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MFI.TO - Q3 2019 Maple Leaf Foods Inc Earnings Call

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OCTOBER 30, 2019 / 6:30PM, MFI.TO - Q3 2019 Maple Leaf Foods Inc Earnings Call

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## PRESENTATION

### Operator

Good afternoon, ladies and gentlemen, and welcome to the Maple Leaf Foods Third Quarter 2019 Results Call hosted by Mr. Michael McCain. My name is Sylvie, and I will be your conference operator today. Please be advised that this call is being recorded. (Operator Instructions)

Mr. McCain, you may begin your conference, sir.

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**Michael H. McCain** - *Maple Leaf Foods Inc. - President, CEO & Director*

Thank you, Sylvie, and good afternoon, everyone, and thank you for joining our third quarter 2019 earnings call. I'm going to provide some commentary on various aspects of our business as we walk through the deck provided and then open up the call for your questions. The news release and today's webcast presentation are available at [mapleleaffoods.com](http://mapleleaffoods.com) under the Investors section.

Before we start, Slide 2 is the reminder that some of the statements made on this call may constitute forward-looking information and that future results may, in fact, deliver -- or differ materially from what we discuss. So please refer to our 2018 annual and Q3 2019 MD&A and other information on our website for a broader description of operations and risk factors that could affect the company's performance.

If I begin -- let's turn please to Slide #3. During the past 2 quarters, we have, here at Maple Leaf and in our quarterly review, set the stage for how we intend to change our game in plant protein, pursuing a deliberate and calculated strategy that is intended to deliver high levels of growth and driving profitable growth in our meat protein business to achieve our EBITDA margin targets, 2 financial segments with 2 different goals.

We've got a lot to unpack here today. We have 4 goals for the meeting. First is we're presenting for our first time the segmented results for meat and plant protein and providing you with greater clarity on the progress and financial strategies for each of these respective businesses. Second, we're going to walk through what were extraordinary market circumstances and the impact of the 2019 global pork markets. Suffice to say they've been abnormally erratic, to say the least. Number three is we want to provide an update on our strategic blueprint for the broader Maple Leaf organization. And then finally, we would like to unpack the significant investments that we're making in plant protein and the gains that we've made to advance brand awareness and market reach in that important growth sector.

I'm pretty confident that you hear this thousands and thousands of times. But we are very confident in concluding that in spite of what appears on the surface to be challenging numbers, there's actually a super good news story unpinning -- underpinning all, and we hope that we can fully, adequately describe that to you today.



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we are providing fully segmented results beginning in Q3. This reflects the 2 very different financial objectives of each of our meat and plant protein businesses.

Our meat business seeks to create value through a significant pipeline of initiatives that will generate profitable growth over the next few years, a 14% to 16% adjusted EBITDA margin target, and we're well on track towards that goal; while our plant protein business reflects the first time in my history ever, in my 40 years in the food industry, at Maple Leaf where we have endorsed, actually intentionally planning to operate the business at a cash flow loss as we capitalize on the enormous opportunity for rapid top line growth and realizing ultimate shareholder value.

Of particular note, and please hold this thought, we have our other eye focused at the same time as we're focused on investment on the safety valve of ensuring that the business we're building is a profitable one when the investment decelerates. And then our ability to transition from rapid growth in the profit harvesting mode can be made relatively swiftly.

In our meat business, our third quarter was highlighted by abnormal erratic conditions. And to be frank, we were on the wrong side of those conditions. They were connected to the dual influences of African swine fever in Asia and global trade. Paradoxically, we expect a rebound effect in the very next fourth quarter.

On more long-term notes, I'm very excited to describe today some of the good news found in executing our blueprint. In brand momentum generated from our renovation last work -- last year and some of the successes and momentum we are realizing in the plant protein business, which is driving the 30%-plus growth rates that we were experiencing. The runway here is super exciting.

On Slide #5, we are reviewing our segmented financial results. In the meat business, we had top line growth of 13.7% or 5.4% excluding acquisitions. And notwithstanding the raw excitement of plant protein, here's a really, really interesting observation. The meat protein categories that we operate in are also growing, which we believe reflects the underlying insight that consumers fundamentally want to consume more protein in total.

Growth in meat protein was driven by a favorable higher-value mix and pricing actions implemented late in the quarter to mitigate higher raw material costs. Continued expansion of sustainable meats, including ongoing double-digit growth in the U.S., also contributed to sales growth. We are very pleased with the momentum of this business, which provides a strong and differentiated platform for our expansion into the U.S. market as well as here in Canada. While we experienced some prepared meats total volume softness in the third quarter in the wake of Q3 pricing action, our brand and food renovation is gaining good momentum in the marketplace reflected mostly in our brand private label mix.

Selling, general and administrative expenses for the third quarter were \$78.8 million compared to \$68.8 million last year in the meat business. As a percentage of sales, SG&A was 8.3% and essentially flat to a year ago. Of course, the 9% EBITDA margin is disappointing, and it's down 90 basis points from last year at this time, but I will describe in a moment how the pork markets were a whopping 220 basis points off the 5-year average and realized wildly erratic behavior in the quarter. Considering these factors, we were not concerned about the transitory margin compression experienced here for these 3 months.

Our plant protein business delivered revenue of \$47 million or 30% growth in sales. Top line growth was driven by expanded distribution of new products and continued increases in sales volume.

Sales growth was supported by significant strategic investments in marketing, in people and in product development pipelines. And reflecting this, SG&A for plant protein in the quarter rose to \$45 million compared to \$8.6 million last year. I referred earlier to the fact that we are focused on the financial safety valve of ensuring that we don't just build any old business in plant protein, but we build a business that at its core is profitable and can be relatively quickly converted to harvest mode, harvesting that profitability.

The metric that we intend to actively report on which demonstrates this is core gross margin. Our actual gross margin in Q3 was 21.3% compared to 25% last year. But our core gross margin, which excludes the impact of inefficiencies associated with start-up production and other various costs



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On a consolidated basis, Maple Leaf Foods reported sales of 13.8% growth to \$996 million and an adjusted EBITDA margin of 5.4%. Adjusted earnings per share for the quarter were \$0.03, and we closed the quarter in a net debt position of \$403 million, of which \$79.5 million was construction capital, construction capital that is primarily related to the building of our new poultry facility in London and the plant protein facility in Shelbyville, Indiana.

Our full year 2019 capital expenditures have been revised down from \$460 million to \$300 million. This change is a cash flow change only and is related to our large-scale projects. It's connected primarily to weather-related delays in starting construction at our new London poultry facility and additional design time requirement to refine our execution plan for the new plant in Shelbyville as we look at maximizing production capacity within our existing network simultaneously with the new capacity.

Turning to Slide 6. I'm going to take the risk of taking a shot at explaining very complex global markets in a temporarily volatile landscape. We work actually on a normal basis in an environment where pork markets operate within a bandwidth and have a typical seasonal rhythm that's somewhat predictable. We know they happen, we manage through them and they self-correct over time.

What the market has experienced over the last 6 months was atypically erratic and warrants explaining given the impact on our Q3 results. As most of you know, African swine fever is sweeping across China and into neighboring parts of Asia. It's estimated that the disease has wiped approximately 50% of China's hog production out. Assuming hog herd losses in China would immediately lead to a tighter global supply situation and higher prices, hog future spiked in the spring. However, to prevent the disease from spreading, Chinese hog herds were culled and frozen inventory of pork domestically stockpiled.

The paradox here is that even though North American markets prematurely anticipated price rises, they actually fell before they rose. Meanwhile, hog producers in North America have been building production in anticipation of export growth, but near term, it was compressed before that growth was realized. In addition, there's been trade interruption impact as China has placed tariffs on U.S. pork and, in fact, completely cut off exports from Canada. It's super critical to understand that these aberrations, these gyrations are incredibly short term. It would be a big mistake to conclude that these are normal in our meat industry. Because of the enormous hole in global protein supply once near-term inventory culling and trade gets even remotely normalized, there will be a significant demand upside and financial opportunity for global pork suppliers free of ASF.

On Slide #7, you can see how this played out in the third quarter for Maple Leaf. And frankly, it wasn't well. Candidly, we were on the wrong side of this market transition that unfolded differently in the summer than what we anticipated in the spring. The chart that you can see on the left is prices for August alone. It's not a seasonal chart. This is the August futures price alone. And in the spring, as the effect of ASF was believed to be material, even in the short term, the market spiked. Our response to this was logical and normal. It was locking in our meat costs as we always do on a 90-day horizon for the summer and then announcing our prepared meats pricing to reflect that fact. But costs that shot up, then promptly began to precipitously fall again through the summer, even though we know they will rise again given the global supply shortage.

While this occurred, primary pork processing margins that you can see in the bottom line compressed severely in this decline market, even though the normal relationship in a declining market would have those things expand. Consequences for our P&L were fourfold in the period: declining value of hogs, compressed value of the primary pork processing spread, delayed effective increases in prepared meats pricing because of these confusing market signals and some prepared meats volume softness.

Now here's the rub. The pork complex was 220 basis points below the 5-year average in the quarter. Given this, a decline of 40 basis points from last year's actual is, in fact, in our judgment, a relatively positive indicator in the underlying health of the business.

The final paradox is this: These circumstances that are now, in fact, behind us, we expect to have offsetting benefit starting in Q4 with our pricing now fully in place. This whipsaw effect in 2019, weak first quarter, strong second quarter, weak third quarter and an expected strong fourth quarter is not, I repeat, it is not the structural norm of our business, and it reflects only the abnormal impact of these global events in trade and African swine fever. And the fundamentals of these conditions when balanced out actually is very much in our favor.



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by our leadership and sustainability and focused on creating shared value that drives commercial and social benefits.

Our blueprint is a road map of our initiatives that advances our vision to be the most sustainable protein company on earth. Ultimately, they tie to delivering on our financial targets and our longer-term competitive marketing -- market positioning, and I'm very, very pleased with the progress we're making.

Let me walk you through some of our accomplishments in the quarter on Slide #9. First and importantly, our action on the climate crisis and reducing our energy, greenhouse gas emissions has been material. I'm incredibly proud that we are only 1 of 2 animal protein companies globally to set science-based targets the gold standard for aggressively reducing our greenhouse gas emissions. This is an important step towards our goal to reduce our environmental footprint by 50% by 2025. It shows climate leadership, and we will drive continued progress on energy and cost reductions attached to that. You should expect to hear many more aspects, exciting aspects of our carbon management strategy as they unfold over the course of the next year.

Our leadership in Raised Without Antibiotic meat is fueling our growth in sustainable meats. Our RWA portfolio clearly differentiates us in the market and continues to deliver strong growth as evidenced by our ongoing double-digit expansion in the U.S. market.

Leading in animal care is a critical part of our blueprint, and our consumer promise is tied very carefully to our animal care commitments. We are implementing some of the most advanced practices in North America. In the third quarter, we completed the conversion of our Edmonton poultry processing facility to controlled atmosphere stunning, the best practice in poultry processing. To expand our capacity and value-added poultry processing, we are constructing, as you know, a scale processing facility in Southwestern Ontario where we will consolidate 3 subscale facilities into 1. As mentioned, we've experienced a slight delay out of the gate due to wet spring weather, but we are full steam ahead moving forward aggressively on construction, and this is a small site photo of the work underway.

Last year, we completed the most significant food renovation and brand positioning in our history. They are proving to be the right strategies. During the quarter, our brands continued to shift our mix towards higher-margin prepared meats branded products, which contributed to higher profitability in the prepared meats segment.

All the work involved in reformulating our products is now fully integrated into our manufacturing processes, resulting in very significant improvements in our operational efficiencies in the quarter, and we've completed a rollout of Prime Raised Without Antibiotic poultry across Canada. Overall, we're pleased with how our prepared meats at our poultry protein operations performed in the third quarter. Our strategies are working, and they're advancing towards our adjusted EBITDA margin target of 14% to 16%.

Turning to Slide 10 and the plant protein segment. Last quarter, we presented how we've pivoted our plant protein strategy to win. We're raising our game and deliberately investing heavily to drive revenue growth to secure our leading position in this transformational market. Many companies actually aspire to be in this business, while Maple Leaf is, in fact, in this business, and we're leading players right now.

So this is the story of investment and investment for growth. We're making significant investments in our brands to expand market penetration. We're making significant investments to step change our capacity, to develop and rapidly execute on new product innovation. We're investing in people and building our organizational bench strength across the board. We're investing to build supply chain excellence. Our running an efficient and effective supply chain is our wheelhouse, and we're bringing these capabilities and expertise to plant protein with the investments in our existing network and building a world-class facility in the U.S.

And yes, to fund these investments, our SG&A in the quarter was \$45 million for the business in total. But I trust you will recognize that this is about investing to drive sustained growth rates of greater than 30% in the business, not about short-term negative cash flows. This kind of growth rate just is not available to us in a traditional food segment, but it is available to us in leveraging our current plant-based meat alternative business that's already in place and operating.



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have our sights on capturing \$3 billion of it, a realistic and very profitable opportunity.

On Slide #12, you'll get the picture of our P&L stack for protein -- for plant protein. The key metrics in this P&L stack to focus on are: first, the growth rate, which is over 20% and which we expect to maintain at this level or higher. The core gross margin at 29% is our financial safety valve, as I mentioned previously, to ensure that we're working towards a profitable terminal value in this business. And the composition of our \$45 million SG&A investments, which I just described, are very clear. I expect -- or we expect to generate negative EBITDA, a profitable core margin growth for the near term as we drive these hyper growth top line rates sustainably. Of course, we can easily and always choose at any moment to decelerate these investments at any time if the markets or if the opportunities warranted. At which time, we would expect to realize normal profitable growth from the high-margin business that we've built, and that's the terminal value.

It is our view that a pure sum of the parts calculation would be prudent modeling and a prudent methodology given these 2 distinct business segments: one with a robust agenda for profitable growth and the other focused on investment for hyper revenue growth at a rate of greater than 30% with, of course, the safety valve. But of course, that is something for each of you to decide, and you're obviously equipped to decide for yourselves on that.

Turning to Slide #13. During the quarter, we ramped up our share of voice to drive increased brand awareness and consumer adoption. Year-to-date, our campaigns have delivered great reach and generated over 1 billion impressions and counting. Our investment in innovation is building our pipeline to expand our portfolio in existing categories and extend into new categories, including chicken alternatives and meat and plant fusion products under the Maple Leaf portfolio. Consumers are bending new products, and we have a lineup of launches that will increasingly fuel this growth and differentiate the brands.

On Slide #14, we highlight some of the breakthrough campaigns that are underway. We've partnered with some high-profile celebrities such as Ellen DeGeneres, Kristen Bell and Dax Shepard, and we've generated great reach and buzz to enhance our brand awareness and product recognition.

Our tailgate tour is traveling across the U.S. and serving our Field Roast and Lightlife products at big college football games. And we've launched a docu series hosted by Roy Choi of Netflix Chef Show Fame. In partnership with Field Roast and Bon Appetit, Roy travels across the U.S., challenging chefs to create dishes with our Field Roast products. I'd encourage you to tune in to Bon Appetit videos to see the chef challenge underway.

On Slide #15, all of these marketing activities have fueled many new points of distribution with our recently announced listings at Kroger, Publix and Target. Our new lineup of burgers, grounds and sausages will exceed 12,000 stores. We've also picked up a number of regional retailers in an important division of Albertsons. Wins in foodservice include Harvey's, Dave & Buster's, Firkin and Red Robin. We're making great headway on all commercial fronts with our investment delivering tangible results, and I can assure you, there's much more to come.

So wrapping up on Slide #16, I'd like to begin by acknowledging Debbie Simpson who's with me here today, and this is her last quarter with Maple Leaf as CFO. She'd be glad to entertain any financial questions that you may have. I'd like to thank Debbie for 12 wonderful years over -- and the last 5 as our Chief Executive Officer, and I wish her well on her new endeavors moving forward.

Now before I open it up to questions, let me summarize as follows. Number one, recognizing the importance of our 2 distinct businesses and differing strategic financial profiles, we fully segmented our results, which now reflects how we manage our business and build value in these distinct segments. Number two, while our meat protein results were overshadowed by erratic pork markets, this is a timing issue and the fundamentals continue to be strong. Number three, our structural adjusted EBITDA in our meat protein business is solid, and our strategies to deliver are on track. Number four, we are leaders in the plant protein market, and we're going to continue to consciously, strategically and intentionally invest in that growth, while we maintain a profitable business model underlying that. And number five, we are building a sustainable enterprise, creating meaningful points of difference that are delivering, in our view, shared value.

So with that, I'd like to turn it over to questions. Sylvie, over to you, please.



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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) And your first question will be from George Doumet.

### George Doumet - Scotiabank Global Banking and Markets, Research Division - Analyst

I just wanted to get started on the plant side. I think that SG&A number kind of surprised a few folks. So would you expect that level to be the adequate one, I guess, to be running at maybe at least for the next few quarters for us to maintain that 3% revenue growth trajectory?

### Michael H. McCain - Maple Leaf Foods Inc. - President, CEO & Director

I think so. That's obviously a topical question, George. We -- our SG&A load is \$45 million. To an emerging business that has the potential to build \$3 billion, \$45 million in a quarter is certainly a shout. And I acknowledged -- we acknowledged last quarter that we have to place some catch-up ball here. We were behind the curve early in the year. We came into the back half of the year recognizing that we needed to play a little bit of catch-up. And \$145 million, the bulk of which is ad and promo, is an important investment and important scale. I would say that our intention -- and I'm not going to give you an answer for how long we intend to invest in this. I think the best answer is for as long as we feel we can continue to invest in a profitable business model and invest for 30-plus-percent growth rate, it kind of makes financial -- good financial sense.

I suspect that 30% growth rates, we'll grow into -- and higher, we expect 30% or higher, we would grow into an SG&A level relatively quickly. But I'd also point out, George, the business that we built just in the last year, the 30% growth rate in the last year, is over half the size of the business that we bought 2 years ago for \$300 million, just to put that statistic into perspective. The business we've grown in the last 30 -- in the last 12 months is over half the size of the business we paid \$300 million for 2 years ago.

So at the end of the day, is \$45 million exactly the right number? You could always argue, could it be a little less, could it be a little bit more. The beauty of this is that we get to rightsize it at any moment in time on very short notice. And we'll look at that based on what we see as the growth opportunities at any moment in time to see whether it should be more, should be less. It's not -- we're not institutionalizing these things. It's an investment, and it's a discretionary investment. And it makes perfect financial sense for us today at this level.

The final observation I would say is that this investment spend level gives us the leading share of voice in the category. Now to a marketer, share of voice really counts. Share of voice says that you have the loudest -- as judged by your financial investment, the loudest voice in the marketplace on a sustained basis. And this gives us actually the largest share of voice in the category at this moment in time, and that's important. That will affect us, our business in a positive sense for 2020, again, particularly in the context of playing catch-up ball.

So I think we're going to -- the plan is to invest in SG&A for as long as we can drive these growth rates, to ensure that we're leading brands -- our brands are leading in the marketplace in share of voice and we have the opportunity to rightsize this at any moment in time.

### George Doumet - Scotiabank Global Banking and Markets, Research Division - Analyst

Okay. And just moving to the gross margin, 29% normalized, but 21%, I guess, after those costs, it's quite a big gap there. So just wondering in terms of start-up costs in general, should we -- I mean, presumably, I guess, there would be more start-up activity? Or can you maybe give us a sense of...





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I'm sorry. Are you -- what are you referring to, George, please?

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**George Doumet** - *Scotiabank Global Banking and Markets, Research Division - Analyst*

Yes. So yes, so your gross margin plant based, you guys called a normalized level at 29%, but the reported level was closer to 21%. So I was just trying to get a sense of, I guess, how much more start-up activity are we going to get? How much -- for the next couple of quarters, presumably, is that going to continue? Or...

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**Michael H. McCain** - *Maple Leaf Foods Inc. - President, CEO & Director*

It could -- it's very hard to call. Some of it is just operating variances. Some of it is scaling up operations. Some of it is start-up. When you're chasing a supply chain to keep up with 30% growth rates, you're just not optimizing things, George. We pay very careful attention in our internal financial systems on what our standard gross margins are, and we have the operating systems and skill set to be able to differentiate between that and operating variances that are attached to these hyper growth-related inefficiencies, start-up costs being one of them.

So we felt that it was really, really super important to share that number with investors because it's a critical metric for us in ensuring that we're building a fundamentally profitable business model. We're not building a unicorn here. We're investing in a profitable business model. And that metric, as a management team, is the single most important metric to ensure that, that's the case as our financial safety valve. So that will bounce around a bit quarter-to-quarter as the situation evolves around this 30% growth rate or more. But we hope to see some stability in the core gross margin.

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**George Doumet** - *Scotiabank Global Banking and Markets, Research Division - Analyst*

Okay. And maybe one more, if I may. Moving over to the meat segment. It looks like we've taken quite a bit of price for Q3, but lean hog prices have come down quite a bit towards the end of the quarter. I'm just wondering how the retailers have reacted to that. Have they been kind of working on more promotional activity? Can you maybe talk a little bit about that environment?

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**Michael H. McCain** - *Maple Leaf Foods Inc. - President, CEO & Director*

So that was the -- as I said, I hope you connected with the candor that we were on the wrong side of that coming into the third quarter. If you look at the chart that was shown on the page, in the spring of this year, as the hog cost, which is -- the hog cost isn't our meat cost, but it's an underlying reflection of the meat cost. And it was in the mid- to high 90s for August coming into the spring when pricing was set. Obviously, by the time July rolled around, the 1st of July rolled around, we had price increases in the marketplace. And the hog price had since -- had subsequently dissipated down to the low 60s. 1/3 of the value of a hog in the month of August dissipated.

That caused some -- obviously, we locked in our meat as we always do. That's the right -- that's the normal and proper business decision for us. We do that every month. So it's not a new thing. We do that all the time. We lock in our meat on a 90-day forward basis. And obviously, when the meat cost went down to the equivalent of a \$60 hog from a \$90 hog, we were on the wrong side of that with pricing in the marketplace.

We didn't -- we continue with our price increases largely because we don't want to whipsaw consumers in this, knowing full well that while hog -- this is the aberration, underlying aberration of ASF is markets going down, but it's going to go back up. We know it's going back up because of ASF. And as that market comes back up, all of our customers recognize that the pricing that we put in the marketplace was reasonable and reasonable expectation.





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different than some of our private label channels, so on and so forth.

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**Operator**

Next question will be from Peter Sklar.

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**Peter Sklar** - *BMO Capital Markets Equity Research - Analyst*

Michael, this increase that you're talking about in ad and promotions, I look on Slide 13, I think you're saying it's up 35x year-over-year.

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**Michael H. McCain** - *Maple Leaf Foods Inc. - President, CEO & Director*

Which one are you looking at?

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**Peter Sklar** - *BMO Capital Markets Equity Research - Analyst*

I'm on Slide 13. And you have about 35x. Does that mean that your spend in ad and promotion is up?

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**Michael H. McCain** - *Maple Leaf Foods Inc. - President, CEO & Director*

35x.

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**Peter Sklar** - *BMO Capital Markets Equity Research - Analyst*

Yes. And where -- is that mostly in Canada or the U.S.? Or...

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**Michael H. McCain** - *Maple Leaf Foods Inc. - President, CEO & Director*

Mostly in the U.S.

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**Peter Sklar** - *BMO Capital Markets Equity Research - Analyst*

Okay. And when you talk about promotion, like are you talking about promotional dollars for retailers? What exactly do you mean by that?

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**Michael H. McCain** - *Maple Leaf Foods Inc. - President, CEO & Director*

No. It's mostly brand connected in that case that comes out of our ad and promo budget. Retailer investments comes out of gross margin. So no, it's in -- basically, it's all dimensions of social media, conventional media, promotional activity, it's just -- there's just countless different components of that. But we tried to highlight some of them, some of the sponsorships, some of the -- across the country. There's a very broad-based advertising and promotional campaign that was commissioned in the third quarter.



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Okay. And then I just wanted to ask you about the 2 new -- the 2 large facilities that you're developing and ramping, which is Shelby and the poultry facility in London. Are those negatively impacting your reported profits now? Or is everything being capitalized? And -- like how does that kind of play out as we go forward into 2020 through 2022?

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**Michael H. McCain** - *Maple Leaf Foods Inc. - President, CEO & Director*

No. It won't affect the results until we get into start-up mode. When we get into start-up, there will be a cost to start-up that will be realized in the P&L. We're -- that's quite a ways down the road. When we are experiencing that, we will identify what that is so that you'll be able to know what the implications of that are so that you can decide whether you want to pull that out or not in your analysis.

The biggest implications between now and then is we see a very significant ramp-up in construction capital in 2020. And you can -- you will get at times well over \$750 million in construction capital at its peak, that if you were following a classic total enterprise valuation model would probably be inappropriate because that would value \$750 million of construction capital at 0, which you can decide whether that's good math or bad math, but I think it's not so good math. And that's why we're calling that out so that you can kind of just look at, well, what's the value of construction capital on the books.

I personally, if I was looking at that, I'd say, well, gee-whiz, it's probably at least worth what you paid for it. It's not worth 0, and it's probably not worth its cash flow value. It's worth at least book value or 0. And that's -- but we wanted to give investors the tools to be able to put a value on that. It's \$80 million in Q3, but it's going to go up rapidly from now through to 2021.

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**Peter Sklar** - *BMO Capital Markets Equity Research - Analyst*

Okay. And then just lastly, do you mind just reviewing again what the -- where you see the ramp periods for Shelbyville and London?

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**Michael H. McCain** - *Maple Leaf Foods Inc. - President, CEO & Director*

The ramp period for London is -- Debbie, it's 2022, is when we're predominantly -- starting in the spring of 2022. Shelbyville would be possibly -- Debbie, 1 year earlier, 2021.

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**Peter Sklar** - *BMO Capital Markets Equity Research - Analyst*

And these kinds of plants, like these big investments, processing plants, like how long is the ramp period? Is it kind of a year? Or is it 2 years or 6 months?

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**Michael H. McCain** - *Maple Leaf Foods Inc. - President, CEO & Director*

I've probably done it maybe somewhere between 30 and 40 times in my career, Peter. I would say it is impossible to peg that for certain. We -- I think 12 to 18 months is a reasonable number, but I've seen some that have been a little better than that, and I've seen some that are a little longer than that. And you know what, it doesn't -- it makes no difference just whether it's a good investment or a bad investment based on how that accordions, but a reasonable planning assumption is 12 to 18 months.

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**Operator**

Next question will be from Irene Nattel.



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Just following up on that last question. So it sounds as though even though the CapEx, it has come down for this year, the time line for the projects remains largely unchanged. Is that correct?

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**Michael H. McCain** - *Maple Leaf Foods Inc. - President, CEO & Director*

Well, there's some risk in the poultry project because right now, we have -- we did suffer some delays as a result of weather. And whether or not that we can in a cost-effective way make that up, is still TBD. We had a very, very -- an ultra wet spring that impacted our construction period this year. So there's some measured in months, measured in months, Irene. I think it's way too early in the game to decide whether or not we can make that up or not.

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**Deborah Simpson;Chief Financial Officer**

Yes. I mean the way we are looking at it is probably from a spend perspective, what was going to be in this year will go into 2020 with a tiny tail into 2021. Maybe some of that spend will tail in -- maybe the tail in 2021 becomes a little bit bigger. But we're not ready to say that yet. And I think most of it at this point probably goes into 2020.

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**Irene Ora Nattel** - *RBC Capital Markets, Research Division - MD of Global Equity Research*

That's very helpful. And then just coming back to the plant-based protein, the marketing strategy, it looks as though you're pursuing sort of an influencer -- in part an influencer strategy. Can you talk a little bit about how long the, I guess, agreements might go? And presumably, they're sort of fairly specific in terms of number of images, et cetera, and that kind of thing?

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**Michael H. McCain** - *Maple Leaf Foods Inc. - President, CEO & Director*

They are, Irene. And yes, it is a very comprehensive and balanced advertising and promotional spend portfolio that includes the influencer components, social media components and conventional media in bonus. I think the more important thing is, though, if you're trying to put a dollar value on that, it's more about the aggregate amount. It's the size of the gun, not the shape of the bullet that counts, if you know what I mean.

And so if we decide to -- if we decide over a period of time to bring in a new set of influencers, change the mix somewhat over there, we would strategically choose to keep the same size of the gun in the marketplace, just maybe change the distribution. So the relevant planning number is we're spending \$45 million today. We're investing for growth. We have a 30% core gross margin safety valve to ensure we're building this profitable business model. And we expect to continue to do this with the leading share of voice while we are experiencing this growth with the optionality of changing it at any moment in time.

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**Irene Ora Nattel** - *RBC Capital Markets, Research Division - MD of Global Equity Research*

That's great. And as you outlined before, I guess, the 4 elements that you're spending in the SG&A, it does look as though there is a part of it, say, on talent and infrastructure, for example, that may be less easy to sort of turn on and off. Would you be able to give us an order of magnitude of the marketing promotional piece of it, 75% of the spend? Is it 60%, 50%? Just so that we can get our minds around that.

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**Michael H. McCain** - *Maple Leaf Foods Inc. - President, CEO & Director*

The ad and promo, the spend would be 70%-ish, plus around 70%. But I would disagree with you, Irene, that the balance of the investment can be rightsized in any moment in time. Maybe it's a little bit longer, but we're -- you're talking -- if you chose -- if we made the decision at any moment



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**Irene Ora Nattel** - RBC Capital Markets, Research Division - MD of Global Equity Research

Okay. That's very helpful. And then if I could just for a moment come back to the other 95% of the business and talk a little bit about the brand renovation strategy and how that's playing out and particularly what you saw as we went through the key summer months in terms of consumer uptake of some of the reformulated product. You mentioned a favorable mix. If you could provide some more color, please.

**Michael H. McCain** - Maple Leaf Foods Inc. - President, CEO & Director

Well, the top line would be is that -- first of all, very good news. Our categories are growing. The -- all of the packaged meats categories that we are participating in today have experienced growth this year. That's good news, check. Number two is we've had excellent brand growth, particularly around our core brands of Schneider and Maple Leaf and also Greenleaf. So that's good news. Check.

We had great uptake on the Maple Leaf brand this year, particularly around the hotdog category, largely connected with, I think, a very ambitious and revolutionary campaign around Maple Leaf Top Dogs. That's good news. And our U.S. business largely centered on sustainable meat and the Greenleaf brand had good growth. In fact, they're growing at double digits so far this year and appear to be growing at that rate on a sustained basis.

What didn't go well is that in the total portfolio, we've got a broad portfolio, whether it's private label, foodservice, regional brands and some of the more -- when we took these price increases, there was some more stress in some of those segments or channels that realized in the quarter and we think is very much a quarterly impact, 1 or 2 quarters, I should say, kind of offsetting volume impact. Notwithstanding that, our aggregate prepared meats profitability was up materially year-over-year in the quarter.

**Operator**

Next question will be from Derek Dley.

**Derek Dley** - Canaccord Genuity Corp., Research Division - MD & Consumer Products Analyst

Just a question on the plant business. You mentioned \$47 million in sales this quarter. And I think last quarter, you guys mentioned a run rate of \$204 million versus -- if I were to run rate the \$47 million, I get \$188 million. So were you referring to something different? Or did we a sequential decline in the plant business?

**Michael H. McCain** - Maple Leaf Foods Inc. - President, CEO & Director

We -- last year -- or last quarter, we did not have fully segmented numbers at our availability with external reporting. So we pulled the internal reporting and made it comparable to what we saw in the marketplace for comparable brands, which was mostly gross sales. And the difference in gross sales and what we report in our segmented reporting, which is net sales, the difference in that is just normal trade discounts. So it's just the difference in the calibration of the metric.

**Derek Dley** - Canaccord Genuity Corp., Research Division - MD & Consumer Products Analyst

Okay. So if you were to normalize, I guess, Q2 versus Q3, you were up in -- you were up sequentially?



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In Q -- we were, yes. We were up in Q2 as well. I think our growth rate was a little bit higher in Q3, but we're on track for next year's number, I think is -- that's, I think, the very material piece. We've got a target of \$280 million next year. And right now, we see that materializing given the distribution gains and the investments that we've made and some as we annualize them.

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**Derek Dley** - *Canaccord Genuity Corp., Research Division - MD & Consumer Products Analyst*

Okay. So that's exactly what I was getting at. So with -- like with the \$188 million sort of run rate that you're at, at the end of this quarter, I'm assuming giving you...

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**Michael H. McCain** - *Maple Leaf Foods Inc. - President, CEO & Director*

It's just -- what we said last quarter and what we said this quarter is just a different metric, gross sales versus the net sales. They are -- external sales as defined by our segmented reporting, and it's just discount rates. There's no difference from what we expect for next year.

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**Derek Dley** - *Canaccord Genuity Corp., Research Division - MD & Consumer Products Analyst*

Okay. So the \$280 million for 2020 is apples-to-apples to the...

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**Michael H. McCain** - *Maple Leaf Foods Inc. - President, CEO & Director*

That's what we believe at this moment in time, yes.

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**Derek Dley** - *Canaccord Genuity Corp., Research Division - MD & Consumer Products Analyst*

Okay. Okay. And then you talked about obviously 30% year-over-year growth this quarter, and you expect to achieve that or above that going forward. I'm sure you've seen or have been made aware of some of this -- the data that's been floating around, I believe, from Nielsen showing a deceleration in sales. So can you just help us sort of map what you guys are seeing and what some of that data might be referring to?

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**Michael H. McCain** - *Maple Leaf Foods Inc. - President, CEO & Director*

Well, I think it's a combination of -- and I can't bridge it because I don't have that data, and I haven't taken the time or effort to try and bridge that data. I think there's a different source of information, number one. I don't think it necessarily covers the breadth of our category -- categories. We have a broad range of categories that we operate in, all of which are growing handsomely. So I'm not sure it's a direct category comparison. And thirdly, I don't know that it spans all of the channels that we operate in. So between channel, category matches and different sources of data, I can't tell you how to bridge that. All I know is we did 30% more this year than last. If you annualize that, that's over -- I think some 56% of the size of the business that we acquired for \$300 million in 2017. Honestly, I'm thrilled. I'm just thrilled.

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**Derek Dley** - *Canaccord Genuity Corp., Research Division - MD & Consumer Products Analyst*

Okay. With the -- just looking at the balance sheet then as well. With the higher -- at least on our end, the higher-than-expected SG&A spending, it looks like that's going to continue for some time here, and particularly, as you head into a heavy CapEx year. Are you still comfortable you can maintain that investment-grade rating on your balance sheet?

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Yes, I am. Yes, we -- that's our goal. And I'm comfortable we can achieve it.

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**Derek Dley** - *Canaccord Genuity Corp., Research Division - MD & Consumer Products Analyst*

Okay. Great. And then just the last one for me, just sort of switching it up back into the meat segment. In terms of the pricing, typically, I think you guys are a leader or a price setter in the market, and it appears that obviously there was some hesitation from retailers with the pricing. And I get, given that you had a material drop in hog prices almost immediately, it was difficult to pass through. But do you still kind of see a very disciplined market as it relates to your competitors?

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**Michael H. McCain** - *Maple Leaf Foods Inc. - President, CEO & Director*

Completely. I think, Derek, it's important to understand that the aberration that existed in this quarter, meat markets and costs that were established for branded product in and around a \$96, \$98 hog. At the time, the quarter was -- actually materialized, those markets were \$60. That's a 30% delta. It's just not normal, if you know what I mean. The consequence of that was not -- that we didn't get price increase. The consequence was there are some portions of our business and channels that didn't realize it fully. We have some contract pricing, for example, that is harder to realize. We have some foodservice pricing that's harder to realize. But by the end of the quarter, it was all fully realized.

I think one of the more important observations, I don't know, Derek, whether you digested this observation, but the aberration of Q3 is -- and I don't like this. I don't mean this is a good thing. I do not like this whipsaw of 2019. But the reality is, and the numbers demonstrate this, is that we expect to see a complete offsets to this in Q4. And I don't like -- we don't give guidance. It's very unusual that I would foreshadow that. But I think it's an important shareholder consideration today is that what we see at this moment in the fourth quarter has the opposite effect of what we experienced in the third quarter. I don't like that. That's not normal volatility in this business. It's a consequence of the trade disruptions and the ASF. But all of the factors would point to that, whether it's our primary processing benchmarks, processing spreads, whether it's the effect that we've now realized the pricing that we implemented in the third quarter, normalization of volumes, natural seasonal rhythms, in some cases. But there's all kinds of factors that would suggest it's -- we expect a rebound in the fourth quarter.

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**Operator**

Next question will be from Michael Van Aelst.

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**Michael Van Aelst** - *TD Securities Equity Research - Research Analyst*

I just want to follow up on that line of question actually in your comments, Mike. So when you're talking about complete offsets expected in Q4, are you talking about Q3 or below-average margins? Q4, you expect to be above-average margins, so you're actually offsetting it as a whole for the second half?

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**Michael H. McCain** - *Maple Leaf Foods Inc. - President, CEO & Director*

My only reluctance, Michael, is we don't give guidance, and we're only 1/3 of the way through the fourth quarter. So I'd rather leave you that directionally, we expect an offset and a rebound. I think our current expectation is it will be higher than the norm in aggregate. But I'm not going to give you guidance in terms of how much higher because we don't give guidance, and we're only 1/3 of the way through the quarter.



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Okay. And so when you talk about offsets, so in Q3, you're hedged at an unfortunate time, I guess, 90 days in advance with that big drop.

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**Michael H. McCain** - *Maple Leaf Foods Inc. - President, CEO & Director*

I want to pause on that, Michael. Not an unfortunate time, our normal time. We always lock in our meat and our pricing in that 90-day window.

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**Michael Van Aelst** - *TD Securities Equity Research - Research Analyst*

So every month, you're hedging 90 days in advance.

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**Michael H. McCain** - *Maple Leaf Foods Inc. - President, CEO & Director*

We're trying -- our pricing is out for that -- for periods of time like that, for everything except for bacon.

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**Michael Van Aelst** - *TD Securities Equity Research - Research Analyst*

And do your competitors do the same?

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**Michael H. McCain** - *Maple Leaf Foods Inc. - President, CEO & Director*

Don't know. Some of them do. Some of them don't. Some of them actually lock in longer and some -- in foodservice, for example, it would be longer. Some private label contracts, it's longer. Some places, it's shorter. But private label businesses and foodservice businesses don't necessarily follow the same pricing rhythms as pended rhythms.

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**Michael Van Aelst** - *TD Securities Equity Research - Research Analyst*

Okay. So as your hedge is out -- I guess what you're trying to say is your hedges going into Q4 actually favorable in this case.

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**Michael H. McCain** - *Maple Leaf Foods Inc. - President, CEO & Director*

Yes, I think they're strong.

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**Michael Van Aelst** - *TD Securities Equity Research - Research Analyst*

Now the price increases you took that came through late August, I guess, and were fully in place by the end of the quarter, with the hog price having pulled back as much as it has, do you have to roll back any of that? Or do you have to give some back in limited time offers? Or how does that work, especially if your competitors may or may not have hedged?

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**Michael H. McCain** - *Maple Leaf Foods Inc. - President, CEO & Director*

Most of our -- some -- we do anticipate that, that will occur to some degree but not materially. I would tell you that most of the people in the industry are recognizing with the rapid change in the back half of this year in the global meat markets, that meat costs are going up -- are expected to go up dramatically. So I don't think anybody at this moment in time is focused on rolling back pricing.





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Okay. Moving on to plant-based protein sales. So you kind of gave a little bit of comments on the scanner data. But just observationally and in talking with your customer base then at retail, how do you see the sell-through being? Is the product moving off the shelves rapidly? Or is that 30% growth mostly channel fill?

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**Michael H. McCain** - *Maple Leaf Foods Inc. - President, CEO & Director*

No. We're getting good velocity. We're very happy with the velocity. We feel that with the investments that we're making, that velocity will do nothing but improve, but it's -- we're very happy with it in the current sense.

And keep in mind, Michael, we have a very broad portfolio of products here that have got 40 years of history, and they're growing as well. So this is not like -- your question maybe is more relevant to the burger, grounds and sausage.

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**Michael Van Aelst** - *TD Securities Equity Research - Research Analyst*

Yes, that's where I'm getting.

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**Michael H. McCain** - *Maple Leaf Foods Inc. - President, CEO & Director*

Our base business is -- we're in -- tempeh is a big category for us. Like we've struggled in the last 1.5 years, struggled like mad to keep up with the growth from a capacity perspective. It's a very important category to us. The dogs category, the sausage category, that Field Roast and Lightlife have been in, continuing to grow. We've struggled with capacity in those cases, so -- to keep up with those growth rates. So it's a pretty broad set of distribution and broad set of categories that we're supporting here, not just the burgers, sausage -- burgers, raw sausage and grounds.

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**Michael Van Aelst** - *TD Securities Equity Research - Research Analyst*

But then the new points of distribution, when you said you doubled your points of distribution, is that mostly for the new products?

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**Michael H. McCain** - *Maple Leaf Foods Inc. - President, CEO & Director*

Yes.

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**Michael Van Aelst** - *TD Securities Equity Research - Research Analyst*

Okay. And so those -- so you're -- but -- and the sell-through then on those burgers and grounds, that's what I was trying to ask you about. Have they been good?

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**Michael H. McCain** - *Maple Leaf Foods Inc. - President, CEO & Director*

Very satisfied, very -- everybody's -- all customers I've talked to, all the data is very satisfied with it.

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**Michael Van Aelst** - *TD Securities Equity Research - Research Analyst*

Okay. Do you have an update on the timing of finding a replacement for Debbie?



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No. No update today.

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**Michael Van Aelst** - TD Securities Equity Research - Research Analyst

I guess do you expect one, though, before she leaves? Or...

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**Michael H. McCain** - Maple Leaf Foods Inc. - President, CEO & Director

We will know. Debbie is moving on to extraordinarily powerful things, I'm sure, but -- beginning next week.

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**Deborah Simpson;Chief Financial Officer**

I'm right here. We are talking when I'm sitting right here.

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**Michael H. McCain** - Maple Leaf Foods Inc. - President, CEO & Director

In the -- I don't think it'll be that long before we do make an announcement, Michael. It won't be very long for sure. In the interim, we have a very competent team behind Debbie, and we've established internally an office of the CFO and the top 3 executives in the company, and they're all 3 just super-skilled capable individuals.

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**Michael Van Aelst** - TD Securities Equity Research - Research Analyst

Okay. And just finally, you talked about the Chinese import suspension having an impact as well in the quarter. Is that meaningful?

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**Michael H. McCain** - Maple Leaf Foods Inc. - President, CEO & Director

How do you define meaningful?

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**Michael Van Aelst** - TD Securities Equity Research - Research Analyst

I don't know. When you look at the drop in your profits and -- or when you look at the profit level, where you should be of that 220 basis points, let's say, would that be included in the 220 basis points?

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**Michael H. McCain** - Maple Leaf Foods Inc. - President, CEO & Director

The 220 basis points was market factors, so it was not -- that was not what we experienced. So the 220 basis points is the market environment shift versus 5-year average, which is defined that of the U.S. market and has nothing to do with Canadian market. The Chinese effect on our results in the quarter was probably 50 basis points-ish, in that range.

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**Michael Van Aelst** - TD Securities Equity Research - Research Analyst

So considering some of those products mostly go to China and there's not as -- some of those products don't have much of a market outside of China, how do you deal with that?



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You get a lower return on those particular products. But the outlook with or without China going forward given the global pork shortage is -- with or without China at play is bullish. Just to put it into perspective, let me give you the demand statistics.

The loss of production of pork in China is estimated to be between -- if I get my data right, I think it's roughly right, between 15 million and 20 million tons. The global trade, all countries all trade per year in pork is about 8 to 9. The increase in production out of the United States shipping into China, if you annualize it, somewhere between 300,000 and 400,000 tons, a drop in the bucket. So over time, although it doesn't affect the Q3, but with the passage of a little bit of time here, the demand shortage is such that the value of pork internationally is profoundly strong. It's just -- at some point in time here, it just becomes a situation of -- in a global market like that, the situation of musical chairs, right?

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**Operator**

Next question will be from Mark Petrie.

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**Mark Robert Petrie** - CIBC Capital Markets, Research Division - Executive Director of Institutional Equity Research & Research Analyst

Obviously, you've covered a lot. I just have a couple of questions. One, I guess, and you sort of touched on it there, Michael, but in the plant-based business, could you just give us a sense of sales performance by channel, if it's relatively consistent? And geography, how the launch into Canada performed? And then even just by brand, Lightlife versus Field Roast, are they relatively comparable in terms of growth?

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**Michael H. McCain** - Maple Leaf Foods Inc. - President, CEO & Director

I don't -- we don't segment that, Mark, so I don't know -- we don't -- and that's not in our current thinking that we would do that. Obviously, the majority of the growth is in retail as opposed to foodservice, number one. Number two is there will be more growth in Lightlife than Field Roast in the quarter just because of the promotional support behind that, although that won't be the case each and every quarter. So we're supporting both of those brands. Beyond that, I don't think there's any underlying story, Mark, between category, customer, channel or brand that I think is relevant to the growth rate here.

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**Mark Robert Petrie** - CIBC Capital Markets, Research Division - Executive Director of Institutional Equity Research & Research Analyst

Okay. And then I guess maybe just at a high level then, do you have a sense of how the refrigerated category grew in Q3 or even year-to-date?

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**Michael H. McCain** - Maple Leaf Foods Inc. - President, CEO & Director

I do. I don't have it at my fingertips. It was certainly more than 30%, driven mostly by some of the competitive entries in burgers, sausage and grounds. So certainly more than that in aggregate but very much focused on the burger segment, which is distorting the -- distorting that relative share of the total refrigerated meat alternative space. But it was more than -- for sure, it's more than 30%.

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**Mark Robert Petrie** - CIBC Capital Markets, Research Division - Executive Director of Institutional Equity Research & Research Analyst

Okay. And then I guess, I'm not sure if there's an easy way to answer this, but I'm just curious about how you sort of think about the risk of ASF coming to North America. What do you think that sort of means for the markets here and how people are positioned? Then I guess how has Maple Leaf adjusted practices to sort of protect itself against that possibility?



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Well, first of all, I would point out that Canada has a reputation around the world as having one of the strongest biosecurity networks in hog production in the world. That's one of the things that has differentiated us for decades, and we've continued to invest in that biosecurity. Number two is the Canadian government, in collaboration with the U.S. government, both from the CFA all the way through to the Canadian Border Security Agency, have doubled down across the board on their safety net to ensure the health of the Canadian herd. That's everything from communications to doubling their K9 at airport security levels. Core, I think they doubled or tripled that. I don't recall exactly the number but something like that. All the way through to applying very aggressive fines for noncompliance at the border, which they've done and which they've enforced.

So a combination of -- just a laundry list of biosecurity and compliance initiatives executed by the government and the industry puts us in a very solid position to be leaders in the world in biosecurity. Of course, nothing is absolute in that regard, and we have to be always mindful of that eventuality.

I would say that what would differentiate this is the -- is it's clear when you think of the statistics that I referred to earlier, 15 million to 20 million tons shortfall of pork in the largest producing area of the world. Basically, ASF has -- is now all through Asia, through Russia, and there have been spots of Europe where it's been identified. If it then shows up in the shores of North America, I think one would have to include that it's everywhere. All of a sudden, just overnight, it's endemic. And it has no impact on human health. The trade implications of something that is then endemic everywhere becomes different than when it's in one location and other countries want to isolate it to that one location.

So I think you can never speak in absolutes, but I think the North American industry is in pretty good shape to be able to both defend it and deal with it in the event that it arises, although highly speculative one I'm telling you.

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**Operator**

At this time, I would like to turn the call back over to Mr. McCain for closing remarks.

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**Michael H. McCain - Maple Leaf Foods Inc. - President, CEO & Director**

Okay. Well, thank you very much. As I said, there was a lot to unpack this quarter. We appreciate everybody's attention to the facts of the quarter. While the numbers might appear on the surface to be unattractive, we're actually quite inspired by them. 30% growth rate in our plant-based protein business, investing for growth, solid safety valve and 9% EBITDA margins in the most erratic, irrational market conditions that this 40-year-old team has ever experienced. All things considered, we feel like we're in great shape and we're plowing forward. So thanks for your time and we look forward to updating you in the next quarter.

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**Operator**

Thank you, sir. Ladies and gentlemen, this does indeed conclude your conference call for today. Once again, thank you for attending. And at this time, we do ask that you please disconnect your lines.

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