scheduled depending on the category couple quarters out. And so you're still seeing some lag effect on all that. So we don't really have an indication of how they are going to play in that category going forward. Our assumption is always that we face formidable competition in all of our categories, and we plan accordingly. So we feel like we've got the right competitive promotion agenda for the fourth quarter on salad dressing.

As we talked about a number of times, the game that we wanted to play since we acquired Wish-Bone was to get the synergies through the supply chain. That's happened, as we talked about before. And as I said, even though our top-line has been below our expectations, our profit has been right on plan because of all of that. And we've been lining up our sales to play the same playbook that we do on all of our brands, which is reinvigorating them. And we reinvigorate through innovation or renovation.

And because of the start-up of manufacturing, we were delayed to do that. We're ready to go now. We've got good innovation that's going to hit in 2016. And that's how we're going to win the game, not by – on the margins of promotion. So the next time we have a call, we will take you through what that innovation is for Wish-Bone. I have to tell you, after promising it for a long time, I can't wait to talk about it. And I think at that point too, we'll get some indication of what the competition looks like in that segment. But way too early to tell right now.

Eric R. Katzman
Deutsche Bank Securities, Inc.

Q

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Okay. And then just one follow-up. I'll pass it on. Craig, the NOLs that have been such a benefit to your cash flow, can you remind me where those – like how much of the NOLs are likely to be used up this year, assuming you make your stated targets? And then what's next year or on an ongoing basis annually? And then I'll pass.

Craig D. Steeneck
Chief Financial Officer & Executive Vice President

A

Yes. So, Eric, the lion's share of – when we did the IPO of roundabout $1 billion NOL, about 75% of that is going to be utilized through the end of 2015. So there's about a 20%, 25% residual that lasts, as we've talked about, from anywhere between 12 years to 15 years. And there's a long tail associated with that. And then the tax provision also benefits. When we did the Wish-Bone acquisition, we did the Gardein acquisition, we got some step-up for amortization, so that flows through the P&L also.

So the lion's share of the NOL will be behind us. We'll become pretty close to a full-fledged taxpayer in 2016 from a cash flow perspective. The advantage of it has been though, because now that we've become a taxpayer, the provision on the P&L has benefited from Domestic Production Activities Deduction, which, once you produce in the U.S. you get a deduction. You can only take that when you are a cash taxpayer, and then also this foreign tax credit that we get from our Canadian business. So tale of two cities, adverse in terms of cash flow, positive in terms of provision that runs through EPS.

Maria A. Sceppaguercio
SVP-Investor Relations & External Communications

A

And then, Eric, just in terms of some of the numbers, you should expect that the NOL deduction going forward will be about $17 million, which is this yield. And then the combination of Wish-Bone and Gardein together is another $45 million. So taken together, you've got over $60 million of a tax shield that'll yield about $17 million or so of cash tax benefit for the next dozen years or so, as Craig mentioned.

Eric R. Katzman
Deutsche Bank Securities, Inc.

Q

Okay. Okay. Perfect. Thank you.

Robert James Gamgort
Chief Executive Officer & Director

A

All right.

Operator: Our next question comes from David Palmer with RBC Capital Markets.

David S. Palmer
RBC Capital Markets LLC

Q

Thanks. Good morning, guys.

Robert James Gamgort
Chief Executive Officer & Director

A

Good morning.

David S. Palmer
RBC Capital Markets LLC

Q

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I was wondering if we could circle back to the organic growth levers. Heading into 2016 if you look at some of your big brands, obviously Birds Eye has been very strong, Wish-Bone and Duncan softer. Is it reasonable to think that there might be moderating growth against these monster comparisons on Birds Eye? And if that's the case, you have Wish-Bone and Duncan which are high-margin brands and categories. It sounds like you think Wish-Bone might finally have a solidly positive year next year. Do you think that might be the SKU that, Birds Eye moderating growth but Wish-Bone and Duncan perhaps kick in a little bit more fully next year?

Robert James Gamgort
Chief Executive Officer & Director

A

Yes. If you step back for a minute and look at how we've been able to deliver the performance we have since the IPO, it's because we've been gaining market share. And that's not a one-time situation; we've gained composite market share now in four out of the past five years and it's actually accelerated just about every year. And we're up about 80 basis points year-to-date versus about 50 basis points a year ago. So that's really the key, which is, we know categories in general in the center of the store have been challenged. We've offset that through share growth, and that share growth has come from a really strong innovation pipeline, not through heavy promotion.

So our expectation is that we continue to do that exact same – use that exact same playbook going forward, which is, we have line of sight to our innovation portfolio across the board. And we feel as good about that forward look on that as we have over the past couple of years. And we should point out in terms of really good compares on some areas and less favorable compares on others is the benefit of having a very diversified portfolio. And if you take a look at that composite market share growth over the past five years, there are some years where one brand is particularly strong and another is weak. And then you get the reverse the following year. But the most important piece is, year-in and year-out, we've been able to gain share across our portfolio through the strength of that innovation.

David S. Palmer
RBC Capital Markets LLC

Q

Just one separate question. When you look down your Nielsen data, a lot of the smaller brands and categories have bigger declines. Is there an SKU rationalization promotion strategy that's perhaps causing a bigger spread between your bigger stuff and your smaller stuff in terms of the growth rates?

Robert James Gamgort
Chief Executive Officer & Director

A

Part of that discrepancy that you point out is driven by our portfolio management strategy of leadership versus foundation brands. And what we've always said is, we target stability in our Foundation brands and we target cash flow to reinvest in our leadership brands. And obviously our leadership brands is where we focus most of our innovation effort. That's exactly what's happening this year.

And then the other thing to point out that's a little bit deeper in there is that we took pricing on a number of those Foundation brands because of particular cost issues, protein for example, on our Armour brand is a good example of that. And that's causing more of a negative impact due to elasticity. But that's us being true to our portfolio management strategy.

So if we see high inflation on a Foundation brand, we're going to take pricing to make sure that we hold the profitability of that. And if that means we lose a little bit of market share, it's not a big deal. None of the changes that you're talking about are material enough to require a portfolio-pruning in terms of SKU-pruning that you talked about. And it's certainly not happening from a retailer side. The distribution points are not the cause of that decline. Most of it is elasticity impact of some pricing targeted against input cost inflation.

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David S. Palmer
RBC Capital Markets LLC

Q

Great. Thank you.

Robert James Gamgort
Chief Executive Officer & Director

A

Okay.

Operator: Our next question comes from Chris Growe with Stifel.

Christopher Growe
Stifel, Nicolaus & Co., Inc.

Q

Hi. Good morning.

Robert James Gamgort
Chief Executive Officer & Director

A

Good morning.

Christopher Growe
Stifel, Nicolaus & Co., Inc.

Q

I just had two questions, if I could. The first would be, you've had innovation in particular in the Birds Eye Frozen area really helping your top-line growth rate. You've talked before about a renewal rate of like 4% to 5%. Are you, maybe even in that division, if you look at the specific, or even overall for the company, is that still a good run rate for this year? Are you running ahead of that? Is there anything incremental contribution from new product activity this year?

Robert James Gamgort
Chief Executive Officer & Director

A

4% to 5% was our historical renewal rate. And we've said that we've been more in the 8% to 9% the past couple of years. And so that's still the right target to use. And again, from the previous answer I gave; some years it's going to be higher on one segment and lower on another. But as a company, that's the right way to think about it. And as we've always talked about in context of our portfolio management strategy, we focus on growth and leadership and stability and foundation and leadership brands are higher margin than foundation brands, so you get a mix improvement there. We also get a mix improvement from our innovation pipeline, because all of our innovation is margin accretive. And so a combination of mix as well as productivity versus inflation is why you're seeing a 160 basis point increase in gross profit. So that's all baked into our long-term algorithm and certainly baked into our guidance.

Christopher Growe
Stifel, Nicolaus & Co., Inc.

Q

Okay. And just a question for you on the Duncan Hines division. Obviously it was a strong margin performance. There's a number of factors. It seems like the Wish-Bone savings are starting to come through a bit here. Also, I'm curious have you lowered marketing spending, gotten more into digital and that tends to be more efficient. Has that helped margins as well? And maybe if I can add one more too, that would be, the measured channel data showed a better performance than what you reported in the quarter for Duncan Hines. Was there any fall bake or inventory adjustments that occurred in the quarter as well?

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Robert James Gamgort
Chief Executive Officer & Director

A

No. I'm glad you pointed it out because we track that very closely. If you look at our business, our shipments track very closely with consumption, especially when you look at it in aggregate. But as you point out here, you see some discrepancies quarter-to-quarter. There's nothing significant in that other than just sometimes inventory gets slightly ahead or slightly behind. That means you always rebound. But over the long term – it's true for every business, but particularly ours, shipments match consumption pretty nicely. And so there's nothing unusual in that.

And your point about more efficiency in marketing dollars is very, very true in the Baking segment. There aren't a lot of categories in food where social and digital play such a strong role. Baking, as I always say is as much about a craft or a hobby than it is just food. And so people love to talk about baking; they seek more information; they get advice from each other. And so we've had tremendous success on the digital and social side of marketing Duncan Hines. And that just happens to be more efficient as well.

Christopher Growe
Stifel, Nicolaus & Co., Inc.

Q

Okay. Thank you for the time.

Robert James Gamgort
Chief Executive Officer & Director

A

Okay.

Operator: Our next question comes from Jonathan Feeney with Athlos Research.

Jonathan P. Feeney
Athlos Research

Q

Good morning. Thanks very much.

Robert James Gamgort
Chief Executive Officer & Director

A

Good morning.

Jonathan P. Feeney
Athlos Research

Q

Bob, I wanted to ask about the secret weapon, Gardein. You, it looks like – and correct me. I don't know if there's some seasonality in that business, but it looks like that's running up a good bit, like, I don't know, I'm calculating 50% or so if that $50 million U.S. from last year is evenly spread across the quarters. I wonder where are you in – two questions; where are you in the sort of distribution versus where you want to be as far as getting that product completely in all the places you want it to get and how big could that be?

And secondly, any change – we just saw this corn transaction maybe bringing a little bit more emphasis to the category, or maybe not I don't know. Any change in the competitive landscape in that meatless arena? Thanks very much.

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Robert James Gamgort
Chief Executive Officer & Director

A

Sure. The category in itself is very exciting. And you see what had been a sleepy meat substitute category is now on fire. It's on fire because it's a great alignment with health and wellness, with sustainability and affordability trends. But most importantly it's on fire because the taste and texture have improved dramatically. And so there's almost no trade-off in taste with these products. And so we're really excited about the potential.

And as we've talked about, if you look at this segment as a percentage of total protein sales, it's so small, almost not measurable. But then you take a look at the plant-based milk segment and that's now grown to be almost 10% of all milk. It shows you what the upside could be for this category. So there aren't – we don't look at competitive issues at all; we just look at category expansion and how there's room for a lot of people to play in the segment. And ultimately, the best product is going to win. And we have a lot of confidence in our product.

In terms of our trends, if I look at the syndicated data, on a traditional channels basis, Gardein's up about 30%; little more than that year-to-date. On a natural and organic channel basis, it's up about 40%. So very rapid expansion, a lot of it just driven by velocity as people are trying the product out, coming back for the repeat. We're at about 80% ACV in the natural channel. We're only in two-thirds of the traditional channel. We have a lot of upside in terms of not just expanding that to call it 80% or 85%, but also we have a lot of upside in increasing the number of SKUs per store, because the average number of SKUs per store is only about seven, which is only a small fraction of the line that we offer. So I think the category has tremendous upside. I think we have tremendous expansion.

Our limiting factor has been capacity. As we talked about, we made a $5 million investment in the plant in Vancouver which was a plant that we acquired as part of the transaction to increase its output. And we announced in the past quarter that we made an acquisition of a former ice cream facility in Hagerstown, Maryland to be able to scale that up regarding production. So, really for the foreseeable future, the limiting factor on the growth of Gardein is capacity. And that's a nice position to be in, in an industry where we talk a lot about growth challenges. That's certainly not the case with Gardein.

....

Jonathan P. Feeney
Athlos Research

Q

And just to follow-up on that, Bob. With the Hagerstown coming online, about how much more growth can that support, I mean order of magnitude. Could you double the business with that? Or are you just pretty much there now?

....

Robert James Gamgort
Chief Executive Officer & Director

A

Yeah. What's nice about it is, we are limited in the Vancouver facility now; we can't put any more lines in that facility. So the investment that we put in there was to increase the output – it was to put one more line in there and then increase the output of the existing line. Hagerstown is a footprint for us to grow for the long term. And so it becomes modular at that point with a much shorter lead time and a much smaller investment to increase capacity. So the big investment is to get the site and to fit the plant out to be able to produce Gardein. And then once we're in that position, we can add lines as needed with a much shorter lead time.

....

Jonathan P. Feeney
Athlos Research

Q

Great. Very helpful. Thank you, Bob.

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Robert James Gamgort
Chief Executive Officer & Director

A

Okay.

Operator: Our next question comes from Michael Gallo with C.L. King.

Michael W. Gallo
C.L. King & Associates, Inc.

Q

Hi. Good morning and congratulations on the very strong Birds Eye results.

Robert James Gamgort
Chief Executive Officer & Director

A

Thank you.

Michael W. Gallo
C.L. King & Associates, Inc.

Q

I want to just delve in a little bit there. Just in general terms, I was wondering if you can give us any more color on how much of the growth in Birds Eye volume would you say came from increased shelf space versus increased SKU velocity as you've done the advertising and are bringing in a lot of new people that seem to be coming back on a recurring basis to the category. Thanks.

Robert James Gamgort
Chief Executive Officer & Director

A

Yeah. The answer's going to be, it's about both. So as we talked about in the prepared remarks, about two points of the share growth was driven by the innovation. And remember, that's all consumption-based. So that's Flavor Full and Protein. And it's really early days on Disney that it – that's off to a strong start, but in limited distribution. So a lot more of that growth is to come, but that's what showed up in the third quarter as a result.

As we talked about, about 75% of our distribution is incremental to the Birds Eye business. But as we talked about before, there's a lot of opportunity in the Frozen section with slow-moving SKUs to get additional distribution. So when you come to the party with very strong platforms like Flavor Full, Protein, and Disney, we're able to get about 75% incrementality in our space.

But if you pull that all back, we're still getting tremendous velocity on the core Birds Eye business, excluding these platforms, because our total share for the period was up over three points. So call it 300 basis points of market share growth, 200 basis points of the 300 basis points driven by the innovation platform. That's still substantial growth on the core items that is just driven off of velocity. So we're in a really good place with Birds Eye with kind of everything hitting right now.

Michael W. Gallo
C.L. King & Associates, Inc.

Q

And then just a follow-up to that. When you've run the advertising and what you've seen in terms of your sell-through, does that make you think about more advertising for next year? Or how should we think about TV advertising for 2016?

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Robert James Gamgort
Chief Executive Officer & Director

A

Oh yeah. Our intention all along has been to ramp up our marketing spend over time. And we do it on a ROI basis. So we're going to put the money where we get a good return on investment. And clearly, we're getting a good return on that Birds Eye investment. Also, Birds Eye Voila! which we advertised this year for the first time and you see the growth numbers that we're getting on that business. And we've got some innovation coming on that as well. So our intention is to ramp that spending up over time because we still think we're well below threshold levels.

Michael W. Gallo
C.L. King & Associates, Inc.

Q

Thank you.

Operator: Our next question comes from Kenneth Zaslow with BMO Capital Markets.

Vishal B. Patel
BMO Capital Markets (United States)

Q

Hi. This is Vishal Patel in for Ken. So with Green Giant in the hands of a new owner, how do you anticipate that company to respond with innovation in the brand? And I realize it wasn't primarily focused in Frozen, but do you expect them to make a push there? Thanks.

Robert James Gamgort
Chief Executive Officer & Director

A

Yeah. It would be really early to tell. The deal hasn't even closed yet officially. The one thing I would point out is, because we've gotten a lot of questions about Birds Eye in the hands of a new owner. General Mills is a really good company and a very good competitor. Remember, that business was handled by the General Mills sales force, which is a incredibly strong sales organization. So I think there's this perception that General Mills didn't compete and didn't focus on it, which is far from true.

So our assumption is, going forward we're going to see the same level of competition going forward as we did in the past. But again, as I would point out, a really expandable category. We don't target any specific competitor with our innovation. We're targeting category expansion because we see this tremendous gap between what consumers are eating in terms of fruit and vegetables and the gap between that and what is recommended by the government. And all of our innovation is targeted at solving that gap and expanding the category, not just taking share from competitors. So competition has been the little focus for Birds Eye; it's been all about expanding the category through the opportunity that I discussed. And we'll continue to run the business that way.

Operator: Our next question comes from Farha Aslam with Stephens, Inc.

Farha Aslam
Stephens, Inc.

Q

Hi. A quick modeling question. The good gross margins we're seeing here in the second half, how should we think about that going into the first part of next year?

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Robert James Gamgort
Chief Executive Officer & Director

A

Yes. That's really too early for us to talk about in terms of how to flow that through. Craig gave you some indication on productivity versus inflation for next year. But we'll give guidance on our next call and give you some thought about timing of that. But that's – it's too early for us to talk about that.

Operator: And I'm not showing any further questions at this time. I'll like to turn the call back over to our host.

Robert James Gamgort
Chief Executive Officer & Director

A

Okay.

Maria A. Sceppaguercio
SVP-Investor Relations & External Communications

All right. Well thanks, everyone, for dialing in this morning and spending the time with us. I'll be around all day. So give me a call if you have any questions. And have a great afternoon. Bye-bye.

Operator: Ladies and gentlemen, this does conclude today's presentation. You may now disconnect. And have a wonderful day.

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