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MFI.TO - Q2 2015 Maple Leaf Foods Inc Earnings Call

EVENT DATE/TIME: JULY 31, 2015 / 2:30PM GMT

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CORPORATE PARTICIPANTS

Debbie Simpson *Maple Leaf Foods Inc. - CFO*

Gary Maksymetz *Maple Leaf Foods Inc. - COO*

CONFERENCE CALL PARTICIPANTS

Irene Nattel *RBC Capital Markets - Analyst*

Mark Petrie *CIBC World Markets - Analyst*

Derek Dley *Canaccord Genuity - Analyst*

Michael Van Aelst *TD Securities - Analyst*

Ken Zaslow *BMO Capital Markets - Analyst*

PRESENTATION

Operator

Good morning, ladies and gentlemen. Welcome to the Maple Leaf Foods second quarter 2015 results conference call hosted by Ms. Debbie Simpson. Please be advised this call is being recorded.

Please note that there will be a question and answer session following the formal remarks and the question and answer session instructions will be read after the presentation. I would like to turn the meeting over to Ms. Debbie Simpson. Please go ahead.

Debbie Simpson - *Maple Leaf Foods Inc. - CFO*

Good morning, everyone, and thank you for joining us. Unfortunately, Michael McCain is unable to be with us on today's call, but I am pleased to be joined by Gary Maksymetz, our Chief Operating Officer.

Today's webcast will review Maple Leaf Foods' financial and operating results for the second quarter of 2015. The news release and today's webcast presentation are available at mapleleaffoods.com under the investor section.

Some of the statements made on this call may constitute forward-looking information and future results may differ materially from what we discuss. Please refer to our 2014 annual MD&A and other information on our website for a broader description of the operations and risk factors that could affect the Company's performance.

I will now turn the call over to Gary.

Gary Maksymetz - *Maple Leaf Foods Inc. - COO*

Thank you, Debbie. Good morning, everyone.

I will begin on page 2 of the presentation. I would start with that we are very pleased with the progress we've made this quarter. The highlights include a continued progression in our EBITDA margin now at 6% with a clear path forward to achieving our strategic goals; a CAD34 million improvement from earnings from last year, which increased adjusted operating earnings to CAD22 million and an adjusted EPS of CAD0.13; closing our last legacy plant; bringing an end to our duplicative prepared meat supply network; strong commercial momentum and volume growth in prepared meats over the prior year; and improved operating performance at our new startup plants. All in, we are very pleased with the progress we've made this quarter.

Turning to Slide 3. Slide 3 charts the financial improvement we have achieved, which is reflected by the significant EBITDA margin growth from the end of 2013. With an EBITDA margin now at 6%, up 5.3% from a year ago, and 1.3% from last quarter, the trend line is clear and strong. Our adjusted EPS was CAD0.13 compared to a loss of CAD0.12 a year ago.

Slide 4 provides the details of the CAD34 million year-over-year improvement in our adjusted operating earnings from a loss of 12 million last year at this time to CAD22 million of earnings this year. The first bar represents CAD26 million in margin improvements in our prepared meats business as we returned to more normalized market conditions and realized a reduction in duplicative overhead following the closure of our legacy plants.

As a reminder, last year we were faced with extraordinary market volatility as a result of the outbreak of the PED virus in US hog production. While protein markets were largely flat, we achieved a CAD2 million improvement compared with the second quarter a year-ago shown in the second green bar. The next bar shows the CAD5 million improvement from higher fresh and prepared meats volume compared to last year, primarily in prepared meats. We have largely restored volumes to where they were prior to last year's price increase, something I will speak to a little later.

The final bar marked "other" represents improved earnings from fresh poultry, reflecting favorable sales mix and improved operating efficiencies, which were partially offset by lower earnings in our fresh pork business.

Turning to Slide 5, commercial momentum continued to strengthen in the quarter. Volume growth in prepared meats has been particularly strong versus the prior year, and we have largely restored volumes to where they were before we took the pricing action in response to high raw material costs. We are particularly pleased with the strong growth in our retail branded business.

Our poultry business benefited from favorable sales mix, primarily driven by growth in our branded fresh business, as well as from cost savings initiatives. We've realized very strong momentum behind Prime Poultry, which is one of our flagship brands. We spoke last quarter about shifting from fixing the business to growing it, and we continue to look for opportunities to advance our leadership in key categories. In the quarter, for example, we introduced several new products, which expanded our ethnic offering and our protein snacking line.

Slide 6 outlines the path to achieving our strategic margin targets and it's really important that I spend some time focusing on this. To reach our near-term 10% target this year, we need to achieve what we've outlined in the column on the left. Each is related to plant optimization, which is focused on our new plant in Hamilton and all are very common to any new manufacturing startup. They include dialing in equipment performance and training, achieving overall equipment effectiveness, or OEE targets, a metric that essentially measures line speeds and utilization, optimizing our formulations on the new processing equipment to improve yields to target levels, and finally, a reduction in overhead that will come when we eliminate all of the additional activity associated with our transformation.

Our plant in Hamilton is unlike any other. It is the largest prepared meats plant in Canada and it replaced six of our legacy facilities. We have multiple production lines for wieners, balogna and deli meats, including 11 slicing and packaging lines. It houses some of the newest and most advanced technology in the industry. Essentially, it is really multiple plants within a plant.

We continue to make progress, but as is always the case in complex startups like this one, near-term predictions are difficult. Frankly, it's rarely a straight line. Having said that, we have consistently said that we feel our strategic margin target of 10% should be a floor in our business, not a ceiling. We have all the fundamentals for that to be true.

Now that we have our new network operational, those new frontiers are becoming more visible. They include increasing the utilization of our assets by finding new ways to squeeze incremental capacity of the new lines, realizing new business development opportunities to utilize this footprint. We are focusing the resources on high return opportunities beyond the ongoing steady pace of innovation. Certainly, the current level of the Canadian dollar is a benefit to us in this regard. I will return to the growth story in a moment.

We also see opportunities to improve our margins through better sales mix and innovation. And finally, we believe there is more opportunity for cost reduction in our SG&A, which is something the entire food industry is focused on. A focus on growth and relentlessly managing costs is why we are confident, that at 10%, will be a floor and not a ceiling over the next five years.

I would like to spend a moment discussing our growth framework as we've outlined on Slide 7. Last quarter, we spoke about developing a growth path and I would like to add some color on our process and thinking on priorities. There are many growth opportunities in the market and as we work on identifying the most meaningful ones, our decisions will be data-driven with a look to growing in ways which offer brand relevance, higher growth segments that clearly are margin accretive, and we will do this with a clear eye towards long-term total shareholder return.

We have also developed a robust sustainability platform which we see as supporting our growth agenda. Our focus is in four key areas: Advancing nutrition and health, our people and community involvement, treating animals well, and environmental sustainability. It is clear to us that our vision for a sustainable protein Company will be a cornerstone for growth well into the future.

I will now turn the call back to Debbie.

Debbie Simpson - *Maple Leaf Foods Inc. - CFO*

Thank you, Gary. Slide 8 provides further information on our cash flow and balance sheet. In the second quarter, we had positive free cash flow of CAD30 million. Cash on hand at the end of the quarter was CAD410 million, after investing CAD42 million in the purchase of 1.8 million shares under our normal course issuer bid. Our share buyback has been continuing this month, and as of yesterday, we had acquired a total of 2.7 million shares for a cumulative investment of CAD64 million.

Our capital expenditures were CAD44 million in the quarter compared to CAD78 million last year. In the first six months, capital expenditures were CAD70 million compared to CAD176 million in 2014. We still expect the capital spending for the year will be in line with our estimate of around CAD120 million.

Finally, for the quarter, we saw a decrease in our restructuring costs to CAD7 million from CAD11 million in the first quarter, CAD4 million of which was in cash. Our year-to-date restructuring costs are CAD18 million, of which CAD11 million was cash, and we now expect restructuring costs for the year to be in the range of CAD25 million to CAD30 million.

Turning to Slide 9, in conclusion, we have had a good quarter where we made meaningful progress on a number of fronts. We reported significant quarter over quarter earnings growth, buoyed by both continued improvement in our manufacturing network and excellent commercial performance. Our volumes have largely been restored, particularly in our retail branded business. We are responsibly deploying capital as we focus on delivering our near-term financial target and developing broader growth plans. We have a clear runway to achieving our 10% EBITDA margin and then building from there.

With that, we would like to open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question is from Irene Nattel. Please go ahead.

Irene Nattel - *RBC Capital Markets - Analyst*

Thanks, and good morning, everybody. If I could please go back to Slide number 6, a very helpful outlining the factors that are going to bridge the gap between 6% and 10%. But if we focus on those four factors on the left side of that slide, could you talk us through how important each one of those is in bridging that gap and when we can expect them to come through in the back half of the year?

Gary Maksymetz - *Maple Leaf Foods Inc. - COO*

Okay. So Irene, it's Gary. Actually, they all play a role, obviously, in getting to the end state of 10%. The key areas where we're focused on and that are driving the performance will be in our -- in yields, getting yield improvements on the equipment, the productivity, and finally in the costs tied to overhead that are still tied to transformation, the resources we've put in place to act on those two.

Irene Nattel - *RBC Capital Markets - Analyst*

Thank you for that. And should we assume that the order in which they are presented is the relative ranking of importance of -- in terms of getting from 6% to 10%?

Debbie Simpson - *Maple Leaf Foods Inc. - CFO*

Irene, I think if you look at it as the first three boxes really delivered the improvement in productivity and yield, and then the fourth box, which is the elimination or the reduction of the overhead, really follows that. So you need to nail the first three, and then the fourth follows.

Irene Nattel - *RBC Capital Markets - Analyst*

Okay. That's great. Thank you. That's very helpful, Debbie. The next question, from your commentary, Debbie, it would appear that clearly, your intention is to continue to buy back stock. Should we therefore assume that you will -- that we should see full execution of the approved NCIB through the balance of the year?

Debbie Simpson - *Maple Leaf Foods Inc. - CFO*

That would certainly be our plan, Irene.

Irene Nattel - *RBC Capital Markets - Analyst*

Okay. That's great. Thank you. And then just finally, and again, I would like to go back to Slide number 4, the CAD26 million improvement in prepared meats margin, part of that is -- it relates to normalizing market conditions. How much of that CAD26 million is the normalized market condition versus, if you will, improved efficiency?

Gary Maksymetz - *Maple Leaf Foods Inc. - COO*

Well, last year, the biggest portion of that is -- well, there's two that contribute to that. It's about last year -- we had runaway costs in the pork market tied to the PED. So we had margin compression last year based on just the slope of the increase in the complex in our meat costs. So the improvement that you're seeing is really tied to those two things. A return to more normalized margins and improvements that we've made in the elimination of duplicative of overheads.

Irene Nattel - *RBC Capital Markets - Analyst*

That's great.

Debbie Simpson - *Maple Leaf Foods Inc. - CFO*

And on that, Irene, the biggest portion of the CAD26 million is related to the reversal of the compression in the margin, and the returning to more normalized margin. And then a smaller piece of the CAD26 million is the elimination of the duplicative overhead.

Irene Nattel - *RBC Capital Markets - Analyst*

Thank you very much for that. And I'll pass it over to someone else.

Debbie Simpson - *Maple Leaf Foods Inc. - CFO*

Thanks, Irene.

Operator

Thank you. The following question is from Mark Petrie. Please go ahead.

Mark Petrie - *CIBC World Markets - Analyst*

Good morning. Just wonder if you could talk a bit more about the retail environment? Clearly, promotions have picked up following your price increases of last year and, obviously, hog prices coming off so significantly. But could you just talk about the environment, where you might still have some room to grow in terms of volumes or catch-up? And then what you're seeing in terms of the relative level of competition from US competitors as it relates to, obviously, the big move in the Canadian dollar?

Gary Maksymetz - *Maple Leaf Foods Inc. - COO*

Okay. Great question. I would say the answer to that is in terms of our volume, we're very satisfied with the progression that we've made in the recovery of our volume. The impact -- the shock actually, of the pricing and the impact of that across the industry last year did translate into some, what we described as short-term volume impact. So our approach was to be patient in terms of the volume recovery. So what we've seen in the second quarter is essentially a return to largely the volumes that we had a year ago.

With respect to your question on the impact of the dollar, the impact of a weaker Canadian dollar for us is essentially a good thing over time. What it does is it creates opportunity for us in the US. We do some business in the US. And it also makes it much more difficult for US competitors here.

So what we're seeing largely is opportunity. Recovery to this point hasn't been driven by the FX, but FX could have impact in the future, which takes quarters. It's not -- the current scenario is we've seen the dollar decline pretty rapidly recently. But improvements in volume, or opportunity for volume, if that's your question, will be more long-term as the market adjusts to the differences in the FX between Canada and the US.

Mark Petrie - *CIBC World Markets - Analyst*

And do you feel like your market share has moved dramatically from this point a year ago?

Gary Maksymetz - *Maple Leaf Foods Inc. - COO*

Well, our volume recovery -- we're satisfied with our level of volume recovery and our market shares have largely recovered to where they were a year ago.

Mark Petrie - *CIBC World Markets - Analyst*

Okay. And then could you just comment on the export business? I think there was a recovery there as well, into Japan. Where are you guys at with that?

Gary Maksymetz - *Maple Leaf Foods Inc. - COO*

Well, our margins in Japan have improved. That is a very volatile market. It is competitive. There was some dynamics in the marketplace earlier in the year with the US port closures. But for the most part, our margins have improved. But that's a fluid dynamic. We manage to margin -- we've been in that market for many years and we manage to a margin that we expect in our business over time.

Mark Petrie - *CIBC World Markets - Analyst*

So there's still room to improve?

Gary Maksymetz - *Maple Leaf Foods Inc. - COO*

Well, as I said, our margins in export are part of our structural margin here, and our approach is, and this is something we've been in for many, many years, is we manage to margins over time. So I would say largely our margins in our pork business for export are about where we would expect them to be.

Mark Petrie - *CIBC World Markets - Analyst*

Okay. That's helpful. Thank you very much.

Operator

Thank you. The following question is from Derek Dley. Please go ahead.

Derek Dley - *Canaccord Genuity - Analyst*

Hi. Can you guys just comment on some of the pricing comments that you made in your MD&A? Did you guys take some of the pricing down in more price-sensitive categories or was it across the broader product suite during the quarter?

Gary Maksymetz - *Maple Leaf Foods Inc. - COO*

I think two things: Largely, the lower pork markets have been offset by FX, but in, for example, in the category of bacon, which is a highly promoted category, we have had to make adjustments to be reflective of the market. And that's showing in our volume recovery.

So where there's been some -- the pork market moves at varying degrees by cut, so for the most part, we are -- our margins have normalized to where we would expect them to be and we need to be responsive to markets. So in this case in the bacon category, we've had to -- we've responded according to the market conditions.

Derek Dley - *Canaccord Genuity - Analyst*

Okay, and I'm assuming all of your competitors have subsequently matched pricing?

Gary Maksymetz - *Maple Leaf Foods Inc. - COO*

Yes. Yes, that's a very, it's a very highly watched category with our customers and with our competitors. So we believe we're -- our market share and margins reflect the fact that we're competitive in the marketplace.

Derek Dley - *Canaccord Genuity - Analyst*

Okay. Great. And can you just, if you can, give us an update on the plan to distribute or deploy capital? Can you give us an update on the time line or the sequence of things that need to happen before you look to do that?

Debbie Simpson - *Maple Leaf Foods Inc. - CFO*

Derek, I think what we said is there's no defined time line. We're working through this. We have made some steps. As you know, we increased our dividend and now we have some activity around the normal course issuer bid in buying shares back, and we've bought 2.7 million shares back to date. But our job number one here is to finish the transformation work.

We are looking at growth opportunities beyond that, and clearly, there will be a requirement for capital for that. But beyond that, there's no defined timeframe. The Board is working through it. On a pace -- somewhat slower pace as we complete job number one and then move towards our new platform of growth.

Derek Dley - *Canaccord Genuity - Analyst*

Okay. Thank you very much.

Operator

Thank you. The following question is from Michael Van Aelst. Please go ahead.

Michael Van Aelst - *TD Securities - Analyst*

Hi, there. A few things. I guess just to be clear -- on the margin, I guess what you're saying is that all the market factors are back in place. So I guess if you were -- if your new plants were running at the proper specs, you would be at 10% or above right now given the current market?

Debbie Simpson - *Maple Leaf Foods Inc. - CFO*

That's exactly spot-on, Michael.

Michael Van Aelst - *TD Securities - Analyst*

All right. When you talk about volumes being largely restored in Q2, was that throughout Q2, or is it just by the end of the second quarter? Did you actually realize all of the recovery on average during the year -- during the quarter? Or did you only hit that by the end of the quarter?

Gary Maksymetz - *Maple Leaf Foods Inc. - COO*

Well, I would say the way to characterize that is that we got more momentum as the quarter went through. So in aggregate, where our volume for the quarter is restored, largely restored, but there was some momentum for that through the quarter.

Michael Van Aelst - *TD Securities - Analyst*

Okay. And then in earlier calls, you've talked about the raise without antibiotics and the opportunities maybe even to get those products into the US. Can you talk to us a little bit about where you are with those products, both in pork and in poultry, and whether -- what kind of success you've had with those types of products, both domestically and prospects into the US?

Gary Maksymetz - *Maple Leaf Foods Inc. - COO*

Yes. RWA, or raised without antibiotics, as it's known in the US, are the fast-growing meat segments both here and in the US. We have a number of RWA products in the market today, and we will be increasing these over the coming months in both Canada and the US.

Michael Van Aelst - *TD Securities - Analyst*

So do you have any shipments of these products into the US yet at this point?

Gary Maksymetz - *Maple Leaf Foods Inc. - COO*

Yes, we do.

Michael Van Aelst - *TD Securities - Analyst*

Okay, and when did those start?

Gary Maksymetz - *Maple Leaf Foods Inc. - COO*

Actually, they started some in the fall of last year and we've been adding to that through this year.

Michael Van Aelst - *TD Securities - Analyst*

Okay. And then finally, can you just explain, you might have mentioned this earlier, but I missed part of it, you mentioned that fresh pork margins were down. What was the reason for that?

Gary Maksymetz - *Maple Leaf Foods Inc. - COO*

Largely on byproducts, the valuation of byproducts. They are a significant part, or can be a significant part, of the total return and the valuations on byproducts are down year-over-year.

Michael Van Aelst - *TD Securities - Analyst*

Okay. Thank you.

Operator

Thank you. The following question is from Ken Zaslow. Please go ahead.

Ken Zaslow - *BMO Capital Markets - Analyst*

Hi, good morning, everyone.

Debbie Simpson - *Maple Leaf Foods Inc. - CFO*

Hi, Ken.

Ken Zaslow - *BMO Capital Markets - Analyst*

So let me just make sure I understand. The only reason you didn't hit the 10% EBITDA margin is because of the market environment?

Gary Maksymetz - *Maple Leaf Foods Inc. - COO*

No.

Debbie Simpson - *Maple Leaf Foods Inc. - CFO*

No, not at all. The market environment's pretty flat, Ken.

Ken Zaslow - *BMO Capital Markets - Analyst*

Oh, okay. I misunderstood the question before then. I must have misunderstood. What was the only reason you missed it for?

Debbie Simpson - *Maple Leaf Foods Inc. - CFO*

So we didn't miss our 10%. We're progressing towards it is how I would frame it. Currently, it's 6% with 4% of a gap to close. What we talked about in our presentation was that that 4% is purely driven by the efficiencies in our new plants.

Ken Zaslow - *BMO Capital Markets - Analyst*

Oh, okay. I just misunderstood the question. So will you be able to achieve the 10% EBITDA margin third or fourth quarter?

Gary Maksymetz - *Maple Leaf Foods Inc. - COO*

Well, there's no -- it's Gary. There's no change in our outlook on that. What we've said is we expect to deliver the 10% in-year and that's still our plan.

Ken Zaslow - *BMO Capital Markets - Analyst*

As in like a full quarter, or is it just going to be like the last month of the year and you could say that you hit the 10%? Like how do you think of that? Hitting it, what does that actually mean?

Gary Maksymetz - *Maple Leaf Foods Inc. - COO*

Well, I think the way to characterize that, Ken, is there are -- as we pointed out, I think it was on Slide 4? What slide is it, Slide 4? Slide 6. There's a number of factors that will drive -- the remaining 4% is on getting our yields, get the equipment running the way it's capable of doing, delivering the yields and meat processing, there's a lot of factors that go into meat yields, the productivity, and then ultimately the overhead on the costs that we've invested in transformation. So those come together.

Those are worth the remaining 4%. We fully expect that those will contribute to the 10%. Startups of this complexity and magnitude are never easy to predict because it's a combination of those four things coming together. So we fully expect that we will deliver that gap in the balance of the year.

Ken Zaslow - *BMO Capital Markets - Analyst*

Okay, and then just continuing on, you understand that you're shifting -- and I think this is the quote, shifting to growing from fixing your business. At 6% EBITDA margin, I think you're still in the fixing mode. Where -- unless you guys are closer to 10% margin, it sounds like from the comment before that your 10% margin may be a little bit at risk, or not. You're saying it's definitely going to be somewhere in the year. But how confident are you that you will be hitting that 10% this year? And how do you shift from growing when we're still in the fixing mode?

Debbie Simpson - *Maple Leaf Foods Inc. - CFO*

Ken, sorry for the confusion. I think the way to look at it is it's a series of steps. So I think what we've said is job number one is to complete hitting the target of the 10%. And what we've outlined is that we expect to do that in the balance of this year, and it all lies in dialing in the efficiencies in our new plants.

What we were talking about beyond that, and clearly that is the fixing, achieving job number one, what we were talking about beyond that is moving from fixing to growth. But your point is absolutely correct. You've got to fix before you grow. But you have to arrive at these things in a sequence. But that does not mean that we haven't been giving some thought to what that growth platform looks like and how we should be approaching it.

Ken Zaslow - *BMO Capital Markets - Analyst*

Okay. And then just two quick questions. One is, what is the magnitude of the price declines in each of the categories?

Debbie Simpson - *Maple Leaf Foods Inc. - CFO*

We wouldn't share specific information by category, Ken.

Ken Zaslow - *BMO Capital Markets - Analyst*

Okay. I just don't have the IRI data in Canada. I'm assuming it's publicly available information. No?

Debbie Simpson - *Maple Leaf Foods Inc. - CFO*

No.

Ken Zaslow - *BMO Capital Markets - Analyst*

Okay. And what is your full-year tax rate expected to be?

Debbie Simpson - *Maple Leaf Foods Inc. - CFO*

So there's no shift there. Around 27%. You would have seen a bit of a bump in Q2 and that was a one-time issue around a favorable ruling that we achieved actually. But I wouldn't expect that to be our ongoing rate. So it's pretty much as you have it modeled.

Ken Zaslow - *BMO Capital Markets - Analyst*

Okay, great. I appreciate it. Thank you.

Debbie Simpson - *Maple Leaf Foods Inc. - CFO*

Not at all.

Operator

Thank you. This concludes the question and answer session. I would like to turn the meeting back over to Mr. Gary Maksymetz. Please go ahead.

Gary Maksymetz - *Maple Leaf Foods Inc. - COO*

Well, thank you, everyone. In closing, I think the appropriate perspective I have, or the perspective I have as well as the team here, is that we were very pleased with the progress we've made this quarter. We have a clear path to what it takes to get to 10%, and as well, beyond. So thank you for your questions and for your participation and, you know what? It's a great long weekend. I would encourage everyone on the call to go buy a few packs of hot dogs and burgers and continue with us. Have a great long weekend.

Operator

Thank you. The conference has now ended. Please disconnect your lines at this time. We thank you for your participation.
