02-Nov-2023

Maple Leaf Foods, Inc. (MFI.CA)

Q3 2023 Earnings Call

CORPORATE PARTICIPANTS

Janet Craig
Investor Contact, Maple Leaf Foods, Inc.

Curtis E. Frank
President and Chief Executive Officer, Maple Leaf Foods, Inc.

Geert Verellen
Chief Financial Officer, Maple Leaf Foods, Inc.

OTHER PARTICIPANTS

George Doumet
Analyst, Scotiabank

Mark Petrie
Analyst, CIBC World Markets, Inc.

Irene Nattel
Analyst, RBC Capital Markets

Michael Van Aelst
Analyst, TD Cowen

Tamy Chen
Analyst, BMO Capital Markets Corp. (Canada)

MANAGEMENT DISCUSSION SECTION

Operator: Good morning, ladies and gentlemen, and welcome to the Maple Leaf Foods Q3 2023 Investor Relations Conference Call. At this time, all lines are in a listen-only mode. Following the presentation, we will conduct a question-and-answer session. [Operator Instructions] This call is being recorded on Thursday, November 2, 2023.

I would now like to turn the conference over to Ms. Janet Craig. Please go ahead, ma'am.

Janet Craig
Investor Contact, Maple Leaf Foods, Inc.

Thank you, Laura, and good morning, everyone. Speaking on the call this morning will be Curtis Frank, President and Chief Executive Officer; and Geert Verellen, Chief financial Officer.

Before we begin, I'd like to remind you that some statements made on today's call may constitute forward-looking information, and our future results may differ materially from what we discuss. Please refer to our Q3 2023 MD&A and other information on our website for a broader description of operations and risk factors that could affect the company's performance. We've also uploaded our Q3 investor deck to our website, which includes support material for the quarter. As always, the Investor Relations team will be available after the call for any follow-up questions you might have.

With that, I'll turn the call over to Curtis Frank. Curtis?

Curtis E. Frank

President and Chief Executive Officer, Maple Leaf Foods, Inc.

Thank you, Janet, and good morning, everyone. It's great to be with you again here today. We've got a lot to talk about this morning, not the least of which is the continued momentum that we see building in our business today. I'm going to go ahead and jump right in with a recap of our quarterly performance. I'll then turn it over to Geert to walk you through a deeper dive into our financial results. And, of course, we will open up the line for your questions.

The headline is that overall, we are very pleased with how we performed over the last quarter, entirely consistent with what we shared with you on our last call. Our focus has not deviated from stabilizing the financial performance of our business in the post-pandemic economic environment, while at the same time executing our blueprint to be the most sustainable protein company on earth. And in the third quarter, we made excellent progress.

As you've seen in our results that were published earlier this morning, we grew our total company sales in the quarter to over CAD 1.2 billion. And at the very same time, we grew our consolidated adjusted EBITDA by 68% to CAD 129 million. The momentum we are building in the business is clear and it is confidence inspiring.

Let's break this down a little further, starting with our Meat Protein business. For the third consecutive quarter this year, we delivered a sequential improvement in adjusted EBITDA margins in our Meat Protein business, recording 11.4%, up from 9.3% last quarter and 8.5% last year. The sequential margin improvement as compared to last quarter was a result of pork market conditions that are improving, but important to note, not yet back to normal, the contributions from our London Poultry and Bacon Centre of Excellence capital projects and a full quarter impact of the pricing actions as expected.

At our largest project in London, the progress has been nothing short of outstanding. We have completed the transition of three of four legacy plants. We are processing over 1.5 million birds per week, with 88% of projected total volume now online and we are producing over 390 SKUs. We are also delivering 97% or greater service levels. We are fully staffed with over 1,500 employees on-site and we are on schedule to complete the final stage of transition in Q4 by absorbing the Schomberg facility volumes.

To sustain our profitable growth momentum, this past quarter, we delivered one of the most impressive single quarters of new product innovation on record. In our flagship Maple Leaf brand, our Maple Leaf Natural Selections three ingredient oven roasted turkey and five ingredient Black Forest ham, which were designed to meet the growing demand for simple, healthy and quality ingredients, are now successfully growing distribution in the market. In our Schneiders brand, we introduced two new delicious schnitzel products, including a pork cutlet and a chicken cutlet, and also rolled out five new sliced meat deli items. In our Fantino & Mondello brand, a brand that we acquired as part of the Quebec based VIAU Foods transaction in 2018, we launched an incredible line of eight dry-cured specialty meats and pizza toppings that bring together hand-rolled quality, artisanal craftsmanship and absolutely amazing great taste.

And finally, we recently worked alongside A&W, one of our largest foodservice partners, to develop and launch three new chicken cruncher sandwiches. These delicious sandwiches are made with chicken raised without antibiotics, supplied by Maple Leaf, and also include a BLT option that features raised without antibiotics bacon, sourced from our new Bacon Centre of Excellence in Winnipeg. This level of innovation continues to differentiate us in the market with both customers and consumers, and certainly sets the stage for future growth in our branded, food service and sustainable meats businesses.

As you can probably tell, there was a lot of really good progress and good news in the quarter that I would personally describe as progress not perfection. We've committed to be fully transparent with you in our communications, not only to highlight where we are executing well and building positive momentum in the business, but also acknowledging where we see opportunities to improve.

In that spirit, the first observation that I would offer is that pork market conditions have not yet fully normalized. You can see this visually in the chart that we have shared on slide 11 of our materials. And I would also point you to the external data that is available through Bloomberg's US Vertically Integrated Pork Margin Index, as an excellent point of reference. While not yet fully normalized, markets did improve in the quarter, mostly traced to a significant market move where the price of USDA bellies increased by more than 80% in less than 30 days, driving up the pork cutout and improving processing margins in the short-term. At the same time, this had a short-term negative impact on our bacon margins in the quarter, which will be addressed as our formula pricing mechanically catches up in Q4.

Additionally, we have work to do in Japan, a market that has been impacted by the competitive dynamics resulting from dislocated pork markets, as well as the devaluation of the Japanese yen. All-in-all, we believe we are approximately 250 basis points of adjusted EBITDA margin away from normalized pork and Japan markets.

While these atypical market dynamics have certainly lasted longer than we would have anticipated, we continue to view this dislocation as transitory. This is supported by the evidence of supply contraction that has been underway globally, as well as the prospects for significantly reduced feed input costs heading into 2024. As we have said consistently, markets will normalize, they always do.

It's important to note that in reviewing the performance of our pork business against our public peer sets in North America, it is clear that our relative performance has been exceptional through these challenging conditions, which again sets us up for excellent performance once markets normalize.

Lastly, we also don't want to shy away from the question of trade down and the impact that pricing has had in terms of what we had to put in place to keep up with the pace of inflation. We did experience some level of volume decline during the quarter, which is completely and fully consistent with what we would normally expect to see after pricing, especially in this kind of inflationary environment. Given the resiliency of our brands, the depth of our innovation agenda, and the runway for continued growth in sustainable meats in Canada and the US, we are confident that the volume impacts will prove to be transitory in time.

Turning to our Plant Protein business, we made great strides again this quarter for delivering our target of achieving adjusted EBITDA neutral by yearend. We've meaningfully reduced the size of our SG&A structure and we've made the necessary changes required to resize our cost structure, we're expanding gross margins and we've narrowed our product assortment to refocus the portfolio to where we have a competitive advantage and where we see the best market opportunities to achieve profitable growth. Put simply, the strategy is working.

Today, we have a strong and growing market share in the refrigerated category and produce sets, where we have maintained brand leadership, we have continued product innovation and we have invested in the capacity required to support growth specifically in our Tempeh facility in Indiana.

We have now delivered three consecutive quarters of stable revenue and we have improved our adjusted EBITDA by over 60% year-over-year. We have a clear path to breakeven and we will be turning the business profitable from there.

Before I turn it over to Geert to take us through a bit of a deeper dive into the details of our financial results in the quarter, I'd like to summarize what I'm seeing in the business and where we are focused. First, we are focused on fully realizing the benefits of our large construction capital projects at London Poultry and our Bacon Centre of Excellence. I'm so pleased with how these startups have gone and we fully expect to exit the year with these investments delivering an annualized adjusted EBITDA of CAD 130 million.

Second, we are focused on achieving our 14% to 16% adjusted EBITDA margin target in the Meat Protein segment. And we have unwavering confidence that we have all the building blocks in place to deliver on this goal as markets normalize.

Third, we are focused on achieving adjusted EBITDA breakeven exiting the year in the Plant Protein business. Here too, we have a clear line of sight to delivering this target.

And finally, we are focused on deleveraging our balance sheet, with momentum building and profits, cash flow generation from the new projects coming online and lower CapEx in 2024, we are on a clear path to our target of net debt to adjusted EBITDA ratio that is in line with investment grade metrics.

With that, I'll now turn the call over to Geert, who'll walk us through our financial results this past quarter in more detail. Geert?

Geert Verellen

Chief Financial Officer, Maple Leaf Foods, Inc.

Thank you, Curtis, and good morning, everyone. As Curtis mentioned, we delivered solid results in the third quarter and this thanks to the underlying strength of our business, the resilience of our brands and our network's operational excellence. And let me unpack the numbers now with you.

Sales in the Meat Protein segment increased 1.4% to CAD 1.2 billion in the quarter. Broadly across the Meat Protein group, the sales increase was driven by pricing action implement in prior quarters to mitigate inflation and structural cost increases, favorable product mix shift, as well as favorable foreign exchange rate impacts. These factors were partially offset by lower volumes. As was the case in the past, we believe that this volume will be recovered as consumers gradually adjust to new price points. In our meat portfolio, we saw strong performance in pork sales volume and pricing. While branded poultry sales were up versus last year, overall poultry sales were lower, with a slight shift from RWA, raised without antibiotics, to conventional poultry. Prepared meat sales were largely flat relative to last year, with volumes and market share down for the quarter. Curtis already referred to this earlier.

All-in-all, Meat Protein adjusted EBITDA was CAD 138 million for the quarter, compared to $101 million in the prior year or an increase of 37%. This increase was driven by the gradual improvement in the pork markets, the contribution of the London Poultry and Bacon plants, pricing action and mix, partly offset by cost inflation. Adjusted EBITDA margin for the Meat segment was 11.4%, a 290 basis point increase from last year. Compared to the second quarter of this year, this 210 basis point jump reflected a sequential improvement in pork market conditions, increased contribution from our London Poultry and Bacon plants as mentioned above, as well as a full quarter of pricing action. Partly offsetting these positives were some headwinds in Japan due to the continued dislocation of pork markets and a weaker yen.

Plant Protein sales were CAD 36.4 million, a decrease of 18.5% in constant currency compared to the same quarter a year ago. The decrease was driven by lower volumes as the entire category has contracted, partly offset by pricing actions to offset inflation. On a sequential basis, Plant Protein sales in US dollars have stabilized for a second consecutive quarter. Plant Protein gross margin was a negative 5.9% in the quarter, an improvement of almost 17 percentage points year-over-year. The increase in gross profit was driven by price increases, operational improvements, largely due to repurposing excess capacity and a reduction in startup expenses, partially offset by lower volumes.

SG&A expenses in Plant Protein were almost CAD 12 million, a decrease of approximately CAD 8 million from a year ago, driven primarily by lower people cost, reflecting our focus to have an appropriate cost structure for this business, as well as lower advertising and promotional expenses. Plant Protein adjusted EBITDA was a loss of approximately CAD 9.4 million, which is a 61.4% improvement, or 62.4% in US dollars from a year ago. We remain on target to meet our goal at yearend of breakeven adjusted EBITDA in this business.

In conclusion, total company sales for the quarter were CAD 1.2 billion and adjusted EBITDA increased by 68% to CAD 129 million. Net loss in the quarter was CAD 4.3 million or a loss of CAD 0.04 per basic share compared to a loss of almost CAD 230 million, or a loss of CAD 1.86 per basic share last year. After removing the impact of the non-cash fair value changes in biological assets and derivative contracts in both years, the one-time impairment charge related to the Plant Protein Group last year, as well as startup expenses and restructuring costs from both periods, adjusted earnings per share were a gain of CAD 0.13 for the quarter, compared to a loss of CAD 0.01 per share last year.

In total, during the quarter we invested CAD 50.5 million in capital expenditures, consisting of approximately CAD 26 million in growth capital, which was largely related to increasing the further processed poultry capacity in our Brampton Prepared Meats facility close to Toronto, and CAD 25 million in maintenance CapEx.

On the balance sheet, net debt increased to approximately CAD 1.8 billion from CAD 1.5 billion a year ago, but decreased CAD 38 million versus the second quarter of this year. As you all know, the majority of this debt is related to our construction capital projects London Poultry and the Bacon Centre of Excellence. Our outlook for Meat Protein and Plant Protein segments remains largely unchanged for the year. You can find our full outlook on slide 17 and in our news release on page 5.

As we continue to fine-tune our capital spend, we now expect our CapEx for 2023 to be approximately CAD 200 million, down from prior guidance that said, we would be less than CAD 250 million. Roughly half of the spend will be attributable to maintenance capital, with the remainder being growth. The growth capital includes, amongst others, an increase in our processed poultry facility at our Walker Drive Plant in Brampton to meet a pipeline of demand that has attractive growth and margin prospects.

We expect to provide you more detailed view of 2024 when we report our fourth quarter in February. What we can share with you again today is our conviction that our cash flow profile next year will be very different from that of recent years. And let me walk you through the big swing factors that we see. First, we are planning for structurally lower CapEx levels. We are now looking at a range of CAD 170 million to CAD 190 million for 2024, compared to approximately CAD 200 million for 2023. So roughly a CAD 10 million to CAD 30 million pickup in cash flow. Second, as we get our London and Bacon plants at cruising speed, startup expenses there will be significantly lower. We expect this to be roughly an CAD 80 million improvement year-over-year. Third is the incremental adjusted EBITDA generated by the London and Bacon plants of CAD 130 million. And fourth is the elimination of the adjusted EBITDA loss in our Plant Protein segment that based on current year-to-date results should at least be worth CAD 30 million.

Looking forward, these four factors alone represent an expected improvement in our cash flow of about CAD 260 million, assuming the midpoint of the CapEx range. To this range, we would have to add the potential impact of a gradual improvement in the global pork markets, which, while unknown at this time, may be very positive. Based on these factors, we believe that we will be in a good position to quickly delever our balance sheet. At the same time, dividend growth, returning capital to shareholders remain a key part of our capital allocation priorities, and we will continue to seek the appropriate balance between all of these.

In summary, beyond our capital allocation strategy and focus on deleveraging the balance sheet, we are confident and committed to achieving our near-term priorities and objectives.

I will now hand the call back to Curtis.

Curtis E. Frank

President and Chief Executive Officer, Maple Leaf Foods, Inc.

Okay. Thank you, Geert. Just a couple of final thoughts before we go ahead and open up the line for questions. The resilience of our business has been undeniable. For most of 2023, we have been largely focused on stabilizing the business in a turbulent environment, while at the same time, completing the execution of our most ambitious capital investment program in our history. We are very proud of what we've accomplished, and more importantly, we are set to deliver. As we look to close out the year, we remain steadfast in our focus on executing our blueprint so that we can progress toward our 14% to 16% adjusted EBITDA meat margin targets in normalized market conditions. While pork markets are definitely not improving as quickly as we would have expected in the precise moment, the green shoots of improvement that we have consistently talked about continue to grow.

Looking out on the horizon, our top priority is to capitalize on the investments we have already made to-date and to seize the many opportunities that are in front of us, to optimize our [indiscernible] (00:20:23) and operational performance, all while taking a very disciplined approach to pursuing growth opportunities as we continue to execute our strategy.

In closing, I want to take the opportunity to express my thanks and gratitude to the team at Maple. We're very fortunate to have so many incredibly talented people across the entirety of our organization, and without their drive and passion, we simply wouldn't be where we are today.

With that, I'll turn the call over to questions, please.

QUESTION AND ANSWER SECTION

Operator: Thank you, sir. Ladies and gentlemen, we will now begin the question-and-answer session. [Operator Instructions] Our first question comes from the line of George Doumet. Please go ahead.

George Doumet
Analyst, Scotiabank

Q

Yeah. Good morning, Curtis and Geert. Can you maybe give us a little bit of a breakdown of those three buckets that contributed to the 210 basis point sequential improvement in EBITDA margins? And how should we think of margin contribution for London and for, I guess, the market bucket for Q4?

Curtis E. Frank
President and Chief Executive Officer, Maple Leaf Foods, Inc.

A

Well, the benefits – Good morning, George, firstly. The benefits that we saw sequentially came predominantly in three areas quarter-over-quarter, which was the market conditions improving in pork, the pricing that we experienced and put in place that we would have expected in terms of having a full quarter benefit in Q3, and of course the startup and benefits that are attributed to London Poultry and our Bacon Centre of Excellence, starting with the benefits, those will continue to ramp-up as the year progresses. So, we haven't split them apart and we're not going to kind of break them apart because I don't think we can be as precise as you would likely hope that we could be. But the benefits for London Poultry and the Bacon Centre of Excellence are going to obviously accelerate as the year progresses. And we're fully confident, we feel really great about the fact that we'll be in an excellent place to exit the year with the CAD 130 million of incremental benefits in London and our Bacon Centre of Excellence.

Markets are really the kind of the wild card in terms of how things are going to perform here in the short-term. As I said, we did have tailwinds quarter-over-quarter in Q3 that give us a lot of optimism for the outlook for the future. But October is not playing out to be nearly as kind as we would have hoped or expected. So it's really those three buckets that are contributing, George. The pricing, the impact of markets and the accelerating benefits that will take place here between now and the end of the year here in London Poultry and our Bacon Centre of Excellence.

George Doumet
Analyst, Scotiabank

Q

Would it be in that order, Curtis? [indiscernible] (00:23:30)

Curtis E. Frank
President and Chief Executive Officer, Maple Leaf Foods, Inc.

A

I don't think I'll put them in order. I prefer not to, but I would say markets would have been the primary driver and the other two contributing.

George Doumet
Analyst, Scotiabank

Q

Okay. It's maybe a bit of a tougher question to answer, but I'm just wondering how much of that 1% volume was a function of kind of the volumetric response to price that we took versus just maybe more general trade down conditions that you've seen across other categories and markets?

Curtis E. Frank
President and Chief Executive Officer, Maple Leaf Foods, Inc.

A

The 1% growth on the top line, George?

George Doumet
Analyst, Scotiabank

Q

Yeah. I was wondering how much of that is volume response versus general conditions?

Curtis E. Frank
President and Chief Executive Officer, Maple Leaf Foods, Inc.

A

Well, to be greatly honest, to be truthful, it's really hard to tease those apart.

George Doumet
Analyst, Scotiabank

Q

Yeah.

Curtis E. Frank
President and Chief Executive Officer, Maple Leaf Foods, Inc.

A

I mean, we did have a volume decline, as I referenced in my comments, in our business across the quarter, which wasn't a surprise to us frankly. That's a normal response from the consumer following the pricing that we've taken. Actually, from my perspective, it would be materially better than what we might have experienced and maybe even what we've seen in kind of the competitive or peer set sell for the quarter. We're in the low-single digits in terms of declines volumetrically, and some of our competitive set would have experienced kind of slip through the data between 6% or 7% volume declines in either their prepared meats business or retail businesses in the US. So, I'm super optimistic that it will return normally. This is a normal cycle of taking pricing, seeing some volume pressure in the short-term, and then, of course, returning back to volume growth. But it's very difficult to tease out the broader market impacts from the pricing in and of itself.

George Doumet
Analyst, Scotiabank

Q

Okay. My last one is how much general comfort do you have in kind of delivering the 3% to 4% revenue growth in meat for Q4, I guess, to hit your guidance? And as we look to next year, do you think you can get back up to kind of the mid-single digit range that we've been delivering over the last few years?

Curtis E. Frank
President and Chief Executive Officer, Maple Leaf Foods, Inc.

A

Two things on that. Our guidance for this year is mid-single digit growth and completely comfortable with that being the case and don't see any reason to change that. We have not yet fully completed our plans and provided guidance for 2024, but it's certainly my expectation that we'll continue to see a top line revenue growth in the business. To what extent, we'll probably look to disclose next quarter rather than this one, but fully expect that we'll be in growth mode next year.

George Doumet
Analyst, Scotiabank

Q

Okay. Thanks for your answers. Good luck.

Curtis E. Frank
President and Chief Executive Officer, Maple Leaf Foods, Inc.
A

Thanks, George.

Geert Verellen
Chief Financial Officer, Maple Leaf Foods, Inc.
A

Thanks, George.

Operator: Thank you. And your next question comes from the line of Mark Petrie. Please go ahead.

Mark Petrie
Analyst, CIBC World Markets, Inc.
Q

[audio gap] (00:26:08-00:26:10) on the volume performance with regards to the quarter, can you give any commentary with regards to the sort of RWA business specifically or the Sustainable Meats business specifically versus the rest of the portfolio?

Curtis E. Frank
President and Chief Executive Officer, Maple Leaf Foods, Inc.
A

Hi, Mark. Good morning. Yeah. Sure I can. The volume and headwinds we experienced were really across the board in the quarter, which, again, is not of a surprise given the magnitude of the pricing that's been put in market over the last maybe even 24 months. But certainly through this last round. So it impacted Sustainable Meats as well, which again, wasn't a surprise. We were down low-single digits across the board in our Prepared Meats portfolio, which would include Sustainable Meats. The reason that, just to add a little bit of color, I think, it's a quarter of challenge. But at the same time, the thing that I would point out is if you go back to maybe pre-pandemic and look at our performance in Sustainable Meats over the course of time, we've now built a CAD 700 million business, which, you know, it's margin accretive in our portfolio. And in the first three quarters of 2023, our growth will be 45% to 50% higher in terms of the size of business relative to pre-pandemic levels, relative to 2019.

So, we're feeling really bullish on an ongoing basis about the health of our RWA business, despite the fact that we were down slightly in Q3. And I would add also, that was mostly a Bacon story in Sustainable Meats. Actually, if you look at our top line revenue, excluding Bacon, it grew slightly in the Sustainable Meats portfolio. So, this is mostly a Bacon story. There was a lot of competitive pressure in the US market throughout the quarter. Many of our peers south of the border are looking aggressively to get their volumes back on track. So, there was a competitive dynamic that played out as well. But overall feeling really, really strong about the Sustainable Meats business in terms of our ability to continue to grow well into 2024 and beyond, frankly.

Maybe the last part I'd add is a little bit on the health of our brands actually. This week I got a little bit of a preview into some brand health data, particularly related to Net Promoter Score and purchase intent. And the one of the things I was really pleased or happy to see and learned was our Net Promoter Scores across kind of our portfolio of leading brands, call it Maple Leaf Schneiders and Maple Leaf PRIME. Our NPS was up across all three of them in Q3 and purchase intent was actually higher across all three brands as well. So, I think that speaks to the level of investment we have in our brands, the continued level of investment we'll have in Q4 and moving forward. And, again, that gives me complete confidence that our volumes will get right back on track here.

Mark Petrie
Analyst, CIBC World Markets, Inc.
Q

Okay. Appreciate that color. Maybe just now on the commodity, you sort of ran through some of the realities, bellies less of a headwind, but October off to a weaker start. Can you just expand on the drivers for October specifically? And what you think would be needed to settle in at normalized markets from today?

Curtis E. Frank
President and Chief Executive Officer, Maple Leaf Foods, Inc.

A

Yeah. I mean, I think let me just start with the conditions in Q3 set up as favorable markets largely on the backs of a rapid run up in the cutout, which was driven by bellies. We added some materials to our investor deck that you might have had an opportunity to look at, I think it's on page 12 actually...

Mark Petrie
Analyst, CIBC World Markets, Inc.

Q

Yes.

Curtis E. Frank
President and Chief Executive Officer, Maple Leaf Foods, Inc.

A

...or sorry 11, and you'll see it clearly there. You see on the left side of the page the kind of what we've historically called the one profit in a pig, we're now referring to it as the Vertically Integrated Index, because I think the Bloomberg data is an excellent source to give you an indication of what's kind of playing out in the market.

On the right side, you'll see how the quarter itself played out, which, there was a rapid run up in the cutout. It drove really positive spreads for a month, maybe two months of the three. And then we started to see vertically integrated margins kind of level off to kind of almost breakeven. Sadly, in October, we would have expected, maybe I would say counter-seasonally and counterintuitively, October margins are not nearly as favorable as we would have expected. That vertically integrated margin is now negative in the moment in a pretty material way, maybe between CAD 27 and CAD 30 kind of thing. So, I think that's good public data that you can turn to.

At the same time, I feel really great about how the macro view of markets is playing out in terms of the ability to get back to more normal conditions over the next number of weeks, months and quarters. I wish I could have a precise moment in time for you when things will be normal, but the macro conditions are playing up well. And I say that because the industry continues to contract in terms of production, but we've been talking about that for several quarters, industry continues to contract. You'll see EU production down 6% to 7% and that's driving higher pricing in the EU. North American production has started to show signs of contraction, which is positive. And I think equally or more important, feed conditions both in terms of feed inventories, but also the outlook for yields and crop conditions that are coming off now and have come off already are set up really well for positive conditions in 2024. So that's probably the best color I can give you, Mark. Hopefully that's helpful.

Mark Petrie
Analyst, CIBC World Markets, Inc.

Q

It is. Thanks a lot. Appreciate it. All the best.

Curtis E. Frank
President and Chief Executive Officer, Maple Leaf Foods, Inc.

A

Thank you.

Operator: Your next question comes from the line of Irene Nattel. Please go ahead.

Irene Nattel
Analyst, RBC Capital Markets

Q

Thanks, and good morning, everyone. Coming at this from a slightly different direction and trying to think through the evolution of margins over the next, let's call it, through 2024. If we take the Q3 margin of 11.4% and we say, okay, let us assume that pork markets, maybe there's some puts and takes, but overall, the impact remains kind of what it is at this moment. So then, if we're looking ahead and we say, okay, another couple of hundred incremental basis of margin from Bacon Centre of Excellence in Poultry, it would take us to a mid-13% in 2024. Does that sound like a reasonable – sort of reasonable set of assumptions to you?

Curtis E. Frank
President and Chief Executive Officer, Maple Leaf Foods, Inc.

A

Like, while I'm not going to give you guidance, Irene. Firstly, good morning. Sorry. I'm not going to give you guidance for 2024, other than to say and recommit and reconfirm that we remain totally confident that we have all the right building blocks in place to deliver our 14% to 16% margin. I think of them as the benefits that are going to come from London Poultry and the Bacon Centre of Excellence, which is CAD 130 million of incremental run rate exiting the year. I think of them as branded growth and innovation. We put some, I thought, really excellent materials in the investor materials today that demonstrate the breadth of the innovation and the sales and margin contribution that are going to come with that in 2024. We've got the hyperinflation kind of macro environment moving behind us and our pricing is fully caught up. I'm very confident that Sustainable Meats will continue to be a profitable growth driver. Our supply chain health on a year-over-year basis is fully restored. Like we're right back to where we should be. And the real wild card is when precisely are pork nut markets going to normalize? And I wish I knew the answer to that.

In the fourth quarter, October, certainly worse than we would have expected. But we need to see how November and December play out. And heading into next year, I think we're really well set up for improving pork market conditions from where we are today. So, I know that's a longer and less precise answer than you would have preferred, but that's just, in a general sense, that's genuinely how we see the shaping up and we're undeterred in our conviction that we will, in fact, deliver 14% to 16%.

Irene Nattel
Analyst, RBC Capital Markets

Q

Understood. If I could return just to the quarter for a moment, the SG&A number in Meat was a really impressive year-over-year decrease. Can you talk about the factors there and how we should be thinking about SG&A on a go-forward basis?

Curtis E. Frank
President and Chief Executive Officer, Maple Leaf Foods, Inc.

A

Geert, do you want to maybe take?

Geert Verellen
Chief Financial Officer, Maple Leaf Foods, Inc.

A

Sure. Good morning, Irene. This is Geert. The SG&A bucket is a combination of a bunch of things. There's some variable compensation in there as well. There may be some timing in there as well from A&P, so advertising and promotion choices that we've made. Going forward, I think we're at a really healthy level of SG&A and maybe because of timing and that comp elements this level is lower than what we would see as a run rate. But I think going forward, that that's probably the most detailed comment we can give today.

Irene Nattel
Analyst, RBC Capital Markets

Q

Okay. So just so on a go-forward basis, we should assume maybe something slightly higher than Q3, but lower than prior year, is that the way to think about it?

Curtis E. Frank
President and Chief Executive Officer, Maple Leaf Foods, Inc.

A

Yeah, maybe slightly higher. I don't see it as a real.

Geert Verellen
Chief Financial Officer, Maple Leaf Foods, Inc.

A

No, I don't think so. It is true that every single quarter, every single year we shave off a couple of basis points on the SG&A because this business is really good at deleveraging and scaling. But the true, I would say, contributors to the 14% to 16% you're going to have to look at in the gross margin. That's what we're really focused on.

Irene Nattel
Analyst, RBC Capital Markets

Q

Okay. That's very helpful. And then just one final question. Just can you please confirm as we think about the deleveraging on the balance sheet, that "investment grade" for you is somewhere in the 3 times to 3.5 times EBITDA?

Geert Verellen
Chief Financial Officer, Maple Leaf Foods, Inc.

A

I would describe it as lower than that, Irene. Structurally our goal would be to be materially lower than 3 times. I don't want to give you a precise target, but below 3 times would be the best answer I can give you in the moment to be confirmatory.

Irene Nattel
Analyst, RBC Capital Markets

Q

Thank you.

Operator: Thank you. And your next question comes from the line of Michael Van Aelst. Please go ahead.

Michael Van Aelst
Analyst, TD Cowen

Q

Hi. Thank you and good morning. On the Plant based side, it seems you continue to right size the SG&A and bring that lower in light of like the current run rate of revenues. I'm curious, though, on the gross margin side, how should we expect the timing of that to ramp up so you can get to the breakeven point? And what are the hurdles you have to get to, to get that gross margin into positive territory?

Curtis E. Frank
President and Chief Executive Officer, Maple Leaf Foods, Inc.

A

Yeah. Hi. Good morning, Mike. I'll answer and then maybe Geert...

Michael Van Aelst
Analyst, TD Cowen

Q

Sure.

Curtis E. Frank
President and Chief Executive Officer, Maple Leaf Foods, Inc.

A

...can add some color where volumes at. So again, Q3 was excellent progress from where we've very historically invested in the business and continue to see sequential improvement. But the 60% improvement, 62% was right in line with our plan and we were very pleased with the outcome. I think maybe even more importantly, we're now in a place where the sales have stabilized, which is really great news for us, not only in terms of building a platform and a foundation from which to grow, but also in terms of starting to deliver gross margin expansion as we've mentioned.

There are few things that I think are going to play out in the fourth quarter that will be additive to our performance that I can maybe talk a little bit about. And then, as I said, Geert can add some color. The first is there's some ongoing work that will take a full effect from a revenue management point of view. And the way we manage our revenues are predominantly around trade spend optimization, started late in Q3 and we'll have a full quarter of benefits in Q4. The second is you'll continue to see the benefits of lower SG&A and our right size kind of organizational design and structure in place. And we do have a new distribution model that we've been talking about that offers significant cost savings and efficiency, and we'll get the full benefit of those cost savings throughout the fourth quarter. So you'll continue to see improvements there.

And then we've been doing a lot of work around while maintaining our conviction and alignments to our brand strategies and what we call our brand manifestos. Also working on product design and cost optimization in the portfolio just from a pure product design and optimization point of view. So those are kind of the heavy hitters. I mean, we're obviously wanting to pivot to growth from there, which will be additive and helpful and certainly have some good plans in place. But that would be my perspective.

Geert, do you have anything though that you would add?

Geert Verellen
Chief Financial Officer, Maple Leaf Foods, Inc.

A

I think that's it. It's pricing, it's freight and storage, and then especially compared to last year, is the fact that we've taken out the excess capacity that was burdening the gross margin. So that's definitely going to be a help in Q4.

Michael Van Aelst
Analyst, TD Cowen

Q

Yeah. And just on the like transferring some of that overhead and production capacity back to, I think it's value-added poultry, has that already happened or is that still to happen in Q4?

Geert Verellen
Chief Financial Officer, Maple Leaf Foods, Inc.

A

The transfer, yeah, there's two phases. There's double one, no longer burdening the Greenleaf or the Plant Protein segment, done. And we're now using our capacity to scale up that further processed poultry opportunity that we have and that both Curtis and I referred to in the script where we're now working on that. So that plant will be up and running, I think, in the first half of next year.

Michael Van Aelst
Analyst, TD Cowen
Q

Okay. All right. And then, secondly, when you talk about the meat market factors, now when we look at that chart clearly there was a big improvement in Q3, bigger than what the numbers might have suggested because the belly price also spiked and that takes time to pass on. But you do talk about passing on higher, like the automatic pass-through of those belly prices into your bacon prices, which should happen in Q4. At the same time, we've seen the belly prices fall off. So I know market conditions haven't been strong so far in Q4, but does the swing in the belly price, coupled with the price pass-through on bacon, does that create some offset to what we're seeing in that vertically integrated number?

Curtis E. Frank
President and Chief Executive Officer, Maple Leaf Foods, Inc.
A

Yeah. Mike, it does some but certainly not all. So, we will get some pickup in our prepared meats margins related to the impact of belly prices coming off and our pricing moving up, just given the formulaic nature of the bacon pricing. So that will be a help to us, but we would have never expected market conditions to be as difficult in pork as they are in October, which will more than offset the benefits from bacon pricing for sure. And it's really a question how of November and December play out, which I'm not in the business of predicting, but we'll see how things play out over the next couple of months.

Michael Van Aelst
Analyst, TD Cowen
Q

Okay. And just finally, when we look at – I understand the normal volume fall off post price increases and then the recovery. But can you just confirm, in Canada did you see an improvement in your volumes as the quarter progressed since the price increases did kick in in Q2? And then in the US, what are you doing down there to try and stabilize and grow the business down there more since a lot of that business in the US is RWA?

Curtis E. Frank
President and Chief Executive Officer, Maple Leaf Foods, Inc.
A

Yeah. On the first question, Mike, although I don't really believe this is necessarily a theme, we did see improving volumes throughout the quarter from the first month performance post price increase to the exit of the quarter, volumes did strengthen. Or maybe said differently, the magnitude of the decline narrowed throughout the quarter. So that's positive news. I think in terms of consumer response, that's positive news. And mindful, Q4 is a heavy quarter on the consumer. I mean, there's a lot going on in the fourth quarter. There's a seasonal element, the dollar stretch pretty hard in terms of conditions for the consumer from a festive and holiday point of view. So I'm mindful of that. But we certainly saw a more positive outcome exiting the quarter than we did at the onset of the quarter. So that's just one data point or insights.

On the RWA side, we continue to direct our attention in two areas. Number one, aligning and plugging into what's important to our customers in the United States. We do that through in-store promotions and the way we bring our Greenfield brand to life with our customers in the US. And number two, continuing to build a pipeline of new business opportunities, which, as I said earlier, I feel really great about for 2024. At a review this week with the team, they were actually on the ground in the US when I spoke with them and I'm feeling really excellent about our prospects for growth in RWA. The short-term conditions around bacon pricing is just a choice. I mean, it's a question of how deep do you want to discount to build features in the United States? And we elected to sustain our pricing strategies. I think over the course of time, our discipline in revenue management has benefited us in margin expansion significantly. And I intend to sustain that discipline. And I think that market discipline will come back as well, while there's short-term pressure on volume, but the competitive sets healing in the United States.

Michael Van Aelst
Analyst, TD Cowen

Q

Great. Thank you, Curtis.

Curtis E. Frank
President and Chief Executive Officer, Maple Leaf Foods, Inc.

A

Thank you.

Operator: We have our last question coming from the line of Tamy Chen. Please go ahead.

Tamy Chen
Analyst, BMO Capital Markets Corp. (Canada)

Q

Hi. Good morning. I have two clarification questions. First, is your free cash flow, I think it's approximately CAD 140 million in the quarter. Could you just confirm just I think looking at your schedule like are you adding back maintenance CapEx?

Geert Verellen
Chief Financial Officer, Maple Leaf Foods, Inc.

A

Yeah.

Curtis E. Frank
President and Chief Executive Officer, Maple Leaf Foods, Inc.

A

Geert, maybe you would – maybe take that one.

Geert Verellen
Chief Financial Officer, Maple Leaf Foods, Inc.

A

Yes. That's it. The deltas that I talked to are more broad sense cash flow improvements, Tamy. So I would be careful what you use as a basis, I'm really focused in our script and we're really focused on the swing factors that we will see transpire next year.

Tamy Chen
Analyst, BMO Capital Markets Corp. (Canada)

Q

Right. I would just have thought that the maintenance CapEx like you wouldn't add that back because that's an ongoing cash outflow?

Curtis E. Frank
President and Chief Executive Officer, Maple Leaf Foods, Inc.

A

Yes. But that's exactly what we do here. When you look at our definition of free cash flow, we do not add back the entire CapEx, we only add back maintenance CapEx because we feel that the other part of CapEx, which is growth, those are discretionary choices that we have. Maintenance CapEx is something we absolutely have to continue to invest it in.

Tamy Chen
Analyst, BMO Capital Markets Corp. (Canada)

Q

Okay. And could you give an update on your startup cost expectation? So this quarter, it was about CAD 24 million, I believe last quarter, I think your guidance was for the second half of this year is around CAD 30 million, if I recall. So, in terms of how you're viewing the startup costs in the second half of this year is that, i.e., implied Q4 like that CAD 30 million for the second half of the year, is that still unchanged? Is that still your expectation there will be a pretty significant drop off in the startup costs in Q4?

Geert Verellen
Chief Financial Officer, Maple Leaf Foods, Inc.
A

So that's a great question. When we think about the startup expenses at EBIT level, we're looking at roughly around CAD 115 million for the full year. So, we've got another CAD 20 million to CAD 25 million to go in the fourth quarter.

Tamy Chen
Analyst, BMO Capital Markets Corp. (Canada)
Q

At the EBIT level? Okay.

Geert Verellen
Chief Financial Officer, Maple Leaf Foods, Inc.
A

Yeah. Yeah.

Tamy Chen
Analyst, BMO Capital Markets Corp. (Canada)
Q

Got it. Okay. And my last question is, so you've talked a lot about how in October the market component is playing out. I'm just curious, when it comes to California's Proposition 12, obviously everyone's got a view on how it might unfold, but curious to hear like are you taking any certain actions on preparing your business for that, if at all? And how are you viewing Proposition 12 and what it might do for the market bucket? It sounds like it might be most disruptive now into early next year. Thank you.

Curtis E. Frank
President and Chief Executive Officer, Maple Leaf Foods, Inc.
A

Yeah. Thanks, Tamy. In terms of the impact of Prop 12 on our business, it's something from an industry perspective, we're obviously being careful attention to, but in terms of the impact on our results in the moment, it is – it's not significant. It's not a significant event for us in terms of the implications to our earnings in the moment. And I certainly don't expect it will be over the course of next quarter. What we're doing is focusing on building our Sustainable Meats portfolio and that includes competitive advantage in two areas. One, pork raised without antibiotics, and number two, the benefits that we've built and the investments that we've made that are well behind us in gestation-crate free and our version of open sow housing. So from that perspective, we feel well-positioned in the market. It's not a material item in terms of our earnings today, and I don't expect it will be in the short-term. I think what we're really paying careful attention to is how will North America, more broadly over the course of the long-term, adapt to the changing regulatory environment. And will there be many different regulations by state or province or country? And there's lots of complexity there to play out yet. But in the moment, it's not a material line for us.

Tamy Chen
Analyst, BMO Capital Markets Corp. (Canada)
Q

Okay. Thank you.

Operator: Thank you. There are no further questions at this time. I'd now like to turn the call back over to Mr. Curtis Frank. Please proceed, sir.

Curtis E. Frank

President and Chief Executive Officer, Maple Leaf Foods, Inc.

Okay. Well, thank you, everyone, for joining today. It's great to be with you and have an opportunity to answer your questions. As I hope you, again from the call, we're feeling very optimistic and proud of what we've accomplished in having three consecutive quarters of a margin expansion in the Meat Protein business and being completely on track with both our ability to achieve adjusted EBITDA neutral in Plant Protein, as well as get the CAD 130 million of benefits, which we're quite excited about in London Poultry and the Bacon Centre of Excellence heading into 2024.

So thanks for your time today and we wish all of you well.

Operator: Thank you, sir. Ladies and gentlemen, this concludes your conference call for today. We thank you for participating and ask that you please disconnect your lines. Have a lovely day.