

08-Aug-2016

Tyson Foods, Inc. (TSN)

Q3 2016 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the Tyson Foods Quarterly Investor Earnings Call. Today's conference is being recorded. If you have any objections, you may disconnect at this time. All participants are in listen-only mode, until the question-and-answer session of today's presentation. [Operator Instructions]

I will now turn the call over to Jon Kathol, Vice President of Investor Relations. Sir, you may now begin.

Jon Kathol
Vice President-Investor Relations

Good morning, and welcome to the Tyson Foods, Inc. Third Quarter Fiscal 2016 Earnings Conference Call. On today's call are Donnie Smith, Chief Executive Officer; Tom Hayes, President; and Dennis Leatherby, Executive Vice President and Chief Financial Officer.

Tyson Foods issued an earnings news release this morning, which has been filed with the SEC on Form 8-K, and is also available on the Investor Relations section of our website at ir.tyson.com. Our remarks today include forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. These statements reflect current views with respect to future events, such as Tysons' outlook for future performance on sales, margin, earnings growth and various other aspects of its business. These statements are subject to risks and uncertainties that could cause actual results to differ materially from our expectations and projections. I encourage

you to read the release issued earlier this morning and our filings with the SEC for a discussion of the risks that can affect our business.

During the call, there will be a discussion of some items that do not conform to U.S. generally accepted accounting principles, or GAAP, including adjusted EPS. Tyson has reconciled these items to the most comparable GAAP measures in the earnings release and on our website at ir.tyson.com.

To be fair to the other analysts, we ask that you limit yourself to one question and one follow-up during the Q&A portion of the call. If you have additional questions, please get back in queue and we'll answer as many of your questions as time allows. I would like to remind everyone that this call is being recorded on Monday, August 8, 2016, at 9:00 a.m. Eastern Time. A replay of today's call will be available on Tysons' website approximately one hour after the conclusion of this call. This broadcast is the property of Tyson Foods and any redistribution, re-transmission or rebroadcast of this call in any form without the expressed written consent of Tyson Foods is strictly prohibited.

I'll now turn the call over to Donnie Smith.

Donald J. Smith

Chief Executive Officer & Director

Thanks, Jon. Good morning, everyone, and thanks for joining us today. We continue to build momentum. Our differentiated business model and our strong performance across all segments are contributing to higher more stable margins. We delivered record third-quarter earnings, operating income, and return on sales. And as a result, we're raising fiscal 2016 adjusted earnings guidance to \$4.40 to \$4.50 a share.

Synergies for the quarter were \$150 million, with \$63 million incremental over Q3 of 2015. Year-to-date, synergies totaled \$415 million, with \$191 million incremental versus the same period last year, and we'll exceed the \$500 million target as planned. We bought back 6.6 million shares in Q3 and another 5.4 million so far in Q4, bringing our total shares repurchased to just over 31 million during the past 12 months. Q3 was an outstanding quarter in what will be a record year.

And now Tom Hayes is on his first earnings call as our new President, will report on our operating segments.

Thomas P. Hayes

President

Great. Good morning, everybody, and thanks a lot, Donnie. I'm really excited to be on the call and looking forward to a lot of interaction, more interaction, with our investors and analysts and, in addition to, leading our amazing team. As Donnie said, I'll take you through the segments and provide color around the results as well as some initial thoughts on 2017.

First, let's look at the Prepared Foods segment. Operating income in the third quarter was \$197 million, with a 10.9% operating margin. Volume, compared to Q3 last year, was up 1.9%, and sales dollars were virtually flat. The lower average selling price resulted from decreased raw material costs and successful pricing strategies to drive volume.

We're particularly pleased with the volume increases in Ball Park hot dogs, Hillshire Farm smoked sausage and lunchmeat. In Q3, we captured 116 million in synergies in the Prepared Foods segment, with \$37 million incremental to third quarter last year. As we look towards 2017, we expect Prepared Foods to remain at the lower

end of the 10% to 12% operating margin range as we continue to invest heavily in innovation, new product launches, and supporting the growth of our leading brands.

Turning to the Chicken segment, Chicken produced operating income of \$380 million, with a 13.9% return on sales. The important call out in Chicken is that we've continued to improve our product mix. We've grown value-added sales by 5% and reduced commodity sales by 10%, which is why the average selling price was up 40 basis points in the quarter where our volume was down 90 basis points versus the same quarter last year. We're being really strategic about our growth. We're growing where we want to grow and it's reflected in the record return on sales. We've restructured our Chicken business to produce higher, more stable margins over time and as a quick reminder, here's how we've done this.

First, we've optimized our cost structure by investing in our operations with good ROIC projects and by taking out more than \$1 billion of inefficiencies from our system. Second, we've diversified our pricing mechanisms. Third, we've upgraded our mix to more value-added branded products to meet demand from our retail and food service customers. Fourth, we've implemented the buy versus growth strategy. And finally, we're providing industry-leading quality and customer service day in and day out.

We expect to finish the fiscal year with an operating margin of more than 12% in the Chicken segment and we think fiscal 2017 will be similar.

Turning to the Beef segment, operating income was \$91 million, with a 2.4% return on sales, compared to a \$7 million loss in the third quarter last year. Volume was up 2.9% as more cattle were available to process, while the average selling price declined 14.6%.

Although we expect fed cattle supplies to increase 2% to 3% in fiscal 2017, domestic availability should increase only slightly due to reduced imports and some export demand improvement. Finally, in the Pork segment, we had another great quarter with \$122 million in operating income and a 9.6% return on sales. This compares to \$64 million and a 5.3% return in Q3 of 2015.

Despite increased production, volume was down 1.7% due to reduced inventories as well as product mix changes. The average selling price was up 7.2%.

Our Pork segment should finish fiscal 2016 with an operating margin above 10% and in 2017, it should be above its 6% to 8% normalized range.

So overall, we expect supplies of chicken, beef and pork to be up 2% to 3% next year. However, domestic demand for protein has been strong. We expect it to continue as prices decline. We'll stay focused on growing sales volume and shifting our mix to more value-added products and we have the unique ability to access multiple channels to meet consumer and customer demand wherever food is sold. This allows us to drive growth and remain a preferred provider with leading brands.

I'm going to turn it back over to Donnie, he's going to expand and give us his thoughts on the macro environment.

Donald J. Smith

Chief Executive Officer & Director

Thanks, Tom. I want to build on what Tom said about growing where we want to grow. Consumer sentiment is mildly positive as unemployment and gasoline prices have decreased, while real GDP and disposable personal income have moved up slightly. In this environment, food-service traffic remains about flat and average check

size is up about 2%. QSR change, which typically drive demand for value-added chicken and prepared foods, are showing the most growth. We're well-aligned with those National Account customers as well as other growing channels in food service.

At retail, efforts to support our brands are paying off. Our Core 9 volume is up 6% for the 13 weeks ended July 24, and our retail fresh volume continues to grow as consumers shift towards the perimeter of the store. We partner with our customers to grow their businesses, which is why our retailers rely on us as category captains for consumer and category insights. Since Tyson and Hillshire came together two years ago, we've more than doubled our category captaincies with retailers to a total of [ph] 143 (9:21).

Innovation also plays a key role in customer growth and therefore ours. Our Vitality Index, which measures the percent of sales from products launched within the previous three years, is projected to exceed 21% for food service and 13% for retail this fiscal year. Those rates are considered best-in-class and include new products like Hillshire Farm Chicken Apple Sausage for convenience stores, cleaner labeled all-natural Chicken for food service distributors, Jimmy Dean frittatas and stuffed hash browns and Ball Park frozen meats for retail and club stores.

We're on track to launch Tyson Tastemakers in e-commerce in the fall and later this month, Tyson Naturals' frozen value-added chicken and new varieties of Hillshire Snacking will roll out at retail. Our differentiated capabilities in both our scalable supply-chain and customer and consumer demand expertise are driving profitable growth in the marketplace. We see this across the key metrics including the category captaincies and the Product Vitality Index that I mentioned earlier. And we expect this to continue as we have the organizational capacity and the resources to drive growth and higher, more stable margins.

Through our strong sales team, we continue to foster strategic customer relationships and leverage our consumer insights, innovation, culinary expertise, service and quality to grow with our customers, develop channels and build brands that will propel us forward. Obviously, we have a lot to be excited about as we finish fiscal 2016 and move into fiscal 2017, which we expect to be another record year and another year of growth.

Now, I'll turn it over to Dennis, who will report on the quarter and give you some early thoughts on next year.

Dennis Leatherby

Chief Financial Officer & Executive Vice President

Thanks, Donnie, and good morning, everyone. Q3 was another great quarter as we delivered record earnings due to strong results across each of our segments. The investments we have made in our brands in optimizing mix across the entire portfolio, has been evident in the growth of our earnings in 2016.

Being a growth company, we see tremendous value in our shares. In Q3, we were able to repurchase 6.6 million shares for \$425 million. So far during the fourth quarter of this year, we've repurchased over 5 million shares for \$380 million. In total, since August of last year, we have repurchased over 31 million shares for just under \$1.8 billion at an average price of about \$56 per share, which underscores our commitment to continue returning cash to shareholders.

Total company return on sales was 8.2%, a record for our third quarter. Operating income was \$767 million, representing a 35% increase over adjusted operating income from Q3 a year ago and also a record for the third quarter.

Our record third-quarter EPS of \$1.25 represents a 51% increase over \$0.83 per share in Q3 last year. On an adjusted basis, Q3 EPS of \$1.21 was also a record and a 51% increase over last year as well. It's important to note that on an adjusted basis our last 12 months' EPS is \$4.26.

Our operating cash flow through three quarters was \$1.9 billion, and we spent \$515 million on capital expenditures. This outpaced our depreciation by \$55 million as we continue to invest in projects with a focus on delivering high ROIC. Our effective tax rate in the third quarter was 31.8% and 33.9% on an adjusted basis.

Net debt-to-EBITDA for the past 12 months was 1.7 times. Including cash of \$197 million, net debt was \$6 billion, and total liquidity was \$1.3 billion. Net interest expense was \$58 million during Q3. For the quarter, average diluted shares outstanding were 388 million.

Now here are some thoughts on full year fiscal 2016 and some early thoughts on fiscal 2017. We expect revenues of approximately \$37 billion for fiscal 2016 and growth in revenues for fiscal 2017. Net interest expense should approximate \$245 million in fiscal 2016 and \$225 million in fiscal 2017. We currently estimate our adjusted effective tax rate to be around 34.8% for fiscal 2016 and 35% for fiscal 2017.

In fiscal 2016, CapEx is expected to approximate \$725 million. In fiscal 2017, we expect CapEx to increase as we continue to focus on projects that create long term shareholder value. Prior to adjusting for any additional share repurchases subsequent to this call, and based on our average share price so far in Q4, we expect our average diluted shares to be around 381 million.

Our last 12 months' adjusted ROIC is 17.5% and is expected to be over 18% by the end of this fiscal year. This is approaching our pre-Hillshire acquisition ROIC of 20.5%, which further illustrates not only the strength of our earnings power but also our commitment to creating incremental shareholder value.

We generated a record \$2.8 billion in operating cash flows the past 12 months, which we used to invest in over \$730 million in CapEx projects, retire \$638 million in notes, which matured in Q2, at a coupon of 6.6%. We also returned approximately \$200 million in dividends to our shareholders and repurchased over 31 million shares for just under \$1.8 billion including repurchases so far in Q4.

So far in fiscal 2016, each segment is operating within or above their normalized ranges. The strong performance of each of our segments gives us confidence to raise our adjusted EPS guidance to a range of \$4.40 to \$4.50 for fiscal 2016. This new range is 40% over our fiscal 2015 adjusted EPS and represents a four-year CAGR of 22%.

And while we stay focused on wrapping up a record year for fiscal 2016, we expect growth in sales, operating income and EPS in fiscal 2017, as we believe the Chicken segment should be over 12% again. Prepared Foods margin should be near the low end of its normalized range of 10% to 12% as we continue to invest heavily in innovation, new product launches and the growth of our brands, our Pork segment should be above its normalized range of 6% to 8%, and the Beef segment should be toward the upper end of its normalized range of 1.5% to 3%.

In closing, the evolution of our business model to produce strong stable margins has set us up for another record year. The bar is set high for 2017 as we come off 40% EPS growth in fiscal 2016, but we're excited about the momentum we are generating, which gives us confidence to achieve high-single digit growth for fiscal 2017. This concludes our prepared remarks.

Tony, we're ready to begin Q&A.

QUESTION AND ANSWER SECTION

Operator: Thank you so much. At this time, I'd like to open up the lines for question-and-answer. [Operator Instructions] We have our first question from Mr. David Palmer. Sir, your line is now open.

David Palmer
RBC Capital Markets LLC

Q

Thank you. Good morning.

Donald J. Smith
Chief Executive Officer & Director

A

Good morning.

David Palmer
RBC Capital Markets LLC

Q

Clearly, fiscal 2016 is going to be a big year and, obviously, that means difficult comparisons, as you mentioned. You also mentioned that you expect growth in next year, but didn't specify that 10% plus, which, for you, has been a long-term annual target. How are you thinking about fiscal 2017 and, specifically, what are the key variables in your mind that will help or hurt you with regard to getting another year of growth or maybe even that 10% next year?

Donald J. Smith
Chief Executive Officer & Director

A

Yeah, sure, David. Let me take that one. So it's early. So if the question is, is it possible to do better than high-single digits, let me put it this way. With what I know today, I'm very confident in saying high-single digit EPS growth. The potential is there for more. So the short answer is, yeah. We can. Keep in mind, as you mentioned, that is coming off a year of EPS growth over 40% and, as Dennis mentioned in his comments, a four-year compounded growth rate of 22%. So here's the way we're thinking about how 2017 is shaping up.

So in Prepared Foods, we're now seeing really solid volume gains across food service and retail just like we thought we would when we got our price gaps right, when our merchandising took effect, when our advertising hit and of course, we're driving really strong innovation, as I mentioned in our comments. So we feel really good about the momentum we have now and taking that through back to school into our fiscal 2017.

Our Chicken business continues to do great. We continue to value up our mix, as Tom mentioned in his comments, and we continue to drive out inefficiencies from the business. So I think Chicken looks like it set up to have another good year of very solid growth and great earnings. In Pork, as we look at that segment, we hear a lot and it's true, that there is more capacity coming online, but we see that capacity coming late in calendar 2017, probably more affecting our 2018 than our fiscal 2017 and we do see about 2%, maybe a little bit more, increase in hog numbers out there. So there's going to be plenty of hogs around and, typically, when the supply is good, then that means another good year for us and that's certainly what we're expecting.

Similar story in Beef. Beef supply continues to grow. We think that fed supply will be up about 2% to 3% next year. Fed supply is moving. We think that the increase will be probably felt greater in the north, which probably benefits us a bit, and then on top of all of that, David, we've got the ability of great cash flow and we'll be returning

a lot of cash to shareholders in buybacks. So that's why we continue to have a lot of confidence about 2017. Feel very good about upper-single digits now and, certainly, if there's more there, we're going to get it.

David Palmer

RBC Capital Markets LLC

Q

A quick follow-up to that is, and I think this really is a controversy, or at least a question in people's minds, is how much is this an issue of controllables versus non-controllables? For instance, in the Chicken segment you have controllables, such as your mix of value-added chicken, maybe even the smaller bird mix and buy versus grow, but there are other cyclical factors like corn prices or whether those small mid-size bird prices continue to hold up. How are you thinking in terms of what is controllable and what is perhaps a big macro variable? Thanks.

Dennis Leatherby

Chief Financial Officer & Executive Vice President

A

Right. So let me – I want to address the grain thing and I'd like Tom to address controllables versus non-controllables and how we view that. So if we look next year at what the forward curve in the corn and soybean market has given us, it looks like the next year is going to be pretty much flat to this year. So we feel good about the way next year is structured. I don't want you to say – I don't want you to think though that corn prices necessarily determine our chicken margins. We diversified a lot of our pricing strategies, which Tom will talk about in a second, to be able to insulate us from that and that's really been our story. Tom?

Thomas P. Hayes

President

A

Yeah, just say, David, in the prepared remarks we talked about the model how it's changing in chicken. And we're getting more specific about this because obviously, it's a huge driver of value. Where we want to grow, we are growing really successfully in both retail and food service in the Chicken business. And what offsets that are the categories where we don't want to grow. So leg quarters, byproducts. That's a part of our business that we just aren't focusing on and we actually have been doing great internalizing more of those leg quarters for our own use on first order value-added products.

So as Donnie said, the pricing mechanism that's a huge driver for us. We've been doing a lot of work on that. And so continuing to drive value-added, it should give you the confidence. We'll continue to talk about that. You'll see it in the numbers, it turns into the right margins, we're focused on volume and margin and executing buy versus grow, and continuing to focus on innovation, value-added service quality. That's the answer but that's where we are going.

David Palmer

RBC Capital Markets LLC

Q

Thank you.

Thomas P. Hayes

President

A

Welcome.

Operator: Thank you. We have our next question from Mr. Tim Ramey. Sir, your line is now open.

Timothy S. Ramey
Pivotal Research Group LLC

Q

Thanks so much. Donnie, you've done a remarkable job with the company. It seems to me that you're sort of kind of one acquisition away from getting this company to where you might wanted to be more – maybe in a more solidly, in the double-digit EBITDA margin camp. I think you've done two quarters now of double-digit EBITDA margins, which is incredible relative to history. How would you react to that comment? And what does the lay of the land look like for M&A?

Donald J. Smith
Chief Executive Officer & Director

A

So, Tim, the great thing about our business is how much organic growth opportunity we have. Protein is obviously very important to consumers, not just in the U.S. but around the world so it's great to be a protein-centered company. And then when you look at the categories that we're in and how consumers are shifting demand, for example, more towards fresh, more towards value-added, seeking more convenience, that kind of thing, that just plays into our wheelhouse because that's what we do.

When you layer on top of how the consumer is shifting, our ability to understand the insights and how to use those insights to drive innovation, those are really key building points to continue in this organic growth story. And of course, we're going to be focusing as Tom mentioned on growing at both retail and food service and value-added poultry and in Prepared Foods. Of course we've got all the raw materials back behind that, that we need and we continue to work on ways to add value to those. So it's just a great organic growth story there.

Now, I'll turn it over to Dennis a little bit and let him talk about our capacity. But certainly, our M&A strategy that is all around first strategic fit, then making sure that target can provide the type of return that we're looking for, and then we also look at the execution and the cultural fit of that kind of target. So, Dennis, do you want to talk about capacity and such?

Dennis Leatherby
Chief Financial Officer & Executive Vice President

A

I think the good thing about what's going on with our strong cash flow and our deleveraging even though we're largely keeping debt flat since March, is that our debt capacity has expanded to the point where we could easily do a Hillshire-size acquisition so long as it's at the right price, we can create the right synergies and generate the right returns. So we're really in good shape there.

Timothy S. Ramey
Pivotal Research Group LLC

Q

Sounds good. So don't need M&A, but M&A could be a positive for the future?

Dennis Leatherby
Chief Financial Officer & Executive Vice President

A

Yes, sir. That's a great way to look at it.

Timothy S. Ramey
Pivotal Research Group LLC

Q

Okay. Thank you.

Dennis Leatherby
Chief Financial Officer & Executive Vice President

A

Thanks.

Operator: Thank you. We have our next question from Mr. Adam Samuelson. Sir, your line is now open.

Adam Samuelson
Goldman Sachs & Co.

Q

Yeah, thanks. Good morning, everyone.

Thomas P. Hayes
President

A

Morning.

Dennis Leatherby
Chief Financial Officer & Executive Vice President

A

Morning.

Adam Samuelson
Goldman Sachs & Co.

Q

Maybe some questions in Prepared Foods, if you don't mind. Maybe first, the guidance for the year of margins at the low-end of the normalized range. You're at 10.9% exactly for the first three quarters, so can you maybe bridge how margins are actually down year-over-year in the fourth quarter, with synergies and lapping some of the AI issues last year? And then with the synergies that you should have incrementally in 2017, can you scope – kind of seems like a really big step up in new product innovation and marketing spend there, but help scope some of the spending bridge for 2017 in Prepared Foods? Thanks.

Thomas P. Hayes
President

A

Sure. Hey, Adam. It's Tom. So what I'd say, and as it relates to this quarter, there is a bit of noise. We had some plant closures that are rolling through the numbers, but the biggest item is that we are investing to grow the business. As we talked – going back several quarters ago, we had a [indiscernible] (27:45). We're trying to resurrect the volume that we had sort of previous to a lot of the input price declines, input cost declines, and we've done it.

The growth has been substantial in our Core 9. So the theme is we're going to continue to invest. We're going to make sure that we have the position on the shelf. I think 2017 is setting up to be a year where there's going to be a lot of protein available. We want to make sure we have the right shelf position, and innovation, as you called out, is going to be significant.

So for the quarter, I'd say there's a bit of noise, but it's really investment we put in the business. And it's showing in the volume results. As we look to 2017, it's really more of the same. We're going to continue to invest and drive growth particularly through innovation, and we'll talk a lot more about that in the future quarters about how that's setting up and what you should expect.

Adam Samuelson
Goldman Sachs & Co.

Q

Okay. And then maybe just a follow-up in the Pork market. There's been some volatility in hogs and bellies and hams in the last couple of weeks. And I would agree that the market's setting up pretty favorable for the back half of this year, but can you talk about the market volatility that you're seeing in the Pork market and some of those values of late?

Donald J. Smith
Chief Executive Officer & Director

A

Yeah, same volatility you've seen, Adam. Of course, belly prices have dropped precipitously, and that kind of thing. What we do is we just stick to our plan. There's a good supply of hogs coming our way. We've got great business out in front of us to add value to those raw materials, which we do. We'd love to see export markets a little better than what they are, but I think over time that could help a little bit.

We don't really use – we said back years ago, we don't really use the freezer as a customer, and we don't. We have a plan for fiscal hedges on bellies. We continue to execute that plan, and then the raw material favorability will work its way in through the pricing over time. Food service reacts a little faster than certainly the retail does, but ultimately that raw material cost will find its way back to the customer.

So, yeah, I echo the volatility. We're weathering it just fine. We're getting into a better demand period certainly than what we've come through, so we feel good about our Pork business on through 2016 and then another really, really solid year in 2017.

Adam Samuelson
Goldman Sachs & Co.

Q

All right. I appreciate the color. Thanks.

Donald J. Smith
Chief Executive Officer & Director

A

Sure.

Operator: Thank you. We have our next question from Ms. Farha Aslam. Ma'am, your line is now open.

Farha Aslam
Stephens, Inc.

Q

Hi. Good morning.

Thomas P. Hayes
President

A

Morning.

Dennis Leatherby
Chief Financial Officer & Executive Vice President

A

Morning.

Farha Aslam
Stephens, Inc.

Q

Can we talk about Chicken? And you highlighted the value-added. Is that improvement coming more in food service? More in retail? Tyson brand? Could you give us more color on where that benefit's coming from?

Thomas P. Hayes
President

A

Sure. Hey, Farha. It's Tom. What we've seen is both in retail and food service – to answer your question, it's more in retail. Overall consumer products, so food that Tyson sells to consumer retail stores, and otherwise we have been – year-over-year, we're doing great. We have fantastic volume growth. As it relates to chicken specifically, that's where the largest benefit is coming from. The Chicken business in food service is strong and I would say getting stronger. So it's not – we don't make either/or decisions because all that business is very profitable to us. When we talk about value-added, if you think about our retail and food service businesses collectively, that's what we mean. So it's primary products that we're focused on. And so it's been in this quarter, I would say more retail benefit. But in looking forward, I think we're going to be well-balanced in both channels.

Farha Aslam
Stephens, Inc.

Q

That's helpful. And just circling back on Beef, your commentary on Beef, particularly for next year is probably the strongest I've seen it in years. Is that sustainable for a longer period of time than just kind of going into next year, given the cattle cycle tends to be long? Could you give us just more color on what is your largest segment in terms of sales?

Thomas P. Hayes
President

A

Yeah, so a couple of things about Beef. So it looks like that next year's fed supply will be up I think a little better than 2%, maybe even approaching 3%. But certainly somewhere in that area. And if you look out another two or three years past that, I think you can count on the same thing, but maybe barring another drought like we had three or four years ago. So it looks to us that the fed supply will continue to increase. And as the fed supply continues to increase, that certainly having more cattle available to process improves our business.

There's another thing that I think helps us with our outlook or feel more and more positive about our outlook on Beef and that is the continued growth of our case-ready offerings. Coming up in, I believe it's October, there is a new regulation on retailers around having to keep up with where the raw material comes from as they grind ground beef back of house. And I think that portends a bright future for our case-ready grinds business. We've certainly been in lots of conversations, and we have the capability to do a lot more of that business than we're doing today. So that could also help improve our Beef margins over time. So we've got a solid outlook and feel very, very good about that part of our business.

Farha Aslam
Stephens, Inc.

Q

That's helpful. Thank you.

Operator: Thank you. We have our next question from Mr. Akshay Jagdale. Sir, your line is now open.

Akshay Jagdale
Jefferies LLC

Q

Good morning, and congratulations on a really good quarter.

Jon Kathol
Vice President-Investor Relations

A

Thanks.

Akshay Jagdale
Jefferies LLC

Q

Can you talk just about Beef a little bit? So this quarter, relative to what we see in the industry spreads, which are tracked by various sources, your performance is still lagging after four years or five years of outperformance; pretty consistently last couple of years and quarters have not been as good. I'm guessing that's all related to the international markets where you have a greater share. So first, tell me if I'm thinking about that correctly. And second, are you expecting that to reverse next year in your guidance commentary or will that be even an upside factor?

Dennis Leatherby
Chief Financial Officer & Executive Vice President

A

Akshay, so certainly, the export factor is a part of it. We do over index, particularly into Asia. And with the drop credit being down some 15% or 20% versus a year ago and those markets being a little softer than we'd like them to be and certainly the values going to those markets being a little softer than we'd like them to be, that has affected us versus the competitive set. But there's another factor I think that needs to be weighed in. If you look at the regional disparities in, let's call it the southern region of cattle procurement and the northern region, we way over index. In terms of our slaughter capacity in the north and cattle in the south have been about \$1 a hundredweight.

So somewhere on the order of \$8 a head cheaper than cattle have been in the north. We think that, that will change over time as some of the smaller feedlots that tend to be in the north closer to the grain begin to increase capacity as the supply of cattle increases. So we think that favors us going forward, certainly from where we have been. So I think those are the really the two biggest factors. Our plants are running great, our efficiency, all that – all the stuff that Steve and his great group are doing to manage the business are in good shape. Those environmental factors are what they are and we'll continue to manage them over time.

Akshay Jagdale
Jefferies LLC

Q

And then just one sort of longer-term question, which is, probably, related to two segments Prepared Foods and Chicken. So you mentioned organic growth opportunities. I feel like the biggest opportunity long-term is to improve the branded mix and sort of the margin mix if I may. So can you give us an update on sort of Core 9 where you stand? The volume performance, obviously, was a big turnaround so that's positive, but over like a three to five-year period like where is your Chicken business relative to where you think it could be from a branded mix and a margin mix perspective? Thank you. I'll pass it on after that.

Thomas P. Hayes
President

A

Okay. Thanks. Akshay, it's Tom. Yeah. So to think about the way that we are growing or have grown the Prepared Foods business, the retail branded portion, the same approach is going to be applied to and soon it's starting to be applied to the Tyson brands in Chicken. So overall, speaking to the Core 9, we have, like I said a lot of innovation in the pipeline. There's a lot of great things that are already out there in the marketplace, Jimmy Dean hash browns, Jimmy Dean frittatas, new Hillshire Snacking platform, which Hillshire Snacking is going very well by the way.

So it's going to be definitely on the back of innovation. There is no question about that and applying that to the Chicken segment, your question in particular, we see there's going to be plenty of opportunity for us to drive growth in areas that right now there hasn't been a lot of innovation. I think of the fresh tray pack chicken has been relatively static for years and years. And we like that opportunity for us to continue to think about how it can be different. So I'd expect you to expect that our innovation efforts against the entire portfolio, Chicken and Prepared Foods will deliver some significant benefits and we'll be talking like I said more about that in the future quarters here but we are planning the same model in terms of marketing innovation to Chicken as we have historically to the Prepared Foods business.

Akshay Jagdale

Jefferies LLC

Q

Thanks. I'll pass it on.

Operator: Thank you. We have our next question from Mr. Ken Goldman. Sir, your line is now open.

Kenneth B. Goldman

JPMorgan Securities LLC

Q

Hi. Good morning, everyone. Thanks for taking the questions. I wanted to ask about the Other segment. I know it's not the biggest segment. I realize it's hard to forecast but I think you're guiding to another loss of roughly \$90 million or so next year. I think maybe investors were hoping for something a little bit better than that. So can you just update us a little bit on the longer-term outlook for this segment and what the strategy might be from here?

Donald J. Smith

Chief Executive Officer & Director

A

Yeah, I'll let Dennis comment on some of the Other, I'll comment on some of the Other. So let me talk about China in particular. So our China business continues to improve over expectations year-over-year. As Sally and the team work to shift our strategy from being a customer-centric strategy to be more of a consumer-centric strategy, we are seeing that that long-term will provide, we think, significant value. And she has a new general manager in China in place, a new sales lead in place. We've got a very, very strong team in China and I'm very optimistic about their ability to continue to improve over time.

I will say though that the dynamics in that market are very difficult. Corn and soybean meal are significantly higher in China than they are here in the United States. And the wholesale markets, you know, we're still somewhat beholden to the wholesale markets because we haven't made a full switch into value-added retail yet. So the wholesale markets continue to be weak and quite a bit weaker than we would've thought the wholesale pork market would've indicated. Usually those two markets move in concert. The wholesale pork market has moved up and chicken has not moved up near as fast as the wholesale pork market has. So very difficult operating environment, but the team's doing a great job strategically turning that business. Now there's some other stuff in Other and I'll let Dennis address that.

Dennis Leatherby

Chief Financial Officer & Executive Vice President

A

Right. So, Ken, what also is in Other is kind of in that bucket of expenditures that doesn't necessarily apply to segments. So for example merger and integration costs have been in there. And to a lesser degree, we also have our SAP activities. We've had one launched. And we're in the process of another upgrade over the next year. So you'll see some of those cost in there as well.

Kenneth B. Goldman

JPMorgan Securities LLC

Q

That's very helpful. Thank you. And my follow-up and I'll be honest, I've been jumping back and forth from calls so just cut me off if this has been asked already, but I think you reduced the tailwind from raw materials in your Prepared Foods segment to [ph] 240 from 300 (41:49). I was a little surprised by that just given what we've seen in hog and pork prices lately and how precipitously they've fallen. I realize that the segment is a lot more than just those two, but maybe if you could help us understand what's driving less of an input benefit to that segment, that would be useful.

Donald J. Smith

Chief Executive Officer & Director

A

Yes. I don't know specifically that we were seeing the exact same thing. What I would say, Ken, of for our Prepared Foods business, a lot of the pricing, when we have input costs deflation it flows through pricing at a pretty significant way. We try to, of course, continually decrease trendline margins over time, but that's kind of whatever benefit we would see, there's a large part of that that flows straight through to pricing reduction. So whatever movements that we would see up or down, that's our intent and like I said trying to make that less volatile over time in terms of our earnings is all about brand investment, innovation investment and continuing to drive the agenda there. And that's sort of the way that we think about fluctuations in commodity cost inputs through the Prepared Foods business.

Thomas P. Hayes

President

A

Ken, we'll have, Jon, dig in a little deeper on your question. He can follow up maybe a little later in the day. Okay?

Kenneth B. Goldman

JPMorgan Securities LLC

Q

All right. Thanks, guys.

Operator: Thank you. We have our next question from Mr. Michael Piken. Sir, your line is now open.

Michael Leith Piken

Cleveland Research Co. LLC

Q

Thank you. Good morning. Just wanted to dig a little bit deeper into Prepared Foods and just trying to understand when we might expect to start to hit the top-end of the range, just looking a couple years out, what type of things would you be looking for to reach the top end? And at what point do you sort of start to parse where your brand spending initiatives have been more successful than others? Thanks.

Thomas P. Hayes
President

A

Yes. So, Michael, it's Tom. We haven't set guidance as it relates to where we think we're going to hit the top end. What we have done is really spent a lot of time on what our innovation pipeline is setting up as and I would say not just in retail, also in the food service. And we like where we sit today. 10.9% and sitting at sort of that lower end of the range. For us is the right spot to be right now given the investments that we're seeing, the availability of those investments in the business. As regards to where we start to hit the ceiling, we have different math objectives, marketing advertising, promotional spend by brand and some of them are more ready than others.

So Jimmy Dean as we've called out in the past is something that we continue to invest highly against. Lots of ROI there and our intent is to get more brands to that same position over time and it would be done by continuing to innovate, and bring the investment up. So no guidance forward as to where we think the ceiling is. What I would just say is as we start to see the progress that we would get us closer to the top end of that range. We're going to invest to continue to have a strong growing Prepared Foods business at those, yeah, within range margins.

Michael Leith Piken
Cleveland Research Co. LLC

Q

All right. Terrific. And then just shifting gears. Could you give us a little bit on the Chicken side of where you see your business evolving on the antibiotic-free side, both with non-human use antibiotics and total antibiotic-free Chicken, where you plan to take the business over the next couple of years? Thanks.

Thomas P. Hayes
President

A

Sure. Yeah, so for – we have announced last year, I think you've seen this that we will be by the end of 2017, calendar 2017 our entire system will be with no antibiotics for use in human health. And we feel this is a really consumer-driven discussion. We have no antibiotic ever product available today. We continue to be ahead of, frankly, executing our strategy that we've intended. And we will go where the consumer is so in terms of what our supply-chain is doing to support that, the message you should take away is we feel good about where we are, actually we're a bit ahead of where we thought we would be and we'll continue to make progress to drive that agenda.

Operator: Thank you. We have our next question from Mr. Robert Moskow. Sir, your line is now open.

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

Q

Thank you for the question. If I think about the element of your business that has really outperformed the most and differentiated you, it's the value-added side of Chicken, and it's been an extraordinary achievement. But I think the challenge I have and others maybe is that when you look at the components of what you define as value-add, it seems like it's a lot of products that could be easily duplicated by your competitors. And maybe they haven't set up the supply-chain, or the further processing capacity yet to do that, and I'm just wondering if you can help us a little bit with how many years ahead do you think you are versus competition? What is it about the way you've set things up, that makes it hard to duplicate? And just maybe help us think of it that way, to understand the competitive advantage.

Thomas P. Hayes
President

A

Thanks, Rob. One of the things that we continue to come back to is those five elements that I talked about in the prepared remarks. Not commenting on competition, how quickly they can come up the curve. I won't speak to that. But it's not any one thing. It's all those in combination that give our model the strength that it has, hence, the operations improvements, we don't typically talk a lot about but it's been really, really impressive what we've done. And we're really thinking about what's the headline there, what have we done that is going to be notable or should be notable is that we feel the Chicken business is now in a spot where it's a pull business versus we're pushing supply on the market.

So our pricing mechanisms reflect that, our move to more value-added products whether it's part-fried products, fully cooked, we're building capacity against those because we continue to see tremendous demand. The buy versus growth strategy we talked a lot about. And then just staying on top of all those things that give us the best supply base that can make sure our customers are served excellently with great services is really what we're about. Okay. I don't know if that's satisfying you or not but it's really it's those five things we talk about in combination, I can't point to any one that's going to be the silver bullet or the panacea for somebody that competes with us, but you're right, but that's [indiscernible] (48:54) we continue to stay focused on.

Robert Moskow

Credit Suisse Securities (USA) LLC (Broker)

Q

Maybe one follow-up, Tom. You're talking about increasing your differentiation in tray pack. How revolutionary can you be there, in what is a pretty basic-looking product?

Thomas P. Hayes

President

A

Well, we love consumer insights. So how revolutionary we can be will be dependent upon what the consumer tells us and where that takes us. Yeah, we're sorting through right now. It's going to be an exciting time. There's a reason to believe that we should not only and I would say fresh frankly but also in the frozen case be doing things that would be above and beyond what people are thinking about today based on what consumers are telling us. We really doubled down on those consumer insights. Probably you got to wait and see, and without stealing the thunder of anybody on our innovation team. So we'll talk about more about that whether it's at CAGNY or other events. That's something that we're really going to be continuously focused on and we're excited to do that.

Robert Moskow

Credit Suisse Securities (USA) LLC (Broker)

Q

Sounds good. Thank you.

Thomas P. Hayes

President

A

You're welcome.

Operator: Thank you. We have our next question from Mr. Jeremy Scott. Sir, your line is now open.

Jeremy Scott

CLSA Americas LLC

Q

Hi. Thanks for the question. Good morning.

Thomas P. Hayes
President

A

Good morning.

Donald J. Smith
Chief Executive Officer & Director

A

Good morning.

Jeremy Scott
CLSA Americas LLC

Q

Just wondering if you can unpack the Chicken margin performance. I think when we started the year, you were looking for Chicken margins to exceed 10%, and as you've outperformed, that's obviously come up, and now we're looking for closer to 13%, 14%. I realize there's a lot of moving parts, and I don't mean to over-simplify, but if we were to isolate the margins you were able to deliver from growing and selling chicken from the margins on your buying platform, under the current conditions, is it reasonable to assume that the buy versus grow model is delivering a margin premium somewhere around 300 bps, 400 bps, just based on your change in guidance? And what's implicit in the fiscal 2017 guidance? Is that level of premium achievable in the market, only when there's a significant excess supply of breast meat?

Thomas P. Hayes
President

A

Yeah, I wouldn't say that, Jeremy. But we couldn't ascribe any certain amount of basis points that are – you're going to drive from any one part of the model. What I would say is as we've talked about our margins prospectively into 2017, we feel like they're going to be about the same as 2016. The idea that we have done things, like we don't have unprotected fixed prices. We continue to drive our business throughout the channels that we have access to. There's a lot of reasons to be happy with the model that you have here at Tyson as it relates to Chicken because we aren't just a one-trick pony. We have a lot of focus channels that we do really well in and we're continuing to drive our expertise in those category captaincies. We're up to [ph] 143 (51:57), I mean, which I think is about double from where we were at the time of the acquisition.

Things that are – we're working with our customers to get to a better place, those are the things that we'll focus on grains. We've looked at this, have the same margins whether up or down. And we're going to have some periods of time based on the slope of the curve. That of course, is going to affect margins. But on balance, we look to make sure that we run our model with no excess, and that's where we've been. And that's what's been the driver of our success.

Jeremy Scott
CLSA Americas LLC

Q

Okay. And just curious about your pricing investments in Prepared Foods. You spoke about getting the gaps right, when or if you expect competitors to turn up the dial? Clearly you've been winning volume share, but at what cost and how long? Do you think that volume growth can continue, if your competitors start to respond?

Thomas P. Hayes
President

A

We think the volume growth – depends on which category you're talking about, the overall Core 9 as we've talked, has done really, really well. Can't speak to what our competition is going to do. Certainly we have predictive

models based on what input costs are doing, then we think we're pretty good at that, understanding where they would go in a rational environment. We're not very good at predicting irrational behavior, but if competitors are going to act rationally, we have a pretty good beat on what we should be doing in terms of investing against our brands.

The idea that this has done a great job for us, we continue to stay focused on, where are the right levels and where are the right gaps, because frankly, we're into the fall of last year, our gaps became such that it was detrimental to the volume of the business. And like I said earlier, we want to make sure that we're in the right spot as we go into 2017 with protein, this is going to be available. And we want to make sure that we are available on shelf and we have the primary position. So I don't know if that answers your questions, but that's – we feel we're in the right spot right now based on the investments that we've made.

Jeremy Scott

CLSA Americas LLC

Q

Got it. Thanks. Just one follow-up on the CapEx guidance, pretty significant reduction quarter-to-quarter on the guidance. Can you just piece that out: what are the drivers there?

Dennis Leatherby

Chief Financial Officer & Executive Vice President

A

Sure. The main drivers are just really the thoroughness at which we're approaching our projects. We're embedding a heavy amount of safety practices at a new level and also continuous improvement. So that's kind of delayed the spend a bit, but it's still coming.

Jeremy Scott

CLSA Americas LLC

Q

Okay. Thanks very much, guys.

Operator: Thank you. We have our next question from Mr. Ken Zaslow. Sir, your line is now open.

Kenneth Bryan Zaslow

BMO Capital Markets (United States)

Q

Hey. Good morning, everyone.

Thomas P. Hayes

President

A

Morning, Ken.

Kenneth Bryan Zaslow

BMO Capital Markets (United States)

Q

Just two questions. One is, at what level will Prepared Foods business investment level off? Not so much that you go to a higher margin, but at the point that you'll feel like you reached a run rate that will continue, rather than having to go incrementally accelerating?

Thomas P. Hayes

President

A

Ken, what I would say is we don't say there's going to be certain level that we would top out at necessarily, in terms of investment. It's going to be – let me use an example, if every brand came up to the ROI that we get on Jimmy Dean across the Core 9. So we'd be spending a lot more and be getting fantastic return for it. The model, what that looks like across every single property, we haven't necessarily done that, I would say. The idea of us continuing to invest, when we get the margin structure that we have and it continues to get better, we will put the foot on the gas. The idea is that we will not find ourselves in a position, we don't think, where we're stopping the investment because we feel like it's going to be way too high. We generally focus on our investments continue to go north on our brand new products, but where that ceiling is? It's really something I can't comment on right now

Kenneth Bryan Zaslou

BMO Capital Markets (United States)

Q

Okay. And then my next question is, as you move to the Chicken business going to more Prepared Foods and more value-added, if Core were to be at \$1, or \$1.50 higher than it is, would that have any impact on your margin outlook for 2017 and beyond?

Thomas P. Hayes

President

A

No. I wouldn't say – I would say no, it wouldn't. Really, for us, it's more about the slope of the curve. So it's not whether or not it's going to be at a certain sustained level or not. It's how quickly we go up or down, and that certainly affects all of our business frankly, not just Poultry. We feel like our model is in a much better position because we have a value-added mix. We have the pricing mechanisms that don't change all at once. So we feel like we're in a really good spot there.

Kenneth Bryan Zaslou

BMO Capital Markets (United States)

Q

So again, your Chicken margin would have stayed at this range even if corn was higher, even like a month ago. So you guys are comfortable, there's no reason to assume that corn has a material impact as you progress through your Chicken margin outlook; is that fair?

Thomas P. Hayes

President

A

Yes, that's fair, and I'd say again, I'd point to the slope. It all – it depends upon the slope of the change.

Kenneth Bryan Zaslou

BMO Capital Markets (United States)

Q

I appreciate it. Thank you.

Thomas P. Hayes

President

A

Yup.

Operator: I show no further questions at this time, sir.

Donald J. Smith

Chief Executive Officer & Director

So before we go, let me reiterate something that we said earlier. With the expected adjusted EPS growth this year in the neighborhood of 40%, we've set the bar high, but we have momentum and we're confident in our ability to achieve high-single digit growth next year. We're growing now, and we're going to keep growing. Thanks for joining us, and have a great day.

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