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EDITED TRANSCRIPT

PF - Q3 2014 Pinnacle Foods Inc Earnings Call

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and thank you for standing by. Welcome to the Pinnacle Foods earnings call for the third quarter ended September 28, 2014. 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 and Communications, Ms. Maria Sceppaguercio. Ms. Sceppaguercio, please go ahead.

Maria Sceppaguercio - ***Pinnacle Foods, Inc. - SVP IR and Communications***

Thank you Jonathan. Good morning everyone, and thanks for joining us today. Here with me to discuss our results for the quarter are Pinnacle's CEO Bob Gamgort and our CFO Craig Steeneck.

Earlier this morning, we issued our press release for the third quarter. If you need, it is available on our website at pinnaclefoods.com.

Consistent with our reporting in previous quarters, we provided in our press release and will discuss here this morning our results on an adjusted pro forma basis. This assumes that our 2013 IPO and subsequent refinancing occurred on the first day of FY13 and excludes IPO refinancing expenses and restructuring related and other items which we collectively referred to as items affecting comparability. Stock-based compensation expense as discussed previously is now included in our results.

The Company believes the adjusted pro forma 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 it is the most meaningful comparison and the most appropriate basis for discussion of our performance. Details of these (inaudible) items are included in the reconciliation tables included in our press release and are discussed in detail in our 10-Q.

Also reconciled in our press release and10-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 metrics discussed on the call are calculated using this methodology unless otherwise indicated and are also reconciled to GAAP measures in the tables that accompany the release.

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Finally I would 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 will hand it over to Bob.

Bob Gamgort *- Pinnacle Foods, Inc. - CEO*

Thanks Maria, and thanks to everyone for joining us today. As indicated in our press release, we continue to execute well in Q3 and delivered another quarter of volume market share growth in a tough industry environment.

Despite the headwinds of higher than expected inflation and very competitive pricing environment, our gross margin performance was solid due to robust productivity and improved product mix. We continue to expect double-digit adjusted EPS growth for the year and have tightened our guidance range to $1.71 to $1.74 or growth of 13% to 14% versus a year go.

Turning to the specifics for the third quarter starting with the topline, we grew consolidated net sales by approximately 9% due to the benefit of Wish-Bone on top of a 1% increase in sales on the base business. North American retail net sales advanced almost 10% driven by Wish-Bone and base business growth. Importantly, the base business performance was driven by strong growth of the leadership brand portfolio.

We again grew our composite market share outpacing the performance of our categories for the quarter with our consumption up 1%. We held or grew share in 8 of our 13 categories with growth focused in many of our largest businesses.

Turning to margin, we expanded our adjusted gross margin by 40 basis points, excluding the one-time benefit last year of an insurance recovery. While below our run rate for the first half, we are pleased with this performance in the context of both a net pricing environment that remains challenging and second-half inflation that is higher than we anticipated. Strong productivity and favorable product mix including Wish-Bone more than offset these factors.

While net pricing continued to be negative in the quarter, it was improved versus the trend in the first half of the year. Some pricing actions to cover inflation across the industry have begun to make their way into the system as manufacturers are increasingly pressured to cover input cost in what has been a persistently challenging net price environment. We have taken a number of pricing actions for products in which protein is a significant driver of overall costs such, as Hungry-Man, Armour, Malley, and Aunt Jemima breakfast entrees.

Our operating expenses in the quarter on an adjusted basis decreased 2.5% versus year ago despite higher consumer marketing investment as we continue to manage our SG&A expenses well. Interest expense approximated $25 million in the quarter, in line with our expectations, while our adjusted tax rate came in at 38.2%. All of these factors combined resulted in adjusted diluted EPS of $0.41 compared to $0.35 in the year ago period. Finally our cash flow generation, a hallmark of Pinnacle, was very strong in the quarter. Craig will take you through the details later.

Turning to our divisions, Birds Eye Frozen division revenue was even with a year go with volume mix growth of approximately 2%, offset by lower net pricing including a 70 basis point benefit in the year ago quarter from the insurance recovery. Net sales for our frozen leadership brand portfolio were up in the quarter driven by a double-digit gain for Birds Eye Voila!, stemming from the introduction of new family size varieties and distribution expansion. Birds Eye vegetables continue to grow consumption and gain share at a healthy pace in the quarter, although net sales were down slightly in the quarter due to shipment timing.

During the quarter, we launched a third year of our breakthrough campaign to encourage kids to eat more vegetables through tie-ins with Disney, the Partnership for a Healthier America and celebrity chef Melissa D'Arabian. The campaign includes advertising on Disney networks along with PR social media campaigns, in-store promotions and consumer sweepstakes. We're pleased with the response to these initiatives and have exciting plans underway for 2015.

During the quarter, we introduced a broccoli with cheese variety to our Birds Eye Steamfresh line and a sweet potatoes with brown sugar variety to our Birds Eye Steamfresh Favorites line. We also added new varieties to our Birds Eye Voila! family sized line.

Net sales for our frozen foundation brand portfolio were down for the quarter. Strong growth of Hungry-Man driven by the success of recently launched additions to our Selects line was offset by lower sales of Aunt Jemima breakfast products including comping against the year ago insurance benefit. We also invested behind a new packaging structure for Aunt Jemima in the quarter, introducing the first resealable bag in the category.

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In terms of market share for the quarter, our total frozen portfolio again outpaced the performance of our categories, growing dollar consumption of 1.2%. Importantly, all of our frozen leadership brands registered share growth in the quarter.

Adjusted EBIT for the division increased 2.3% despite lapping the $2.7 million prior-year insurance recovery. Excluding this impact, EBIT increased by approximately 8.5%. Productivity savings and lower marketing expense drove the EBIT growth and were partially offset by higher logistics costs and packaging investments.

Our Duncan Hines Grocery division posted another quarter of strong topline growth, driven by the benefit of Wish-Bone and growth of both leadership and foundation brand portfolios. In terms of market share, our grocery division also outpaced the performance of our category. Composite market share grew 30 basis points in the quarter on our 1% increase in dollar consumption.

Among our leadership brands, Duncan Hines, Mrs. Butterworth's and Log Cabin grew share during the quarter while Wish-Bone and Vlasic experienced share weakness. During the quarter, we continued to expand our Duncan Hines baking mix portfolio with the launch of several limited edition and decadent varieties for the fall bake season.

We also introduced Vlasic bold and spicy pickles into regional distribution. Bold and spicy is expected to be incremental for the category and Vlasic, and we plan to expand distribution and support for the new-line during 2015. Adjusted EBIT for the division was up 35%, reflecting the net sales growth including Wish-Bone as well as productivity savings partially offset by higher input cost and increased in investment consumer marketing mainly for Wish-Bone.

Turning to Wish-Bone, market share has begun to improve versus the performance in the first half as we are now lapping more normalized levels of promotion on the business in the year ago period. We're making more progress in the food channel where we grew share in the quarter versus other channels where we still have more work to do. Overall, the category has been weak in all channels.

Earlier this year, we launched an integrative print, shopper marketing and social media campaign leveraging Wish-Bone's heritage and leading share position in Italian dressing. We continue to develop our innovation plans for the brand as we expect a new internal manufacturing capability to be a key enabler.

Profit performance from the Wish-Bone business has been strong and is tracking very much on plan as is the planned start up of internal manufacturing at the end of the first quarter of 2015. As a result, we continue to expect to achieve full run rate EBITDA of $65 million for Wish-Bone during 2015 with the full benefit realized in 2016 consistent with our acquisition model.

Our Specialty Foods division, which includes our private-label food service and snack businesses, posted a 6% increase in sales for the quarter, driven by the timing of private-label canned meat sales and the benefit of Wish-Bone food service. Specialty adjusted EBIT advanced 32% in the quarter, driven by growth in sales and productivity savings partially offset by higher input costs particularly proteins and logistics. With that, I will hand it over to Craig who will take you through the financial details in the quarter.

Craig Steeneck *- Pinnacle Foods, Inc. - CFO*

Thanks Bob and good morning everyone. Starting with sales, our consolidated net sales increased 9% in the third quarter to $624 million, largely driven by the benefit of Wish-Bone as well as base business growth as we experienced strength across our leadership brand portfolio.

North American retail net sales advanced approximately 10%, reflecting a 9.1% benefit from Wish-Bone and higher volume mix of 2.1% on the base business. Partially offsetting this growth was lower net pricing of 1.4%, including a 0.5% unfavorable impact from lapping the insurance recovery in the year ago period as well as unfavorable foreign currency translation of 0.2%.

For our frozen division, net sales were essentially in line with year ago. Higher volume mix of 1.8% was offset by lower net pricing of 2%, which included a 0.7% unfavorable impact from lapping the insurance recovery in the year ago period.

From a brand perspective, double-digit growth of Birds Eye Voila! and strong growth from Hungry-Man were largely offset by lower sales of Aunt Jemima breakfast products. For our Duncan Hines division, net sales advanced 21% due to our 19.5% benefit from Wish-Bone and higher volume mix of 2.5% partially offset by lower net pricing of 0.7% and unfavorable foreign currency translation of 0.4%. The base business growth was primarily driven by Duncan Hines, Vlasic, and Log Cabin leadership brands as well as Armour, Malley's and foundation brands.

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Finally, our specialty food segment net sales increased 5.7% in the quarter reflecting higher volume mix of 4.8% and a 1.4% benefit from the Wish-Bone food service business, partially offset by lower net pricing of 0.5%. For the base business, the growth was driven by private label canned meat, largely reflecting expected timing of sales versus a year go between Q3 and Q4.

Now turning to gross profit, on an adjusted basis, our gross profit increased 9% to $171 million and as a percentage of net sales, was even with year ago at 27.4%. This comparison was unfavorably impacted by about 40 basis points from the year go insurance recovery.

As Bob indicated, in the context of a highly competitive pricing environment, and higher than expected inflation, we're pleased with these results. Very strong productivity and favorable product mix drove the increase versus year ago in the quarter.

Inflation which totaled about 3.5% in the quarter was above our expectations due to higher protein and logistics costs, with the latter driven by constrained trucking capacity in the industry. Productivity was very strong in the quarter at slightly above 4%.

Excluding items affecting comparability, EBIT increased approximately 19% to $101.9 million in the quarter, largely reflecting the growth in gross profit and lower administrative expenses, partially offset by higher consumer marketing largely behind Wish-Bone. Adjusted EBITDA in the quarter advanced 15.5% to $122 million.

Interest expense for the quarter on an adjusted pro forma basis increased 29% to $24.8 million, driven by the debt we incurred from the Wish-Bone acquisition. On the same basis, the effective tax rate for the quarter was 38.2% compared to 38.8% in the prior-year period, primarily reflecting a decrease in the Company's tax liability associated with filing our 2013 tax returns. Adjusted pro forma net earnings increased approximately 17% to $47.6 million or $0.41 per diluted share in the quarter, compared to $40.8 million or $0.35 per diluted share in the third quarter of 2013.

In terms of our outlook for the year, we continue to expect double-digit growth and adjusted EPS and tightened our guidance range from $1.70 to $1.75 per diluted share to $1.71 to $1.74 per diluted share, which represents growth of 13% to 14% versus year ago. This guidance reflects the following assumptions. Input cost inflation is now expected to approximate 2.5% versus 2% previously expected, due to the higher anticipated protein and freight costs discussed earlier.

Productivity for the year is now expected to be in the 3.5% to 4% of comps range which represents the higher end of our previous 3% to 4% range. Overhead related expenses are expected to decline as a percentage of sales for the year.

The effective tax rate has now been reduced to an expected range of 38.2% to 38.4% for the year, reflecting a tax benefit realized in the first three quarters. And finally, we expect interest expense for the year at slightly above $96 million and a diluted weighted average share count of approximately 117 million shares.

Now turning to cash flow. Net cash provided by operating activities advanced significantly in the third quarter to $226 million. This includes the net cash benefit of $151 million from the Hillshire termination fee we discussed with you previously as well as very strong cash flow generation totaling $75 million from our operations. This $75 million compares with approximately $30 million in cash flow generated in the third quarter last year and was driven by our ongoing aggressive management of working capital.

Capital expenditures in the quarter totaled $26.5 million compared to $18.9 million in the third quarter of 2013. For the year, we continue to expect CapEx to be in the range of $120 million to $130 million, including approximately $50 million for the Wish-Bone manufacturing integration and $5 million of CapEx associate with the Duncan Hines manufacturing facility in Centralia, Illinois.

Turning to liquidity. We reduced our debt by $200 million in early Q3 using the net cash benefit from the Hillshire termination fee along with cash on hand. As a result, at quarter end, our total gross debt was $2.3 billion, which includes $1.9 billion in term loans and $350 million in 4.875% senior notes.

Cash at the end of the quarter totaled $140 million, bringing our net debt to approximately $2.1 billion. As expected, this debt reduction, coupled with our strong cash flow generation during the quarter, enabled us to achieve a net leverage ratio of 4.21 times in Q3, triggering the anticipated 25 basis point interest rate step down on our term loans, which is effective immediately.

On an annualized basis, the combined interest expense benefit of the $200 million debt reduction and the interest-rate step down will generate approximately $10 million of improvement in interest expense going forward. And finally, as previously disclosed, Blackstone sold 17.25 million shares in a secondary offering in September including an over allotment option of 2.25 million shares that was exercised by the underwriters in October.

As a result of this offering, Blackstone's ownership of Pinnacle now stands at 36.6%. With that, let's open the call to your questions.

QUESTION AND ANSWER

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Operator

(Operator Instructions)

Andrew Lazar, Barclays.

Andrew Lazar - ***Barclays Capital - Analyst***

Good morning everybody. Just two questions for me. First, you probably saw last week your main competitor in frozen vegetables and baking mixes called out those two categories as areas they've got to get on their front foot from a promotional and competitive standpoint.

As they have lost considerable share in each of them over time, and we see that obviously showing up in your share gains as well. Just trying to get a sense of how that plays out, how you see the competitive dynamic changing or not as you go through the end of this year into the beginning of next year and I have a follow-up.

Bob Gamgort - ***Pinnacle Foods, Inc. - CEO***

Thanks. Yes it's true. If you look at the scanner data across the industry and our categories and for the two categories that I think you're referring to specifically, baking and vegetables, you are going to see they have been very promotional. And while we had a to be competitive, if you drill down that scanner data, you will see that our pricing and merchandising has really been in line with the category average and in some cases we've been less aggressive on price and merchandising, particularly in those categories.

So it's not that we are winning through aggressive pricing and promotion. We are winning through innovation and distribution gains that are associated with the innovation, which is not only one for us from a market share standpoint, but we really view it as a win for customers.

They don't care about market share; they care about category growth as do we. And if we are able to drive new users into the category and even come out with more value-added items that are higher margin for us and slightly higher price points for our retailers, that's the win. That's the game we have been playing, and it served us really well, and we are going to continue to play that game.

Having said that, unfortunately the short-term response from competitors in general who share is price, and some of that you will be able to track in the scanner data and some of it is in the form of things like IRC, on package coupons, instant coupon machines which we are seeing pop up, but you really won't see in the scanner data. And these are pretty classic short-term reactions when you want to recapture share.

So we are all over it. We managed that, and depending on the depth and length of those kind of events, we may have to recalibrate our promotion plan. But be clear, it is not a game that we really want to play and nor do our retailers.

One thing that we mentioned on this call is that we have seen an uptick in inflation particularly in proteins and logistics. So I think that uptick in inflation, which is going to go across the industry, is going to moderate some of the promotional activities in general. But there are going to be cases in specific categories and competitors where we are going to have to be on top of it as we always are.

Andrew Lazar - ***Barclays Capital - Analyst***

That's helpful, and then you mentioned the uptick in inflation. I'm just curious, it's early to start talk about guidance for next year and such. But one of the things that has certainly been a favorable impact for you guys this year has been the trade-off between productivity and inflation and the way that has come through for the year as a whole.

And I get the question a decent amount that as we move into next year, to the extent that you still have obviously a good sight line around productivity, if in fact inflation does become more of a headwind and that trade-off isn't as favorable, does that mean the operating environment for you guys and how you deliver what you are supposed to just gets that much more difficult? Or how do you see that playing out directionally even though I haven't laid it all out yet?

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Bob Gamgort - ***Pinnacle Foods, Inc. - CEO***

Sure, just let me talk about it conceptually because we really haven't laid it out for 2015 yet. We feel really good about our productivity. We gave long-term targets all the way back to the IPO saying we would be in the 3% to 4% cost of goods, and we continue to deliver at the high end of that range.

We keep getting better and better at this productivity program that we call MVP, and we get greater line of sight to the savings because we identified the pipeline earlier and earlier every year. And we have good tools and systems to allow us to track the progress of those projects.

But as you point out, if inflation across the industry picks up, then it chips away at some of the favorability that is generated by that productivity versus inflation relationship. And that leaves you with two other tools. One of them is mix, and we feel really positive about our mix we got from two different levers.

One is by our leadership brands growing faster than our foundation brands and by the fact that all of our innovation is margin accretive. On our next call, we will be talking about some of that 2015 innovation pipeline that we feel really good about.

And the other one is price. And we always use this term because it's true. It is the wildcard in all of this.

And we have taken some pricing actions in areas where we have seen extreme inflation. We are seeing pricing actions across the industry, and I think that's the piece that is hard to predict right now which is what will be the consumer response to -- relatively low levels of pricing.

But again, as the formula you laid out there -- you really are going to have to take some pricing in the industry to be able to offset that. What I like about us and our business model is because we run such high levels of productivity, we always feel like we are the last ones that need to take pricing to cover that.

But I think it will happen across the industry. We will see very targeted surgical -- you could use that word, levels of pricing. You will not see list pricing increase.

Maybe in the form of surcharges, maybe in the form of trade rate reductions. In small areas, but let's be clear some pricing needs to happen across the industry.

Andrew Lazar - ***Barclays Capital - Analyst***

Got it, thanks for your help.

Bob Gamgort - ***Pinnacle Foods, Inc. - CEO***

Sure.

Operator

Bryan Spillane, Bank of America.

David Lee - ***BofA Merrill Lynch - Analyst***

Hi good morning. This is David Lee sitting in for Bryan.

Bob Gamgort - ***Pinnacle Foods, Inc. - CEO***

Good morning.

David Lee - ***BofA Merrill Lynch - Analyst***

Good morning. I just want to just a couple of questions specifically about the baking category given the solid performances Duncan Hines.

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First on just the competitive environment, you have mentioned the category in the recent past is being especially competitive. If you can share a little bit of what you're seeing in the category and whether the environment is more or less similar or has changed.

And second, based on what we can see in the data in the scanner data you have been gaining share. Is this being driven primarily by the innovation especially around key seasons?

Bob Gamgort - ***Pinnacle Foods, Inc. - CEO***

Yes. The baking specifics really play off of previous conversation we just had about the promotional environment in general, which is the baking category is always promotionally intensive. I don't know a time window in which it hasn't been.

And what's really working for us is this consistent level of innovation. Some of that you would say is more permanent innovation. Other elements of our pipeline are really seasonal or in and out, special editions. It is really the combination of all of those that are working really well for us.

So we've got a great plate of innovation for the fourth quarter. We focus it on Decadent and Signature which is at a slightly higher price point, and it's really focused on seasonal items and special editions that the consumer can only get for limited period of time.

We typically sell them in display only vehicles so they don't go on the shelf, they get put out on the floor. And that is what's allowed us to continue to win.

But let's be clear, we have three different pricing tiers in our portfolio. We do the classic Signature and Decadent.

While we innovate very heavily in the Decadent area and introduce items that the Signature price point, we have to remain promotionally a competitive at the classic level because we view those as more interchangeable. And so that something we are constantly calibrating out and we are competitive from a price standpoint.

We feel good about our plans for the fourth quarter. A lot of that gets locked up early. But we know during the share gains we expect a pretty strong competitive response, and that's something we have built into our price.

David Lee - ***BofA Merrill Lynch - Analyst***

Great, thank you.

Bob Gamgort - ***Pinnacle Foods, Inc. - CEO***

Sure.

Operator

Jason English, Goldman Sachs.

Jason English - ***Goldman Sachs - Analyst***

Good money folks.

Bob Gamgort - ***Pinnacle Foods, Inc. - CEO***

Hi Jason.

Jason English - ***Goldman Sachs - Analyst***

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Let's pick up where that last question left off. You have some good success in seasonal -- strong Easter and now strong fall bake.

Hershey always talks about a strong win in the current season typically being a precursor to a strong subsequent season. Do you see a similar pattern in baking?

And then on a related topic, there's been some industry chatter of late that Walmart once again may be curtailing some display activity in its action alley traffic corridors for next Easter. Are you hearing similar chatter, and if so, how should we think about implications for Easter seasonal products?

Bob Gamgort - ***Pinnacle Foods, Inc. - CEO***

Having worked in the category that you are talking about previously, you referenced Hershey, I think what you're talking about are what they were talking about is that when you have a really good season, an Easter or Christmas, that you get positive momentum from the retailer because they than want to bet on you further in the following season. And I think that's very true, and I think that's true with retailers in all situations. When you deliver on your commitments, whether it is a seasonal event or innovation, you build a lot of credibility and you get more latitude to continue to mutually grow businesses.

I think that is critical, and that's why on the seasonals and limited editions, we have been really careful not to flood the market. Because that's the fastest way to have a negative response to these items.

And that's why we have done them as a constrained supply. When they're gone, there gone as we say. And we want to leave people wanting more, and then that's the right way to run this business. The good news is we have a lot of people including me in this organization that have worked on very heavy seasonal businesses, so we know how to manage that.

With regard to Easter we really haven't heard that yet. If you take a look at baking mixes and what their role is in the retailer portfolio, during the seasonal timeframe they're are tremendous traffic draw. And I would be surprised if they were pulled back on items that are traffic draws to their stores because that's really what is needed right now.

And our partnership with Walmart has been very very strong and based on mutually growing our businesses both from a pop on standpoint as well as a profit standpoint. And I don't have any indication that that is going to shift dramatically in the first part of next year.

Jason English - ***Goldman Sachs - Analyst***

Thanks Bob, that's helpful. I will pass it on.

Operator

Farha Aslam, Stephens Inc.

Farha Aslam - ***Stephens Inc. - Analyst***

Good morning.

Bob Gamgort - ***Pinnacle Foods, Inc. - CEO***

Good morning.

Farha Aslam - ***Stephens Inc. - Analyst***

Your relationship with retailers, could you talk about your overall distribution and your performance in the various retail channels?

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Bob Gamgort - ***Pinnacle Foods, Inc. - CEO***

Sure. From a distribution standpoint, something you can pick up in the scanner data, if you look at our total distribution points, you are going to see that they're up year-over-year, which is in my experience the biggest correlation between share growth and all potential drivers is really distribution growth. But you don't get distribution growth unless you're bringing new ideas to the table that have the velocity to justify that space.

And that's what our innovation has done for us. That's really when you dig into what is driving a lot of the share growth it is innovation, also enabling distribution growth I think is the primary driver of our growth.

With regard to how we build our relationship with retailers, an investment that we made in the past couple of years was bringing a bunch of our headquarter responsibility in-house. So the past we had outsourced that when we were a smaller organization, and now we have the internal sales organization that represents the headquarters of retailers, represents more than half of our sales.

And I can tell you when you take a look at our promotional execution in there and those accounts, it's been incredibly strong. We talked on the last call about the reduction in promotional efficiency in the industry, and we said yes, that is true, it is happening across the industry.

But we have seen less of a degradation in promotional effectiveness. In other words our promotions are relatively more effective.

I can connect that directly to our people being out there and really representing our business effectively. Because behind those people in the field, we also made an investment over the past couple of years in headquarter support, category leadership, marketing, trade analytics, that's really serving us well right now in this environment.

I think all of the elements that we just talked about there are really the healthy drivers of growth. Good from a profit perspective and also really good from a retail perspective because that the quality growth they want to see as well.

Farha Aslam - ***Stephens Inc. - Analyst***

Thanks, that is helpful. And as a follow-up on the inflation front on protein and logistics, could you give us some color on roughly how much proteins are up and how much logistic is up or you and how long you expect that inflation headwind to continue.

Craig Steeneck - ***Pinnacle Foods, Inc. - CFO***

Good morning. Yes. First of all, just go back and describe our overall cost of goods. We had $1.8 billion of cost of goods, and there is roughly $550 million to $600 million of that is in logistics and conversion cost.

The residual $1.2 billion is what we will call input costs, and our input costs are -- we have a wide variety in there. So it's a very significant mix.

The higher inflation are ones with low deflation or high level of inflation where we have seen prices come down, tradable grains like wheat, corn, and soybeans. We've also seen reductions in sugar and cocoa. That basket has been enormously positive for us.

Lower levels of inflation, we see that in our core vegetables, internally produced ones, broccoli, cauliflower, packaging and dairy. Those are lower levels of inflation. The warehouse piece is -- warehouse and transportation, mostly transportation on the freight side, has been in the 4% to 5% inflation and, we see that continuing obviously for the balance of this year into next year because that's structural and fundamental in the marketplace.

There is less capacity for railcars because oil and coal are using that. The compensation for drivers is more expensive because there's a dearth of drivers who are available. So those pressures are going to remain.

And lastly on the protein side, our protein input cost basket is around $125 million to $150 million, and we have seen particularly in this third quarter inflation in those core amounts of beef, pork, and Turkey in excess of 20%. And I would say that is likely to continue for the -- certainly the balance of this year and into next year also.

Farha Aslam - ***Stephens Inc. - Analyst***

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Great, that is helpful. Thank you.

Operator

Eric Katzman, Deutsche Bank.

Eric Katzman *- Deutsche Bank - Analyst*

Hi good morning everybody.

Bob Gamgort *- Pinnacle Foods, Inc. - CEO*

Good morning Eric.

Eric Katzman *- Deutsche Bank - Analyst*

It's a good time for you, seems like it's a bad time for everybody else in the industry. Two questions. One, I think you highlighted that Hungry-Man was relatively strong in the quarter. I guess counter to what seems like trends for simple ingredients, health and wellness, organic, that brand with all respect seems like the opposite.

So I'm just wondering why that brand is doing well. What you are doing different that is countering a lot of trends in the market to have success there and then I have a broader follow-up.

Bob Gamgort *- Pinnacle Foods, Inc. - CEO*

Sure thing. We agree when we take a look at the macro consumer trend where we want to invest our money going forward, but in terms of marketing spend innovation and acquisitions is more in the faster growing health and wellness areas. And that's why we are really bullish on Birds Eye which is now a billion-dollar brand.

If we want to align our portfolio against the faster growth streams within the industry, part of our overall mission of reinvigorating iconic brands is to do the best with whatever brand that we have. And what's fascinating about Hungry-Man is it's got a very unique position in the marketplace.

It is comfort food, in ample quantities which is lacking tremendously in that case, in that freezer case. There's core group of users that really love it. There's really no substitute for.

We made a strategic choice a couple years ago I think that runs counter to what is happened in the industry across-the-board which is instead of cheapening the product, we decided to create two price tiers and actually enhance the product quality and price for it. And so within Hungry-Man, we upgraded the product across the board in terms of its flavor delivery, the quality of the food in it, reduced price and then we created a Selects tier which is higher priced items but driven by really good quality food. And the best being our classic fried chicken which is an outstanding product, and our consumers pay for it.

And the growth we're getting now as we decided to expand the Selects line with on trend flavors, pulled pork would be a great example, and you can't do that at an incredibly low price point. You have to charge people for it, and we find consumers are willing to pay for it.

Combination of knowing who you are, having a really unique position in the marketplace and staying true to that position by not cheapening or reducing the quantity which would kill the brand. That has allowed us to do really well and buck the trends in the category. And people are really going for protein right now as you know. One of the things that we are able to do is deliver a lot of protein, and that's something we are going to take more credit for going forward.

Eric Katzman *- Deutsche Bank - Analyst*

Thanks for that. And then the broader question, the group's valuation is quite high relative to the market and relative to history. Obviously at least earlier in the year asset values were going on pretty high multiples.

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You have a core competency and a goal of delivering to shareholders either M&A through debt or reverse trust. Can you talk a little bit about what you are seeing out there? And what should we expect from -- on the M&A front going forward?

Bob Gamgort - ***Pinnacle Foods, Inc. - CEO***

Sure. We have said from the very beginning that we base our PSR on organic growth because that's what we control, but we all know that adding on the right acquisition is a tremendous accelerator for performance and Wish-Bone was a good example of that.

We talked a lot on the last call about the M&A environment. Not a lot has changed, but let me reiterate a couple of points which is one is, we still aggressively drive the pipeline of M&A ideas and the majority of ideas we're working on are those we initiated versus waiting for things, up for sale. They range the entire continuum from small but really strategic add-ons to opportunities that are really transformational.

The barriers to get these really -- good conversations are nice, but we need action. The barrier to go from a nice conversation to action remains tax leakage and stranded overhead for the seller, and to a lesser degree but still there in the past six months certainly are expectations from multiples.

There were a number of deals that went out, Ragu, Hillshire, Annie's that went out at very high multiples. I think some people at stars in their eyes when they saw some of those multiples and expected their assets to trade a lot higher. You're not seeing them trade at those multiples right now, and I think that's a little bit of reality setting back in.

So those are the obstacles we need to work through, and we work through them by creative structuring among other conversations that we have to allow the seller to participate in some of the upside and not be penalized by the tax leakage. The one thing I would point out is we do get this question a lot is if we see something that is small but very strategic, doesn't preclude us from doing something much larger, and I would tell you absolutely not. We have to mine this entire continuum, but going after something that makes a lot of sense at smaller doesn't stop us or even slow us down from going after some of these bigger deals because depending on how you structure it, as we have discussed before, it actually had no impact on debt if you did something like a reverse mortgage trust.

Eric Katzman - ***Deutsche Bank - Analyst***

This is a follow-up to that, maybe Bob or Craig. Is there a -- I know there is a minimum in terms of the reverse trust in terms of doubling your market cap. But is there any issues on the max?

Bob Gamgort - ***Pinnacle Foods, Inc. - CEO***

No. It's fairly complicated, so I will give you the short answer to it. The short answer is the value of the combined Company's, the Company that spins off has to be 51% or more of the combined value.

So roughly, the spinoff entity has to be slightly larger than we are, but there are a number of ways of getting that valuation to calibrate through debt and dividends, et cetera, and that's where it gets very complex. You think about a business that is slightly larger than we are from a profit standpoint.

There's no cap on the size of it. You can go as large as you want. That's the minimum size.

Eric Katzman - ***Deutsche Bank - Analyst***

Thanks I will pass it on.

Operator

Robert Moskow, Credit Suisse.

Robert Moskow - ***Credit Suisse - Analyst***

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Hi thank you.

Bob Gamgort - ***Pinnacle Foods, Inc. - CEO***

Hi Rob.

Robert Moskow - ***Credit Suisse - Analyst***

Good morning. Bob I wanted to know, maybe you could delve a little deeper into Farha's question about distribution gains specifically in frozen. Have you seen retailers making any significant changes about how they allocate door space to competitors?

You can see the Nielsen data showing big declines for at least two of your big competitors. Do you see anything radically changing?

And then secondly, if your price realization in frozen was down 2%, and I want to know if you could comment on that given that you're talking also about inflation in protein. I think a little bit of inflation in vegetables. Did you have any unusual promotional activity to drive the prices down?

Bob Gamgort - ***Pinnacle Foods, Inc. - CEO***

No. Let's go through a couple of these. I think first is when you look at the frozen space, a large section in the store and it is important to retailers from a profit perspective, but it is fixed. Not a lot of movement in the absolute space in there, and as we talked about before, there are a lot of other formats, drug, dollar, that are expanding their freezer capacity because it's a good way for them to offer alternatives to the consumers without worrying about a lot of spoilage.

And even when you see new grocery retailers setting up new stores, they're not shrinking the frozen section. It's really a fixed amount of space and it's a game of how do they allocate that for the maximum amount of growth and sales and profitability, so it's a constant reallocation game.

The dynamics you're seeing is they are making ongoing recalibration based on velocity of different brands and velocities of different categories. Our Birds Eye Voila! business, we expanded distribution on that dramatically because the velocities are incredibly strong. We're now the number one brand in that category and we have been offered more space in many situations and we wanted to take.

So we've got full distribution in many accounts based on our velocities in there. It's always a lagging indicator. The velocities are the leading indicator.

It takes time for the retailers to go through -- do that analysis and quite honestly figure out how they're going to replace that space with something that is faster. That's why we get great receptivity when we bring innovation to the table, particularly in frozen, beaches they really do have a list of things that they would like to reduce space on. And there just looking for the next idea that can actually deliver higher velocity.

I think that's going to continue. It's going to be an evolution from the picture you saw five years ago to what you see today, and five years from now I think the distribution within frozen will look very different. The absolute space will remain the same, but the composition of that space will shift towards those items that are faster growing.

Robert Moskow - ***Credit Suisse - Analyst***

Sure. Price realization for frozen?

Bob Gamgort - ***Pinnacle Foods, Inc. - CEO***

From a price realization side, that is reflective of a heavy promotional environment, and our internal price realization. When you look at this category by category, you're going to see some really different trends within frozen.

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You're going to see in some cases for example -- I think a good example of that is in Birds Eye. In Birds Eye, you can see some negative price realization within our own P&L, but when you take a look at Nielsen or IRI, you may see average price per unit going up.

Some people ask us is that retailer margin? It's not. It's really that we are able to sell higher priced items, so that's either Chef's Favorite which is a more premium item or larger sizes. So we're getting a positive mix benefit of that, although the net price realization on that might actually be a bit lower.

We are operating in a very promotional environment, trying to keep all of the levers balanced nicely between productivity, pricing, inflation and efficiency of promotion. And one of the big hidden opportunities in there is mix.

And I think the example I just gave you on vegetable is one where mix is working in our favor and you can see that in the scanner data. But it might show up as negative price realization on our own internal numbers because we had to be slightly more aggressive to make that happen.

Robert Moskow - ***Credit Suisse - Analyst***

If I go back to February, I think that's when ConAgra announced they were going to rationalize their frozen line to some degree, especially in Healthy Choice. Did that end up benefiting you just in terms of making room for more space this year?

And do you think there is more to come in terms of space gains next year? Was there an unusual one-time benefit from that this year?

Bob Gamgort - ***Pinnacle Foods, Inc. - CEO***

There is no unusual one-time benefit because as I said, there is a long list of items that are slow-moving in the frozen category that the retailers would be happy to replace with something that is really innovative that brings a new benefit to the category. The challenge is the geography. Where are those items and are they adjacent to the category that are growing, and there's a labor to required to make that reset, which is why there is a lag between the numbers and when you actually see the change in space.

And I think typically my experience has been in the industry that the retailer makes a choice to rationalize the lines before manufacturers do. We are usually on the slow side of this, and when we announce rationalization, it's after the retailers have made the decision.

Robert Moskow - ***Credit Suisse - Analyst***

Make sense, thank you very much.

Bob Gamgort - ***Pinnacle Foods, Inc. - CEO***

Sure.

Operator

Matthew Grainger, Morgan Stanley.

Matthew Grainger - ***Morgan Stanley - Analyst***

Hi, good morning everyone.

Bob Gamgort - ***Pinnacle Foods, Inc. - CEO***

Hi Matt.

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Matthew Grainger *- Morgan Stanley - Analyst*

Hi. Craig, could you talk a bit more about the nature of the savings you are achieving on the overhead side both for the quarter and the full-year? I know you have strong productivity efforts in place, but I already think of you as best in class for the industry.

So the question is where is there still you room to get leaner? Where are you getting leaner? And just related, where do you see advertising and consumer marketing coming in as a percentage of sales this year?

Craig Steeneck *- Pinnacle Foods, Inc. - CFO*

I appreciate the compliment, Matt. There are always opportunities to be able to save additional cost, and as we have seen inflation rising slightly in the pricing environment that it is as we discussed, we are continuing to tighten our belts relative to all areas of the P&L and including cash flow management to ensure that we are driving the EPS growth.

Our productivity program absolutely focuses on cost of goods, but we bring indirect spend into that equation also. And we have a new person on board who was looking into our SG&A and other non-cost related spending to be able to find additional improvement. We never stop looking for savings an improvement in that area.

Bob Gamgort *- Pinnacle Foods, Inc. - CEO*

I think we targeted around 9% of sales as our SG&A target, and we said we would hold that at that level as we continue to expand. We haven't changed outlook. That's really the way we think about SG&A.

When you look at it quarter to quarter and year to year, when we see opportunities as Craig points out to be able to push that, we are going to push that really hard. At minimum, it enables us to help offset inflation which is embedded in SG&A which is salary and benefits which is the biggest driver of inflation.

We have some good success with that right now. Taking advantage of some opportunities, but over time we haven't changed our outlook at about 9% is the right target for us. And as you point out, that is the low-end of the industry, so we don't see that as a long-term opportunity.

Craig Steeneck *- Pinnacle Foods, Inc. - CFO*

To answer the second question on what we call direct to consumer spend, really no change relative to that. We see it being summer between 2% to 2.5% of net sales.

As we talked about in the past, that is a very different breakdown on our leadership brands versus foundation where in Birds Eye and Duncan Hines obviously that percentage is going to be a lot more significant and a lot less so on the foundation brands. And obviously the other thing is first three quarters, you get into Q4 now you're comping against Wishbone.

Matthew Grainger *- Morgan Stanley - Analyst*

Okay and I'm not sure if I'm thinking of the right long-term benchmark, but that 2% to 2.5%, where does that stand relative to your go forward targets?

Craig Steeneck *- Pinnacle Foods, Inc. - CFO*

It is consistent. And has to do with the mix between leadership and foundation.

Matthew Grainger *- Morgan Stanley - Analyst*

Okay. Craig another one for you, the growth in specialty, can you help me understand better what happened this quarter, the progression on sales and margin going forward?

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Craig Steeneck - ***Pinnacle Foods, Inc. - CFO***

Yes. Look, we had an extraordinary benefit that came into the third quarter. A lot of private label canned meat business is big business, so we got a one-off positive incremental piece of revenue in this third quarter.

And that's really going to come -- some of that will come out of the fourth quarter. So you shouldn't anticipate that the growth rate you see in specialty in Q3 is something that is going to continue.

Bob Gamgort - ***Pinnacle Foods, Inc. - CEO***

Specialty is the one area where we have our private label and food service which as you know we reduced overtime. The volume comes in -- sales come in a bit lumpier in that division than they do in the other divisions whether it is a big Food Service by or a private label bid.

Sometimes it comes in uneven. We've got a little bit of a benefit from that in this quarter.

Craig Steeneck - ***Pinnacle Foods, Inc. - CFO***

One thing we're very proud of is despite some of the revenues coming down there, the margin in specialty we continue to manage very aggressively, and you see significant increases in margin percentage and quantum in specialty. On a long-term basis we expect that to continue even with a little but lower sales basis.

Matthew Grainger - ***Morgan Stanley - Analyst***

Okay, so excluding that, sales still down but profit still up.

Craig Steeneck - ***Pinnacle Foods, Inc. - CFO***

Correct.

Matthew Grainger - ***Morgan Stanley - Analyst***

Thanks everyone.

Operator

Chris Growe from Stifel Nicolaus.

Chris Growe - ***Stifel Nicolaus - Analyst***

Hi good morning.

Bob Gamgort - ***Pinnacle Foods, Inc. - CEO***

Hi Chris.

Chris Growe - ***Stifel Nicolaus - Analyst***

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Two quick questions for you. I wanted to ask can you say what categories that you have taken pricing in already at least have been announced. Are categories where competitors have moved but you haven't moved yet? Or if you could answer that first please.

Bob Gamgort - ***Pinnacle Foods, Inc. - CEO***

The categories in which we've announced pricing are really protein related. Hungry-Man, Armour, Mally, Aunt Jemima entrees are really the ones we have announced.

We haven't seen a lot of pricing going through and other categories, but when you take a look at the inflationary pressures that are coming, it's something that we expect to happen. And again we are the last ones that need to take pricing because of our strong productivity effort. And so we expect to see some of that going through.

In this type of environment, the pricing is less visible than in the past because it is rare to see an announcement go out with a list price increase. We are more realistically seeing our reductions in trade, surcharges, pieces that are a little bit more under the radar screen.

And so you really have to track your scanner data to be able to see that come through. But again just given the dynamic in the industry and the fact that gross margins as you guys have seen across the industry have been really challenged for the past six months, there are really very few places to go other than try to pass pricing. So I think you will see it across the industry.

Chris Growe - ***Stifel Nicolaus - Analyst***

Related to that, our Company's -- are you approaching pricing with a little more skepticism just given what the consumer is? Related to that, I've got more questions about lower gas prices, a little increase in snap benefits, does that give relief to the consumer that you think is pricing could go through more easily this time around?

Bob Gamgort - ***Pinnacle Foods, Inc. - CEO***

It's less about being skeptical and more about being precise. I can't -- it is tough to take pricing in the past five years. And what pricing used to mean in this industry was you issue a price increase and you have some sort of price protection and you would move on. There is very little of that going on.

We have invested as part of that sales organization boost where we brought our headquarter sales in-house for a lot of our customers and also into a lot of trade and pricing analytics. And so it's really getting down to -- it's much more of a micro pricing strategy where you have to understand the elasticities are different by SKU, by tiers, and that's why we have been more thoughtful about how we have taken pricing and try to do it in small increment that are behind or below the radar screen rather than big list price increases.

Last time we talked, you are right, there are some bright spots in the consumer environment. The unemployment rate continues to decline which we like, and the fuel pricing benefits give some boost to discretionary spending.

The one piece I found a bit sobering that offsets all that is when you look at the exit polls from the recent elections, just how pessimistic Americans were. 80% of people were worried about the future economy, two thirds of Americans thought the economy was getting worse. A big percentage of people, slightly over half thought the next generation was going to live below the current generation.

While there are some bright spots and we are all really encouraged that we will allow some pricing to go through, let's be clear the consumer's not feeling good, and they voted by changing a lot of incumbents out during the last year. I thought it was more telling what the attitude polls were coming out of there. I think something we have to be very careful about.

Chris Growe - ***Stifel Nicolaus - Analyst***

That's interesting, thank you.

Bob Gamgort - ***Pinnacle Foods, Inc. - CEO***

Sure.

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Operator

Michael Gallo from CL King.

Michael Gallo *- CL King - Analyst*

Hi good morning.

Bob Gamgort *- Pinnacle Foods, Inc. - CEO*

Good morning.

Michael Gallo *- CL King - Analyst*

Just wanted to drill in a little bit on Wish-Bone. You've owned it now a little more than a year. Wondering when we will start to see some of the innovation playbooks that you have been able to rollout successfully at Birds Eye and Duncan.

I know you launched the dry mixes recently, but some thoughts on whether that is 2015 we start to see that and also when we might start to see more integration into some of the other lines for example perhaps in the Voila! line or the ability to cross the portfolio. Thank you.

Bob Gamgort *- Pinnacle Foods, Inc. - CEO*

Sure, you're already seeing some of the integration. We have launched a Voila! balsamic chicken, and we co- branded it with Wish-Bone, and we did the testing with and without the Wish-Bone brand on it. And consumer acceptance was higher with that -- with Wish-Bone on the label.

We're doing that are ready, and in terms of promotion whether it be at the trade level or consumer level we are getting more of a portfolio solution to consumers. You're going to continue to see more and more of that. That is just very much in the category of low hanging fruit for us to take advantage of.

With regard to innovation, we made a choice that we want to get our plant up and running, and we see that as a real enabler to innovation. And that's right on track to happen by the end of the first quarter 2015. It also happens to be one of the biggest drivers of where we are getting synergies on this.

And one of the reasons we made this choice is that by exposing our innovation pipeline earlier, we have to get a co-manufacturer. Quite frankly we don't like the idea of showing them our innovation pipeline, and once we leave, we vacate that capacity for them to go out and copy that idea.

So I think what we decided to do on that is get the basic specs on the business, even though some of the shares have been challenged particularly outside of grocery as you point out the profit contribution is right on track with that business, so we have been able to manage it very well. Where bullish about the innovation pipeline we have in place, but we want to get that plant up and going so that we are doing it in-house versus tipping our hand to everybody.

Whether that means somehow the second half of 2015 or the first half of 2016, I don't know as we sit here today. It's something we will update you guys on when we talk about our innovation plans for 2015.

Michael Gallo *- CL King - Analyst*

Thanks very much.

Bob Gamgort *- Pinnacle Foods, Inc. - CEO*

Sure.

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Operator

Andrew Lazar, Barclays.

Andrew Lazar - ***Barclays Capital - Analyst***

Thanks for the follow-up. And for the record but my kids haven't gotten the memo yet on the next generation living below the previous generation.

Bob Gamgort - ***Pinnacle Foods, Inc. - CEO***

Mine seem to think they will be living a much better life as well.

Andrew Lazar - ***Barclays Capital - Analyst***

Just a quick follow-up. I know last quarter and the second quarter industry calls, a lot of discussion from pretty much every company about the ineffectiveness of trade promotion and retail, and there was a little of that in the third quarter as well, but it seems less so.

And I didn't know whether that was just because it hadn't changed and it was still an issue or if you have seen any real change hopefully for the better on that front. But my sense is probably not.

Bob Gamgort - ***Pinnacle Foods, Inc. - CEO***

It's still negative, and as we talked about, we have fairly sophisticated analytics, but if you just look at good old IRI or Nielsen merchandising affects or merchandising efficiency numbers, they're all negative. And again, it is -- I hate talking about relative victory, but it becomes a relative game, and ours are down as well.

They're just not down as much as there are four categories in total, but I think its pretty simple to explain what is going on here. A really weak consumer environment, weak topline for manufacturers, still capacity in the industry and up until very recently a very low level of inflation. A lot of promotion.

And the deeper that you go and the more that you extend the weeks of promotion, promotions start blending into each other, and the sense of what is a real price starts to go away. And that's why promotional efficiencies drop.

People don't load up on promotions like they once did because they know there's another one around the corner. Again, we are using a lot of analysts to make better.

I wish it were great news on that, but I think it's just not being talked about right now because it's a continuation in that store has been told. If there is more pressure from inflation, a reduction in promotion and the Windows start to shrink especially in terms of weeks, you will see promotional efficiencies starting to rebound very nicely.

Craig Steeneck - ***Pinnacle Foods, Inc. - CFO***

Another factor, the second quarter tends to be a period of higher promotional activity. Around the Easter holiday, and the summertime tends to be much less activity in terms of seasonality.

Andrew Lazar - ***Barclays Capital - Analyst***

Thanks very much.

Operator

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Carla Casella, JPMorgan.

Carla Casella - ***JPMorgan - Analyst***

Hi, one question on the debt you paid down. Was the term loan paid down pro rata?

Craig Steeneck - ***Pinnacle Foods, Inc. - CFO***

No. It was all against the large term loan. Not against the Wish-Bone term loan.

Carla Casella - ***JPMorgan - Analyst***

Okay, great. And then on the -- competitive environment and talking about pricing, have you seen any impact of the Albertson's and Safeway talking about investing more in price? When retailers talk more about investing in price, are they pushing back on you for more promotional activity?

Craig Steeneck - ***Pinnacle Foods, Inc. - CFO***

Sure. Any retailer will fund some of that through margin compression. But my experience is that ultimately it goes back to the manufacturers to fund part of it if not the majority of that.

When you look at any retailer specifically, my question is always what's their starting point. Retailer at a high relative price to their competitors in the marketplace, and they will get more competitive on price because they will start matching it? It really was very difficult to comment on these things one retailer at a time.

Carla Casella - ***JPMorgan - Analyst***

Great. Thanks a lot.

Operator

Thank you. This does conclude the question-and-answer session of today's program. I would like to hand the program back to management for any closing remarks.

Maria Sceppaguercio - ***Pinnacle Foods, Inc. - SVP IR and Communications***

Thank you everyone. I just wanted to let you know we will be filing our 10-Q this morning, and I'm around all day if you have any questions. Don't hesitate to reach out. Thanks for listening in.

Operator

Thank you ladies and gentlemen for your participation in today's conference. This does conclude today's program. You may now disconnect. Good day.

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