Conagra Brands

Q3 FY24 Earnings Call

April 4, 2024

CORPORATE PARTICIPANTS

Melissa Napier - *Senior Vice President of Investor Relations*

Sean Connolly – *President and Chief Executive Officer*

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PRESENTATION

Melissa Napier
Good morning. This is Melissa Napier from Conagra Brands. Thank you for listening to these prepared remarks on our fiscal 2024 third quarter earnings. At 9:30 eastern time this morning, we will hold a separate live question and answer session on today's results, which you can access via webcast on our Investor Relations website. Our press release, presentation materials, and a transcript of these prepared remarks are also available there.

I'm joined this morning by Sean Connolly, our CEO, and Dave Marberger, our CFO. We will be making some forward-looking statements today. And while we are making these statements in good faith based on current information, we do not have any guarantee about the results we will achieve. Descriptions of our risk factors are included in our filings with the SEC. We will also be discussing some non-GAAP financial measures. Please see the earnings release and the slides for GAAP to non-GAAP reconciliations and information on our comparability items, which can be found in the Investor Relations section of our website. I'll now turn the call over to Sean.

Sean Connolly
Thanks, Melissa. Good morning, everyone. Thank you for joining our third quarter fiscal '24 earnings call. Our Q3 results demonstrate steady progress and the continuation of the momentum we've been building throughout the course of the fiscal year. This starts with our top-line performance, which again saw sequential improvement driven by our brand building investments in key areas. Our brands continued to perform well in the broader market, including strong unit share gains across our portfolio, particularly in the large frozen single-serve meals category. Importantly, outstanding progress on delivering cost savings helped fuel these investments, enabling us to simultaneously improve volumes and sustain margin recovery.

In addition to our solid margin performance, our strong free cash flow drove further reduction in our net leverage ratio, as we continue to prioritize debt reduction. As we enter the fourth quarter, our financial results and strategic initiatives further support our confidence in our ability to achieve our targets and drive value for shareholders. Based on the consumer response to our investments, our progress on cost savings, and year-to-date performance, we are increasing our expectations for adjusted operating margin while reaffirming our net sales and adjusted EPS guidance.

Turning to slide five, our Q3 results were largely in line with expectations. As we just discussed, we saw sequential volume recovery. We're supporting our brands with high quality merchandising and advertising. Importantly, as we have made these investments, we've been able to sustain our gross margin. We also continue to deliver substantial improvements in free cash flow over the first three quarters of fiscal '24 with an outstanding conversion rate of approximately 124%, further bolstered by year-to-date cost savings of 4%, which I'll dig into in a moment.

Slide six shows our Q3 results. Net sales were approximately $3 billion reflecting an organic net sales decline of 2%. Adjusted gross margin increased 52 basis points to 28.7% driven by increased productivity. Adjusted operating margin was 16.4% representing a 49 basis point decrease over the prior year quarter. Q3 adjusted EPS was $0.69, which decreased $0.07 over the prior year quarter largely due to our increased investments in A&P and SG&A, which we'll touch on later.

As you can see on slide seven, stabilization in our supply chain has resulted in stabilization within our manufacturing structure. From an improved flow of raw materials to a more experienced workforce to getting goods out the door more quickly, this stabilization has enabled us to further drive our productivity initiatives. On a year-to-date basis, we've delivered significant improvement across key supply chain metrics from fiscal 2023. Our service levels reached 96%. We've reduced our inventory dollars by 7.1% over the prior year quarter. And as I noted a moment ago, cost savings reached 4% year-to-date. That includes cost savings of 4.6% in Q3.

While these numbers may fluctuate slightly from quarter to quarter, the improvement in trend is undeniable and a credit to our dedicated employees. Productivity is critical to supporting investments across our business, and strong productivity performance unlocks our ability to invest in our brands while maintaining margins.

As we discussed at CAGNY and earlier today, we maintain a multifaceted and disciplined investment program as shown here on slide eight. We are continuing our robust brand building investments across merchandising, innovation, and advertising to drive volumes while sustaining the gross margin recovery we have worked hard to achieve over the past couple of years. So, we continue to see good ROI from these investments. Consumers are responding to our merchandising and advertising as our brands are standing out, both inside and outside of stores.

We also continue to prioritize investment in innovation, which remains the most important tool in our strategic playbook and the key to strengthening our brands while driving sustainable, long-term growth. This year's innovation slate has been met with some of the strongest customer enthusiasm we've seen yet.

On slide nine, you can see the cadence of our volume recovery. Importantly, this is not a new phenomenon, but a continuation and acceleration of the progress that began two quarters ago. Additionally, trends in consumption across our key domains, as seen here on slide 10, reinforce our confidence in even further volume recovery. Again, a continuation and acceleration of the progress we've seen through the course of the year.

And encouragingly, that momentum has continued in Q4, driven by frozen, where our most recent four weeks of volume consumption improved to -1.2% versus year ago. That's around a 6.5 percentage point improvement since Q1. I also want to point out that Conagra's portfolio has proven to be especially resilient when compared to the broader market. On slide 11, you'll see approximately 52% of our brands are holding or gaining unit share, a 12 point increase compared to the prior year period. And our share performance is even stronger within our strategic frozen and snacks domains.

Importantly, approximately 59% of our brands in those two domains held or gained unit share, which compares favorably relative to the performance of our peers in their strategic domains. This strong share performance has been fueled by the solid lifts we've generated through high quality merchandising investments, as shown here on slide 12. We have demonstrated growth across the entire portfolio when compared to prior year levels, particularly in our frozen domain where we have focused our investments.

When looking at frozen specifically on slide 13, we are outperforming the market on a volume basis amidst what's been a challenging volume environment overall. We realized a one point unit share gain in the total category with single-serve meals, sides, and desserts driving the increase and strong performance from some of our biggest and most strategic brands like Healthy Choice, Banquet, P.F. Chang's Home Menu, and Marie Callender's.

Taking a closer look at single-serve meals on slide 14, you can see the extent to which our strategic investments in enhanced merchandising across this category enabled us to deliver record share performance. Slide 15 highlights some exciting innovation we have planned through 2024. Starting with our single-serve meals, we are innovating across the portfolio to cater to a greater variety of consumer preferences by elevating and modernizing our recipes.

For larger groups, we are expanding our multi-serve meal portfolio with the addition of frozen products that offer incredible value to consumers, both in terms of quality and price. We're also moving our Dolly Parton line into frozen, offering both baked goods and frozen meals. And finally in vegetables, we are expanding our Bird's Eye brand with exceptional culinary inspired products that appeal to younger, more affluent households.

Slide 16 details our International and Foodservice segment performance. In our International segment, volume and net sales increased over the prior year quarter driven by strong performance in our Mexico and Global Export businesses. This carried forward the momentum we've built thus far in fiscal 2024, as organic net sales have increased 4.8% year-to-date. Net sales in our Foodservice segment decreased in the quarter, largely due to our decisions to reduce or exit less profitable business in lower priority categories, as well as some softness in food-away-from-home traffic.

Despite this year-over-year decrease, we've seen a 2.9% improvement in organic net sales year-to-date. We continue to deliver very strong free cash flow, which has enabled us to improve our net leverage ratio. Dave will cover this in more detail shortly. But as you can see, on slide 17, we drove a meaningful improvement in free cash flow and concluded the quarter with $1.2 billion of free cash flow year-to-date. Our efforts to prioritize debt reduction continued to yield strong results, and in Q3, we reduced our net leverage ratio to 3.44x times.

Our fiscal 2024 guidance across key metrics remains largely unchanged. However, we are updating our adjusted operating margin guidance to reflect our ability to drive value by balancing our investments in our brands with cost savings. Overall, we are pleased with our performance during the quarter, which reinforces our confidence in our brands, plans, people, and agility. With that, I'll pass the call over to Dave to cover the financials in more detail.

Dave Marberger
Thanks, Sean. And good morning, everyone. Slide 20 highlights our results from the quarter, which demonstrate our steady progress on top-line recovery while maintaining our margins. Q3 marked the fourth consecutive quarter where we've reported an improvement in the rate of volume change over the prior year's quarter.

Q3 net sales were $3 billion, reflecting a 1.7% decrease from the prior year quarter, and an organic net sales decline of 2%. We made strategic investments to support volume recovery while delivering solid margin performance during the third quarter. Q3 adjusted gross margin was 28.7%, an increase of 52 basis points versus prior year, and an improvement from first half adjusted gross margin of 27.2%.

Adjusted SG&A increased 7.4% primarily driven by the timing of incentive compensation expense. A&P also increased 6.5% and was 2.8% of net sales, reflecting our increased advertising investment on the Birds Eye and Healthy Choice brands. Adjusted EBITDA decreased 5.3%, driven by lower operating profit and a reduction in equity method investment earnings as our Ardent Mills Joint Venture wrapped on record earnings in the prior year. We delivered Q3 adjusted net income of $329 million, or $0.69 per diluted share.

Slide 21 provides a breakdown of our net sales for Q3. The 2% decrease in organic net sales was primarily driven by a 1.8% decrease in volume given the lower-but improving- consumption trends, as well as a (0.2)% negative impact from price mix, largely driven by the company's investments in the quarter. While our investments are up in the quarter as we planned, total merchandised consumption is in line with pre-COVID levels. We also saw a small benefit of 0.3% from the favorable impact of foreign exchange.

Slide 22 outlines the top-line performance for each segment in Q3. As Sean detailed, we drove volume recovery across our domestic retail business during Q3 versus last quarter. Our Grocery and Snacks segment increased net sales 3.4% in the quarter versus prior year, driven by improved price mix. Net sales declined 8.1% in our Refrigerated and Frozen segment, due mostly to an increase in strategic investments in our frozen business.

While these investments contributed to a decline in price mix of 4.8% in the quarter, they supported dollar share gains, most notably in our frozen single-serve meals category. We are confident that our continued merchandising investment and innovation will help our domestic retail volumes continue to improve moving forward. Our International segment’s performance was primarily driven by another strong quarter from the company's Mexico and Global Export businesses. Our Foodservice segment was impacted by year-over-year volume declines that were partially offset by price mix increases.

Turning to our Q3 adjusted operating margin bridge on slide 23, we continue to focus on driving operational efficiency and cost savings to improve our margins. In Q3, our efforts drove a 52 basis point increase in adjusted gross margin from prior year. We delivered a 3.3 percentage point margin increase in supply chain productivity, which represents approximately 4.6% of cost of goods sold for Q3. This was offset by a 1% impact from absorption.

We also realized a one-time benefit related to insurance proceeds from prior year lost sales from our canned meat recall within our Grocery and Snacks segment, and a smaller one-time benefit in our International segment. We are very pleased with the continued improvement in our supply chain, as Sean discussed, enabling us to increase investment while improving our gross margins.

Slide 24 details our adjusted operating margin performance by segment for Q3. Our Grocery and Snacks, Foodservice and International segments all delivered double digit adjusted operating profit growth and significant adjusted operating margin improvement in Q3, driven by the cost savings and productivity improvement just discussed. Our Refrigerated and Frozen segment operating margin was 16.9% for Q3, which was 30 basis points above the Q2 margin. However, Refrigerated and Frozen operating margin was below prior year by 385 basis points due primarily to higher prior year's gross margin, which benefited from the timing of inflation-driven pricing, and secondarily to increased merchandising and A&P investment in the current year quarter.

As Sean highlighted, we see this investment driving strong lifts and we will continue to invest in a disciplined manner moving forward. Overall, the efficiency of our operations in Q3 resulted in cost savings that enabled us to fund investment while maintaining gross margin. That is a formula we want to continue going forward.

Q3 adjusted EPS was $0.69, which decreased $0.07 over the prior year quarter. EPS was impacted by lower net sales in Q3 but offset due to our strong cost savings performance. The entire amount of the adjusted EPS decline in Q3 was driven by the increase in adjusted SG&A and A&P investment, a slightly higher tax rate versus a year ago, and lower equity method investment earnings from Ardent Mills.

Slide 26 displays our continued progress on free cash flow and our net leverage ratio. For year-to-date Q3, we delivered a $786 million improvement in free cash flow over the first three quarters of fiscal ’23, which represents a free cash flow conversion rate of approximately 124%. Our focus on managing inventory levels and improvement in accounts payable, combined with our improved cash returns from our Ardent Mills Joint Venture, contributed to these strong results.

Not only is our free cash flow conversion the highest it's been in recent history, our free cash flow yield is the top among our peer group over the last 12 months. We continue to prioritize debt reduction, and our strong free cash flow enabled us to reduce debt more than $700 million over the last 12 months and by approximately $400 million since the last quarter. This resulted in a lower net leverage ratio of 3.44x times at the end of Q3. And we now expect our year end net leverage ratio to remain at this level, which is an improvement versus our estimate last quarter.

Slide 27 updates our full year fiscal 2024 guidance assumptions. Given the productivity progress we detailed today, we have modestly increased our adjusted operating margin expectations to approximately 15.8% for the full year. Our guidance ranges for organic net sales and adjusted EPS remain unchanged. We expect to finish the year towards the lower end of our organic net sales range and towards the midpoint of our adjusted EPS range. We are also adjusting expectations for CapEx and interest expense, which we now anticipate at $425 and $435 million, respectively.

That concludes our prepared remarks. Thank you for your interest in Conagra Brands.