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Tyson Foods, Inc. (TSN)

Q2 2016 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the Tyson Foods Quarterly Investor Earnings Call. At this time, all participants are in a listen-only mode. Questions will be taken after the presentation. [Operator Instructions] This call is being recorded. If you object, please disconnect now.

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

Jon Kathol

Vice President-Investor Relations

Good morning and thank you for joining us today for Tyson Foods conference call for the second quarter of the 2016 fiscal year. On today's call are Donnie Smith, President and Chief Executive Officer; and Dennis Leatherby, Executive Vice President and Chief Financial Officer.

Our remarks today include forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. 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 news release issued earlier this morning and our filings with the Securities and Exchange Commission for a discussion of the risks that can affect our business.

To be fair to other analysts in the queue, we ask that you limit yourself to one question and one follow-up during the Q&A portion of our call. If you have additional questions, please get back in the queue and we'll answer as many of your questions as time allows.

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

Donald J. Smith

President, Chief Executive Officer & Director

Thanks, Jon. Good morning, everyone. Our transformation continues and our momentum is building with another record-setting quarter characterized by strong performances across all segments. Versus Q2 last year, operating income grew 27% to \$704 million with an operating margin of 7.7%, both records for a second quarter which is typically our most challenging. We delivered adjusted EPS of \$1.07.

Our strategies for growth are working. Our team is focused on innovation and building our portfolio of leading products and brands. We're adjusting to consumer trends and shifts in the marketplace and we're capturing synergies. Total synergies for the quarter were \$144 million. Year-to-date, synergies are \$265 million and are ahead of pace to exceed \$500 million by the end of the fiscal year. Total synergies since the acquisition are \$450 million.

Diving into the specifics for the quarter, Prepared Foods, Chicken and Pork were in or above their normalized margin ranges while Beef just missed its range after recovering from losses a year ago. Total volume was up 2.1% excluding the divestiture of our Mexico chicken operation. Top line sales were down across the board as the deflationary environment continued for beef, pork, and chicken prices.

Prepared Foods' operating income was \$197 million with a 10.9% return on sales, tying the previous record. Operating income improved due to product mix changes and lower input cost. Total volume compared to Q2 last

year was down 0.3%, sales dollars were down 3.6% due to lower inputs and pricing actions at retail as we positioned our portfolio to accelerate volume growth in the back half of the year.

IRI data indicates that our efforts to drive volume momentum is having the intended effect as volumes are up 4% for the most recent four-week period in the Core 9 on the back of significant share gains, driven primarily by Ball Park hotdogs, Jimmy Dean breakfast sausage and Hillshire Farm smoked sausage and lunch meat.

In Q2, we captured \$111 million in synergies in the Prepared Foods segment with \$41 million incremental to Q2 of last year. We expect the segment's operating margin to be at the low end of the normalized range in fiscal 2016 as we continue putting a good portion of the synergies back into the business for innovation, new product launches, and strengthening our brands to support long-term growth.

The Chicken segment produced operating income of \$347 million and the 12.7% return on sales was a Q2 record. Volume was up 1.7% while sales dollars were down 3.3%. Over the past five years, we've differentiated our Chicken business by being more consumer-driven. We've upgraded our mix to more value-added and branded products. We've diversified our pricing mechanisms. We've optimized our cost structure by investing in our operations with good ROI projects. We've implemented our buy versus growth strategy and we're providing industry-leading quality and customer service.

Because of the actions we've taken and because they've proven to produce higher, more stable margins, we're raising the normalized range to 9% to 11%. Although we're taking the range up to 11% on the top end, I'll hurry on to say that we expect the Chicken segment to come in above 12% for 2016. And while it's early to talk about fiscal 2017, we expect a similar operating environment next year.

Moving on to the Beef segment, despite a challenging quarter, Beef showed significant improvement over Q2 last year. Operating income was \$46 million with a 1.3% return on sales. Volume was up 2.8% due to an increase in live cattle processed as a result of higher fed cattle supplies while sales dollars were down 11.9%. We're pleased with the performance of our beef business and we expect the segment's operating margin to be in its normalized range of 1.5% to 3%.

Pork had a great quarter with \$140 million in operating income and an 11.8% return on sales. Demand for pork was strong and volume was up 3.1% compared to the same period last year resulting in improved capacity utilization. As pricing declined, sales dollars were down 1.2%. With the increased hog supplies in fiscal 2016, we believe the Pork segment's operating margin will be above its normalized range at around 10%.

Let's move from our segments to consumer and channel trends. As we mentioned last quarter, our efforts to expand retail branded total points of distribution and close pricing gaps were implemented slower than planned, but we see the tide turning. According to IRI, total Tyson retail volume excluding raw frozen chicken and ground beef chubs is up 3% in the latest four-week period versus flat in the 52-week view, driven, of course, by the growth in the Core 9. So clearly, momentum is building and we feel great about our growth-driving initiatives throughout the upcoming summer season.

In addition to volume, Core 9 share is up as well. Dollar share is up 0.7 of a share point and volume share is up 1.6 share points in the most recent four-week view.

In the macro environment, consumer sentiment is strong and disposable personal income continues to rise. Economic optimism is driving growth in the fresh department, and attractive fresh meat and poultry pricing is also a factor as volumes are up nearly 3% for the latest 13 weeks. In foodservice, NPD is reporting growth in both traffic and check size.

While we play across all areas of foodservice, we're especially well aligned with the national foodservice chains that are showing the most growth. Within broad-line distributors, chicken is up 6%. Among branded chicken companies, Tyson has the number-one share by far in each of the eight major categories and we're growing share in five of eight categories.

To keep our products relevant with consumers, we must keep refreshing our offerings through flavor and formula updates, line extensions and disruptive innovation. In July, we'll be introducing Jimmy Dean stuffed hash browns and Ball Park frozen sandwich meats, including pulled pork, meatballs and steakhouse burgers. Retailer acceptance has been very good and sell-in is going well. In September, we're launching an extension of the Hillshire Snacking platform and we'll roll out our new Tyson Naturals line of frozen chicken products featuring all-natural ingredients and no antibiotics ever.

As we innovate, we'll align with customers to grow where the growth is. Non-store retail, or e-commerce, is projecting to grow three times faster than the rest of the market, so we've begun innovating with the e-commerce shopper and retailer in mind. We'll continue to partner with the leading U.S. retailers, testing click-and-collect models.

Additionally, as we announced at CAGNY, we're expanding our relationship with AmazonFresh to sell fresh protein as well as partner with them around innovation. We plan to launch Tyson Taste Makers, a line of chef-inspired meal kits in premium proteins for home delivery with AmazonFresh this fall.

We have a lot to be excited about in 2016 and we're generating momentum to carry us through 2017. Our portfolio is aligned with consumer trends and marketplace shifts. The retail Core 9 continues outpacing total food and beverage with volume growth that's accelerating. We're growing with growing customers. Our foodservice portfolio is positioned with growing national accounts and categories in broad-line distribution. We're innovating with new products across all channels. Our innovation pipeline is extensive and driven by consumer insights.

We're valuing up our product mix. We're driving growth. We're in a good macro environment. We're capturing synergies, we're buying back stock. We're on track for another record year, and we're raising 2016 adjusted earnings guidance to \$4.20 to \$4.30 a share, which would give us a full-year EPS CAGR of at least 21%. All that adds up to a great fiscal year, and we expect 2017 to be even better. Through a game-changing acquisition and continuous improvement, Tyson Foods is a different company.

Now, let's go to Dennis.

Dennis Leatherby

Chief Financial Officer & Executive Vice President

Thanks, Donnie, and good morning, everyone. Q2 was another record quarter as we delivered robust results across each of our segments. With record second quarter EPS and operating income, we continue to deliver the growth, synergies, innovation and operating income that is transforming Tyson from a protein company to a demand-driven protein-centric food company. We were able to repurchase 6.9 million shares for \$400 million in Q2. So far during the third quarter of this year, we repurchased approximately 3 million shares for \$200 million. In total, over the past 10 months, we have now repurchased over 22 million shares for approximately \$1.1 billion, underscoring our commitment to continue returning cash to shareholders.

Q2 revenues were \$9.2 billion, representing a decrease of 8% due to continued declines in beef, pork, and chicken prices. However, volumes grew 2.1% when excluding the divestiture of our Mexico operation in the prior year.

Total company return on sales was 7.7%, a record for the second quarter. Operating income was \$704 million, representing a 27% increase over adjusted operating income from Q2 a year ago and is also a record for the second quarter. Our record second quarter adjusted EPS of \$1.07 represents a 43% increase over \$0.75 adjusted earnings per share in Q2 last year. I would also like to note that on an adjusted basis, our last 12 months' EPS is \$3.85.

Our operating cash flow through two quarters was \$1.1 billion, and we spent \$355 million on capital expenditures. This outpaced our depreciation by \$50 million as we continue to invest in projects with a focus on delivering high ROIC. Our effective tax rate in the second quarter was 32.7% on a GAAP basis and 34.5% on an adjusted basis. Net debt to EBITDA for the past 12 months was 1.8 times. Including cash of \$254 million, net debt was \$6.1 billion. Total liquidity was \$1.2 billion, which is in line with our minimum liquidity target.

During the second quarter, we retired the 6.6%, \$638 million 2016 notes that were due, and since the acquisition of Hillshire in August 2014 we reduced our gross debt by about \$2.1 billion. Our rapid leverage reduction in under two years reflects our commitment to maintaining investment-grade credit ratings. Net interest expense was \$63 million during Q2. For the quarter, our diluted shares outstanding were 393 million.

Now, here are some additional thoughts on fiscal 2016. We expect revenues of approximately \$37 billion, which includes the impact of our fiscal 2015 divestitures and declines in beef, pork, and chicken prices. Through six months, we captured \$265 million of synergies and are ahead of pace to exceed \$500 million by the end of the fiscal year. Additionally, total synergies since the Hillshire acquisition are \$450 million. Net interest expense should approximate \$245 million. We currently estimate our adjusted effective tax rate to be around 35%. CapEx is expected to approximate \$850 million 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 in Q2, we expect our average diluted shares to be around 390 million.

As we have demonstrated, our capital allocation priorities are governed by our disciplined focus on driving long-term shareholder value. Our priorities for deploying our significant operating cash flow are for investing in consumer-preferred portfolio driven by innovation and brand building along with growing our businesses organically through our operational efficiency and capital expansion projects, acquiring businesses that support our strategic objectives and returning cash to shareholders through share repurchases and dividends all while maintaining plenty of liquidity, investment-grade credit ratings, and continuing to expand our debt capacity.

As we've discussed on our earnings calls over the past few years, we've been transforming our Chicken business. We have grown our branded products which are anchored in consumer insights and innovation. We've reduced our commodity sales as we created a model that is 90% full and only 10% pushed to the market. And we have implemented our buy versus growth strategy where we can purchase up to 10% of our chicken meat on the open market to margin up.

These initiatives have helped transform our Chicken business to create a higher, more stable margin structure for what we believe is a new level of profitability for the segment. As a result, we are increasing the Chicken segment's normalized range to 9% to 11% as this will more accurately reflect the impact of the sustainable fundamental business improvements in our Chicken segment as we accelerate growth.

In closing, we delivered record results in our second quarter, which is typically softer and seasonally more challenging. As mentioned in this morning's release, we are raising our adjusted EPS guidance range to \$4.20 to \$4.30 per share for fiscal 2016, up from our previous range of \$3.85 to \$3.95. This new range is up more than 30% over 2015 adjusted EPS. This new range also represents a compounded annual growth rate of at least 21% adjusted EPS for the four-year period of 2012 to 2016.

We are excited about momentum we have going into fiscal 2017 as we continue to transform our business with leading brands in advantaged categories that put us in a unique position to drive long-term shareholder value.

That concludes our prepared remarks. Charmaine, we're ready to begin Q&A.

QUESTION AND ANSWER SECTION

Operator: Thank you, sir. [Operator Instructions] Our first question comes from the line of Mr. David Palmer of RBC Capital Markets. Sir, your line is open. You may begin.

David Palmer
RBC Capital Markets LLC

Q

Thanks. Good morning. Donnie, thanks for the detailed update and the guidance for 2016. I know it's early but I know investors' minds will be racing ahead to 2017 and thinking about how you're going to lap this strong year. Do you anticipate 10% plus EPS growth next year? Is that in the cards? And if so, what is coming into focus that's going to help you get there and what are some of the major unknowns or potential offsets that you're thinking about? Thanks.

Donald J. Smith
President, Chief Executive Officer & Director

A

Thanks, David. So first of all, yeah, it's great to finish what looks like will be another record year for us in 2016, something of a, what, 30% increase over last year and well beyond our stated goal of at least 10% EPS growth over time. So as we look forward, we feel great about the momentum that we're generating, so let's talk a little bit about what we know. So we know we're driving growth. If we see in the most recent four-week data in IRI, we're gaining momentum as we move into and closer to Memorial Day and on through the summer season. That feels really good. Our mix has improved. There was some private label volume that we did not renew but we feel great about our opportunities to grow going forward, so we like our mix.

We're investing a lot in long-term growth, great advertising, a lot of investment in innovation. We announced a new processing plant for our Chicken business. We needed some further processing capacity in the par fryer arena. We're getting that around us now. We've got good capacity in fully cooked so we feel great about that. As we look into our Prepared Foods group, we've got really strong merchandising lined up for the summer season. I think that will help carry a lot of momentum into the fall and into next year. Great innovation pipeline, so we'll have some good innovation to continue to add next year.

Our Chicken business has really improved. I feel real good about volume growth in the back half of our year in chicken. Pork looks like it's going to have another good year in 2017. We've got what looks like to be good supply of hogs coming our way. Beef, same story. We've got a good supply of cattle coming our way, it looks like in 2017. So if you add all that up with great cash flow and our ability to continue to invest in the business, it feels really solid for 2017. Now for the stuff we don't know, the commodity-related stuff, grain, et cetera, we don't know that yet, but no reason to believe that we won't have. You've got a plan going ahead for a normal crop year. So no reason not to believe that wouldn't happen now.

David Palmer
RBC Capital Markets LLC

Q

I'll pass it along. Thank you very much.

Donald J. Smith
President, Chief Executive Officer & Director

A

Yeah, thanks.

Operator: Thank you, Mr. Palmer. Our next question comes from the line of Adam Samuelson of Goldman Sachs.

Adam L. Samuelson
Goldman Sachs & Co.

Q

Thanks. Good morning, everyone. Maybe first, I wanted to talk, Donnie and Dennis and team, on the new chicken margin range, the 9% to 11%, maybe help think about it or give some clarity on what you think the bigger drivers of the 200-basis-point upgrade would've been and if you look at 2016 performance, you would see that you're still operating at least 100 basis points above the high-end, maybe think about the areas that would cause you to drift down into the lower – back into the range moving forward. Thank you.

Donald J. Smith
President, Chief Executive Officer & Director

A

Yes. So, Adam, what we do is we run a series of statistical models that take into account the change in our business model. They would include mix, various pricing mechanisms, the supply and demand environment around grain and that kind of thing and they look at all of those fundamentals over the very long-term. And so in looking at the model, it showed clearly that it was time for us to raise our normalized range. As far as the over-performance goes, we've got very strong volume this year, we feel good about that. Obviously, our grain position is favorable this year with the low end of what we expect the five-year range of grain to be, and that helps over-deliver a bit.

And if you look going forward at what might cause any dip, it's that level of fundamentals, primarily driven around the grain. But I tell you, we've done a very good job of utilizing the price discovery mechanisms afforded to us to be able to take a lot of the grain volatility out of our business. We've priced much more of our products off in some kind of a grain-based mechanism, so we feel good about the diversity of our pricing mechanisms, the price discovery mechanisms that we can employ on the grain side to stabilize those margins. So that's our view on the guidance.

Adam L. Samuelson
Goldman Sachs & Co.

Q

That's very helpful. And then if I can just have a follow-up, as I look at the second quarter, typically it was through the prepared remarks, usually the second quarter is the seasonal low point for the year, but if I would bet any even just the second level performance to the back half, you'd be above the high-end of the guidance range. So maybe help us think about why the normal seasonality through your business wouldn't apply in 2016 or if there was something unusual in the first half of 2016 that was extra beneficial.

Donald J. Smith
President, Chief Executive Officer & Director

A

So, we're obviously off to a really good start, right? Our Prepared Foods has done – our Prepared Foods business has performed very well. The volume was a little bit light for us, particularly in Q2, getting our price gaps reflected on the shelf took a little longer than we had expected, and that cost us a little bit of volume, but that's about the only thing that you can say. There might have been a little softness in pizza toppings but that's about the only

thing you could say negative about our Prepared Foods business. It is doing very well and it is really building momentum.

The Chicken segment, great quarter, right? A lot of things came our way, grain was good, volume was up a little bit. We've improved our mix, so that feels really good. Beef, so much better than last year. Good cattle supply around us, looks like that will continue on through the rest of the summer. So, I feel good about where we are certainly. I think we're in a good spot for now in our guidance.

Adam L. Samuelson

Goldman Sachs & Co.

Q

Great. Thanks very much.

Donald J. Smith

President, Chief Executive Officer & Director

A

You bet.

Operator: Thank you, Mr. Samuelson. Our next question comes from the line of Ken Goldman of JPMorgan. Sir, your line is open.

Kenneth B. Goldman

JPMorgan Securities LLC

Q

Hi. Good morning, everyone. Thanks for taking my question.

Donald J. Smith

President, Chief Executive Officer & Director

A

Good morning.

Kenneth B. Goldman

JPMorgan Securities LLC

Q

Hey, Donnie, just in response to Dave Palmer's question with a follow-up, you said that the company's goal is for 10% plus EPS growth quote over time. That's the same terminology you used at CAGNY, but it is a little different than what Tyson previously said, which was for 10% plus every single year. I think – so I just wanted to clarify, personally for me, it's more reasonable to expect 10% plus on average at every single year, but I just wanted to, again, clarify. Is the goal double-digit growth, 2016, 2017, 2018 every single year or is it more that sort of CAGR over a longer period you expect to get that?

Donald J. Smith

President, Chief Executive Officer & Director

A

Well, we've tried to be pretty consistent about saying 10% EPS growth over time, but our goal is to always grow our earnings, grow our volume. We've got a great growth story and we want to take every advantage of that we can. We've got a great consumer-relevant portfolio. We've got super innovation pipeline lined up. And so, yeah, we should be able to expect good EPS growth. It's too early to call what we think 2017 will be here, but for all the things I mentioned in, you know, for David's question, feel great about our opportunity for 2017 to be even better.

Kenneth B. Goldman

JPMorgan Securities LLC

Q

Okay. And for my follow-up, Pilgrim's announced it's going to convert an entire facility into organic chicken. Just curious for your take on this. Is this something Tyson would consider given the consumer shifts out there, or is organic less of a priority for the company right now?

Donald J. Smith

President, Chief Executive Officer & Director

A

Well, we go where the consumer leads us. I mentioned a little earlier we're building that a new par -fry plant. We've got great demand for that processing type, and so we're building that plant for long-term growth. We've got some great organic products today in our portfolio. So far, we're able to source that meat outside of our production, but we'll continue to focus on the consumer and whether it's no antibiotics ever or natural offerings, organic, whatever it may be, we're going to be a consumer-led company and we'll respond accordingly.

Kenneth B. Goldman

JPMorgan Securities LLC

Q

Thank you, Donnie.

Donald J. Smith

President, Chief Executive Officer & Director

A

You bet.

Operator: Our next question comes from Farha Aslam of Stephens, Inc. Your line is open.

Farha Aslam

Stephens, Inc.

Q

Hi. Good morning.

Donald J. Smith

President, Chief Executive Officer & Director

A

Good morning, Farha.

Farha Aslam

Stephens, Inc.

Q

My first question is on Prepared Foods. In your release, you highlight that you have a three-year pipeline. Would that involve incremental more spending than what you're doing today, or is there a way you can pare it back? And how should we think about those Prepared Foods margins going forward over the next few years?

Donald J. Smith

President, Chief Executive Officer & Director

A

Yeah, I think we feel good about our ability to grow our Prepared Foods business while maintaining 10% to 12% margins. And that's really what we want to do. Could we push the margin structure a little harder? Yeah, we could, but we have the opportunity to grow. Our customers want us to grow, and so we feel like that 10% to 12% range gives us the growth opportunity that that business can afford the consumer.

So, I feel really good about the [ph] map (27:58) spending that we have focused on our business. We spend that disproportionately in categories, so not all of the brands get the exact same amount of spending, so we spend disproportionately where we can get growth. Jeff and Eric and Tim and the teams have a great plan setup to be

able to drive growth in the back-half and carry that momentum on into 2017. We're doing a super job on our pricing now. We've got great merchandising lined up for the summer season. So we've got, like I said, a three-year pipeline and there's a lot of versatility in that pipeline about our ability to – if one particular innovation may take longer to get to market than we expected, then there's others in the pipeline that can fill that slot so we can continue to give the customer the kind of innovations that they need to keep the categories fresh. So we feel like we're set up really well.

Farha Aslam

Stephens, Inc.

Q

That's helpful. And as a follow-up on Pork, you highlighted that you have good hog supplies coming to you. But we also have incremental processing capacity that's coming online over the next three years to four years. Do you anticipate that increased capacity will impact your Pork margins? Or will the availability of hogs continue to match the capacity, that you should continue to have some pretty strong Pork margins?

Donald J. Smith

President, Chief Executive Officer & Director

A

Yeah, the pork industry has been shifting and developing for years. We've got strong relationships with our suppliers and, by the way, on the customer side. Our math shows that the supply growth and the demand growth are in relative balance over the next few years. We're still in the right locations. We've still got a great supply base close to us. We've got great customer demand for the product. And in our Prepared Foods business, as we continue to grow that, we'll have even more opportunities to create value. So we feel really good about how our Pork business is lined up for the next few years.

Farha Aslam

Stephens, Inc.

Q

That's helpful. Thank you.

Operator: Thank you, Ms. Aslam. Our next question comes from the line of Akshay Jagdale of Jefferies. Your line is open.

Akshay Jagdale

Jefferies LLC

Q

Good morning and congratulations.

Donald J. Smith

President, Chief Executive Officer & Director

A

Thanks, Akshay.

Akshay Jagdale

Jefferies LLC

Q

So I wanted ask about Prepared Foods. Can you help us quantify or just give us some sense of how much of the savings or tailwind that you have from lower commodity costs over the last couple years, which is in excess of \$500 million, and the synergies which are a cumulative \$500 million through the end of this year, how much of that is being passed on to consumers in the form of lower pricing, whether it's in your food service business and/or Prepared Foods? And also, how much of it roughly is being reinvested in [ph] map? (31:08) Just can you give me some sense of that? And then I have a follow-up.

Donald J. Smith

President, Chief Executive Officer & Director

A

Okay. So let's think about Prepared Foods. About half of our Prepared Foods business is food service. And a pretty sizable majority of our foodservice business has a pass-through pricing relationship, so a lot of that, the commodity pricing, does get passed along. If you look on the – well, another thing to note, too, about 80% or so of the synergy capture is in Prepared Foods. The rest is spread out across the rest of our segments.

And, Akshay, we spend about 5% or so on [ph] map (32:01). And we're investing really heavily in growth. We've got a lot of innovation. We've talked about getting our price gaps right. We've gotten our price gaps right, and we're seeing the volume response that we suspected we would see. So that's a great investment for us. And we'll continue to do that to grow our Prepared Foods business. That business is built for growth. We've got great brands in great categories. And we've got a very good growth story, and we're going to continue to invest to grow.

Akshay Jagdale

Jefferies LLC

Q

Perfect. And then just to follow up on that train of thought. So Prepared Foods -- you mentioned the four-week data in Nielsen. Can you give us a sense of what it was in the quarter? And then more importantly, with all these investments long-term, what should be the algorithm for that particular piece of your business? So the Core 9 should grow at what rate longer term once all these investments start to pay off?

Donald J. Smith

President, Chief Executive Officer & Director

A

Yeah. So again, I'm going to use the – I will go to the last 12-week data. And if -- we had the exact same spread between the 12-week data and the 52-week data as we did the four-week. And I'm looking at if we look just at the – well, what I'm going to do: let me use all of our branded portfolio, minus the raw frozen IQF and then I'm going to take out ground beef chubs. Both of those are UPC'ed. But the consumer is wanting those in a tray instead of the UPC items. And so that volume is moving out of the IRI data. Well, it's showing negative in the IRI data, but we're not losing the sale. We're just selling it in the fresh category.

So when I look at our branded business, minus IQF and ground beef chubs for the 12-week period, we're showing 3% volume growth versus being flat in the 52-week view. So we see the exact same thing. And looking back at Q2, it took us a little longer than we wanted to get the pricing gaps realized on the shelf. And now that we're there, I expect to see good momentum all through the summer selling season, especially in light of the merchandising we've got set up and the advertising that we've got employed. So feel really good about that growth prospect.

Longer-term, our brands, we use the phrase, we have advantaged brands in advantaged categories, and we do. The categories we're in outpace food and beverage growth. And I think over time, you should expect us to grow at about 1.5 times the category growth. And so when you run that algorithm, you're in categories that are outgrowing total food and beverage and you're out at the – the brand leader in a lot of those categories, you're outrunning that growth by 1.5 times. That sets up very well to add a lot of shareholder value over time.

Akshay Jagdale

Jefferies LLC

Q

Perfect. I'll pass it on. Thanks.

Donald J. Smith

President, Chief Executive Officer & Director

A

Thanks.

Operator: Thank you, Mr. Jagdale. Our next question comes from the line of Mr. Tim Ramey of Pivotal Research. Your line is open, sir.

Timothy S. Ramey
Pivotal Research Group LLC

Q

Good morning. Thanks.

Donald J. Smith
President, Chief Executive Officer & Director

A

Hey, Tim.

Timothy S. Ramey
Pivotal Research Group LLC

Q

And let me add my congratulations, Donnie.

Donald J. Smith
President, Chief Executive Officer & Director

A

Thank you.

Timothy S. Ramey
Pivotal Research Group LLC

Q

Hey, it wasn't that long ago we reduced the range in Beef. And at least to me, perhaps the most important and encouraging number of the morning was the Beef performance in its seasonally weakest quarter, with volume growth. And that range is a big range, to say 1.5% to 3% for the full year. Do you have any kind of preview as to what the sell-in for grilling season looks like or any kind of update on what we should be thinking about this summer, because it looks like this could be a source of significant growth?

Donald J. Smith
President, Chief Executive Officer & Director

A

Yeah. So with the drop in the cut-out and a little bit more stabilization, if you can call it that, in cattle futures, it feels like that the retailers have been much more willing to feature beef coming up for Memorial Day forward. 50s have been pretty cheap, so ground beef is a good value. If you look at the latest 13 weeks, ground beef is up about 6% or so on a 15% decrease in price. And you continue – actually, it accelerates just a tad to about 6.5% in the four-week view on about the same kind of a price decline. So this cheaper cut-out is going to mean better Beef volume, I think.

Plus, we've got supply around us. There's still a bit of heifer retention. You're seeing heifers about 44% or so of the slaughter, so we're still growing the herd a bit. It looks like to us that for the year, now it will be obviously bigger in the back-half, for the year, we ought to see about 2% increase in the fed cattle supply this year, and we think that's the number for the next two years. Again, because we know we're very well positioned where the big feed lots are, where the big high-capacity feed lots are. So, yeah, it feels good to have the worst over – the worst behind us in Beef and good supply coming to us, and that will help certainly our margins.

Timothy S. Ramey
Pivotal Research Group LLC

Q

And just a quick one on the capital structure. You've done a great job of bringing back debt capacity. You've done a great job with the Hillshire acquisition. From your perspective, what does the landscape look like in terms of other packaged food or just the overall deal outlook? Is there something out there or is it getting more difficult?

Donald J. Smith
President, Chief Executive Officer & Director

A

I don't think deal flow is as robust as it's been over the last four years or five years, but we have a very consistent view that we look first of all for strategic fit. And then we look at, in the absence of that, and I think that one of the great things about our business, Tim, is that we've got a very good organic growth story. And so as we look at the landscape, no need for us to push into a deal that doesn't fit us strategically or that kind of thing. So although the landscape is a little thinner than it has been, we continue to look. We want to grow and we want to grow organically and we want to grow inorganically and Dennis has got us a great balance sheet and a lot of capacity to be able to do that. In the meantime, I think buying back our stock is a great way to return cash to shareholders, and we'll stay on that and stay pretty consistent with our uses of capital like we have been for the last three years, four years.

Timothy S. Ramey
Pivotal Research Group LLC

Q

Thanks so much.

Donald J. Smith
President, Chief Executive Officer & Director

A

You bet. Thanks, Tim.

Operator: Thanks you, Mr. Ramey. Our next question comes from the line of Mr. Jeremy Scott from CLSA.

Jeremy Scott
CLSA Americas LLC

Q

Good morning.

Donald J. Smith
President, Chief Executive Officer & Director

A

Good morning.

Dennis Leatherby
Chief Financial Officer & Executive Vice President

A

Good morning.

Jeremy Scott
CLSA Americas LLC

Q

Just wanted to ask, switching gears a bit, the status of the market in China. The USDA has been sounding the alarm on commercial broiler supplies, given the inability to source grandparent breeders from the U.S. I think the current forecast calls for down double digits in 2016 and 2017. So from your vantage point, number one, is that an

accurate assessment of the state of the market? And what can that mean for your operations and down the road, when and if export bans are lifted, could we see white meat imports into China? Thank you.

Donald J. Smith

President, Chief Executive Officer & Director

A

Hard say on that last part. I wouldn't dare to – I wouldn't venture to take a guess there. We are seeing higher pork prices in China, which typically lead to higher chicken prices, but chicken demand has remained a bit soft, and we've not seen the price of chicken respond like we have, like it normally does in proportion to pork. I will tell you this, though, that our sell-in, our international team are focused on driving value in fresh, branded chicken and I think they're making good headway, they're seeing good momentum. Any of the market factors like a lower chicken supply that would ultimately lead to higher wholesale markets would only benefit our business. But in the meantime, we're certainly not standing on our – or back on our laurels. We're working hard to grow our business and to grow a great branded fresh offering.

Jeremy Scott

CLSA Americas LLC

Q

Okay. But from your vantage point, does that magnitude drop in production sound reasonable?

Donald J. Smith

President, Chief Executive Officer & Director

A

Yes. Oh, I'm sorry, yes. Yes, yeah.

Jeremy Scott

CLSA Americas LLC

Q

Okay. Thank you.

Operator: Thank you, Mr. Scott. Our next question comes from the line of Mr. Brett Hundley [BB&T Capital Markets].

Brett Michael Hundley

BB&T Capital Markets

Q

Hey. Good morning, guys.

Donald J. Smith

President, Chief Executive Officer & Director

A

Good morning.

Dennis Leatherby

Chief Financial Officer & Executive Vice President

A

Good morning.

Brett Michael Hundley

BB&T Capital Markets

Q

Congratulations on a great quarter. Dennis and Donnie, I have an initial question for you on the balance sheet. Your net debt ticked back up this quarter, went up about \$570 million plus from fiscal Q1. And I know you generate a lot of strong cash flow in the back half for the year. And so, Dennis, I'm just curious to get a sense of

maybe how net debt can trend into the end of the year and if there's a target where you'd like to exit the year from a leverage standpoint. And somewhat related to that, are you okay putting debt on the balance sheet to buy back stock or would you rather just use cash flow?

Dennis Leatherby

Chief Financial Officer & Executive Vice President

A

Great questions. I'll peel this apart, first off, that we did expect the net debt to go up seasonally as you may recall, we have cattle and hogs deferrals that flip from the end of December into March that we have to pay off, typically, \$300 million to \$400 million a year. So that's not unusual. We did say we did have a lot of extra cash going into this quarter on purpose because we intended to pay off the 2016 notes, which were \$638 million. So, that answers that part of the question. As far as net debt for the rest of the year, I would say that it will be generally in the area of where we are now, maybe up or down \$50 million or \$100 million. And to answer the question about borrowing to buy back stock, we would rather not. We think it's a better use of our resources to invest in growth first and foremost and then use the rest to buy back stock and continue to build our debt capacity.

Brett Michael Hundley

BB&T Capital Markets

Q

That's great. I really appreciate that. And then just as a follow-on, when we think about using the balance sheet that you have for M&A, I wanted to follow on to Tim's question. It appears to us that there's not a ton of attractive assets for sale here in the U.S. domestically, and if they are, they're quite expensive. And so I'm wondering if we might see any kind of, I don't want to call it pivot, but a pivot from you guys where you might focus more on international M&A opportunities. The landscape seems interesting there. And I just wanted to get some color from you guys or an update on what you might look at, would it be more on the fresh side or would you want to continue to focus on the consumer and value-add, where are you looking? Just any parameters you can give us would be really helpful. Thank you.

Donald J. Smith

President, Chief Executive Officer & Director

A

Brett, certainly, international would also or is also a M&A focus. Our strategy is to grow value-added poultry and Prepared Foods, and international. And so – and think value-added poultry and Prepared Foods when you think international. So those are the type of businesses that we would be looking at and focusing on because that's, as Sally often reminds us, about 96% of the population is outside of the U.S. and food consumption is going to grow around the world. So we want to be positioned to be able to grow for the long-term and that means international as well. So you're absolutely thinking right to think that international acquisitions would be targets as well.

Brett Michael Hundley

BB&T Capital Markets

Q

And maybe just real quick, is it fair to say that international presents more opportunities than domestic right now?

Donald J. Smith

President, Chief Executive Officer & Director

A

It's hard to say, Brett. That's a no call there.

Brett Michael Hundley

BB&T Capital Markets

Q

Okay. Thanks. I'll leave it there.

Donald J. Smith
President, Chief Executive Officer & Director

A

Okay.

Operator: Thank you, Mr. Hundley. Our next question comes from the line of Mr. Robert Moskow of Credit Suisse.

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

Q

Hi. Thank you. Hey, I wanted to ask about the synergies. You have visibility into an increase in fiscal 2017 to get to more than \$700 million. Can you talk about what's going to be incrementally better to drive those synergies higher for Prepared Foods? And then also, I think you said you decided to walk away from some private label business. Does that impact your capacity utilization at all in any negative or maybe it just improves the mix, but how does that influence the synergies, if at all?

Donald J. Smith
President, Chief Executive Officer & Director

A

Thanks. Good question. So, yeah, on the synergies, the biggest factor so far has been operational improvements, frankly in the legacy Tyson Prepared Foods business. As we move forward, our procurement synergies become a larger component, so think packaging materials, cooking ingredients, maintenance and repair items and all those kinds of things. And so we feel really good about where we are going forward on the synergy landscape, and it will move – the synergy capture will move more from the operational piece in – the operational component into the procurement component, and then the last piece will be in the network optimization and the logistics component, and that will come later in 2017, and some of that will actually bleed over into 2018, I think.

Remind me of the second half of your question.

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

Q

Just you said you walked away from some private label business. I wanted to know if that impacts the utilization at your plants. Because I remember that was a big part of your synergies in the first year.

Donald J. Smith
President, Chief Executive Officer & Director

A

Yes. So, yes, it did, but when we look at that, you kind of look at your contribution margin and that was some business that we – it's hard – sorry: I guess it's a little bit hard to say it this way, but that's some business we needed to do without. Now, we are rapidly working to replace that volume and I think as we move on through the rest of this year and going into 2017, we will replace that business with other business. And so, yeah, it had a short-term effect on capacity utilization, but that was all built into our 2016 plans. And we'll have every opportunity to get some business back around us to fill in that void. and that's where our sales team is working really hard to get that done.

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

Q

Okay. Good. So just to repeat, Donnie, it was part of your 2016 plan or was it kind of a surprise to 2016?

Donald J. Smith

President, Chief Executive Officer & Director

A

No, no, no, no, no. It was built in. As we came into 2016, we did not renew the business last year for this year. So we knew that that capacity would be vacant this year, and we've been working on filling that up. So, yeah, it was part of the 2016 plan.

Robert Moskow

Credit Suisse Securities (USA) LLC (Broker)

Q

All right. Thank you.

Donald J. Smith

President, Chief Executive Officer & Director

A

You bet.

Operator: Thank you, Mr. Moskow. Our next question comes from the line of Mr. Michael Piken of Cleveland Research.

Michael Leith Piken

Cleveland Research Co. LLC

Q

Yes, good morning. Congratulations on a good quarter. I just wanted to see, the latest data from USDA regarding the breeder flock showed a fairly sizable increase in the number of pullet chicks hatched last month. And I'm just wondering, is this potentially the start of a trend? I know you don't want to extrapolate too much from one month, but just your view in terms of how expansion may play out heading into fiscal 2017 would be helpful.

Donald J. Smith

President, Chief Executive Officer & Director

A

Yeah, so you're right. You don't read too much into one month. It's better to look at kind of a three-month average. But what we're hearing is that you're seeing an increase in AI in Mexico, and so my guess is, is that a lot of those pullets are down to supply eggs for that market. That'd be my guess. I don't see any indication that there's an increase coming in the U.S. Egg sets now are about 98% of a year ago, so you can kind of see what the next quarter looks like. So my guess is a lot of that's going to Mexico.

Michael Leith Piken

Cleveland Research Co. LLC

Q

Okay. Terrific. And I guess as a follow-up question, as you think about the business over the next couple years, are you seeing any change in terms of how your customers are viewing purchasing in terms of more people looking for grain-based type contracts or less spot buying, given that there's not too much expansion forecast, or is it still kind of the same type of contracting you've seen historically in food service and retail? Thanks.

Donald J. Smith

President, Chief Executive Officer & Director

A

Yeah, we really don't see any changes. We've evolved our pricing mechanisms over the last three years or four years, and I'm assuming that we'll continue to evolve them over time to make sure that we can ensure supply and work with our customers on pricing mechanisms that work for both of us. I think a big key for our business – and I know our teams are focused on this is to make sure that we've got the very best quality out there and we have

outstanding service. And our team is doing a super job at that right now. So we'll continue to work on those things as we move forward.

Michael Leith Piken

Cleveland Research Co. LLC

Q

All right. Thank you very much.

Donald J. Smith

President, Chief Executive Officer & Director

A

You bet. Thanks.

Operator: Thank you, Mr. Piken. Our last question comes from the line of Mr. Ken Zaslow of Bank of Montréal.

Kenneth Bryan Zaslow

BMO Capital Markets (United States)

Q

Hey. Good morning, everyone.

Donald J. Smith

President, Chief Executive Officer & Director

A

Good morning.

Kenneth Bryan Zaslow

BMO Capital Markets (United States)

Q

Just two questions. One is there a natural limit to your Chicken margin? You're going from 5% to 7%, 7% to 9%, 9% to 11% and you see a company, Hormel, do the similar thing with Turkey business. Can you talk about how the progression can go beyond this higher margin structure?

Donald J. Smith

President, Chief Executive Officer & Director

A

Ken, our business is built for growth, right? And frankly, I would much rather have a 9%, 10%, 11% Chicken business that's growing and outgrowing the categories that we're in than to push the margin structure and end up having to sacrifice growth to do that. So that's how we look at it. We're actively working on getting – we've got a lot of fully cooked capacity available right now. We're actively working on putting a lot of par fry capacity around us. I think the team has done a super job changing the mix that we are seeing some shift from frozen into fresh at retail and our folks are all over that. That's actually good for our business. So I think as we've looked out and run our models for the next five years, what we tried to do is get some large portion on standard deviation of the mean and that kind of thing built into the model to be able to reflect a business that can grow and maintain stable higher margins.

Kenneth Bryan Zaslow

BMO Capital Markets (United States)

Q

Okay. And then if I think about 2017, when I look at it just on a big picture level, if our Chicken margins are going to stay roughly where they are, your Beef is probably coming off the bottom of the cycle and you're going to grow Prepared Foods business, so it does seem like there is opportunity for you to actually have reasonable growth in 2017. Is that not a fair way of just taking a stab at it?

Donald J. Smith
President, Chief Executive Officer & Director

A

You've got it. And I think, too, with adequate supply of pork, and we portend an adequate supply of pork, that means you should have favorable raw materials again next year in our Prepared Foods business, which should allow us to be able to grow that business and have a favorable margin structure. So we feel great about the way 2017 is shaping up. It's early, but we feel good about it.

Kenneth Bryan Zaslou
BMO Capital Markets (United States)

Q

Great. Thank you.

Operator: Thank you. We do not have any more questions on queue. I would like to hand the call back to our speakers.

Donald J. Smith
President, Chief Executive Officer & Director

Well, let's end by reemphasizing, I think, an important point. As we continue growing our volume and our earnings, everything else will fall in line. Growth is and will be our primary focus. Thanks, everybody, for joining us today and I hope you have a great week.

Operator: Thank you. That ends today's conference call. Thank you all for participating. You may now disconnect.

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