

Tyson Foods, Inc.

**May 18, 2016
08:10 AM EDT**

Ken Zaslow: We're fortunate again this year to have Tyson kick off the conference. Over the last 6.5 years Donnie Smith and Donnie King have transformed Tyson into a top tier, multi-protein company with long-term strategic and growth targets. Defining expectations repeatedly, the team has taken Tyson's earnings and stock to new heights and Tyson's business model has become more predictable with expansion of its prepared foods business and the structural improvements to its chicken margins.

Instead of a presentation format, we're going to kick off today with a fireside chat with the two Donnies; Donnie Smith, President and CEO of Tyson and Donnie King, President of North American Operations. Welcome, guys.

Donnie Smith: Thanks.

Donnie King: Thanks.

Ken Zaslow: I'm going to kick it off with a pretty general question. And we're going to also keep the app going so please feel free to ask questions. We're going to keep everything going.

My first question is, in 2012 you laid out a target to generate 10% annual EPS growth. As we sit here today, and using the midpoint of your guidance, Tyson will generate nearly 21% annual EPS growth since 2012, far above your expectations. But to be fair, within those years Tyson generated more than 30% in two of those years and less than 8% in one of those years. So my question is in kicking it off, as you look into 2017 and beyond, can you frame how you think of Tyson's outlook in either terms of growth or earnings power and how we should think about it?

Donnie Smith: Yeah. I think we're comfortable saying that we consistently expect EPS growth at least 10% a year. So-- and here's what I mean. As you pointed out, over the last four years we've had a year a little bit over-- a little bit over 10%, a year close to 5% and a couple of years up around 25% or 30%, right? And I-- while it's too soon to call 2017, because I can't say whether 2017 will be better than 5%, less-- above 10% yet, we need some more information before we're comfortable making that call, I'm very confident in saying we expect EPS to grow next year and we expect, frankly, operating income to improve next year.

So let's think through the portfolio. We'll start with prepared foods. So we are seeing

now the volume response that we've been looking for as we get our price gaps right, turn the MAP on, get our merchandising right, and so that gives us a lot of confidence that we're going to build a lot of momentum through the summer that'll carry over into 2017. Chicken feels like to us, while we've still got some grain information, all that kind of stuff we need to know, it feels like it's setting up pretty well again next year like this year.

If you look at pork, pork's projected-- we feel like in 2017 the supply and demand balance will be about like it is this year. Yeah, you got more capacity coming on late in the year, but you're probably going to have more spot coming on. And then beef, safe to say the worst is over and the beef supply cycle. We'll be up about 2%. Probably a little stronger than that in the back half of this year, but about 2% for the year in Fed supply and we think Fed supply will be back up again next year.

So, with any kind of improvement in exports, with any kind of improvement in our international operations, and we're working on all that-- all those things, it feels pretty good that 2017's set up to be another good growth year for us.

Ken Zaslow: Just to kind of make sure I-- does it also depend on how big 2016 is? Is that a fair point (inaudible)?

Donnie Smith: Yeah.

Ken Zaslow: Okay.

Donnie Smith: Yeah.

Ken Zaslow: Just making sure. Look, Tyson recently increased its chicken margins from 9% to 11% and this year is at above 12%. Is there a natural limit to margin-- into the margin structure and are there opportunities for you to further expand the margins beyond the 9% to 11%? And I'm not talking about next year. I'm just talking generally. What is the opportunity? Is there a natural limit to chicken margins?

Donnie Smith: Let me make one quick comment and then I'll turn it over quickly to the architect here. So if there is a limit it's self-imposed and it's based on growth. Obviously consumer demand for chicken continues to be good, not only here but around the world. And our customers want us to help them grow their business and we-- as you know, we're focused on growth. And so we would much rather have a business that is growing in the 9%, 10%, 11%, 12% range than pushing a business to have 14% margins but it's flat to declining because, ultimately, what happens is you end up destroying some of that brand strength. And when you go back to regain that it-- you're going to sacrifice a lot of margin. So if you're focused on your business over the long term, which we are, we would-- we really want to see consistent growth year over year in our volume and keep a good earnings structure. Donnie?

Donnie King: Well, in terms of the limitation, I agree with what Donnie said. We didn't rehearse that. But I don't see a limitation other than one that we would impose upon ourselves. We-- it's been well chronicled over the transformation of our chicken business that we've taken well over \$1 billion out of our cost structure. We did that while improving our mix and getting pricing and other things right, adding to our capacities in terms of value-added capacity. So did a lot of things there to set us up well for the future.

But even with what I said about what we've been able to capture, if you look at the runway ahead there's still just a tremendous amount of opportunity for us in chicken and

we continue to unlock that every day. And we have a full-court press in terms of our continuous improvement projects going on. And seemingly, every rock we turn over we find money and then every rock subsequently after that then we find more money. And it's all about just really wringing out all the waste in our business. The unfortunate part of that is there is waste and the better part of that is we've not unlocked all of it so it's a gift that's going to continue to give us some upside as we move further down the road.

Ken Zaslow: Look, at this point I'd say most investors understand your buy-versus-growth strategy, as well as that you've changed your pricing. The question I get a lot is why are other companies not doing the exact same thing? It seems like, look, you have a plan that's working. It seems like if I was another company looking inside I'd be like, well, let me try and follow this, but people are not [taking] away your margin. And can you talk about what's your capability advantage and why you're able to successfully keep it?

Donnie Smith: Yeah, quickly and I'll let Donnie add. So the real beauty in buy versus grow is that we can take advantage of I'll call oversupply of raw materials in the marketplace at costs during certain times of the year that are often below our cost of production. And we have such a large value-added portfolio, both at food service, a dominant share at food service, and certainly a dominant share at retail. And so we're able to purchase those raw materials and put them into a value-added sale and actually expand margins. So I think our competitive advantage in that is our vast scale in the value-added component of the chicken sold across America.

Ken Zaslow: And what is your market share (inaudible)?

Donnie Smith: In retail we're probably 55% share of retail and we're dominant in food services. It's a little harder to tell because of the way the data flows, but it's huge.

Donnie King: I would just add this to that. I mean there are a number of different business models as it relates to chicken and everyone gets to choose their own. And we made a conscious decision to change our model, one of where brands and being in a number one brand position was important to our model; one where we wanted to add value to products and where we added capacity and so forth for our FP and continue to drive share in that area, but we didn't want to be in the commodity portion of the business.

So key to that model is-- and I won't have these numbers exactly right, but we were close to a 70% pull, meaning consumer pull, on our products, our chicken products, and we've transformed that to something on the order of 85%, 90% pull, consumer pull. And that's part of that whole mix improvement. And very simply the secret sauce in that is we don't have excess chicken pieces or parts to sell. And so going back historically, that 70%, when we were 70% consumer pull, you know what? We really liked a lot of those sells. It's that 30% that we had to dispose of either to Russia in the form of a leg quarter or push into the market because a sale didn't materialize. That's the part we didn't like and it really hurt us from a profitability perspective. So that consumer pull portion or part of our portfolio and the change in our model has really been instrumental in changing and transforming our business.

Ken Zaslow: Another-- kind of keeping with the chicken for a little bit, how much is Tyson insulated from the surge of commodity input prices, but also what if breast prices go up, too, right? So does your model-- again, not today, but in two years from now or a year from now when breast prices are much higher and soybean and corn prices go up, how does your model adjust to that? And is there a risk that maybe you'll be at the low end of your range or below that and how does it work?

Donnie Smith: Sure. Well, in terms of the way the model really works, that excess that I talked about, it's a critical driver of making this model work. So what we did very simply is we reduced our chicken production capability, growing of the animals, and that was on purpose. But we increased our FP capacity and our sales of those value-added products; again, on purpose. And our model is built so that-- with the flexibility so that if chicken margins are really low, if there's excess supply, we have a choice to make. We can grow that animal or we can buy the raw material. So if the market's low or there's excess, we do buy the raw material. In a situation where chicken might be tight, where sales came in much higher than what was projected-- and oh, by the way, we have about a quarter advance on that, to be able to see that. It typically is not a surprise. But then we would grow the animal. We've maintained the productive capability in our model so that we can grow 10% less or grow 10% more and we've already built in the cost structure to be able to handle that either way. So if the market goes up breast meat we would simply grow more animals.

Ken Zaslow: Great. Just shifting gears to prepared foods, one of the key learnings from the Hillshire acquisition, how has bringing Hillshire into Tyson changed your approach across other businesses?

Donnie Smith: I think, fortunately, we're much more consumer driven today than perhaps we were before the acquisition. I'd also say that our focus on driving brand growth and understanding the right categories to be in, and having the right position in the right categories that are both meaningful to the consumer and to the customer, is much better today than it was before that acquisition.

I think Tyson was a good company, right, and had changed their chicken business and was working hard to improve our prepared foods business, but the Hillshire acquisition really unlocked a lot of capability on both the supply and the demand side. A huge turn in our prepared foods business has been on the-- let's call it legacy Tyson side where we had some stranded facilities that were in a back office position; that now we've been able to take that product mix and put it into much more modern and efficient plants. We've closed some facilities to make the total production footprint a whole lot more sustainable for the long term. And so there's been-- and we see a lot of that showing up in the synergies on the supply side.

On the demand side we've just learned a ton about how to generate demand. The revenue management model's, the statistics that the Hillshire team brought to the table around how to understand the return on MAP spending and how to incrementally drive MAP spending at the right time against the right categories, that's-- and we'll use that knowledge progressively into the future.

Ken Zaslow: Can you give us some examples? I always like to hear like really--.

Donnie Smith: Yeah.

Ken Zaslow: Not just the high level, but give us examples of how it's changed.

Donnie Smith: Yeah. So-- well, let me talk about a new one. Let me talk about the innovation pipeline. So before the acquisition we typically had something on the order of a 12- to 18-month innovation pipeline that, frankly, was skewed more heavily probably towards food service, particularly in prepared foods. Now we've got about a 3.5-year pipeline. And there was a lot of synergy around having the R&D and Insights & Innovation teams-- if

you'll remember, Hillshire, most of their food service business was bakery and sweet goods. Most of our food service business was meat. And so when that Insights and R&D team got to look over into the R&D that we had in food service around the meat, oh, there's a great application for that at retail, that kind of thing. So over time there'll be a lot of synergy that comes on the grow side from having that combination. We didn't have that before and that's a powerful tool going forward.

Donnie, you may want to talk about some of the supply and plant configurations and that kind of thing.

Donnie King:

Well, let me add this first. I think it's important to know that the rationale behind the Hillshire acquisition. And we knew that going into that that we could absolutely destroy the value by doing it the wrong way. And doing it the wrong way would have been either doing it the Hillshire way or doing it the Tyson way, which has quite honestly been our history. It would have destroyed the value. What we had to do was not the Hillshire way or the Tyson way. It was to come up with a better way. And I think we've come up with a better way by-- and Donnie talked about some of those examples. But it's-- the model is very simply a high revenue/low cost play which is-- if you look at what everyone in the food space is trying to do now, they're-- many of which have the high revenue but now they're trying to get to low cost. And we got elements of those and we're trying to make that work together.

But we had-- in terms of some of the things that we did, we had an asset that we chose to shutter and we called it the Project Ulysses because the plant was built when Ulysses Grant was President. And so, as you can imagine, there's been a few improvements in the industry since then. And it was a great opportunity to take that cost structure in that plant where we had great people and put it into a more modern facility where we could have an improved cost structure as well as the product quality improvement.

Ken Zaslow:

I'm going to take just one from the audience. Can you talk about the trends in the antibiotic-free products? Is there more margin opportunity there?

Donnie Smith:

Sure. The answer to the second question is yes. So today somewhere between 6% and 10% of the chickens sold in America are probably no antibiotic ever, something like that, if you include both food service and retail. Incidentally, probably a percent or so would be organic. No antibiotic ever gives you two advantages. Number one, I think you get a lot of the halo of the natural component without a tremendous amount of incremental cost, which has to come with the organic because the grain is so much more expensive. I think we're seeing no antibiotic ever grow in double digits, 15% or so growth annually, off a pretty small base compared to the norm. But we've converted a few complexes to no antibiotic ever, so we've got plenty of supply to take care of any demand that's coming our way. We've got two or three of our complexes now that we've already switched to no human-used antibiotics for a customer that wants that requirement.

So we think the trend will continue to grow. I think in terms of raw pounds, certainly no antibiotic ever will outgrow organic. I think traditional, just because of its sheer size - and it's growing at a couple percent a year - in terms of sheer pounds will outgrow both, obviously. But it's going to continue to grow and we're going to continue to be a part of it.

Ken Zaslow:

Obviously doing a very detail-type question, but I feel like there's a lot of confusion out there in the prepared foods volume. Look, there's a discrepancy between IRI data and you guys talk about growth.

Donnie Smith: Yeah.

Ken Zaslow: And I'll be honest with you, I scratch my head a lot on this one and there seems to be a disconnect. Can you talk about where we see the disconnect and how you actually are seeing volume growth? And I'm sorry to kind of--.

Donnie Smith: No, no, no, no. I'll try to keep this fast, okay?

Ken Zaslow: Yeah.

Donnie Smith: So IRI measure all UPC net weight barcode items, right? There are two categories that IRI captures the data on that are important to consider because they make a meaningful difference in the IRI growth, but not in the company's growth. There's one, individually quick-frozen chicken, so think breast meat, wings, tenders, thigh meat, that kind of thing, in a five-pound bag, individually frozen at retail, right? That's net weight UPC'd. That category is probably down close to 30%. Our volume in that category is down in the four-week view probably close to 25%.

Now, so what's wrong with that? Well, the consumer is shifting from frozen breast meat to fresh breast meat. So we're picking up that sale in the non-UPC'd retail case, but you lose the volume in IRI because it's moving from an item with a UPC code on it to a random-eight item that doesn't have a UPC code on it. Now, we can track the volume through perishable groups and other services and we're confident with the growth in our fresh business. We're-- the Company's keeping the volume. Actually, fresh is probably outgrowing the pace that we're losing in IQF.

The second item beyond IQF is a net weight ground beef. We call them chubs. But if you think of roll sausage, like Jimmy Dean roll sausage, you've got a one-pound roll of breakfast sausage, right? But if you look in the meat case, there's also ground beef in a one-pound, two-pound, maybe a five-pound-- we call them chubs, but a roll. Net weight UPC'd. That-- a lot of those items are again going to the meat case in a tray. We don't mind that a bit. Whether it's in the roll or in the tray, indifferent to us. Good margins in both. But in our eye it looks like our volume's going down.

So, when we factor out these net weight beef chubs and we factor out the IQF breast meat that's moving-- or IQF in general that's moving to the fresh case, our volume in the latest four week is up about 4%. And if you compare that to where were we in the 52-week view, probably around flat. And that's-- and so we've been watching that ever since the turn into 2016. We've talked a lot about getting our price gaps right to the competition. And so we're seeing in some of our categories-- smoked sausage is doing phenomenal, breakfast sausage is doing great. Frozen breakfast is-- well, last week in terms of volume growth we had volume growth in all of our core nine categories. One was flat, so I guess technically call it eight of nine, and we were growing share points in eight of nine.

So I feel great about the volume coming to us, but it's hard to see that in IRI. And we've got to figure out a way to unpack that and make that a little bit more visible to you and we're working on being able to do that. Does that make sense?

Ken Zaslow: Absolutely. I'm going to take a couple from the audience as well and it goes towards growth. And I'll kind of lay it out as how much of your growth is going to be expected from acquisitions over the next couple of years? You did actually recently say \$7 billion to \$9 billion of debt capacity. So kind of just pairing in some of these. Is Brazil part of

the growth strategy? Would you-- obviously there's been news about you thinking about going into Brazil. And another part of that question is, a lot of large-cap food companies have announced corporate venture arms to get a better view of the market. What are you doing in this area? So a lot of questions just about growth, either through acquisitions or through mining it through joint-- corporate venture and arms.

Donnie Smith:

Yeah. So before I get to the capital structure issue, let me talk about how we think about growth in general. So if you look at our business, we have advantaged brands in advantaged categories. In other words, a lot of the categories that we're in are outgrowing food and beverage and they're supported by an advantaged supply chain. So we have every reason to believe that we should be able to organically outpace the growth in our categories by at least 1.5 times. So think at retail, if retail refrigerated and frozen meat is going to grow at a percent, we ought to be doing-- we ought to be able to do at least 1.5 times that over time. And I think we're positioned to do very well there. Now, hey, I think pork will grow. Obviously we've passed the low end of the cycle in beef so beef will grow. Our chicken business is growing. So I think we have a great opportunity to continue to sustain organic growth.

That said, we've also got a great balance sheet and a great capital structure to be able to do M&A when it fits. Our most important concern around M&A is does it fit strategically. Let's just use Hillshire as an example, alright? I don't think there's anybody in the room that would argue that the Hillshire acquisition was a tremendous strategic fit and it's created tremendous value, right? Those are the kind of things we're looking for.

So we want to be protein-centric and there's been a little confusion over maybe what that means. Well, here's the thing. Consumers, we know that consumers' consumption of protein is increasing. Certainly the consumption of meat protein continues to increase. But you know the consumption of non-meat protein increases, too. And by that kind of keep in your mind maybe-- well, hey, we do a-- better not say anything about which customer but we do a great-- for example, black bean burger in a QSR. It's a great-tasting burger and this is from a meat guy, right? So consumers-- the consumer demand for those type of items continues to grow and we continue to keep an eye on that because we want to stay relevant with the consumers.

So again, we do have a lot of capacity in terms of the leverage capacity. We've bought back a lot of stock. We keep that in treasury. We've got great cash flow. So I think we're in the position to be able to do a deal that would add to the business.

Talking about Brazil, for example, we sold our Brazilian business a couple years ago; not necessarily because of the geography, but because the business wasn't in a position to win. We didn't have any clear differentiating capabilities. And there's a common-use strategy development tool that talks about where to play and how to win. Well, where to play was not an issue but how to win was. So it wasn't necessarily a geographical issue. It was how that business was positioned. And it's better-- the business is better positioned in the hands it's in now in terms of creating value than it was in our hands.

Ken Zaslow:

In terms of businesses that fit within your strategy, your strategy is reduce volatility, increase earnings.

Donnie Smith:

Yeah.

Ken Zaslow:

You have a beef asset that doesn't seem to fit either one of those characteristics. How does it fit strategically in your model?

Donnie Smith: Yeah, a good question. So again, I think the worst is over in beef in terms of the supply so margins will continue. If you think about our beef business, if we're at the upper half of the range, say 2.5%-3% on sales, that business will have about a 20% ROIC. So it turns cash really, really fast.

But there's a couple of things that are happening that I'm really interested in that we need to take a look at. There are new regulations that are facing our retail customers around the food safety components of grinding beef if your grocery store. We are in more conversations today than we've been in in a long time about case-ready ground beef. And if you look at the-- I don't know if it's the majority, but the largest component of beef sold in the US is going to be ground beef. So there may very well be a good opportunity for us going forward there. Don't know yet, too early to say, but it looks promising.

Now the second thing is, as you know, we're moving into e-commerce. As you know, it's very, very difficult to sell branded fresh meat at retail because the retailer often wants to use that category as a differentiator. We do think, and we've started talking about Tyson Tastemakers, which is a new line of products, a curated line of products that will be sold in the e-commerce channel and a large component of that will be beef. And there'll be some pork and chicken in that line, too. We think there's an opportunity to add a lot of value to beef. So I want to see how those two things play out in our future in regard to the beef segment.

Ken Zaslow: Okay. One would-- or at least I have said so often. One would say, I've said, that we are swimming in hogs, which creates a distinct advantage for our packers. How long does that advantage last and is there a fear that the pork packer margins-- and again, not this quarter, I'm talking about in a year from now, may subside because of the tightening of hog supplies.

Donnie King: Well, it certainly has been very profitable for packers over recent years. And quite frankly, that's the driver for why you're seeing so many producers now want to become packers and that's where all the growth from a packer perspective is coming from. There's still plenty of room in the pork space for everyone to make a decent return there. And quite frankly, the producers wanted a larger share of those packer margins. And so that's the driver in it. There's still going to be plenty of hogs. We've got more capacity, but we needed more capacity because pork consumption continues to grow; not only in the US, but abroad. I mean, on the average, pork production is about a third of the cost here that it would be in China. So it's a huge opportunity to export pork products so we have to grow.

Chicken and pork are used largely-- I mean they're so flexible in terms of what you can do with them and you can think of them as an entree, center of the plate, but they're also a great ingredient meat. You can add flavors to them and breading and they really-- in the way of fully cooked or par-fry they lend themselves with the ability to do that more so than others.

But over the-- let's call it 2016 and 2017, you'll see some moving around and different alignments between producers and packers, but I don't anticipate business interruption as a result of that. I don't anticipate margin compression as a result of that. We'll find a way to-- as industry, certain as Tyson, to find the yes and the win between the packer and the producer in the hog space.

Ken Zaslow: Let me go to the iPad again. What impact is the organic movement having on your

business? Easy enough. In the food service-- we always talk about retail and I know you alluded to it a little bit, but food service is still one-third of your revenue.

Donnie Smith:

Yeah.

Ken Zaslow:

Can you talk about what the environment is, how the margins compare to your retail business and what is the promotional spending among the different proteins?

Donnie Smith:

Traffic is up about 0.5%. As prices have come down, check size is up. We have a major, major food service customer that's now doing all-day breakfast that's driving growth there. And I think we've seen a lot of our QSRs-- if you look-- matter of fact, if you look at where the predominant amount of growth is at food service, it's QSR and then it's-- on the non-national account side it's driven by broad-line distributors. We have great relationships with the customers that are growing in both of those components of food service, so we feel very good about being able to grow in the future.

If you look at the margin structure, in prepared foods about half of our business is food service, about half of our business is retail. The food service margin structure is slightly lower. A lot of the meat components of our food service business have pass-through costing structures. We, working along with our customers, have shortened the cycle in which the pricing and the raw materials converge. In the past there may have been a very long time between the time the raw material changed and when the pricing would change. It's been beneficial for both us and the customer to narrow that and so that's been a key change over the last couple of years.

So our margins in food service prepared foods are slightly less than in retail. In chicken, their margins in food service are about the same as they are in retail. There's going to be times of the year, big seasonal times when they'll diverge a little bit, but if you average them out over the course of a year they're about the same.

Donnie King:

I would add this. If you think about how we're positioned there, is we obviously have all the different proteins along with prepared foods, but we are comparable in size at retail and food service. So wherever the consumer goes, whether they eat at home or away from home and the meal occasion in which they eat, we're well positioned to provide a solution for them on any day part in any channel.

Donnie Smith:

That's a great add.

Ken Zaslow:

So I'm going to end it with one last question for hopefully both of you. And unfortunate, we have like two minutes left. How would you measure your success in three years?

Donnie Smith:

Volume's going to continue to grow. We've got to outpace category growth like we talked about. Margin expansion will continue. At least 10% EPS growth over time. And I'd say this. We-- and Donnie's led the charge here. We're-- we have a very concerted effort to continue to improve the quality of food, the quality of the environment in which our team members produce that food. Our Company's never been safer. And this year we're seeing safety improvements above any year that-- certainly since-- in my tenure as CEO. These guys are doing a phenomenal job taking care of our team members and making great food and making a difference. We're a large company. We're in a lot of communities and we have the ability to make a great social impact and it's important for us to continue to do that. And if we don't do that, I wouldn't consider us to be successful.

Donnie King:

Well, obviously growth and Donnie touched on that. I mean it's critical. To have higher

margins and now be growing to me would be disappointing for us so growth is certainly on that. And I really like what you said, Donnie, in terms of social responsibility and really providing a unique, great opportunity for a team member to come to work and spend their life with Tyson Foods and support their families and do that in a way better than we've provided historically.

Ken Zaslow: Great. With that, thank you so much.

Donnie Smith: Thanks again, Ken.

Donnie King: Yeah. Great.

Ken Zaslow: You're welcome