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CPB - Q1 2018 Campbell Soup Co Earnings Call

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CPB reported 1Q18 adjusted EPS of $0.92.

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to Campbell Soup First Quarter Fiscal 2018 Earnings Conference Call. (Operator Instructions) As a reminder, today's conference call is being recorded. I would now like to turn the conference over to Ken Gosnell, Vice President, Finance Strategy and Investor Relations. Please go ahead.

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

Thank you, Candace. Good morning, everyone. Welcome to the first quarter earnings call for Campbell Soup's fiscal 2018. With me here in New Jersey are Denise Morrison, President and CEO; and Anthony DiSilvestro, CFO. As usual, we've created slides to accompany our earnings presentation. You will find the slides posted on your website this morning at investor.campbellsoupcompany.com. This call is open to the media who participate in 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 risks. 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.

In the first quarter of fiscal 2018, the company adopted new accounting guidance that changes the presentation of net periodic pension cost and net periodic postretirement benefit cost. Certain amounts in the prior year were reclassified to conform to the current year presentation. The reclassifications did not impact EBIT. Also beginning in fiscal 2018, the business in Latin America is managed as part of the Global Biscuits and

Snacks segment rather than the Americas Simple Meals and Beverages segment as in prior years. Prior period segment results have been adjusted retrospectively to reflect this change. An 8-K will be filed on December 8, along with our 10-Q, which will recast historical quarterly and annual financial information reflecting both of these changes.

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

Denise M. Morrison *- Campbell Soup Company - President, CEO & Director*

Thanks, Ken. Good morning, and welcome, everyone, to our first quarter call. Today, we'll discuss our results in the quarter, our updated outlook for the remainder of fiscal 2018 and the actions we're taking to improve our performance and to position Campbell for long-term growth.

When we last spoke in September, we outlined our expectations for fiscal 2018 and indicated that we anticipated a challenging first half. However, the first quarter was weaker than we expected, particularly for our U.S. Soup business. In the quarter, our organic sales declined 2%, driven primarily by declines in U.S. Soup. Adjusted EBIT declined 14%. There were several factors that contributed to this performance. First, in September, we discussed how a key customer's different promotional approach to the soup category would negatively impact our U.S. Soup business in fiscal 2018. This had a larger impact on sales than originally anticipated primarily due to a lower seasonal inventory build compared to a year ago. The dialogue with this key customer remains open and I'm very optimistic that we will reach a positive resolution. Second, unfavorable weather negatively impacted carrot crop yields and led to supply constraints and higher-than-expected costs. As a result, we placed customers on allocation in the quarter. We expect to be off allocation by December. And finally, the hurricane recovery efforts in Florida and Texas resulted in higher-than-expected supply chain costs due to the surge in demand for transportation and logistics. We'll be impacted by this in the near term but the cost impact will moderate over time. As a result of the factors that impacted gross margin and our commitment to maintain investments in the business, we updated our fiscal 2018 guidance this morning. For fiscal 2018, our outlook for sales remains unchanged. We continue to expect net sales to be in the range of minus 2% to flat for the year. However, we have lowered our earnings outlook, reflecting our gross margin performance in the first quarter and our outlook for the remainder of the year. We now expect adjusted EBIT to change by minus 4% to minus 2%, previously minus 1% to plus 1%, and adjusted EPS to change by minus 3% to minus 1%, previously flat to plus 2%.

The operating environment remains challenging for the many reasons we've cited over the past year, but we continue to believe that it's imperative to invest back in our business to differentiate our brands, to drive innovation, particularly in health and well-being and snacking, to accelerate our e-commerce capabilities and to diversify our portfolio. That's why we remain committed to reinvest a portion of our ongoing cost savings into the areas that hold the greatest prospects for growth. In Q1, we continue to invest back in our core business and in the pursuit of new growth opportunities, including support for our product innovations, our real food efforts, building our e-commerce unit as well as funding longer-term innovation efforts. First, we're supporting our new product innovations such as Well Yes! soup and Chunky Maxx soups, Pepperidge Farm Farmhouse cookies and Bolthouse Farms Plant Protein Milk, a dairy alternative with 10 grams of protein. Second, in real food, we completed the transition out of BPA in our can linings in the United States and Canada and continue to convert our soups to chicken with no antibiotics. Third, our newly formed e-commerce unit in North America has been very active. While small, our e-commerce sales increased significantly in the quarter. We launched several meal kits through our strategic partnership with Chef'd. We also made progress on enhancing our distribution capabilities in partnership with DHL, opening a facility in Fort Worth and breaking ground on another in Ohio. This will help meet the growing demand for customization from both traditional and e-commerce customers. In the health and well-being space, we continue to fund Habit, a personalized nutrition start-up. Habit is an example of how we're investing in new models of innovation. Over time, we expect multiple business models to emerge. Following the national launch of its nutrition test kits in August, the Habit team is expanding rapidly and adding top talent. And we also continued our venture-capital activities as the single limited partner in Acre Venture Partners. However, these efforts are not enough. While we're moving in the right direction and positioning the company for long-term success, our Q1 results are a clear indication that we have more to do to complete our strategic transition, including more innovation focused on health and well-being and snacking; gaining a larger share of e-commerce revenue and a greater presence in growth channels; increased expansion in developing markets; and continued focus on external development.

Speaking of external development. As you know, on September 27, we delayed the closing of our acquisition of Pacific Foods of Oregon, pending their resolution of some recently filed litigation unrelated to Campbell. While the timing is not yet definite, we have reason to believe that conditions will be met that will allow us to complete the transaction by the end of 2017.

With that as context, I'll review our performance across our divisions. Let's start with Americas Simple Meals and Beverages, where sales and operating earnings both declined. The decline on the top line was driven primarily by U.S. Soup and V8 beverages. U.S. Soup sales declined 9%. As I stated earlier, a lower seasonal inventory build versus year ago at a key customer accounted for 7 points of the decline and 2 points were due to reduced consumer takeaway. There is positive performance in the balance of the marketplace where our soup program has been well received and consumer takeaway is up slightly. We have strong business plans with our key customers. We're driving trial of our new products, Well Yes!, Chunky Maxx and Swanson soup kits, and we continue to support our brands with competitive levels of advertising and consumer promotion. While we're experiencing private label competition in our broth business, private label market share in soup is below average for center store food categories and up slightly. We constantly innovate and test our products to ensure they meet or exceed consumer taste preferences. We believe that innovation and brand differentiation are critically important in the soup category, which is why we're continuing to invest in our brands.

The shelf-stable beverage category remained challenged and sales of V8 products declined. Despite this decline, we're seeing positive consumption trends on V8 Vegetable Juice and V8 +Energy. We're pleased with the sales gains of our simple meal products, driven by Prego, as well as sales growth in Canada in Foodservice. Looking ahead, we expect the operating environment to remain challenging, and therefore, we're taking additional actions to improve our performance. We've started to shift our soup marketing spending from equity-building campaigns to a sharper focus on product attributes that differentiate Campbell brands. We're increasing in-store presence with stronger messaging, and we're aggressively ramping up our e-commerce plans.

Now shifting to our Global Biscuits and Snacks division. Overall, I feel good about our performance in Global Biscuits and Snacks to start the year. This division delivered growth on both the top and bottom lines. Sales gains were primarily driven by the continued solid performance of Pepperidge Farm. This sales growth was fueled by our snacks business, with a one-two punch from crackers and cookies. Our Goldfish crackers continue to outperform the category in a meaningful way. In fact, Goldfish became the #1 snack cracker in the category over the last quarter. The brand's continued growth was fueled by our increasing ounces into houses approach. This is all about providing wholesome, delicious snacks that can be enjoyed in a variety of new packaging formats, including single-serve multipacks.

The second driver of our sales growth was our cookie business behind the successful launch of the Farmhouse brand, Milano cookies, and the rejuvenated Pepperidge Farm Chunk Cookie line. The Farmhouse launch is one of Pepperidge Farm's best product introductions in over a decade with strong trial and repeat. Made with simple ingredients, this thin, crispy cookie is the type of snack consumers are seeking and has been incremental to the category. We employed a similar approach with our Pepperidge Farm Chunk Cookies. We improved our recipes using larger chocolate chunks and cage-free eggs while also updating and simplifying our packaging. It's satisfying to see our Real Food Philosophy resonating with consumers in our cookie portfolio.

Outside the U.S., Asia Pacific sales were mixed. Sales declines in Australia were partly offset by gains in Indonesia. We faced increased competitive activity in Australia's chocolate biscuits but delivered solid results in savory crackers behind the reintroduction of original shapes crackers where we gained share.

Now let's turn to Campbell Fresh. In Campbell Fresh, sales were comparable to a year ago. We're encouraged that our CPG products grew for the second consecutive quarter behind Garden Fresh Gourmet and Bolthouse Farms salad dressing. Sales of Bolthouse Farms beverages were comparable to year ago. We're now back to normal beverage capacity. Our new co-packer was fully operational midway through the quarter and our service levels steadily improved, helping us instill confidence with customers. As a result, we started to return to more normal levels of promotional activity late in the quarter and expect that trend to continue in the second quarter.

Looking ahead, we have strong innovation plans in place with the continued rollout of Bolthouse Farms Plant Protein Milk, new Garden Fresh Gourmet fresh soup and salsa products in the first half and a range of Bolthouse Farms (inaudible) and beverages in the back half.

Turning to farms. Sales of carrots declined in the quarter. Our carrot crops were negatively impacted by adverse weather. Due to these low yields, we placed customers on allocation in the quarter. Learning our lesson from a similar experience in 2016, the new Campbell Fresh team did not compromise the quality of carrots we deliver to customers. As stated earlier, we expect that we'll be off allocation by December. We continue to expect Campbell Fresh to return to profitable growth this fiscal year.

While I'm not satisfied with our results this quarter, I'm also not deterred. Despite challenges within U.S. Soup, V8 and carrots, other parts of the business are growing. The Global Biscuits and Snacks division remained a bright spot, especially Pepperidge Farm. Simple Meals, Canada and Foodservice performed well and the Campbell Fresh turnaround is progressing. We're taking the appropriate steps to address our immediate issues and remain focused on the actions that will position Campbell for long-term growth. We will continue to invest to differentiate our brands, enhance our real food credentials, drive innovation, particularly in health and well-being and snacking, build our e-commerce organization and pursue smart external development.

Thank you, and I will turn the call over to our Chief Financial Officer, Anthony DiSilvestro.

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

Thanks, Denise, and good morning. Before getting into the details, I wanted to give you my perspective on the quarter and revised 2018 guidance.

Our first quarter results were below our expectations largely for 3 reasons. First, while we anticipated that U.S. Soup sales would be negatively impacted by reduced support levels with a key customer, the sales decline in the quarter was more than anticipated primarily due to a lower seasonal inventory build with this same customer, which accounted for 7 points of the soup sales decline. Given the seasonality of our soup business, quarterly fluctuations in retailer inventory level are mostly timing related. Second, as a result of unfavorable weather, we experienced lower crop yields on carrots, which had a negative impact on our gross margin performance. And third, also impacting our gross margin, we experienced higher transportation and logistics cost, reflecting the impact of industry-wide carrier capacity issues.

On a positive note, we continue to make progress against our cost savings target of $450 million by the end of fiscal 2020, delivering another $20 million of savings in the quarter. This brings the program to date total to $345 million. And as Denise highlighted, we will continue to reinvest a portion of the savings back into the business to drive growth over the long term.

As you've seen in the release, we are revising our full year guidance. While we are not changing our range for sales, we are lowering the ranges for adjusted EBIT and adjusted EPS by 3 percentage points, which equates to about $45 million in EBIT. This change primarily reflects the impact of carrier shortages on our transportation and logistics cost and the unanticipated impact of the weather-related carrot yield issue.

Now I'll review our results in more detail. For the first quarter, as reported and organic sales declined by 2%. The decline in organic sales was driven by lower sales in Americas Simple Meals and Beverages, partly offset by growth in Global Biscuits and Snacks. Adjusted EBIT decreased 14% to $417 million, reflecting a lower adjusted gross margin, lower sales and higher administrative expenses, partly offset by lower marketing and selling expenses. Reflecting a reduction in the tax rate and a lower share count, adjusted EPS decreased 8% or $0.08 to $0.92 per share.

Breaking down our sales performance for the quarter. Organic net sales declined 2%, all driven by lower volume. Volume declined in Americas Simple Meals and Beverages reflecting declines in U.S. Soup and V8 beverages, partly offset by gains in Prego pasta sauces. Volumes also declined in Campbell Fresh, which was entirely attributable to the decline of carrots, a direct result of placing customers on allocation, as Denise mentioned earlier. This was partly offset by volume gains in Global Biscuits and Snacks, reflecting continued momentum on Goldfish crackers and Pepperidge Farm cookies. Overall, promotional spending rates were comparable to the prior year. And although it rounds to 0 on the chart, we did have a slightly positive impact from currency translation, principally the Canadian and Australian dollar, bringing the change in our as reported sales to minus 2%. Our adjusted gross margin percentage decreased 210 basis points in the quarter. First, cost inflation and other factors had a negative impact of 250 basis points. Almost 2/3 of this was cost inflation, which, on a rate basis, increased about 2.5%, reflecting higher prices on meat, steel cans, aluminum and dairy. The remaining 1/3 was driven by several factors. As I mentioned, we had higher carrot cost and higher transportation and logistics cost. In addition, we incurred losses on open commodity hedges as compared to gains in the prior year quarter and we had higher costs associated with investments in our real food initiative. These negative drivers were partly offset by benefits from our cost savings initiatives. Mix had a negative impact of 80 basis points, primarily due to the impact of lower U.S. Soup sales. Pricing and promotional spending had little to no impact on the quarter. 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 210 basis points to 36.5%.

Marketing and selling expenses declined 5% in the quarter, reflecting lower advertising and consumer promotion expenses and benefits from our cost savings initiatives. Adjusted administrative expenses increased 17%, primarily due to higher information technology costs, expenses related to the pending acquisition of Pacific Foods, inflation and investment in long-term innovation. Looking ahead, we do not expect this rate of increase in administrative expenses for the balance of the year.

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 decreased $0.08 from $1 in the prior year quarter to $0.92 per share in the current quarter. On a currency-neutral basis, the decline in adjusted EBIT had a negative $0.16 impact on EPS, 2/3 of which was driven by our gross margin performance. Net interest expense was up $2 million, reflecting higher rates and had no impact on EPS. Currency translation from both a stronger Canadian and Australian dollar added $0.01 EPS benefit. Using excess cash flow to repurchase shares reduced our share count, adding a $0.03 EPS benefit. Our adjusted tax rate in the quarter declined by about 4 percentage points to 28.2%. The lower adjusted tax rate in the current quarter was driven by a favorable settlement of certain U.S. state tax matters. The lower tax rate increased adjusted EPS by $0.05, completing the bridge to $0.92 per share.

Now turning to our segment results. In Americas Simple Meals and Beverages, organic sales declined 5%, driven primarily by declines in U.S. Soup and V8 beverages, partly offset by gains in Simple Meals, driven by Prego pasta sauces, and excluding the favorable impact of currency translation, gains in our retail business in Canada and our North America Foodservice business. Sales of U.S. Soup decreased 9%, driven primarily by declines in condensed and broth. The lower sales reflects a 7-point decrease due to a lower seasonal build of retailer inventory. Consumer takeaway measured channels declined by 2% in the quarter. Both the inventory-driven decline and reduction in consumer takeaway reflect our performance with a key customer we've referenced. Operating earnings decreased 14% in the quarter to $328 million. The decrease was primarily driven by lower sales volume and a lower gross margin percentage, partly offset by lower marketing and selling expenses. Segment gross margin performance was impacted by higher transportation and logistics cost and negative mix.

Here's a look at U.S. wet soup category performance and our share results as measured by IRI. For the 52-week period ending October 29, 2017, the category as a whole increased 10 basis points. Our sales in measured channels declined 40 basis points. We had a 58.5% market share for the 52-week period, with a share loss of 30 basis points. Private label grew share by 130 basis points, primarily reflecting gains in broth, finishing at 14.3%. All other branded players collectively had a share of 27.2%, declining 100 basis points. In Global Biscuits and Snacks, organic sales increased 2%, driven by continued gains in Goldfish crackers, which benefited from promotional activity and new items and gains in Pepperidge Farm cookies benefiting from the launch of farmhouse cookies as well as growth of Milano and Chunk Cookies. Excluding the favorable impact of currency translation, biscuit sales in the Asia Pacific region were down slightly as lower sales in Arnott's Australia were partly offset by growth in Indonesia. Operating earnings increased 4% to $120 million, primarily driven by higher sales volume.

In the Campbell Fresh segment, organic sales were comparable to the prior year at $234 million as sales gains of carrot ingredients, Garden Fresh Gourmet and Bolthouse Farms salad dressings were offset by a decline in carrots. Sales of Bolthouse Farms beverages were comparable to the prior year. With our new beverage co-packer now up and running, we expect to have sufficient product supply to support our promotional program going forward. As a result of the crop yield issue, carrot sales were on allocation for part of the quarter resulting in the sales decline. The segment generated a $6 million operating loss for the quarter as compared to $1 million of earnings a year ago. The year-over-year decline was primarily driven by the cost impact of lower carrot yields.

Cash from operations was $188 million compared to $221 million in 2017. The decline reflects higher payments on hedging activities and higher seasonal working capital requirement, partly offset by higher cash earnings. For the full year, we expect to generate strong cash flow from operations of approximately $1.2 billion.

Capital expenditures were $58 million, $10 million higher than the prior year. We paid dividends totaling $111 million compared to $100 million in 2017. The increase reflects our 12% increase in our quarterly dividend to $0.35 per share as announced in September of fiscal 2017. In aggregate, we repurchased $86 million of shares in the quarter, $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. Net debt of $3.3 billion was comparable to last year.

Now I'll review our revised 2018 outlook. As I said earlier, we continue to expect sales to change by minus 2% to 0%. Consistent with our previous guidance, we expect sales declines in Americas Simple Meals and Beverages driven primarily by U.S. Soup will be partly offset by growth in Global

Biscuits and Snacks and in Campbell Fresh. We now expect our adjusted gross margin percentage to be comparable to last year, lower than previously anticipated, primarily due to higher transportation and logistics cost and the cost impact of lower carrot yields. Reflecting the reduced expectation on gross margin, we now expect adjusted EBIT to decline by minus 4% to minus 2% and adjusted EPS to decline by minus 3% to minus 1%. Both earnings ranges are 3 percentage points below our previous expectation.

We continue to expect our cost savings program, which is incremental to our ongoing supply chain productivity gains, to deliver $60 million to $70 million of savings, most of which will impact COPS. This guidance assumes that the impact of currency translation will be nominal and that the adjusted tax rate is expected to be approximately 32%. Given the seasonality of our business and the timing of these unforeseen cost issues, we expect to see significantly weaker performance in the second quarter followed by improvements in the second half.

That concludes my remarks, and now 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. (Operator Instructions) Okay, Candace.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Ken Goldman of JPMorgan.

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

One of the questions I get on Campbell, Denise, is what is the board's thoughts on the carrot business at this point? Because, obviously, the carrot business, I think, has underperformed expectations, it's fair to say. And at this point, it's volatile and unpredictable. And from an investor perspective, that leads to uncertainty, which leads to lower multiples. So I'm just curious how committed the board is to sort of keeping the carrot business itself as opposed to the rest of Bolthouse, which obviously still has some upside from a packaged food perspective.

Denise M. Morrison - *Campbell Soup Company - President, CEO & Director*

Yes, yes. There's no question, Ken, that we have experienced volatility in the carrot business due primarily to weather issues in California, dealing with extremes in rain and heat, which has affected the crop. While we can't control the weather, we can control what we do about it. And I believe that we did the right thing this time around by putting customers on allocation, not harvesting early and keeping the quality of our carrots. Understand that the role of carrots in this business is it's the scale of distribution for the CPG products. And one of the reasons why we acquired the business was to grow the CPG portion and recognize that the carrots are the chassis for distribution at best pricing. So we'll continue to take this into consideration going forward. We'd like to get to the point of stability in carrots and growth in CPG, and that's our strategy.

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

Okay. And then, my follow-up is, Denise, you talked about getting a little bit optimistic or maybe you are optimistic about the conversations with the key customer that the promotion has maybe been lost temporarily with. Can you give us a little more color on where that optimism comes from and when the earliest it might be that you might get that promotion back in some form?

Denise M. Morrison - *Campbell Soup Company - President, CEO & Director*

While I can't talk about any specifics, I can say that the dialogue remains open and it's very positive.

Operator

And our next question comes from Matthew Grainger of Morgan Stanley.

Matthew Cameron Grainger - *Morgan Stanley, Research Division - Executive Director*

I wanted to ask another follow-up on the soup issue. Most of your competitors have characterized this specific circumstance in soup with this one retailer as a very isolated case. And I think what we're hearing from others is that there's just the need for greater levels of innovation and that's going to be sufficient to protect relationships with key retailers, provide value for all stakeholders and avoid having others run into similar situation. So I guess, do you agree with that characterization of soup being an isolated pressure point in the industry? And if that's true, what could you have done differently or do you need to do differently to avoid this going forward, to the extent that this, perhaps, is an issue that's disproportionately affecting the condensed business? Is there a need to try and bring some type of innovation to that area of the business that's been a little bit more static from a product standpoint in recent years?

Denise M. Morrison - *Campbell Soup Company - President, CEO & Director*

Yes. I'll answer that question from a couple of perspectives. First of all, in the rest of the market, the soup program has been very strong. New products have been well received. New Well Yes! is at 83% ACV distribution. We're supporting the brands. New Chunky Maxx has hit the market now with 40% more protein, and protein is really on trend. So we're pretty pleased with the performance in the rest of the market, with consumption up slightly. So that's -- and we believe we'll continue to see that momentum into the second quarter. The other fact is that our other businesses in this key retailer are incredibly robust. So I would say that I do agree that the soup situation is isolated.

Matthew Cameron Grainger - *Morgan Stanley, Research Division - Executive Director*

Okay. And I know it's going to be difficult to comment on this and you might just defer, but given -- obviously, you ran the numbers and didn't want to meet their demands on this particular category or in the soup category, and you're seeing solid consumption or modest growth in other customers in the category. Given that dynamic, I mean, do you have a sense of how they view the return profile of their approach to the soup category this year, given that they're losing a fair amount of share in a relatively high-margin category and what the implications of that might be for the likelihood of seeing similar situations going forward?

Denise M. Morrison - *Campbell Soup Company - President, CEO & Director*

You're right. I'll defer.

Operator

And our next question comes from Andrew Lazar of Barclays.

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

Just one last one on that particular issue. When you talk about the dialogue being positive and open, would this be something that potentially could impact positively this fiscal year? Or are we at a point where plans are in place such that -- and you've done things with, obviously, other retailers that seem to be effective. Is it really more of an FY '19 scenario? Or is there some way to salvage some of this year? And then, Anthony, I think at the last call, you mentioned that this promotional issue would probably be about a 1% top line drag for the full year for the company as a whole. Is that still around where you think we are? Or has the first quarter led that to be somewhat different now?

Denise M. Morrison - *Campbell Soup Company - President, CEO & Director*

I'll take the first part, Andrew. I -- let's see, we said this in September, but we expect that the first half on soup will be weaker than year ago, and we expect [some] momentum in the second half.

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

On your other question, yes, we did say that soup performance would have about 1 point impact on total company. I would say still rounds to 1 but probably a little bit higher.

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

Okay. And then, the last thing would just be, I think you mentioned that obviously a big part of what we saw in the fiscal first quarter was the lower year-over-year inventory build. In fiscal 2Q, was there also an inventory build seasonally last year that we wouldn't get this year? Or would soup shipments look a little bit more like consumption this time around as we go into the 2Q?

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

Yes, the seasonal build goes through the second quarter. I mean, it's kind of hard to say. Obviously, we didn't build as much in Q1, but given where we sit today and given our outlook for consumption, it's hard to say what's going to happen relative to inventory movements going forward, but I would expect them to be significantly more muted than the Q1 impact.

Operator

And our next question comes from Robert Moskow of Crédit Suisse.

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

I wanted to make sure that I understood that comment too, Anthony. So you're saying that, is there still de-loading that you expect in second quarter? In other words, that your shipments will trail soup consumption in second quarter as well? And also, is that just at this one retailer or is that across multiple retailers that you're seeing the de-loading.

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

So be careful with the term de-loading. Yes, the impact is all one customer. And basically, you have a curve that builds kind of steeply in Q1 and less steeply in Q2. And certainly, the seasonal build through Q1 was significantly below last year. Now that curve starts to kind of come down a little bit or increase at a slower rate in the second quarter, and it's really difficult to predict shipments vis-à-vis consumption, but I would expect to have a much more tighter delta between shipments and consumption in the second quarter than the first.

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

Okay. I think I get it. And in one of your slides, you showed that private label soup has expanded market share by over 100 basis points. Has this retailer really pushed private label as a substitute for your brand in the category? Or is that private label gain happening across multiple retailers?

Denise M. Morrison - *Campbell Soup Company - President, CEO & Director*

I don't think private label is a new phenomenon. Private label is pretty prevalent. And what we have seen is more of a push on private label in the broth business in the market at large. Actually, our -- the share that private label has of condensed soup and RTS soup is significantly below the average in center-store categories and only up slightly, but broth has definitely been impacted.

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

And how would you expect that to impact the Pacific Foods business? I think Pacific is largely broth, isn't it?

Denise M. Morrison - *Campbell Soup Company - President, CEO & Director*

The Pacific Foods brand is highly differentiated, being organic and natural. So we believe that will be a good add to our line.

Operator

And our next question comes from Bryan Spillane of Bank of America.

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

Just wanted to follow up on gross margin and I just want to make sure I heard this right. Are we -- are you expecting that gross margin will be under worse pressure or more pressure in 2Q versus 1Q and then sort of get better in the second half? And I guess just a follow-up on that is, are you doing -- what are the remedial actions to improve gross margins? Are you raising prices or pulling through more productivity? Just trying to understand sort of what'll get the gross margins to improve as you go through the year.

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

Yes, I think the first part of that question is understanding what happened in the first quarter. I mean, we're down a couple of hundred basis points primarily due to 3 things, 2 of which are going to stay on the year and one of which is going to turn. The higher transportation and logistic costs certainly had a negative impact on Q1. That's going to impact the year. The second is the carrot cost issue related to yield. That impacted the first quarter and will also stick on the year. The third, and this one is primarily timing, with soup down 9% in the first quarter, there's a pretty significant negative mix impact from that and most of that should turn. So as we look at the full year now, we would say we expect gross margin to be about flat. And I think the way to decompose that is to think about our productivity savings, so we're targeting 3% of cost, and that will just about offset cost inflation as well as some of the investments we're making in Real Foods, Denise mentioned what those were. And then, the other 2 components, we had previously expected and still expect to deliver cost savings of $60 million to $70 million, most of which will impact COPS. And to a large extent, that's largely offset now by these unanticipated cost issues, both transportation and logistics, as well as the carrot yield. Now in terms of phasing, given the seasonality of the soup business, certainly, the consumption expectation will have a more significant impact on Q2. The timing of those 2 cost issues, transportation and logistics and carrots, more impactful on Q2, and then we'd expect to see improvement in the back half.

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

Okay. So but 2Q isn't more pressure than 1Q. I guess, 1Q, you also had a pretty difficult gross margin for carrots as opposed to last year.

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

No, no. I wouldn't say more pressure. No, I -- no, but relative to the second half, yes, but not relative to 2Q.

Operator

And our next question comes from Steve Strycula of UBS.

Steven A. Strycula - *UBS Investment Bank, Research Division - Director and Equity Research Analyst*

Just a follow-up on Bryan's question. Does this imply that gross margin in the back half of the year are going to be up about 150 basis points or greater? Just want to make sure I'm thinking about that correctly and I've got a follow-up.

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

Yes. We would expect them to be up in the second half for sure.

Steven A. Strycula - *UBS Investment Bank, Research Division - Director and Equity Research Analyst*

Okay, great. That's helpful. And then, Denise, can you comment a little bit about the overall category right now? Are you seeing any shrinkage in total points of distribution of retail across the U.S. channel plays right now? Or are you just seeing a little bit of rotation between a little bit of private label and branded mix here and there?

Denise M. Morrison - *Campbell Soup Company - President, CEO & Director*

Just for clarification, because we're in the Snacks category and many fresh categories, are you referring to the soup category?

Steven A. Strycula - *UBS Investment Bank, Research Division - Director and Equity Research Analyst*

Yes, specifically. But while you're at it, if you want to comment on snacking, given what we're seeing with Kellogg's DSD transition, that would be helpful, too.

Denise M. Morrison - *Campbell Soup Company - President, CEO & Director*

Okay. Let me start there. In our Pepperidge Farm business, we've seen a lot of robust consumption, particularly on Goldfish and cookies, as I stated before. We continue to increase our shelf space merchandising. So they're really doing a great job. In Campbell Fresh, again, the CPG part of the business has returned to growth, up a couple of points for the second consecutive quarter. And we didn't start promoting beverages until October so we will now return to a normal promotional schedule in quarter 2, and we have a huge innovation suite coming to market in quarter 3. So we believe that the CPG part of Campbell Fresh will have momentum. In the soup category in the rest of the market, we continue to see robust plans. We do audit shelves every year but we have not gotten the results of that. We'll let you know when we do. And so we're just running our play.

Operator

And our next question comes from Chris Growe with Stifel.

THOMSON REUTERS

Christopher Robert Growe - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD and Analyst*

Just a question for you, to follow-up on an earlier question. In relation to the change in promotional program at this key customer, if you were to effect some sort of plan now or soon, given the seasonality of this business, could it be in place by the end of the soup season? Could you be back for promoting relatively quickly if something got worked out there?

Denise M. Morrison - *Campbell Soup Company - President, CEO & Director*

I'm not going to comment on the specifics of a customer program.

Christopher Robert Growe - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD and Analyst*

Okay. Even the timing at which you could affect the promotion?

Denise M. Morrison - *Campbell Soup Company - President, CEO & Director*

All I'm willing to say is that we are in open discussion and are positive about it.

Christopher Robert Growe - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD and Analyst*

Okay, got you. And then if I could just ask a quick question on the margin recovery in the C-Fresh division. You're back to promoting more heavily. I think you mentioned that, Anthony, and you do have some easy comps and I know carrot cost will be an ongoing issue. But it seems like that business should get back to profit -- generating operating profit, does that happen as quickly as Q2? Or is there an upfront investment that may kind of slow that rebuild in profitability in that division

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

Yes, a couple of things. I would say if we didn't have this yield issue in Q1, Campbell Fresh's division would've generated a profit. So yes, it can turn around pretty quickly. We'll have a little bit of a lingering impact of the carrot yield issue into the second quarter. Denise mentioned we're on allocation. That should be behind us by December. So we would expect to see profitability pretty quick in Campbell Fresh. And as we've said before, on a full year basis, we would expect to deliver both top and bottom line growth.

Denise M. Morrison - *Campbell Soup Company - President, CEO & Director*

Chris, in addition, we have a very robust supply chain productivity program since we've integrated the supply chain into Campbell's and put them on our productivity program. We have a very good line of sight to some significant cost savings, which will enhance the profitability of the business.

Operator

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

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

Just a follow-up question, just broadly on soup, what -- is there any auditing that you've done about how you've gotten here with the retailer issues in soup and particularly with regard to price gap to private label and the push behind private label? One theory is that the price gaps have widened over recent years. And I think a natural concern was that these issues wouldn't just be local to one retailer in the future that we would see broader private label pushes by other retailers, so any comments on that would be helpful.

Denise M. Morrison - *Campbell Soup Company - President, CEO & Director*

We do very robust analytics on our price gaps and thresholds of the brands versus private label. So we have a good indication of what that looks like, both from the regular retail pricing and also the merchandising pricing with the frequency that we merchandise. So that's under constant watch and that's not different. We've been doing that forever. So I would just say that in the broth business, what we have done to address private label and that's where we have experienced the competition, is we've changed our advertising messaging more to house [wants] and is differentiated versus private label, starting with the fact that the first ingredient in Swanson is chicken stock whereas the first ingredient in most private label is water. And so we're calling attention to some of the attributes that distinguish the Swanson brand from private label. And then, of course, the pending acquisition of Pacific, as I mentioned, we're pretty enthusiastic about what differentiation that brand brings to the line. In RTS and condensed, private label is a factor but it's really under average and we have not -- we haven't seen an increase. I mean, it's been up slightly, so -- but we continue to watch it and we'll make sure we continue to be competitive.

Operator

And our next question comes from David Driscoll of Citi Research.

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

So apologies for some more soup questions. They keep coming. Soup inventory, Anthony, can you just talk about why this doesn't impact guidance? I think you called out the carrot issue and the supply chain, the freight issue as the big changes to the guidance. But I'm not 100% clear why the soup inventory issues in Q1 don't also impact the guidance. And the simple question would be, if this big retailer is not ordering product, why doesn't this have some kind of impact on upcoming sales?

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

So I'll start with the end of that question. I think it's likely that the lower inventory build -- will have -- is an indicator of near-term consumption. So I think we would expect to see some consumption declines. And then the other question, yes, both the carrot issue and the freight issue were both unanticipated and impacting the year. But I think the way to think about retailer inventories, they start our fiscal year at relatively low levels. They go through a significant increase in Q1, Q2 and then come back down in the back half. So it really is volatility amongst the quarters as opposed to impact for us on our fiscal year, given our fiscal year is about when those inventories are at their lowest point. So that one is more about timing, which is why I didn't talk about it in terms of our full year guidance.

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

And then related to that, soup [definitely] is down 2% and this isn't -- and soup is not really a factor in the guidance change. Is it fair to say that your full year expectations for the soup season is down about 2%?

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

I don't want to give you a specific number but probably a little south of that.

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

Last thing from me is just on freight. Can you just talk about how this plays out over time? I'm a little confused about the factors here. We've got a hurricane truck availability issue. That should improve. That feels like it's going to be good as time progresses. But I believe there's some new rules coming that are negative. So this freight issue, is the cost -- is this going to get better or is it going to get worse as time progresses?

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

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This one is hard to say. I mean, obviously, we've experienced the impact of the hurricanes and the shortages and it has pushed us out into the spot market and when that happens, it certainly drives up costs. We've had to do some more inter-plant and some -- experience some more warehousing costs that we've tried to rebalance kind of the network to get around some of that. It is our expectations for this impact to moderate as we go through the rest of our fiscal year, but it's taken a while. And as we sit here today, if you look at any kind of capacity report, it's still well above where it's been over the last 6 or 7 years. So I can't tell you exactly when that's going to moderate, but we're assuming that's going to take a little while.

Operator

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

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

I'm going to cram 2 questions in, if I may. First, in terms of top line drivers, can you help us understand why you're not seeing any sort of promo price mix benefit as you suffer so many -- so much volume loss related to subsidized promoted sales?

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

Yes, I can take that one. What's happening, and the reason you don't see a promotional lift in terms of sales is there's a couple of offsets. One, if you look at the dollar spend for promo on soup, for example, it is down double digits in the first quarter. But what's happening is we're spending back a little bit on broth. We're spending back a little bit on both the Prego business and on V8. And the other reason you don't see it as much as with soup volumes being down as part of mostly related to that inventory issue, we calculate trade rate on a rate basis, so the volume decline is muting, right, the promotional rate a little bit. But I think the better indicator is, on a dollar basis, our trade is down significantly on soup.

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

Okay. And then, the second question, I think, comes back to a lot of the questions you've gotten today. They all sort of tether back to the believability of your ability to get the acceleration you're talking about in the back half. Denise, I think you kind of vaguely implied that maybe soup, you're expecting to grow in the back half. And Steve asked the question about gross margin. I mean, at minimum, it sounds like your guidance implies 150 basis points of expansion, minimum in the back half of the year. Can you give us a little more teeth or a little more meat on the bone in terms of the drivers of those dynamics to help restore some credibility in that path of acceleration?

Denise M. Morrison - *Campbell Soup Company - President, CEO & Director*

I -- we said in September and continue to believe that we will have a weaker first half than second half in soup based on what we know at this point. And in terms of the gross margin, Anthony, do you want to handle that one?

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

Yes. I would say, typically, our cost productivity program is more kind of, I would say, back-end weighted as opposed to front end, given the seasonality of the business and our ability to get into some of the plants when there's some downtime. So that's certainly more back half than front half. The other thing is this mix issue of soup in the first quarter, in effect, should turn as we go through the balance of the year, so that's a positive. And the third, as I said before, on our cost savings program, which is an addition to the productivity program, a lot of that should be coming in the back half as well. So we do expect to see improved gross margin performance in the back half.

Denise M. Morrison - *Campbell Soup Company - President, CEO & Director*

Yes. In the back half, we have a greater mix in our Global Biscuits and Snacks business and Campbell Fresh.

Operator

And our final question comes from the line of Michael Lavery of Piper Jaffray.

Michael Scott Lavery - *Piper Jaffray Companies, Research Division - Principal & Senior Research Analyst*

I just want to understand this, Anthony, something you just said, if I'm hearing you right, it sounds like you're expecting the 7 points of lost inventory build to come back over the course of the year. And if that's correct, can you explain why you think that's the case?

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

Yes. I'd go back to some of what I said earlier. It's you need to understand the seasonality of the soup business and what happens to retailer inventory level. I think the easiest way to explain it is that our fiscal year is essentially the lowest point of retailer inventory. And then, they build and we're talking about significant build, in the first and second quarters, right. So where you strike that line on that inventory build between Q1 and Q2 just introduces volatility amongst the quarters. By the time we get to the end of fiscal year, those inventory levels will come out, right? So any kind of lower seasonal build here means less of a seasonal decline on the back half. So kind of nets itself out a little bit.

Denise M. Morrison - *Campbell Soup Company - President, CEO & Director*

The main thing to focus on is the consumption in the quarter. Soup consumption was down 2.3%.

Michael Scott Lavery - *Piper Jaffray Companies, Research Division - Principal & Senior Research Analyst*

Can you help me understand a little bit of the dynamics with this promotional change? Because I think that's how you've typically characterized it, but it also sounds like if it simply were a question of spending more money and adding promotional dollars and that would benefit you, then you would have probably simply just done it. So how many pieces of the puzzle are there beyond that? Because it sounds like there's potentially or maybe even probably some shelf space changes. Is that a fair assumption? And if so, then wouldn't that perhaps have a lasting impact on the inventory level through the course of the year?

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

I would say we really haven't seen any shelf space changes. When we deal with our customers, we agree around a promotional program. That includes new items. It includes merchandising amongst other things and promotional programming. So it isn't just a dollars and cents kind of thing. I think the thing that impacts the inventory build is what is the merchandising program on a go-forward basis. And that's why I said earlier that this lower retailer inventory build could be an indication of what's going to happen to consumption in, say, for example, the second quarter.

Michael Scott Lavery - *Piper Jaffray Companies, Research Division - Principal & Senior Research Analyst*

Okay. And just one last unrelated one. You touched on significant growth on your e-commerce business. Can you just give a sense across your portfolio of what types of products lend itself to good performance online? I would assume it probably varies a bit. Are there some that tend to do much better than others? And what would those be?

Denise M. Morrison - *Campbell Soup Company - President, CEO & Director*

Yes. We have a couple of things going on there. And our e-commerce business is still small, and for the industry, it's still small. But we're focused on building capabilities in terms of really understanding the consumers' path to purchase in that space. We are working predominantly with pure-play e-tailers and also omni, and we're working with Chef'd on meal kits in that space. So we're trying some different things. We're working literally across all of our brands and bundling brands based on what the customer wants to do in that space. So I think we're trying a lot of things. One of the things that's very encouraging though is we brought in some top talent and we believe that as more consumers shift to e-commerce, whether it's order online, pick up at store or order online and deliver to home, we'll be well poised to participate and lead in that space.

Operator

And that concludes our question-and-answer session for today. I'd like to turn the conference back over to Ken Gosnell for any closing remarks.

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

Thank you, Candace. We thank everyone for joining our first quarter earnings call and webcast. A full replay will be available about 2 hours after our call by going online or calling 1 (404) 537-3406. The access code is 6692642. You'll have until December 5 at midnight, at which point we move our earnings call strictly to the website, investor.campbellsoupcompany.com, under News & Events. Just click on Recent Webcasts & Presentations. If you have any further questions, please call me at (856) 342-6081. If you are a reporter with questions, please call Thomas Hushen, Associate Director of Communications at (856) 342-5227. Thanks, everyone. Happy Thanksgiving.

Operator

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