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Kenvue, Inc. (KVUE)

Q3 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Greetings, and welcome to Kenvue's Third Quarter 2023 Earnings Conference Call. My name is Darryl, and I'll be your operator today. At this time, all participants are in a listen-only mode. The question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference call is being recorded.

It is now my pleasure to introduce you to Kenvue's Vice President of Investor Relations, Tina Romani.

Tina Romani
Head-Investor Relations, Kenvue, Inc.

Good morning, everyone. I am pleased to be joined today by Thibaut Mongon, Chief Executive Officer and Director; and Paul Ruh, Chief Financial Officer.

Before we get started, I'd like to remind you that today's call includes forward-looking statements regarding, among other things, our operating and financial performance, market opportunities and growth. These statements represent our current beliefs or expectations about future events and are subject to various risks, uncertainties and assumptions that could cause our actual results to differ materially. For information regarding these risks and uncertainties, please refer to our earnings materials related to this call, posted on our website and our filings with the SEC.

During this call, we've also referenced certain non-GAAP financial information. The presentation of this non-GAAP financial information is not intended to be considered in isolation or as a substitute for financial information presented in accordance with GAAP. A reconciliation of these items to the nearest US GAAP measure can be found in this morning's press release and our presentation available on the Investor Relations section of our company's website, kenvue.com

And with that, I'm pleased to turn the call over to Thibaut.

Thibaut Mongon

Chief Executive Officer & Director, Kenvue, Inc.

Thank you, Tina. Good morning, and thank you for joining us today. I'm pleased to be here with you, hosting our first earning call as a fully independent company. Since our last call, Kenvue has formally separated from Johnson & Johnson, and we are now included in the S&P 500 index, solidifying our place as the world's largest pure-play consumer health company by revenue. It's hard to believe it has only been two months since J&J completed their successful exchange offer, given all we have accomplished this year.

So, in addition to delivering another healthy quarter, with 3.6% organic growth this quarter on top of 4.7% growth last year, we also continued to make tremendous progress, standing up Kenvue for success as a standalone company. From the creation of legal entities and the transfer of licenses, to the development of fit-for-purpose company policies and build our systems, our teams continued to execute our separation plan successfully and on time. We remain on track in building a consumer-focused operating infrastructure, while simultaneously bringing to life our purpose to realize our extraordinary power of everyday care and delivering profitable growth.

Operating in the attractive consumer health space with an unparalleled portfolio of science-backed, healthcare-professional-recommended trusted brands is what drives the resiliency and sustainability of our performance. We do all this in what continues to be a volatile environment, and we are conscious of the impact of the current geopolitical and macroeconomic situation on consumer behavior. It is our long track record through economic cycles and our performance this year that give us confidence in the superiority of our model based on brands that are part of daily rituals and designed for moments that matter.

Every day, we continue to make sure our brands are attractive for all consumers, and we cultivate their desire for our efficacious, trusted products. Similar to Q2 and consistent with what we have seen historically, while consumers may be trending down in certain discretionary categories, we continue to see strong affinity for our brands and stable private label penetration. As a standalone company, our teams remain focused on advancing consumer health through innovation, bringing new options to market that consumers love and expanding the reach of our brands in the categories we operate in.

And we see this reflected in the healthy performance of our portfolio again this quarter, starting with our largest segment, Self Care. Once again this quarter, Self Care has demonstrated its ability to serve consumers with trusted solutions when they're needed most. Even as unprecedented levels of cold, cough and flu incidents started to normalize as expected this quarter, we continue to see Self Care outperform the market, growing 6.7% on top of a strong 6.9% growth last year, driven by both value validation and positive volumes, with all our product categories growing mid to high-single digit. Consumer loyalty to our brands alongside investments in relevant brand activation, introduction of consumer experience, enhanced innovation and premiumization continue to foster volume growth and share gains.

Let me share some examples with you. In Digestive Health, our Imodium and Pepcid brands are outpacing the market, as supply recovery and strong consumer demand underpin growth. As consumer preferences shift away from preventive solutions to immediate relief products, our teams strategically launched successful brand activation campaigns that capitalize on this dynamic, ultimately accelerating our share gains during the quarter.

In Pain Care, even with cold and flu incidence levels down and a slow start to the season so far as the weather in the Northern Hemisphere remained unseasonably warm, we are gaining share this year globally through premium innovation and product premiumization. Tylenol is the number one pain brand globally, continues to gain share with successful premiumization initiatives and the reintroduction of product activation and displays, supporting growth. This is testament to the brand's leadership, the enviable consumer and healthcare professional trust and the strength of our teams.

Another standout innovation in this category that deserves highlighting is our recently launched Motrin Dual Action product in the US. It combines two core ingredients from two iconic brands, Motrin and Tylenol. And the combination of these two brands is resonating with our consumers with eight hours of relief in pain and inflammation, driving share gain for Motrin. Beyond the US, we apply a similar winning formula around the world. In China, for example, Motrin recently expanded into a more holistic field of solutions with the successful launch of new Motrin fever patches.

Within allergy, while the season remains soft, with lower incidence levels this year, we have continued to drive accelerated share gains globally and in our largest market in US. Adult's Zyrtec has maintained its number one branded share leadership for 77 consecutive weeks now and children's Zyrtec achieved number one branded share position through an impactful go-to-market strategy and high-top outreach to healthcare professionals, supporting the successful launch of children's Zyrtec chewables last year. We also drove share gains for Benadryl in the US with the launch of our Extra Strength formula and for our allergy portfolio in China.

Smoking cessation had another quarter as well. In the UK, our Nicorette team secured a new indication for vaping cessation. Early indications of consumer response have been strong, with Nicorette gaining share and increasing household penetration. This new indication demonstrates Kenvue's credibility in establishing new standards in the category, while also highlighting the opportunity for growth in other markets around the world.

Through these examples, you see the Kenvue model at work. We continuously strengthen our leadership positions across product categories, introducing impactful innovations, bringing healthcare professionals new clinical data and identifying solutions to help address unmet consumer health needs. And we do this successfully, extending the reach of our iconic brands to deliver sustainable growth.

Before I wrap on Self Care, I want to take a moment to address the US acetaminophen litigation, which we appreciate based on our engagement with many of you in recent weeks, remains top of mind. As you will understand, I'm limiting on what I can say on active litigation. However, given some of the noise and frankly, misinformation we have seen lately, I believe, we should provide some clarity.

Over the past several months, it's important to note that the only meaningful development in the litigation from our perspective has been that FDA continues to maintain the same pregnancy advice on acetaminophen labels that has been in place for decades. This conclusion is based on multiple reviews since 2014, with the most recent being March 2023 that recent studies do not change FDA's view on acetaminophen safety. For us at Kenvue, nothing is more important than the health and safety of the people who use our products.

We're also concerned about the potential for real public health consequences in allowing claims made in courtrooms to influence medical decisions. Acetaminophen is one of the most studied medications in history and is often recommended by doctors as a first-line treatment option for women who have a fever or experiencing pain during pregnancy; conditions that, when left untreated, are scientifically known to potentially have serious health consequences for both mother and baby. And we'll continue to stand behind the safety of our product.

Getting back to the third quarter and moving to Skin Health and Beauty. While we are executing on our plans to gradually increase performance with organic growth about flat this quarter, our current results do not reflect our long-term ambition for the segment nor the underlying strength of our brands. There were two primary pockets of weakness this quarter in the segment, which accounted for about two-third of the 6.8% volume decline. First, the continued impact of the rationalization initiatives we conducted last year; and second, the general market softness in China.

Starting with the first. As a reminder, we made a decision in 2022 to discontinue certain codes to focus on the production of core lines, while we were experiencing supply chain disruption. These discontinuations resulted in lost points of distribution in the 2022 US retailer planogram resets. And with planogram resets occurring annually, our first opportunity to regain a portion of this distribution point is with the fall 2023 resets, which are happening as we speak. While we expect to still see an impact of the discontinuations in the fourth quarter as these changes take time to materialize in our results, it's good to see our teams securing a number of wins with the customers' resets.

Moving to China, we see continued softness in that geography, with Chinese consumers being more cautious on spending. As I shared last quarter, we have expected a slower recovery in China, and unfortunately, that's what we see happening. We remain positive on the long-term prospects in China as well. We have operated there for many years and have confidence in the market's potential longer term. But we need to be patient as we expect continued softness in the market in Q4. And our teams on the ground will continue to be agile and allocate resources according to the opportunities they see in the market. Importantly, despite these two distinct dynamics, we were pleased to see sequential quarter-over-quarter improvement when looking at organic sales on a two-year basis, which factors in some of the unique supply recovery dynamics we are lapping in the back half of 2022.

If we look at the performance of Skin Health by geography now, in the US, our largest market, when excluding the impact of discontinuations, we are pleased to see sequential progress in our recovery plan with some of our core platforms gaining share. This quarter, we've expanded our beloved Neutrogena Hydro Boost line by elevating our science, design and packaging. This include upgrading the water gel format with dye-free, fragrance-free options, alongside more sustainable packaging; and also introducing our new Hydro Boost Water Cream, which delivers nine times more lightweight hydration. These two innovations are in the top three new launches in facial moisturizers. And Hydro Boost won the 2023 PEOPLE Beauty Award in this category, reflecting its status as its category prototype in hydration.

We've also had a strong finish to the sun season, growing more than 80% faster than the market and regaining our leadership position through experience-enhancing innovation and compelling brand activation, with Neutrogena holding nearly half of the top 10 launches of the category. Building on these successes, we continue to deploy our recovery plan and look forward to sequential improvement in the coming quarters.

Outside the US, I've already spoken about China. But in other markets, we're excited to see positive initial reaction to the reintroduction of innovation and benefits from four resets completed earlier in the year. This quarter, we have seen Skin Health and Beauty core meetings in both Latin America and Europe. In Latin America, strong performance was driven by strength in sun, coupled with positive customer response to the Neutrogena Hydro Boost innovation I just talked about.

In Europe, momentum continued in Neutrogena and Aveeno, with mid-teens growth across priority markets on strong consumer response to the new product innovation our teams launched early in the year. Neutrogena is currently growing twice as fast as a category in Germany, outpacing the competition, fueled by the continued success of our Hydro Boost and Retinol Boost lines. In the UK, Aveeno continues to accelerate its share growth with the team holding the number one position in body care and also doubling its share in face care versus a year ago.

With Europe being the first in the portfolio to launch innovation and completing their floor resets early in the year, we believe this market serves as a leading indicator for the remainder of the globe. While we expect gradual recovery to continue, we acknowledge there is more work ahead. Our brand equities are strong, and these examples of success give us confidence that with the proper support, the segment will deliver, over time, a level of performance aligned to our long-term ambition.

And in Essential Health, with 3.8% organic growth this quarter, Essential Health continues to deliver ahead of our long-term growth goals for the segments. Our value realization and premiumization strategies continues to perform well, with 10 points of valuation realization, offset by about 6 points of volume. And about 2 points of the volume decline can be attributed to the softness in China I just talked about, with the remaining, reflecting on prioritization of margin recovery through value realization, as well as certain markets and competitive dynamics.

Innovation in oral care, premiumization in women's health and strength in the US baby care are fueling our growth. Starting with mouthwash, we continue to see strength with Listerine Gum Therapy in the US. Recognizing three out of four adults suffer from some form of gum disease in the US, you may remember that we launched earlier this year Listerine Gum Therapy to address this unmet consumer need. Under Listerine, the number one oral care brand on the market, and with acceptance by the American Dental Association, we have seen immediate success post-launch, with Listerine Gum Therapy quickly winning and holding the number one new product innovation in the mouthwash category.

In addition, we also continue to see positive response from healthcare professionals with our five times flossing claim gaining traction around the world. And we see the impact in our performance. While being roughly five times larger than the next competitor, Listerine continues to gain share globally, through the strength of our innovation, healthcare professional recommendations and a strong distribution network.

In Baby Care, our global leadership in baby toiletries remains strong. Johnson's Baby and Aveeno baby are the number one and number two brands in the baby toiletries category globally and are eight times and two times bigger than the next closest competitor, respectively. While we continued to see pressure in Asia, in the US, our largest market, we see strong growth with Johnson's Baby and Aveeno Baby gaining share with supply recovery, value innovation and the successful launch of Aveeno Kids, which is driving substantial growth, becoming the fastest-growing brand in the US kids toiletries market. Finally in women's health and wound care, we had another quarter of solid growth.

So, as you can tell, our Q3 performance exemplifies the power of our portfolio. While we continue to operate in a dynamic environment, requiring agility and customer intimacy, I am pleased with the way our teams have been able to deliver on our top line objectives this quarter and throughout the year. The same applies to the balance of the P&L. And Paul will walk you through the details of our financials. We are pleased with our ability to navigate market dynamics and deliver earnings per share in line with expectations, while executing our plan to stand up our standalone company for success.

So, in closing, we delivered another quarter of healthy growth as a result of the balance we have across our intentionally curated portfolio of iconic brands, the power and agility of our operating model and the execution of our 22,000 Kenvuers around the world. I want to take this opportunity to thank our teams for their outstanding focus, their owners' mindset and their bearing spirit. As a fully independent company, they demonstrate every day their commitment to deliver innovative healthcare solutions to our more than 1.2 billion consumers around the globe.

And with that, I'll pass the call over to Paul, to review our financial results in more detail.

Paul Ruh

Chief Financial Officer, Kenvue, Inc.

Thank you, Thibaut; and good morning, everyone. Echoing Thibaut's sentiments, I'd like to commend the ongoing passion of our people and our dedication to standing up Kenvue to be well-positioned over the long term. The energy I felt across the organization over the past several months has been inspiring. Not only have our teams made tremendous progress in executing the separation, they also delivered in the face of continued inflationary and macroeconomic pressures and the dynamic operating environment.

Getting into performance. We had another healthy quarter with 3.3% reported growth and 3.6% organic growth. In terms of drivers, value realization, which is comprised of price and mix, represented 7.1% points of growth. The majority of the value realization reflects the benefit of price actions we have taken in the first half of this year, with a contribution of approximately 20% from carryover actions, we executed in the second half of 2022.

Volume was down 3.5% points, with approximately two-thirds of the decline attributed to two distinct factors: First, last year's portfolio rationalization; and, second, the continued market softness in China that Thibaut spoke about. Excluding these unique dynamics, our results demonstrate consumers' affinity to our brands. Acknowledging that performance in certain pockets of the portfolio is not where we would like it to be. The fact that we were able to deliver results in line with our commitments at this early stage in our journey, exemplify the strength and resiliency for our portfolio and operating model. This drives the reliability of the results alongside durable cash flow generation.

Transitioning to our results-based segment. Strength in Self Care continued with 6.7% organic growth. We continued to see strong positive value realization of 5.5% points alongside a 1.2% points volume increase. As Thibaut mentioned, our teams continued to strengthen our Self Care portfolio with a broad range of offerings from allergy and pain, to smoking cessation and digestive health, with all product categories contributing to growth.

We recognize that there's a lot of attention on cold, cough and flu products as we and the entire industry, lap unprecedented demand over the past few years. To-date, we have observed a delayed start of the season. And we have incorporated the slow start in our outlook for the balance of 2023. We, of course, are ready for whatever the season may bring, and we'll work with our customers to ensure our products are available to meet consumers' needs.

Lastly, in Self Care. With regards to phenylephrine or PE, while this ingredient has been in the headlines recently due to the ongoing FDA review, the agency has been clear that the review is not about the safety of our PE and they have not made a determination about oral PE in the monograph nor have they advised consumers to discontinue use. The FDA routinely reviews ingredients. And as always, we will work with the agency and our customers to ensure that we continue to offer a variety of options of both OTC and behind the counter solutions to serve the needs of our consumers. To date, we have not seen any impact on our business. Let me remind you, we're not the leader in the cold and flu category, with products containing PE across our portfolio representing just 2% of our global revenue and the US comprising about half of that.

In Skin Health and Beauty, organic growth was negative 0.4% this quarter. Value realization of 6.4 points was more than offset by 6.8 points of volume decrease. Approximately two-thirds of this volume declined can be attributed to our portfolio decisions last year, resulting in lost distribution points this year alongside continued market softness in China.

With regards to recapture of points of distribution in the US, while we are pleased with our progress and are stable these costs, we don't expect to regain all of the lost ground overnight. Our expectations for gradual recovery remain the same. As we have spoken about, we prioritize Sun given the seasonality of the business, then focus on Face with Body and Hair Care next in our recovery plan.

As Thibaut articulated, we have confidence in our strong brand equities as demonstrated by our performance in EMEA and LATAM. When supported by the right level of inventory, product distribution and innovation, we see the flywheel in the business that fuels the growth. We look forward to restoring these elements across the segment.

In Essential Health, we grew organically by 3.8% this quarter as we execute on our value realization and premiumization strategy, with 10 points of value realization offset by 6 points of volume decline. Approximately one-third of the decline can be attributed to market softness in China. Heading into Q4, we see continued momentum in Oral Care behind the holistic value realization plans people spoke about. Premium innovation, such as Aveeno Kids, amongst others, continue to perform quite well, putting Essential Health on track to deliver another strong quarter.

Now, turning to gross margins. Excluding amortization, adjusted gross margin was 59.4%, an expansion of 80 basis points versus last year. Similar to Q2, we continue to see significant, though moderating, inflationary headwinds. Positive trend in logistics and resins have been more than offset by ongoing pressures in energy and continued wage inflation. This pressure was heightened by worsening FX with further devaluation of local currencies such as the Russian ruble and the Argentinian peso, adding incremental pressure to gross margin. FX negatively impacted gross margin by approximately 1.3 points, an acceleration from prior quarter's approximately 1 point impact. Assuming current spot rates, we expect this pressure to continue into the balance of the year that we would not expect to fully offset.

During the quarter, we were able to more than offset these pressures through proactive productivity initiatives as per planned, including procurement category cost reduction, improving supply chain manufacturing efficiencies, and leveraging digital and automation technologies. I'm incredibly proud of our talented operations teams who work in an end-to-end fashion with the R&D and commercial teams, driving efficiencies and executing successful innovation. During the quarter, we also realized some benefits as a result of non-recurring items related to the separation as we continue to evolve to a more fit-for-purpose organization.

Moving to adjusted operating income. Adjusted operating income margin was 23.3% and reflects the impact of the FX headwinds I just mentioned as well as incremental costs of being a stand-alone public company. In line with expectations and prior quarter, our stand-alone public company costs were approximately $50 million to $60 million, and we continue to expect this same level in Q4 as several of our investments are concentrated upfront in the process. We continue to expect these costs to decrease and be offset by other productivity efforts over time, with total public company costs remaining in line with our initial expectations. SG&A also included expenses incurred related to the implementation of our new fit for purpose IT infrastructure and spend around digital capability enhancements.

Moving to Taxes. On a reported basis, our Q3 tax rate is approximately 25.1%. Below reported tax rate versus prior quarter is primarily due to a change in accounting policy with regards to the treatment of global intangible low tax income or GILTI to be in line with peer companies in the consumer goods industry. On an adjusted basis, our Q3 effective tax rate is 25.3%.

The primary drivers for this higher tax rate versus last year are, first, high US tax on all US income net of foreign tax credits and, second, high tax expense related to prior year return provision adjustments and tax law changes offset by windfall benefit on share-based compensation and tax benefit related to the full separation from Johnson & Johnson. And finally, our adjusted net income was $590 million and adjusted diluted earnings per share were $0.31.

In sum, we continue to operate in a dynamic environment that requires agility and where brand loyalty is rewarded. Our Q3 top and bottom-line performance is a testament to the power of our portfolio of iconic brands and the strength of our operating model.

Now moving to cash and capital allocation, we ended the quarter with a cash balance of $1.1 billion and expect operating cash flow to be approximately $2 billion year-to-date, exemplifying our strong cash conversion. Our disciplined capital allocation philosophy remains the same. First and foremost, we responsibly invest resources in our iconic brands to drive profitable growth through marketing, R&D and capital investments.

Secondly, dividends serve as an important part of our TSR algorithm. In line with our commitments, we were proud to pay our first dividend this quarter of $383 million. And this morning, we announced that our board declared a fourth quarter dividend of $0.20 per share. Third, a reliable cash flow generation allows us to prudently delever and reduce interest expense over time.

Fourth, we assess potential inorganic tuck-in growth opportunities that build on our capabilities and strengthen our position as a leader in consumer health. And lastly, we use share repurchase to offset dilution from divesting or exercise of stock-based compensation. Today, we announced our board of directors has authorized a program to repurchase up to 27 million shares of outstanding common stock for this purpose.

Getting into our outlook for the remainder of the year. With the strengthening of the dollar, we now expect the impact of translation of foreign currency fluctuations to negatively impact reported net sales growth by approximately one to two points. Separately, given the soft start of the cold and flu season, we are tightening our previously provided outlook, which included expectations for a more normal season. As I mentioned, so far in the US and in Europe, we haven't really seen the start of the season, which we would typically see at this point in the year. As a result, we expect net sales growth for the full year to be between 4% and 4.5%, and organic growth to be between 5.5% and 6%. On the bottom line, we expect full year adjusted diluted EPS to be in the range of $1.26 to $1.28, which also includes the higher negative impact of FX on gross margin versus our prior expectations.

With regards to remaining fiscal 2023 guidance items, we continue to expect reported net interest expense to be approximately $270 million and approximately $300 million on an adjusted basis. We now expect our reported effective tax rate to be between 25.5% and 26.5%, reflecting the change in accounting policy of GILTI taxes I previously discussed. On an adjusted basis, we expect the range to be between 24.5% and 25.5%. The higher rate versus prior year is primarily driven by jurisdictional mix of earnings and higher US tax on foreign income, net of foreign tax credits in 2023 as compared to 2022. And lastly, our earnings per share range assumes a full year 2023 weighted average share count of 1.852 billion shares.

A couple of notes regarding other assumptions in our guidance. As you review your models for the remainder of the year, it will be important to consider the comps in prior year, particularly in health care, where we are lapping a mid-teens growth as we experienced unprecedented levels of demand as a result of the tripledemic in the US and a strong cold and flu season globally last year.

Further, in Skin Health and Beauty, in addition to continuing to see the impacts of discontinuations until the end of the year, we will also be lapping stronger comps in the fourth quarter of the prior year as we restored supply. With regards to gross margin, in addition to the FX impact I mentioned previously, our fourth quarter gross margins are generally lower from a seasonality perspective as we typically perform our annual maintenance at our manufacturing sites at the end of the calendar year.

In summary, as I reflect on the quarter, I am pleased with the way our teams continue to perform in a volatile environment while executing our separation plan successfully and on time. Operating as one team, we have been able to deliver on top line and earnings expectations year-to-date. This performance allows us to feel confident in our ability to deliver on our commitments for the full year and stand up Kenvue on a foundation for long-term success.

Now, we will open up the line for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. At this time, we will be conducting a question-and-answer session. In the interest of time, we ask that you limit yourself to one question and one follow-up to allow for as many questions as possible. [Operator Instructions] Our first questions come from the line of Andrea Teixeira JPMorgan. Please proceed with your questions.

Andrea Teixeira
Analyst, JPMorgan Securities LLC

Q

Thank you, operator, and good morning, everyone. So, Thibaut, Paul, you gave a lot of examples of the headwinds that you are facing – that you faced in the third quarter and you're facing into the fourth and potentially the first quarter, I understand, given the very strong cold season last year. So, can you give us like some sense of underlying consumption that you're seeing vis-à-vis what your investors should expect in 2024? I think at this point, we are all hoping to get some clarity and some of your peers have given us a little bit of more color in terms of underlying. I understand, of course, if you can put aside Self Care and then focus on the beauty and skin and health because some of that was self-inflicted. If you can comment on how we should be seeing and looking into 2024 in terms of balancing volumes and pricing.

And just my clarification as a second part, your underlying volume decline in the quarter, if I do the math correctly, was this to about 1.5% if you extrapolate those two items that you discretely pointed out? Can you talk on how much do you think consumption would still be negative in the divisions, I would say, in particular Self Care? And how innovation can play a role into 2024 given that? Thank you.

Thibaut Mongon
Chief Executive Officer & Director, Kenvue, Inc.

A

All right. Good morning, Andrea. Thank you for your questions. So, a lot in your questions. So, let me get into it point by point. So, talking about the consumption, the underlying consumption we see in our business, we see that our consumers continue to be focused on taking care of their own health. We see strong – continued strong affinity with our brands. We need to unpack the different puts and takes we have in our results, but you see in our Q3 results the strength of the other portfolio and the strong affinity consumers have for our brands.

If you look at the Self Care segment, you see that all our categories are growing behind consumer demand, healthcare professional recommendation, innovation. We continue to innovate very strongly. I gave you in my remarks a number of examples. And we intend to continue to execute this model where we strengthen our leadership positions with a continuous flow of innovation, new clinical data for healthcare professionals, and to cultivate the vibrancy of our portfolio, which is, I remind you, broader than cold and flu with a vibrant business in allergy, in smoking cessation, in digestive health.

So, we continue to be excited about the prospect of our largest segment, Self Care, understanding that we are comping a very strong – unusually strong, as we said all along, tripledemic and very high cold and flu season we had last winter. And we would certainly not expect the same level of incidents to be replicated this year. That's why we talked all along that we are planning for a more normal season. As you heard from us this morning, so far we haven't seen really the season starting and that's what we reflect in our guidance for this year. But we continue to be excited about the strength of the portfolio and the breadth of the portfolio.

If I move to Skin Health, there are a lot of elements and puts and takes here. So, that makes it a bit more difficult to understand our performance. So, let me unpack it for you. For Q3, we are first lapping a relatively strong Q3 of 2022 with 4.7% organic growth last year as we began to rebuild service levels. On top of that, we have the impact of the discontinuations we did last year. Those were known and expected.

As you heard in our prepared remark, we expect to continue to see some of that in Q4 as planogram resets are becoming effective in the US and around the world. And we see the Chinese consumer being – continuing to be very choiceful and cautious about where they spend their money. And that affects demand in this market. So, these three elements are really masking other bright spots that we have in our Skin Health segment. You heard that Latin America and Europe are doing very well. We concluded in Q3 a very strong sun season in the US.

And as we have said all along, our Skin Health business has been disrupted. We are executing our recovery plan. We are not expecting an overnight improvement. The recovery will be gradual not linear. We started with Sun for obvious reason to catch the season. We are now moving to Face and Body. Lubriderm is doing well. We are launching a number of innovation, especially in the Hydro Boost range in the US. And we'll continue to move with Body and Hair being next in line. So, how we – do we believe that our current performance reflect our long-term ambition for this segment? Absolutely not. But are we confident that the cadence of our recovery plan is on track? Absolutely. And you are going to see that continuing in 2024.

Operator: Thank you. Our next questions come from the line of Steve Powers with Deutsche Bank. Please proceed with your questions.

Stephen Powers
Analyst, Deutsche Bank Securities, Inc.

Q

Hey, great, and good morning. Thank you very much. A few questions. So, Thibaut, maybe to pick up on your last thread there, just maybe a little bit more detail if you could around the expected pacing of distribution point recovery in Skin Health and Beauty. I appreciate the phasing of Face and then Body and Hair, but how much progress, if there is a way to quantify a recovery of those lost distribution points should we expect in this first phase? And how long do you think it will take to fully recover overall? That's question number one.

Question number two, I guess, as we step back and maybe, Paul, this is for you, just given the slower cold and flu dynamics that you've called out, the China backdrop that you've called out, as well as currency headwinds, I guess, have you altered at all your investment plans or investment levels in marketing or other commercial demand building initiatives because of those headwinds? Or are you still planning to invest as you were before and perhaps offsetting that with other forms of productivity or the like? Thank you very much.

Thibaut Mongon
Chief Executive Officer & Director, Kenvue, Inc.

A

Good morning, Steve. So, let me take the first question and, Paul, you take the second one. So in terms of recovery, as I said, we expect the recovery to continue to be gradual, not to be linear.

You see you see the dynamics in the China markets. It is an important market for skin health. We don't expect the market to improve soon and certainly not in Q4.

In terms of distribution points in the US, the planogram resets are happening as we speak. They happen in the fall. We are pleased with the wins that our teams have been able to get as part of these planogram resets. It takes a little bit of time to – for these resets to materialize in our results. So, you are going to see some initial impact in Q4 and then going up from there into 2024.

But I cannot reinforce enough how, as I've said all along, that it's not going to be an overnight improvement. It's a plan that we have planned for 2023 and 2024. And what matters for us is to ensure that we continue to be on track with the execution on this plan.

Paul, do you want to take the second one?

Paul Ruh
Chief Financial Officer, Kenvue, Inc.

A

Happy to. Yes. Thanks, Steve, and great to talk to you. So, our priority number one is to make sure that we keep the flywheel turning. Therefore, as you saw in the results of Q3, we put a lot of emphasis on productivity and you see that reflected in our gross margins. Because we don't want to miss on the opportunities to invest where we see the growth and a model – operating model allows us to do that.

What we do is when we see opportunities to invest with high rate of return, we move the resources to that place. And if the season is starting slowly, we move the resources to where we see the season or the other opportunities for growth already there.

So we have not changed our investment plans overall. Our focus is to deliver on the productivity to maintain those investments where they make most sense in terms of return.

Thibaut Mongon
Chief Executive Officer & Director, Kenvue, Inc.

A

And I would add, you'll see that reflected in our innovation program in Q3. And we have a lot of exciting innovation lined up for Q4. You will see more displays and brand activation with Tylenol.

I talked about with our innovation, Motrin Dual Action that is doing very well and allowing Motrin to gain share. You will see brand activation around Neutrogena Hydro Boost range in particular and continued activation in Europe as well.

Stephen Powers
Analyst, Deutsche Bank Securities, Inc.
Q

Great. Thank you very much, both of you.

Thibaut Mongon
Chief Executive Officer & Director, Kenvue, Inc.
A

Thank you.

Operator: Thank you. Our next questions come from the line of Jason English with Goldman Sachs. Please proceed with your questions.

Jason English
Analyst, Goldman Sachs & Co. LLC
Q

Hey. Good morning, folks. Thanks for slotting me in. Two questions. I'll start with a change topic over to cold and flu. We heard P&G last week, double-digit growth on Vicks, really good sell-in there. And we heard from Reckitt who also talked about really good sell-in around cold and flu.

Your message is obviously contrasting pretty sharply with that, and I guess it's a little unclear why, and two potential explanations. One, your sell-in is weaker, suggesting like maybe retailers are planning for a little less support behind you than your competitors. Or secondly, like maybe selling fine, you're just looking around the corner saying sell-in's good but the season looks soft so we're going to plan for less pull-through as we look forward.

So, can you help provide a little more clarity on how we reconcile those and which of those potential scenarios is most close to the truth?

Thibaut Mongon
Chief Executive Officer & Director, Kenvue, Inc.
A

Jason, good morning first. You are absolutely right in your analysis. We have the second scenario in mind. That's what we are seeing. We see ourselves and our retailers ready for the season. Everybody is prepared for the season, and that's reflecting in the sell-in and that's reflecting in the strong performance of our health care business in Q3.

Having said that, when we look around the corner and look at signs of start of the season, we have not seen that so far given the very warm weather we have seen in the US, in Europe.

And so that's what we are reflecting in our outlook, not so much the sell-in. That is, as always, good to make sure that everybody is ready for the season, but more what we see on the ground in terms of start of season.

Jason English
Analyst, Goldman Sachs & Co. LLC
Q

Understood.

Paul Ruh
Chief Financial Officer, Kenvue, Inc.
A

And a couple of points to add maybe, Jason. The first one is our readiness compared to what it was before is much higher. We have actually increased our capacity in several lines. And also, in our IT infrastructure to be able to connect much better with our retailers.

So when the signal is there, we will be ready to react. That means that we – on a total end-to-end value chain, we're be able to optimize inventories for the benefit of us and the retailers as well.

So, we will be ready and the situation is much better after the learning that we had from the previous pandemic years.

Jason English
Analyst, Goldman Sachs & Co. LLC

Q

Helpful stuff. Thank you and congrats on the success you see in Skin Health & Beauty in Europe. Like you said, I hope it is indeed an early indication of what the US could look like when all these initiatives take hold.

You mentioned that the cadence of the improvement is on track. It doesn't – from the outside looking, it doesn't seem like that's the case at all. We spoke last quarter about the cadence of the destock, right – sorry, not the destock, the rationalization happened this quarter last year.

You're supposed to come out of this quarter having fully cycled that. And in fact, you're supposed to come out this quarter with now more product slotted in on a shelf reset. So this was supposed to pivot from a headwind to full – almost net neutralized this quarter to tail end in the fourth quarter. Now you're saying now not the case, it's actually going to be a headwind again in the fourth quarter.

So, something's gone wrong. The shelf resets must not be going as well as expected or there's other discontinuations elsewhere. Help me understand kind of what's been – what's derailing this path of improvement?

Thibaut Mongon
Chief Executive Officer & Director, Kenvue, Inc.

A

Yeah. So let me take this one. On Skin Health & Beauty and the recovery of distribution in the US. As you know, planogram reset happened in the fall. So we are just going through the resets as we speak, right, in the US depending on which customer you are talking about.

As I said, we are pleased of some of the wins we have had with these resets. And you are going to see improvement, but not immediate. That has always been our plan and we are going to – we are seeing continued impact this quarter. You are going to see continued impact in Q4 less and less as quarter four unfolds as this new planogram resets materialize in our numbers.

So, you had a lasting impact of these losses of distribution points. But you are right, we are recovering gradually, as we said all along, through planogram resets, through launch of innovation. And that's what we saw with Sun that's what we are going to see in face and body, and hair will be next.

Jason English
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Thank you.

Operator: Thank you. Our next question comes from the line of Anna Lizzul with Bank of America. Please proceed with your question.

Anna Lizzul
Analyst, BofA Securities, Inc.

Q

Hi. Good morning and thank you for the question. On Self Care, volumes were a bit better than expected despite the more normalized or slower start to the cold and cough season.

We've noticed that you gained market share nicely in the Self Care categories over the past few years. So even if we do see a softer winter season overall, should we expect volumes to continue to be bolstered by those market share gains?

Thibaut Mongon
Chief Executive Officer & Director, Kenvue, Inc.

A

Hey, Anna. Good morning. Good question. I think what you – you rightly said that we have consistently outperformed the market for a long time now in health care, and we continue to see that happening. You also see the power of the portfolio, our broad based portfolio in health care covering multiple categories.

So, in terms of volume, we certainly continue to expect our non-seasonal categories to outperform with innovation, with strong brand activation, and execution around the world, with customers and health care professionals.

With regards to the cough and flu season, given the totally abnormal high season with the tripledemic we had last year, as we said all along, we would not expect the same type of volume to materialize, this year.

So no change in this area. We continue to grow and fire on all cylinders on the non-seasonal part of the portfolio. For the seasonal part of the portfolio, we will see where the season goes.

What I can tell you is that within this season, we are absolutely ready to be extremely competitive. Paul mentioned about our supply capacities has been expanded and we are absolutely ready to have to be very competitive this season.

Anna Lizzul
Analyst, BofA Securities, Inc.

Q

Thank you for that. And I also wanted to follow up on Skin Health & Beauty. You did mention in your prepared remarks you are introducing some innovation within the Neutrogena brand. Is that helping you add or regain distribution?

And then just in terms of the innovation, given that's typically more premium in nature year-over-year, the pricing slowed this quarter versus last year. I'm just wondering why that was given the innovation that you introduced.

Thibaut Mongon
Chief Executive Officer & Director, Kenvue, Inc.

A

So, absolutely, you're right. We are introducing innovation around the world. I talked about the positive impact that this innovation had in Europe. If you talk about Neutrogena, Germany is a great example where our new Hydro Boost lines and Retinol Boost lines are doing extremely well over there.

For us, this fall and winter, our hydration line, Hydro Boost, which is really the hero line in hydration for Neutrogena is strengthened, I would say with innovation we are launching this quarter with our new Hydrogel Cream and new options in our hydro gels – Hydro Boost gels, sorry. And this allows to have a halo effect on the entire Hydro Boost range and you will see displays and brand activations for the entire range beyond the innovation but building on this innovation.

So, absolutely innovation is part of our algorithm for success and helps us activate brands in a much bigger way, in-store and online.

Anna Lizzul
Analyst, BofA Securities, Inc.

Q

Thank you.

Operator: Thank you. Our next questions comes from the line of Filippo Falorni with Citi. Please proceed with your questions.

Filippo Falorni
Analyst, Citigroup Global Markets, Inc.

Q

Hey. Good morning, everyone. Question on China, I believe you talked about being a headwind in the quarter. Can you give us some sizing of the China business and some color on where your main exposure is, but on a segment basis?

And longer term, clearly, the macro picture is still challenging there. But like what are your expectations of an improvement in China consumer trends and your business performance there? Thank you.

Thibaut Mongon
Chief Executive Officer & Director, Kenvue, Inc.

A

Yes. China represents about 7% of our global revenue, Filippo. So, that gives you a sense of our exposure to China that is not disproportionate, I would say.

We see, as I said, the consumer to be cautious and choiceful in their spending. And we see that reflecting in our portfolio of Skin Health and Essential Health segments have been impacted by this behavior in China. And we don't expect short-term recovery in that area.

On the other hand, on the Self Care side, we continue to see vibrant demand for our brands in allergy, analgesics as an example.

So, lots of – again, the power of the Kenvue portfolio that allows us to continue to be confident in the long-term outlook in this market. We continue to innovate in this market. I talked about Motrin fever patches, and as an example of the type of innovation we are launching in the market.

So, for China, the power of the portfolio will continue to be agile and move resources to see we – to the areas where we get a good return. Clearly, today, it's more in the health care side than the other parts of the business.

But our teams on the ground are agile, and we'll continue to be ready. We have been in China for decades. We are in China for the long term, and we remain confident in the long-term prospect of this market, given the size of the middle class, the Healthy China 2030 agenda, and all the underlying factors in that market.

Filippo Falorni
Analyst, Citigroup Global Markets, Inc.

Q

Great. Thank you.

Operator: Thank you. Our final questions will be from the line of Susan Anderson with Canaccord Genuity. Please proceed with your questions.

Susan Anderson
Analyst, Canaccord Genuity LLC

Q

Hi, good morning. Thanks for taking my question. I was wondering if maybe you could talk about just the input cost inflation you called out still pressuring gross margin. Is that still higher costs flowing through just kind of wrapping around or has things elevated further?

And then, maybe if you could just talk about between commodity costs, labor, etcetera, what the drivers are there when you expect it to potentially fall off? Thanks.

Paul Ruh
Chief Financial Officer, Kenvue, Inc.

A

Thank you, Susan. And as I said, we still see some elevated inflation, although it is slowing down. You think about the pockets of our cost spine, we still see some elevated inflation, in particular in two areas.

Number one, it's in energy and labor. On the areas where we see the declines, it's already in resins, agrochemicals. Logistics a significant decline given the normalization of the – particularly, the freight lines, both on the sea and on land. So overall, we see a diminishing inflation. We are also adjusting our pricing accordingly.

Remember as a principle, we are aiming to maintain our gross margins through value realization and premiumization to ensure that we maintain our gross margins and nothing more. So we have a healthy margins to be able to invest back into brands. So that's our principle. We're living into it and we are seeing the inflation diminishing which is a good thing.

Susan Anderson
Analyst, Canaccord Genuity LLC

Q

Great. And then, if I could just add one more also on the Beauty & Skin segment, just the operating income, it looks like there was increasing deleverage there. Is that mainly from just lower sales or is there something else going on there, too?

Paul Ruh
Chief Financial Officer, Kenvue, Inc.

A

In the case of Skin Health & Beauty, if you look at our margins, we are focusing our efforts on improving our gross margins to be able to create more fuel for growth.

The other thing that is particular in our business is we move the resources around. And when we see the opportunity to invest there, like in this case, when we see the new innovation, we're actually moving our resources to be able to drive that innovation.

In the end, it's a temporary, more phasing matter when it comes to the quarterly margins. But if you look at it on a normalized basis, on a full year basis, you will not see those ups and downs. It's just how the phasing of our advertising spend.

But we are focusing our efforts on the healthy gross margins to be able to invest back in our brands and not only Skin Health but in general.

Susan Anderson
Analyst, Canaccord Genuity LLC

Q

Great. Thanks so much. Good luck the rest of the year.

Paul Ruh
Chief Financial Officer, Kenvue, Inc.

A

Thank you.

Operator: Thank you. We have reached the end of our question-and-answer session. I would now like to hand the call over to Thibaut for any closing remarks.

Thibaut Mongon
Chief Executive Officer & Director, Kenvue, Inc.

So, thank you, everyone, for participating to today's call. Once again, as you heard from Paul and I, we are pleased with our third quarter results. It was another healthy quarter for Kenvue.

We believe they reflect the strength of our model, the power of a portfolio of iconic brands with operating results and strong cash flow generation underscoring the strength of our position in the consumer health space.

So, we look forward to connecting – with all of you again to keep you updated on our continuous progress on our future earnings call. So, have a great day and thank you, everyone.

Operator: Thank you. This does conclude today's conference. Thank you for your participation. Have a wonderful day. You may disconnect your lines at this time.