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CPB - Q3 2018 Campbell Soup Co Earnings Call

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OVERVIEW:

Co. reported YTD FY18 YoverY as-reported net sales growth of 4% and adjusted EPS of $2.62. 3Q18 as-reported net sales were $2.125b and adjusted EPS was $0.70. Expects FY18 sales (including Snyder's-Lance acquisition) to grow plus 10% to plus 11% and adjusted EPS (including Snyder's-Lance acquisition) to be $2.85-2.90.

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Campbell Soup Third Quarter 2018 Earnings Conference Call. (Operator Instructions) As a reminder, this conference call may be recorded.

I would now like to introduce your host for today's conference, Mr. Ken Gosnell, Vice President, Finance Strategy and Investor Relations. Sir, you may begin.

Ken Gosnell - *Campbell Soup Company - VP of Finance Strategy & IR*

Thank you, Crystal. Good morning, everyone. Welcome to the third quarter earnings call for Campbell Soup's fiscal 2018. With me here in New Jersey are Keith McLoughlin, interim CEO; and Anthony DiSilvestro, CFO. As usual, we've created slides to accompany our earnings presentation. You will find the slides posted on our website this morning at investor.campbellsoupcompany.com. This call is open to the media, who'll participate in a listen-only mode.

Today, we will make forward-looking statements, which reflect our current expectations. These statements rely on assumptions and estimates, which could be inaccurate and are subject to risk. Please refer to Slide 2 or our SEC filings for a list of factors that could cause our actual results to vary materially from those anticipated in forward-looking statements.

Because we use non-GAAP measures, we have provided a reconciliation of these measures to the most directly comparable GAAP measure, which is included in our appendix.

With that, let me turn the call over to Keith.

Keith R. McLoughlin - *Campbell Soup Company - Independent Director*

Thank you, Ken, and good morning, everyone. My name is Keith McLoughlin, the new interim CEO of Campbell Soup company and a board member since 2016. Thank you for joining our third quarter conference call today.

As you have seen from this morning's press release, we announced that Denise Morrison has chosen to retire after 15 years with the company, having served the last 7 years as President and CEO. I'd like to start by thanking Denise for her leadership and dedication to Campbell.

Denise repositioned our portfolio toward the faster-growing snacking and health and well-being categories with important acquisitions like Snyder's-Lance and Pacific Foods. It has indeed been a pleasure working with her as a board member over the last few years. On behalf of the Board of Directors and the entire management team, we thank Denise and wish her all the very best.

Let me just start out by describing how we'll handle the call today. I'll make a few brief opening comments, and then our Chief Financial Officer, Anthony DiSilvestro, will review in detail the financial results, the updated guidance, and he will answer your questions. After the Q&A, I'll make some closing remarks, and we'll end the call on time by 9:30.

Let me start by describing my role. As interim CEO, my mandate from the board is clear: one, to lead the company, along with the Campbell's leadership team, until the board appoints the new chief; and two, to get the performance back on track for the company by conducting a thorough review of our strategic and operating plans, the composition of our entire portfolio and the associated allocation of our resources, capital cost and people. All this work will be under the advisement and supervision of the board. We, of course, will conduct this work with rigor, objectivity and urgency.

As disclosed in our earnings release this morning, we delivered results that were below expectations, ours and yours. Our company has clearly faced challenges. Some of those are external factors that are impacting the entire industry, and others stem from our execution. As a board member and interim CEO, these results are unsatisfactory and disappointing to us as well as our shareholders.

I've been on the Board of Directors for almost 3 years now and know Campbell well. It's a great company with talented employees and a portfolio of leading brands across multiple categories. Brands such as Pepperidge Farms, Campbell, Swanson, Arnott's, V8, Prego, Pace, Plum and Kelsen are tremendous assets for this corporation. The recent addition of the Snyder's-Lance portfolio of brands and Pacific Foods, both of which I strongly supported, will enhance our growth potential as we expand into the faster-growing snacking categories and enhance our health and well-being offerings of soup and broth.

This company has and will continue to have a strong commitment to all of its stakeholders, including consumers, customers, employees and shareholders. We remain committed to bringing high-quality, differentiated products to the market at the right price and supporting our brands with compelling marketing and broad availability. These commitments will not change.

Additionally, our core values will not change. Our values around operating with integrity and ethics, treating all people with dignity and respect and operating with safety and sustainability remain steadfast. What must change and will change is our execution and our financial performance. Our mandate is to create long-term value for our shareholders. We intend to take appropriate and decisive actions to ensure that Campbell is positioned to compete and win in the marketplace. That means we must take a fresh look at our strategies, our operations and our portfolio and to do so with urgency.

Toward that end, beginning today, we will undertake a thorough and critical review of all aspects of our strategic and operating plans, including the composition of our entire portfolio. That work will inform our capital allocation and resource deployment priorities. Everything is on the table. There are no sacred cows. We expect this process to take a few months, and we intend to share the progress of this review with you during our fourth quarter call at the end of August.

While we are unable to share a detailed plan today, we do anticipate that the combination of persistent headwinds, the issues we're facing and the possibility of stepped-up investment spending will make fiscal 2019 a challenging year. Looking ahead, I'm confident that this company has a bright future. We have powerful and relevant brands, enviable products and market positions, strong cash flow and committed and talented people.

Under the leadership of our newly appointed Chief Operating Officer, Luca Mignini, our global biscuits and snacks business has delivered consistent top and bottom line growth. As we successfully integrate Snyder's-Lance and capture the synergies, build a large and differentiated snacking business and improve the performance of the balance of the portfolio, we will deliver consistent profitable growth, which will create value for our shareholders.

We recognize, of course, that you may have questions about the portfolio review that's underway. However, we will not be able to add any additional details at this time as we have just begun, and we're not in a position to speculate on any aspect of it. I look forward to sharing our plan with you on our fourth quarter call on August 30.

I now will turn it over to Anthony, who will review the results, and then be available to take your questions. Anthony?

Anthony P. DiSilvestro - *Campbell Soup Company - Senior VP & CFO*

Thanks, Keith, and good morning. I'd first like to welcome Keith to his new role. I've known Keith since he joined the Campbell board in 2016, and I look forward to working with him.

Before getting into the details, I wanted to give you my perspective on the quarter and revised 2018 guidance. In the quarter, we successfully completed the acquisition of Snyder's-Lance. This is our largest acquisition ever, and it will meaningfully shift our portfolio towards the faster-growing snacking categories. On a pro forma basis, snacking will become almost 1/2 of our portfolio of sales.

The consumer takeaway performance on the core Snyder's-Lance brands looks good, and the teams are working well together. We remain confident in our ability to deliver the targeted $295 million in cost savings and synergies. The work performed since the acquisition closed has confirmed our initial synergy assumptions, and we are making good progress putting in place detailed plans to deliver cost synergies.

While our organic sales were stable in a difficult environment, our challenge in the quarter was clearly our adjusted gross margin performance, as the percentage declined by about 4 points compared to last year, including a 1 point negative mix impact from our recent acquisitions. Gross margin performance was driven by higher-than-expected cost inflation, primarily higher transportation and logistic costs, higher supply chain costs in Campbell Fresh and increased promotional spending in U.S. Soup and Pepperidge Farms.

As a result of the disappointing Campbell Fresh performance, we revised the long-term forecast for that business, and we recorded a $619 million pretax noncash impairment charge in our GAAP results. We are all disappointed with the results of C-Fresh, and we acknowledge that they are unacceptable.

We continue to make progress on our multi-year cost-savings program. We generated $25 million of savings in the quarter, bringing the program to date total to $390 million. Our success in realizing these savings gives us further confidence in our ability to achieve the Snyder's synergies.

We are updating our full year guidance to reflect lower expectation for gross margin performance, with the 2 primary drivers being the performance of Campbell Fresh and the inflationary impact of higher transportation and logistics costs. We're also including the impact of the Snyder's-Lance acquisition in the guidance, which, as we expected, is dilutive to adjusted EPS in the 4 months of ownership in fiscal 2018.

While we are very confident in our ability to deliver targeted cost synergies and the overall acquisition economics, we have uncovered some short-term issues, which I'll discuss. At the end of my presentation, I will comment on our plan to address the company's financial and operating challenges, our portfolio of businesses and projected financial performance.

Now I'll review our third quarter results in more detail. For the third quarter, net sales on an as-reported basis increased 15% to $2,125,000,000. Excluding a 14-point benefit from the acquisitions of Snyder's-Lance and Pacific Foods and a 1-point benefit from currency translation, organic net sales were comparable to the prior year, as gains in Global Biscuits and Snacks and Campbell Fresh were offset by declines in Americas Simple Meals and Beverages.

Adjusted EBIT in the quarter increased 1% to $308 million. Excluding the impact of the Snyder's-Lance and Pacific Foods acquisitions, adjusted EBIT declined 6%, primarily due to lower gross margin performance, partly offset by lower adjusted administrative expenses and lower adjusted marketing and selling expenses.

Adjusted EPS increased 19% or $0.11 to $0.70 per share, reflecting a favorable tax timing benefit, partly offset by higher adjusted interest expense attributable to both the Snyder's-Lance and Pacific Foods acquisitions.

Through the first 3 quarters ending April, as-reported net sales increased 4%, and organic net sales declined by 1% compared to the prior year. Adjusted EBIT decreased 7% to $1,127,000,000. Excluding the impact of the recent acquisitions, adjusted EBIT decreased 8%, and adjusted EPS of $2.62 was up 4%.

Breaking down our sales performance for the quarter. Organic net sales were comparable to last year, as volume gains were offset by increased promotional spending. Overall, promotion -- promotional spending rates increased in Americas Simple Meals and Beverages, driven by U.S. Soup, and in Global Biscuits and Snacks, reflecting increased spending behind Goldfish crackers.

There was a positive impact in currency translation of 1%, principally the Australian and Canadian dollars. The recent addition of Snyder's-Lance and Pacific Foods to the portfolio added 14 percentage points, bringing our as-reported sales increase versus the prior year to 15%.

Our adjusted gross margin percentage decreased 390 basis points in the quarter, falling short of our expectations from a combination of declines in the base business and the mix impact of acquisitions. First, cost inflation and other factors had a negative impact of 320 basis points. Over 2/3 of that was cost inflation, which, on a rate basis, increased 4.5%, reflecting higher prices on dairy, meat, steel cans and aluminum as well as the higher-than-anticipated escalation of transportation and logistics costs.

The remaining decline was driven by higher supply chain costs in Campbell Fresh and investments associated with our real food initiative. These negative drivers were partly offset by benefits from our cost-savings initiatives.

With gross margins below the Campbell average, the addition of Snyder's-Lance and Pacific Foods to the portfolio decreased gross margins by 1.1 points. We fully expect that the margins of these businesses will increase over time, as we integrate them into Campbell and achieve synergies. The higher promotional spending in Americas Simple Meals and Beverages and Global Biscuits and Snacks, that I previously mentioned, had a negative impact of 60 basis points. Mix had a slightly negative impact of 30 basis points.

Lastly, our supply chain productivity program, which is incremental to our cost-savings program, contributed 130 basis points of margin improvement. All-in, our adjusted gross margin percentage decreased 390 basis points to 32%.

Adjusted marketing and selling expenses increased 8% in the quarter, primarily due to the impact of recent acquisitions, partly offset by the benefits from our cost-saving initiatives. Adjusted administrative expenses decreased 6% to $127 million, primarily due to lower incentive compensation and benefit cost, partly offset by the impact of recent acquisitions.

For additional perspective on our performance, this chart breaks down our adjusted EPS change between our operating performance and below-the-line items. Adjusted EPS increased $0.11 from $0.59 in the prior year quarter to $0.70 per share in the current quarter. On a currency-neutral basis, adjusted EBIT had a $0.01 impact in EPS, as the benefit from the recent acquisitions was partly offset by EBIT decline on the base business.

Adjusted net interest expense increased by $32 million, a $0.07 negative impact to EPS, driven by an increase in the debt level, funding our recent acquisitions and reflecting the impact of higher interest rates.

Our adjusted EPS results are benefiting by $0.17 from a lower adjusted effective tax rate. Our adjusted effective tax rate in the quarter declined by about 20 percentage points to 15.3%, driven by the favorable timing of tax expense on an adjusted basis in Q3 related to the impairment charges, which we expect will reverse in Q4.

Benefiting from share repurchases in prior periods, a lower share count added a $0.01 benefit to EPS. And lastly, currency translation had no impact on EPS, completing the bridge to $0.70 per share. Although not shown on the chart, the Snyder's-Lance and Pacific Foods acquisitions in aggregate had a negative EPS impact of approximately $0.03.

Now turning to our segment results. In Americas Simple Meals and Beverages, organic sales declined 2%, driven primarily by declines in V8 beverages, Plum Organics and U.S. Soup. Excluding the benefit of the acquisition of Pacific Foods, sales of U.S. Soup declined 1%, driven by declines in condensed soups, partly offset by gains in broth and ready-to-serve soups. As expected, we are seeing improved sales performance in U.S. Soup relative to the first half.

Segment operating earnings declined 3% in the quarter to $217 million. The decrease was primarily driven by a lower gross margin percentage, partly offset by lower administrative expenses and lower marketing and selling expenses.

Segment gross margin performance continued to be impacted by higher transportation and logistics cost and from the negative mix impact of adding Pacific Foods to the portfolio.

Here's a look at U.S. wet soup category performance and our share results as measured by IRI. Our results are shown on a pro forma basis, including the recently acquired Pacific Foods business.

For the 52-week period ending April 29, 2018, the category continued to show growth, increasing 130 basis points. However, our sales in measured channels declined 1.9%. We had a 59.5% market share for the 52-week period, down 2 points from a year ago. Our consumption and share decline are attributable to our performance with a key customer, which we've previously discussed.

Private label grew share by 140 basis points, primarily reflecting gains in broth, finishing at 15.3%. All other branded players collectively had a share of 25.2%, increasing 60 basis points.

In Global Biscuits and Snacks, sales were $862 million in the quarter, including $207 million from Snyder's-Lance. Excluding the benefit of the acquisition and favorable currency translation, organic sales increased 1%, driven by gains in Pepperidge Farm Snacks, reflecting continued growth in Goldfish crackers as well as in cookies, driven by gains in Farmhouse and Milano.

Segment operating earnings increased 23% to $123 million, primarily driven by the benefit of the Snyder's-Lance acquisition. Excluding the impact of the acquisition, segment earnings grew modestly.

In the Campbell Fresh segment, organic sales increased 1% to $251 million, driven primarily by gains in refrigerated soup. Sales of Bolthouse Farms refrigerated beverages were comparable to the prior year. The segment had an operating loss of $19 million in the quarter compared to earnings of $1 million in the prior year.

The earnings decline was primarily driven by a lower gross margin percentage, reflecting lower manufacturing efficiencies and reduced carrot crop yields as well as cost inflation, including significantly higher transportation and logistics cost. The earnings performance of Campbell Fresh is significantly below our expectations as our gross margin has been impacted by the factors I listed.

As a result of the performance of Bolthouse Farms CPG and the anticipated loss of private label refrigerated soup contract with certain customers, we performed interim impairment assessment on the Bolthouse Farms CPG business and the deli reporting unit, which includes our fresh soup and Garden Fresh Gourmet businesses. In our GAAP results and within corporate, we recorded pretax noncash impairment charges totaling $619 million or $1.65 per share, reflecting our reduced expectation for current and future earnings and cash flows.

On a company-wide basis, cash from operations increased slightly to $1,024,000,000 compared to $1,011,000,000 in 2017, as higher cash earnings, benefiting from U.S. tax reform, were partly offset by a slight increase in working capital requirements. Capital expenditures were $223 million, $28 million higher than the prior year, reflecting investments to support our cost-saving initiatives.

We paid dividends totaling $321 million compared to $314 million in 2017, reflecting the 12% increase in the quarterly dividend rate announced in September of fiscal 2017. In aggregate, we repurchased $86 million of shares on a year-to-date basis, $75 million of which were under our strategic share repurchase program. The balance of the repurchases were made to offset dilution from equity-based compensation. With the acquisitions of Snyder's-Lance, we have suspended our share repurchases and did not make any share repurchases in the third quarter.

Net debt of $9.6 billion is up from $3.1 billion a year ago, reflecting the impact of the $6.1 billion acquisition of Snyder's-Lance and the $700 million acquisition of Pacific Foods, partly offset by positive cash flow from the base business. As we've stated before, our priority is to delever the balance sheet following the Snyder's-Lance acquisition.

Now I'll review our revised 2018 guidance. As shown, we have isolated changes on our base business from the impact of now including the Snyder's-Lance acquisition. I'll start with the sales line. On the base business, we're raising the low end of the sales range, which is now 0% to plus 1%. The acquisition of Snyder's-Lance adds 9 to 10 points of sale, bringing the new range for our sales guidance to plus 10% to plus 11% compared to 2017.

Due to lower expectations for gross margin performance, which I'll discuss in a moment, we now expect adjusted EBIT, in aggregate, to decline by minus 8% to minus 6%, which, relative to our previous guidance, reflects a 4-point reduction on the base business, partly offset by a 3-point contribution from the Snyder's-Lance acquisition.

We now expect adjusted EPS to decline by minus 6% to minus 5%, implying a range of $2.85 to $2.90. This includes a forecasted decline on the base of minus 3% to minus 1%, 5 points below our previous guidance and a $0.10 per share negative impact from the Snyder's-Lance acquisition for the 4 months of ownership in 2018. The Snyder's-Lance estimate includes the ongoing impact of purchase accounting and the incremental interest expense associated with funding the transaction.

Given the changes to our outlook, I'll provide a recap of the key assumptions. Our expectation for cost inflation for the year on a rate basis has increased to approximately 4%, reflecting unanticipated increases in transportation and logistics cost. We continue to expect to generate ongoing supply chain productivity gains, excluding the benefit of our cost-savings program, of approximately 3% of cost of products sold.

And against our cost-savings program, we expect to deliver $75 million to $85 million of cost savings, most of which will impact costs. We now expect our adjusted gross margin percentage to decline by approximately 3 percentage points, with 1 point attributable to the mix impact of our recent acquisitions and about 2 points from declines on the base business.

The decline in the base business is attributable to 3 drivers. The underperformance of Campbell Fresh represents about half of the decline, with the balance split between the higher-than-expected transportation and logistics costs and slightly higher promotional spending.

Below the line, our adjusted interest expense is now expected to increase to a range of $220 million to $225 million, including the impact of the Snyder's-Lance acquisition. We now expect our adjusted tax rate, which has benefited from U.S. tax reform, to be in the range of 26% to 27% in 2018, slightly higher than our prior forecast.

The rate forecast also implies a reversal of the Q3 timing benefit in the fourth quarter. This guidance assumes that the impact of currency translation will be slightly positive. We are now forecasting capital expenditures of approximately $440 million, which is an increase from the previous outlook, reflecting spending for the 4-month period on Snyder's-Lance.

Lastly, I will update you on our 2019 outlook for Snyder's-Lance. We've owned the business for about 8 weeks, and we remain very optimistic about the long-term potential of the Snyder's-Lance business. Our initial work has confirmed the cost and synergy opportunity, and our long-term financial expectations for this business, including the 2021 EPS accretion, have not changed.

That being said, there are several issues we have uncovered, which will impact fiscal 2019. These include a higher-than-expected trade rate, as the company's plan for price realization did not materialize; the impact of higher freight and transportation costs that we're all experiencing; and from higher-than-anticipated costs associated with the relocation and startup of nut-production equipment.

While we believe these issues are addressable, we now expect the Snyder's-Lance acquisition will be modestly dilutive to our 2019 adjusted earnings per share. As I said before, we remain confident that this acquisition will create shareholder value.

Before wrapping up, I have a few additional comments on what you should expect from us going forward. As Keith stated, we are not satisfied with our performance and with our expectations for 2018. We know that things must change to drive the performance our shareholders expect from Campbell. We are facing both execution-related and external challenges.

We are analyzing these issues in depth, developing action plans to address them and doing so with a heightened sense of urgency. In addition, we are going to undertake a strategic review of the businesses and brands within our portfolio.

On our Q4 earnings call, we intend to share a comprehensive plan and timetable to address the company's challenges and opportunities. On that call, we will also provide our financial guidance for 2019. At this stage, given what we know about accelerating cost inflation, in part due to the anticipated impact of import tariffs and the continuing headwind on transportation and logistics cost, we expect our margins will be down in fiscal 2019.

We are being tough-minded and realistic about where we are today and what needs to be done to improve the business. That said, we remain very optimistic about Campbell's long-term potential. We believe there is a clear path to improve financial performance as we strengthen our terrific snacking platform through the integration of Snyder's-Lance, improve our performance in soup and address our challenges in Campbell Fresh.

And at our Investor Day on October 3, we will share more details of our business unit plan for fiscal 2019 as well as our longer-term plans for 2020 and beyond. We look forward to communicating in more depth in August and October.

Before we go to Q&A, Keith and I want to acknowledge that you are likely to have questions about the strategic review we are undertaking. Similarly, we are sure that you are aware that it is not in our best interest to engage in speculative what-if questions or hypothetical scenarios. So please note that we chose our words carefully this morning, and we will not have much to add on this topic until we get back to you on August 30.

With that, I'll turn it back to Ken for the Q&A.

Ken Gosnell - *Campbell Soup Company - VP of Finance Strategy & IR*

Thanks, Anthony. We will now start our Q&A session with Anthony. (Operator Instructions) Okay, Crystal.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Bryan Spillane from Bank of America.

Bryan Douglass Spillane - *BofA Merrill Lynch, Research Division - MD of Equity Research*

I just wanted to ask -- just a clarification and then a question. Anthony, in the comment you made about margins being down in 2019, is that both the base business so before the acquisition and then the dilutive impact of the acquisition? Or is it -- just want to make sure that we're understanding that -- whether it's the base will be down and then the acquisition is also dilutive to margins.

Anthony P. DiSilvestro - *Campbell Soup Company - Senior VP & CFO*

Yes. It's actually both, Bryan. The comments primarily relate to what we're seeing on the base business and the impact of cost inflation that we foresee continuing. And also, in the first year, when we add Snyder's-Lance to the portfolio, the mix impact will also have a negative impact on margin.

Bryan Douglass Spillane - *BofA Merrill Lynch, Research Division - MD of Equity Research*

Okay. And then just a question on as you're going through strategic review, as we're thinking about the debt that you've just taken on to acquire Lance, is there anything in the terms of your those debt -- in the terms of the debt that you've taken on that provides any limitations to whatever you may contemplate doing in terms of the portfolio? I'm just trying to understand how much flexibility you may or may not have given the debt you've just taken on.

Anthony P. DiSilvestro - *Campbell Soup Company - Senior VP & CFO*

Yes. There's only one small piece of the acquisition financing that has a covenant in it, but we're well below that. And anything we do, I don't think that will be an issue whatsoever.

Operator

And our next question comes from Andrew Lazar from Barclays.

Andrew Lazar - *Barclays Bank PLC, Research Division - MD & Senior Research Analyst*

My question is going to be about pricing. And if you expect any incremental pricing to help, I guess, cover some of the inflation headwinds in fiscal '19. And I asked that partly because of just some of the concerns around the industry's ability to get that in this environment and then also more specifically, because of the comment you made around Lance. And I think the increased trade rate because of some pricing that I think you said did not materialize. So perhaps you can roll that up into your anticipation around incremental pricing, particularly in light of also the promotional spending in soup that transpired as you kind of got back into promotional activity with a key customer.

Anthony P. DiSilvestro - *Campbell Soup Company - Senior VP & CFO*

Sure. I mean, I guess the problem starts with the forecast that we're seeing for an acceleration in cost inflation and part of that due to the impact of upcoming tariff. So we see pretty significant increases on steel and aluminum and other parts of the commodity basket, things like wheat, resins. Corrugated is another area where we see some increases. So that's obviously going to put some pressure on the margin. And obviously, the question is what is the impact of potential pricing to help to offset that. I don't have a lot of details for you today on that. What I will say, and as you know, it's a very challenging environment out there today. It's a competitive retailer market, and we're all mindful of that. That being said, it would certainly be our intention that, over time, productivity and pricing will offset cost inflation. The challenge is the timing. The other thing that we do and working on is the impact of our cost-savings program to help offset some of that. So as we've done in the past, we do have the 3% annual cost-productivity program coming out of the supply chain. We're also making progress against our targeted $500 million of cost savings by 2020. Our recent decision to close our Toronto manufacturing operations is a good example and relocating most of that production to our U.S. thermal plants. So we're doing all we can to offset the inflationary impact. But as we rack it all up, we do see pressure on the margins going into 2019.

Operator

And our next question comes from Ken Goldman from JPMorgan.

Kenneth B. Goldman - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Two from me, if I may. I'm curious about, Keith, the board's search for the next CEO, how that process begins for you as a board really, even goes what the portfolio will look like, what are the challenges involved with that and also really, which qualities you're looking for in the next CEO. I know you talked about some things that are nonnegotiable, such as ethics and so forth. But any color you can give in terms of the kind of person that would be right for the company at this time? And then I guess my second question is on the dividend, and I'm just curious what the board's thoughts are on maintaining that with or without the strategic review.

Anthony P. DiSilvestro - *Campbell Soup Company - Senior VP & CFO*

Ken, I'm going to take that. Given this is Keith's first day, he's not going to participate in the Q&A session. But with respect to the dividend, 2 things I can say. We have a well-articulated priority for the uses of cash. It starts with reinvesting in our business and capital expenditures. Second is the dividend. And third, in the current environment, is to reduce leverage by paying down the debt. We have a robust and significant cash flow, which we fully expect we will continue to maintain a competitive dividend level and to have that dividend increase over time with earnings. So I think the management team as well as the board certainly supports the continued payment of a competitive dividend, and we see nothing that we're looking at that would change that at all.

Operator

And our next question comes from David Palmer from RBC Capital Markets.

David Sterling Palmer - *RBC Capital Markets, LLC, Research Division - MD of Food and Restaurants and Consumer Analysts*

Keith mentioned a need to rebase earnings further in fiscal 2019, and you added some comments about freight cost and trade rate. And obviously, this talks to the push and pull of cost versus pricing power. But I think long term, there's still that question in -- of the company's ability to meaningfully drive a profitable growth. And so in what areas do you envision Campbell perhaps spending more or executing differently to really promote a more balanced profitable growth? And does -- is there spending in fiscal '19 going towards that and not just essentially rebasing in light of your pricing net of commodities?

Anthony P. DiSilvestro - *Campbell Soup Company - Senior VP & CFO*

Yes. I mean, it's a bit premature to get into too much detail around 2019. But you kind of hinted that the exact idea of the review and what's going to come out of it is a clear articulation of those things we need to do to reposition the company to drive long-term and profitable growth. And as I think about it, we have some great examples within our portfolio. And I think it exemplifies what a branded food company needs to do to deliver. And that's having a product quality that's superior to competition; continuing to innovate in the marketplace; appropriately managing the price gaps, the competition and private label; supporting those brands with compelling advertising and at a competitive level. I think when we do that, it's a win-win-win. It's a win for our consumers, our customers and for us. And I would say a brand like Prego is a good example where we've been able to do that and grow consumption and share. On the other hand, our broth business is a category we haven't done that, and private label has gained some share. So I think if we undertake the review, we're going to look at the portfolio. We're going to look at what got us into this situation and what do we need to change the long-term trajectory of sales and earnings. Because we believe we can do it, and we're optimistic that there is a positive long-term financial performance that will come out of that.

Operator

And our next question comes from David Driscoll from Citi.

David Christopher Driscoll - *Citigroup Inc, Research Division - MD and Senior Research Analyst*

So I wanted to -- I have 2 questions. I'd like to just start off and say, is it fair to say that the bulk of the problems today are C-Fresh-related as it was by far the largest negative variance versus our expectations? And you tick off so many factors, guys, I feel like sometimes it's -- the importance of the different ones is not that clear to people listening to the call. So just number one, can you confirm that my comment, that C-Fresh was the biggest negative variance, is accurate? And then critically here, why are the supply chain fixes not working? Campbell has put an amazing amount of effort and time into getting the supply chain right at C-Fresh. And it just feels like we just keep hearing problems. What's wrong with the supply chain at C-Fresh?

Anthony P. DiSilvestro - *Campbell Soup Company - Senior VP & CFO*

Yes. So the first part, just to give the overall context and dimensionalize the C-Fresh issue. So if I go back to where we started the year in terms of our gross margin expectations and where we are now, so we're a couple of points below where we started. Half of that is the situation at Campbell Fresh. And I mean, certainly we face significant challenges there, and the return to profitability has proven certainly more challenging than we anticipated. And I think the situation which we need to analyze further in the fourth quarter, it goes beyond supply chain. We're seeing low crop yields on carrots. We're seeing lower manufacturing yields. We're seeing higher cost inflation in things like transportation and logistics. We've had to go to co-packers, and those are more expensive. The one thing that's actually mitigating some of these issues is the benefit of the productivity program that our supply chain has brought to bear. But unfortunately, it hasn't done enough to offset the other issue. So we're going to take a step back. We're going to do a deeper dive in the fourth quarter and look at the drivers of that performance and figure out what do we do going forward with respect to the Campbell Fresh business.

David Christopher Driscoll - *Citigroup Inc, Research Division - MD and Senior Research Analyst*

And then just one follow-up, Anthony. The factors -- could you be more clear about the factors in '19? I know you're not giving guidance. But I don't like when we get just a couple of negatives, and we don't get enough to understand what you're trying to tell us here on F '19. You have tax benefits that come in, in the first portion of '19. So it's not all negative that there's just no positives here. There was expectations of a lot of cost savings that are supposed to come in, but I'm -- I feel like the tone is so negative on F '19 that we're not getting any balance on it. Is that intentional because these margin declines are so significant?

Anthony P. DiSilvestro - *Campbell Soup Company - Senior VP & CFO*

No, no. It's trying to be transparent in terms of what we see on the horizon. And given what we know now, we'd rather tell you now than tell you later. The issue is primarily one of cost inflation. And we're seeing and expecting an acceleration on the rate of inflation across a number of ingredient and packaging items. For example, we expect double-digit increases on steel and aluminum. A lot of that driven -- or all of it driven by the impact of anticipated tariffs. We're also expecting higher inflation on wheat and vegetables and resins and corrugated. So this is a meaningfully -- meaningful shift in the inflation outlook. Yes, we are going to continue to drive savings to help mitigate that, our 3% productivity program. Our cost-savings initiative continues to deliver. But they're just not sufficient to offset some of these headwinds. So we wanted to be transparent on that today and share with you kind of what we know at this point in time. We clearly have more work to do on this. We're in the midst of rolling up our operating plans and actions for next year. The strategic review we're going to take in the fourth quarter will also inform what actions we take in 2019. But again, we just wanted to share with you what we see on the horizon.

Operator

And our next question comes from Jason English from Goldman Sachs.

Jason M. English - *Goldman Sachs Group Inc., Research Division - VP*

I guess there's a lot of areas we can go. I'll come to soup real quick. You've resolved the issues with the key customer. Is there any reason to believe one way or the other that any other customers are pushing for concessions to sustain this support there?

Anthony P. DiSilvestro - *Campbell Soup Company - Senior VP & CFO*

Yes. So back to the first point. We have made some progress on U.S. Soup. You can see we're down 1% in the quarter versus minus 8% in the first half. Again, we made some progress. We are, as we speak, undertaking our joint business plans with our key customers for next fiscal year and so that will help inform kind of the outlook for next year. I forgot the second part of your question, Jason.

Jason M. English - *Goldman Sachs Group Inc., Research Division - VP*

I'm really -- my core question is whether or not you have to make concessions to other retailers.

Anthony P. DiSilvestro - *Campbell Soup Company - Senior VP & CFO*

Look, it's a competitive environment. And if you look at the markets we operate in, whether it's Australia or Canada or increasingly so, in the U.S., there is clearly tension, and we need to continue to manage through that. And the way I think we do that is to do the things that make branded foods companies successful around their products and their marketing and their brand support and their availability. So we'll continue to do that and work through these joint business plans with our customers. So there's not really much more I can say on that one.

Jason M. English - *Goldman Sachs Group Inc., Research Division - VP*

Okay. And I want to come back real quick, my last question, I guess, to Ken Goldman's question on cash flow, use of cash, dividend, et cetera. I was surprised to see you financed Lance with so much short-dated debt. And I know you talked about your robust cash flow, but it doesn't look like it's -- and I think you would agree, it's not robust enough to service the debt maturity over the next 3 years. What levers do you have to pull to navigate through that? Or should we be expecting you to be rolling that debt and refinancing on the forward, likely into a higher-rate environment?

Anthony P. DiSilvestro - *Campbell Soup Company - Senior VP & CFO*

Yes. I think what we'll do is, as I said before, in terms of our priorities for the use of cash, once we fund our CapEx program, which obviously we're managing very carefully, pay the dividend, the balance will go to reduce debt. And so some of that obviously will get repaid and the balance that we clearly expect to refinance, and we'll have to see what the rate environment is at that time. But I think in the near term, I think we're well positioned in terms of our capital structure and the maturity schedule.

Operator

And our next question comes from Robert Moskow from Credit Suisse.

Robert Bain Moskow - *Crédit Suisse AG, Research Division - Research Analyst*

Anthony, can you give us a little more color as to what has gone off plan on Snyder's-Lance? You mentioned that they were trying to execute a price-realization strategy. What's been causing that to go awry? And secondly, can you talk a little bit about the reaction of, I guess, the Snyder's-Lance independent distribution network to this merger? What steps has been -- have been done to bring them into the fold within Campbell? What's been communicated to them to make sure that execution stays on track?

Anthony P. DiSilvestro - *Campbell Soup Company - Senior VP & CFO*

Yes. So let me try to address some of those areas. I probably won't be able to address all of them. But in terms of where we are with Snyder's-Lance, I would say, first and foremost, we're very optimistic about what we've seen. We've owned the business now for 8 weeks, and I would say that we're even more confident now in our ability to deliver the $295 million of cost and synergy savings. And as we look longer term, we're certainly on track to deliver the acquisition economics and the 2021 accretion goal. So I just want to make sure we talk about this in the right context. So -- but we have uncovered a couple of things, right? One is the higher-than-expected trade rate, and it reflects -- and I don't want to get into too much detail here, some decisions taken by the former management team. I think what's important, and in our Pepperidge Farm business, we have a very disciplined approach, process and system to managing trade spend, and we are going to implement that in Snyder's-Lance. So that will help us immensely manage the situation. The second thing that's impacting us, and we're all seeing it is the impact of the higher transportation and logistics cost, which, quite frankly, did not moderate as we have expected. And the last situation, which we're working through, is some challenges related to relocating some Emerald nut production from California to Charlotte. The restart-up of that equipment has proven more challenging than the former management team thought and more challenging than we initially thought. So we're working through those 3 issues. We have action plans in place to do that. We believe they're short-term and addressable and remain very optimistic in the long-term outlook for the Snyder's opportunity. With respect to the DSD network, I mean all I can really say on that one is we now have 3 DSD systems, 2 for Pepperidge, 1 for bakery, 1 for snacks and now 1 for Snyder's-Lance, and we will continue to operate those 3 systems independently. That being said, there are significant opportunity to capture synergy in the distribution network, both at the warehouse level and at the depot level.

Operator

And our next question comes from John Baumgartner from Wells Fargo.

John Joseph Baumgartner - *Wells Fargo Securities, LLC, Research Division - VP and Senior Analyst*

Anthony, I wanted to dig into the cash expectations for Lance. I mean, it seems the company had really been lacking in terms of automation and robotics in the plants. At the same time, the SKU complexity would seemingly suggest kind of a nice -- an opportunity for working capital improvement. So on balance, between working capital needs, incremental CapEx, synergies being back half-weighted in your guidance, how do you think about Lance's contribution to free cash over the next 1 to 2 years?

Anthony P. DiSilvestro - *Campbell Soup Company - Senior VP & CFO*

Yes. I think a couple of things there happened. And as we look at the business and some of you have looked at, obviously, at the consumer takeaway, it actually has been negatively impacted by the SKU rationalization efforts that the former management team started and that also we support. I think there's a long tail in the portfolio, and we're doing our best to clean that up a little bit. As our supply chain people have gone through those plants, we see significant opportunities to improve the effectiveness of the operations, potential network optimization opportunities given the overlap between our plant infrastructure and their plant infrastructure. And when we put together our deal model, we did anticipate some investments early on to correct those and to improve the long-term performance of the manufacturing network. So we will continue to execute those plans. We're very confident, as I said before, in the long-term ability for this business to generate positive cash flow. But it does require some investments both on the CapEx lines to take care of some quality situations that we see, to improve some efficiency and some costs related to getting at some of the synergy opportunity. Again, all those were factored in our acquisition economics, and we're confident certainly in our ability to fund those.

Operator

And that does conclude our question-and-answer session for today's conference. I would now like to turn the conference back over to Mr. Gosnell for any closing remarks.

Ken Gosnell - *Campbell Soup Company - VP of Finance Strategy & IR*

Thanks, Crystal. Keith is going to make a few closing comments.

Keith R. McLoughlin - *Campbell Soup Company - Independent Director*

Okay. Thanks, Ken. Actually, I just wanted to comment briefly on the question of the board and succession. Of course, the board is working on that. They're thinking about that. But candidly, right now, we're focused on the work we described, the strategy and the portfolio review and honestly, righting the ship. That's what we're focused on right now.

As one question I noted, part of that work will be input to the board on the candidate qualifications and potential. So it's a little bit hard to know precisely what we need in that role until we complete the review, although you kind of know 90-10 what the candidate needs to look like. I would say we have talented candidates inside the company, and we will continue to focus on the mission that we have at hand and getting things back on track.

Lastly, I'd just like to acknowledge, as many of you have pointed out, we're facing some tough market conditions and also some poor operating performance just straight ahead. We have some hard and urgent work in front of us, and we'll face that head on. However, we start from a foundation of strength that's been built over almost 150 years, with products and brands, market positions, margins and cash flow that would be the envy of many, many companies. So we'll do that.

This company has a deep keel, being built over all that time and with that kind of cash and balance sheet strength, and we'll come out of this stronger. I'm confident in that. Lastly, I'd just say, of course, I'm going to be out, listening and talking to customers and suppliers and shareholders, and I very much look forward to meeting many, if not all, of you in the process.

Thank you for your time and interest today, and have a nice weekend. And let me turn it back over to Ken to close the meeting.

Ken Gosnell - *Campbell Soup Company - VP of Finance Strategy & IR*

Thanks, Keith. We thank you for joining our second (sic) [third] quarter earnings call and webcast. A full replay will be available about 2 hours after the call concludes by going online or calling 1 (404) 537-3406. The access code is 649-8114. You will have until June 1, 2018, at which point we move the earnings call strictly to the website, investor.campbellsoupcompany.com, under News and Events, just click on the Recent Webcasts and Presentations.

If you have further questions, please call me at (856) 342-6081. If you are a reporter with questions, please call Tom Hushen at (856) 342-5227. That concludes today's call. Thanks, everybody.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program. You may all disconnect. Everyone, have a wonderful day.