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TSN - Q2 2015 Tyson Foods Earnings Conference Call

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OVERVIEW:

Co. reported 2Q15 YoverY revenue growth of 10.5% and GAAP EPS of $0.75. Expects FY15 revenue to be approx. $41b and adjusted EPS to be $3.30-3.40.

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PRESENTATION

Operator

Welcome to the Tyson quarterly investor earnings call.

(Operator Instructions)

This call is being recorded. If you have any objections, you may disconnect at this point. Now, I would like to hand the call over to your host, Mr. Jon Kathol, Vice President of Investor Relations. Sir, you may begin.

Jon Kathol - *Tyson Foods, Inc. - VP of IR*

Good morning, and thank you for joining us for Tyson Foods' conference call for the second quarter of FY15. On today's call are Donnie Smith, President and Chief Executive Officer, and Dennis Leatherby, Executive Vice President and Chief Financial Officer.

Our remarks today include forward-looking statements, as defined in the Private Securities Litigation Reform Act of 1995. These statements are subject to the risks and uncertainties that could cause actual results to differ materially from our expectations and projections. I encourage you to read the news release issued earlier this morning and our filings with the Securities and Exchange Commission for a discussion of the risks that can affect our business.

This morning, we will be referring to our second-quarter adjusted operating income and EPS. The Company uses non-GAAP results such as adjusted EPS, adjusted operating margin, and adjusted operating income, to provide investors with a better understanding of the Company's operating performance, by excluding the impact of certain non-recurring items affecting comparability. Please refer to today's news release for a full reconciliation of our GAAP to adjusted results.

As always, we'll have a Q&A session following our prepared remarks. To ensure we get to as many of you as possible, please limit yourself to one question and one follow-up, and then get back in the queue for any additional questions. I'll now turn the call over to Donnie Smith.

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

Thanks, Jon. Good morning, everyone, and thanks for joining us today. I'm pleased with our second-quarter results.

EPS was $0.75 on both an adjusted and a GAAP basis, and adjusted operating margin was 5.5%. Adjusted operating income was a Q2 record, and up 53% over the same period last year. We captured $77 million in total synergies during the quarter, bringing the total to $137 million so far this year.

We initially set annual synergy targets of more than $225 million for this year, and in excess of $500 million for 2017. Our progress is ahead of schedule, and we are optimistic about the synergy opportunities, so we're increasing those targets to more than $250 million this fiscal year, $400 million in 2016, and $600 million in 2017.

Now, let's discuss the operating segments, and then I'll come back to the overall outlook. The prepared foods segment posted a record adjusted operating margin of 8.4%, and record operating income of $157 million in the second quarter. Sales volume was up 70.6%, with the acquired Hillshire brand showing increased momentum through strategic pricing, brand building, and innovation.

These expanded capabilities, our consumer preferred brand portfolio, and a strong growing innovation pipeline, will allow us to drive continued growth. We expect to maintain our current earnings trajectory, and quickly move towards the new 10% to 12% normalized range, indicating the strength and the relevance of the new Tyson 2.0.

I'd also like to point out that $70 million of the $77 million of synergy capture in the quarter came in the prepared foods segment. Through synergies, we are re-rating the cost structure of our prepared foods business, and growing the top and the bottom lines.

In the chicken segment, for the second quarter, volume and price were roughly flat compared to Q2 of 2014. The operating margin was 11.7%, and I'd like to point out that segment operating income for the last 12 months exceeded $1 billion. We feel really good about how we've managed our chicken business, and I think we've positioned ourselves well.

We've put our retail value-added poultry business back on track, and maintained our position as the number one brand in the country. In fact, our IRI four-week data indicate that our market share for frozen breaded chicken is 53.7%, which is only a point or two below where we were when the operational challenges occurred last year.

Also within the chicken segment, we've right-sized our small bird business, and the big bird business is running well. Tyson Fresh Chicken, which is still the number one brand, is outperforming its peers, and the volume that will be coming from the plant in South Georgia that we are converting to tray pack is already fully committed.

As you are aware, avian influenza in the upper Midwest has affected mostly turkey and table leg flocks. At this point, the primary impact on our business is not from bird health concerns, but rather from the loss of export markets for certain states, and the resulting excess leg quarters in the domestic market.

We've positioned ourselves well over the past several years by reducing our dependency on export leg quarters, which now represent only a small percentage of our total portfolio. We have a very good whole bird mix, especially beneficial in times of depressed leg quarter pricing, and our buy versus grow strategy means that we're not producing leg quarters that aren't sold.

We're also fast-tracking innovation to get more dark meat into value-added form at both retail and food service, so we've got plenty of positives to offset the negatives. Our chicken business is having a great year. Adjusted for the lower leg quarter prices, we are now expecting in the back half, we expect operating income for the full fiscal year of approximately 11%.

In the beef segment, volume was down slightly, with pricing up 9%. Operating margin was negative 0.5%. We knew it would be a tough quarter for beef, but it was more disappointing than expected.

Higher fed cattle cost, and lower export volumes due to the West Coast port slowdown, made it difficult to pass along increased input costs. The product is moving again out of the West Coast, albeit slower than we'd hoped, and it could take another two to three months to clear.

Orders have continued to flow in, which is encouraging for export demand, and also on the second quarter, the start-up of our Dakota City, Nebraska plant, following a significant renovation project, increased operating costs, but we now have the largest, most modern beef facility in the United States.

For FY15, we expect fed cattle supply to be down 5% to 6% from last year, and we think we've experienced the bottom of the beef supply cycle. After this year, we believe we'll see slow incremental improvement in supply. Our beef segment results should improve in the back half of the year, and while profitable for the year, FY15 results are expected to be below FY14. It is important to remember that we'll continue to run our beef business for margin, not market share.

In the pork segment, volume was down 4.4%, and sales price was down over 15%. Operating margin was 8.2%. Our volume decrease was due to the sale of our Heinold business, and excluding the impact of the divestiture, our sales volume grew 3.2%.

Demand for pork has been a little softer than expected, as wholesale price declines have not been realized in the retail channel. We expect feature activity to improve soon, which should improve pork consumption. Because a higher percentage of pork is exported than beef, the West Coast port issue had a greater effect on domestic pork supplies.

In addition, there are more hogs coming into the market, and coupled with increased weights, pork supply could be up 8% to 10% in the near term. However, we don't think it will stay at those levels for long, because that scenario isn't sustainable. For the rest of the year, we'll continue to maximize revenue, relative to the live hog markets, through operational efficiencies and mix optimization, and we think the pork segment will be in the range for the year.

In the international segment, volume was down just over 30% due to the sale of our operations in Brazil, and continued weak demand in China. Pricing was down 2.7%, also due to demand in China, as well as currency devaluation in Mexico. Operating margin was a negative 6.8%.

Segment operating losses improved, following the sale of our Brazilian operations, and improved market conditions in Mexico. The sale of our Mexico operations is pending the necessary government approvals, and we expect to receive the decision during FY15. Chicken pricing weakness in China persists, although we are starting to see some improvement, based on stronger pork pricing. We expect the international segment's adjusted operating loss to improve by about $25 million for the fiscal year.

Now let's take a look at the sales channel information. At retail, Tyson was up 3% in the latest 52 weeks, which is on track with all food and beverage retail sales through the end of March. Not only did eight out of our nine core businesses have positive dollar sales growth, in both the latest year and the latest quarter, six of nine had positive dollar share growth.

In the total fresh meats and deli universe, dollar sales were up 6% for all fresh meats, for the 52 weeks ended March 28. Retail prices were up 19% for ground beef, and 16% for whole muscle cuts, while pork retails were up 14%, and fresh chicken was up 4%, indicating continued strong domestic demand for protein.

At food service, dollar sales were up 3% for all commercial restaurants. The largest growth came in QSR Mexican, with dollar sales up 11% in the March ending year, and QSR chicken had the second-highest growth rate.

Economic conditions for spending are the most favorable in seven years. Unemployment's down, wages are growing, consumer confidence is up, and inflation is in check. Consumers are spending less on fuel, and more on food.

Although value consciousness appears to be here to stay, the consumer's ability and willingness to pay for value-added benefits is moving in a direction to afford and support protein innovation in the marketplace. We'll leverage this direction as we continue to deliver relevant innovation, with new varieties for Park's Finest hot dogs by Ball Park, and Hillshire Farm Natural lunch meat.

We'll also be introducing three disruptive innovation platforms in Q4, capitalizing on the snacking and freshness consumer trends, with the launches of Hillshire Snacking, Ball Park Jerky, and Jimmy Dean Simple Scrambles. We'll break into two sections of the store with these launches, and while still continuing to expand our convenient meal and snacking offerings in frozen chicken.

Our Hillshire snacking launch continues to show success in test market. Within the test, category growth is up 17%, with Hillshire responsible for nearly half the growth. And especially important to our retail partners, over a third of Hillshire Snacking dollars are incremental to the category. We are also seeing successful food service innovation behind Chef Pierre Layer Luxe pies, and we're looking forward to launches coming this month within food service brands such as Tyson Red Label chicken, and our expansion of Bistro Collection desserts.

All this puts Tyson Foods in a solid position. Cash flow is strong, giving us options for 2016. If there aren't any strategic acquisitions of interest, we'll invest in our business, and buy back stock.

Our balanced portfolio, increased synergy capture, and strong momentum in prepared foods, coupled with favorable pork raw material costs, give us confidence that we'll achieve our annual guidance of $3.30 to $3.40 adjusted EPS, despite near-term challenges. We are very well-positioned with sound fundamentals, and a solid growth story.

Synergy capture is going very well. We are gaining momentum in retail brands, as we make rapid progress with the integration. We have advantaged brands in advantaged categories.

Protein is extremely relevant to today's consumers. According to IRI, 99% of our refrigerated product sales are in categories that are showing positive year-over-year growth. In frozen foods, 92% of our products are in categories that are showing growth over last year.

We are currently number two among all other major food and beverage companies in terms of dollar sales growth for the 52 weeks ended March 19. And let's not forget food service, where restaurant traffic is showing growth, as consumers benefit from lower gas prices and improved economic conditions. We have a lot going for us, and we are comfortable projecting at least 10% EPS -- adjusted EPS growth in FY16, which is in keeping with our stated goals.

And now, let's go to Dennis for the financial update.

Dennis Leatherby - *Tyson Foods, Inc. - EVP & CFO*

Thanks, Donnie, and good morning, everyone. Q2 was another record quarter, as we delivered strong financial results, demonstrating the value of the diversity of our portfolio. Our revenues grew by 10.5% compared to the same period a year ago, as we produced our third consecutive $10 billion quarter.

Adjusted return on sales for the quarter was 5.5%, and adjusted operating income was $553 million, representing a 53% increase over Q2 of 2014. Our adjusted earnings per share of $0.75 this quarter was a record for our second quarter, and represents a 25% increase from $0.60 in the comparative period last year. Our rolling four-quarter adjusted EPS of $3.14 reached another milestone by surpassing $3 per share, and has been consistently growing over the past eight quarters.

Operating cash flow through two quarters was $808 million, and we spent $435 million on capital expenditures, which was $139 million greater than depreciation. And as we continued to invest in projects with a focus on delivering high ROIC. Our effective tax rate in the second quarter was 35.6%.

Net debt to EBITDA for the past 12 months was 3.3 times. On a pro forma basis, including Hillshire's results for the past 12 months, net debt to adjusted EBITDA was 2.7 times. Net interest expense was $70 million during the second quarter. Including cash of $223 million, net debt was $7.4 billion. Total liquidity was $1.3 billion, remaining above our goal of $1.2 billion.

For the quarter, our diluted shares outstanding were 415 million. The sale of our Mexican operation is pending the necessary government approvals, and we expect to receive a decision during FY15. Subject to completion of the sale, we will use the proceeds to pay down debt.

Now here are some thoughts on the remainder of FY15. Please note, our accounting cycle results in a 53-week year in FY15, as compared to a 52-week year in FY14. Accordingly, this outlook is based on a 52-week year to make a better year-over-year comparison.

We expect revenues of approximately $41 billion for FY15, which is over 9% growth compared to FY14. This is driven primarily by a full year of Hillshire brands, offset by a reduction in our international operations. In FY15, we expect to capture more than $250 million from our prepared foods profit improvement initiatives, and Hillshire brands synergies.

Net interest expense should approximate $275 million for FY15. We currently estimate our adjusted effective tax rate to be around 35.5%. CapEx is expected to be $900 million, which is approximately $300 million or 50% more than our depreciation, as we continue to focus on projects that create long-term shareholder value.

By the end of FY15, we expect net debt to adjusted EBITDA of approximately 2 times. Based on our average share price in Q2, we expect our diluted shares in Q3 to be around 415 million, prior to considering any changes in our stock price, which would impact the dilution from our tangible equity units.

Our priorities for the significant cash flows that our operations will generate are for continued rapid deleveraging and strengthening of our balance sheet; the sustained focus on disciplined capital allocation to drive long-term shareholder value; creating incremental debt capacity to fund acquisitions to fulfill our growth strategies; and returning cash to shareholders through our share repurchases and dividends, all while maintaining plenty of liquidity.

In closing, our Q2 results continued to demonstrate the value of our diversified business model. With the addition of Hillshire valuing up our portfolio, along with the synergies we expect to capture, prepared foods is expected to finish strong with margins above 8% for the remainder of FY15. Our chicken segment has delivered more than $1 billion in operating income over the past 12 months, and should produce an operating margin of approximately 11% for FY15.

Although our beef segment has faced volatile market conditions this year, we believe the worst is behind us. We expect our beef segment to be profitable in FY15, but below 2014 results, while our pork segment is projected to operate in its normalized range for the year.

Despite a number of headwinds coming at us, we have a great team, which gives me confidence we will deliver strong results in the second half of the year, to not only meet our guidance of $3.30 to $3.40 adjusted earnings per share, but also grow EPS by at least 10% in FY16. That concludes our prepared remarks. Operator, we're ready to begin the Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Ken Goldman, JPMorgan.

Ken Goldman - *JPMorgan - Analyst*

I know these are difficult to put into numbers, but you had two headwinds in the quarter. Avian flu and the West Coast port strike, that you said didn't help. So is there any way for us to quantify how much these headwinds hurt margins or EPS in the quarter?

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

Ken, as we look at, I'm going to combine them both. Probably around $20 million for Q2. As you know, they are continuing to linger, so we're going to have to continue dealing with them over the next quarter or two, but we're hoping that the West Coast port issue should clear up in the next two or three months. There's some ebbs and flows that keep us from having all the confidence we'd like to have in that, but figure Q2 at $20 million, and some of that gets pushed into Q3 and on forward.

Ken Goldman - *JPMorgan - Analyst*

And that's $20 million to the operating line?

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

Right. Round numbers, $0.03 a share, something like that.

Ken Goldman - *JPMorgan - Analyst*

Perfect. I just wanted to make sure it wasn't on the net line. And then, I realize not everything is going as well as initially forecast this year. Namely beef, but most of the business is doing pretty well.

And you keep beating consensus estimates, raising synergy targets, so my question is this. if you had to focus on one reason why you didn't raise guidance today, would beef be the primary reason, or was there something else we should be looking at?

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

As we look at prepared foods, we'll continue to deliver over 8% in prepared foods. Now, there's a couple of categories, by the way, the categories that are showing really good growth, where we've given up a little bit of share, and we are going to need to reinvest some of the raw material savings in the back half, to regain that share, and protect of those businesses for the long-term.

The other categories, it's probably export-related. With the West coast port slowdown, if we are two to three months from seeing that, then that's going to linger a little bit into Q4, and we're just uncertain as to whether or not our estimate on that's correct.

And then these AI bans, we've seen even as late as last week, we saw a couple of other outbreaks or a few more outbreaks of AI up in the upper Midwest in turkey and table leg flocks. And as those outbreaks continue, it continues to push out the time when those AI bans would be lifted. And so, we are predicting a little bit more export late quarter pricing softness in the back half, than what we had thought before. So hopefully that sums it up.

Ken Goldman - *JPMorgan - Analyst*

It does. Thank you very much.

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

And if we are overly conservative on these issues, then certainly our back half could improve further.

Ken Goldman - *JPMorgan - Analyst*

Great. Thank you very much.

Operator

Kenneth Zaslow, Bank of Montreal.

Kenneth Zaslow - *BMO Capital Markets - Analyst*

I wanted to explore the prepared foods a little bit more. So you're hitting 8.4% this quarter in margins. And I get the point that you're going to be having to reinvest some of the lower input costs, but how does it not sequentially improve throughout the year, as your synergy targets go up? At least -- or in excess of 8% should seems like it should be in excess of 9%, or in excess of 10%. Can you help us understand that?

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

Well certainly as we get into 2016, Ken, our expectation is to be rapidly approaching our new projected normalized range of 10% to 12%. And what we're talking about is just the flow of operating income improvement to get to that point. So with the favorability in raw materials, plus what we're going to need to reinvest back in some of these categories, we are going to be over 8% in the back half. If raw materials are little more favorable than we thought, then certainly that number will improve, but you will see a sequential increase in operating income in our prepared foods segment on foods this fiscal year, and then into next.

Kenneth Zaslow - *BMO Capital Markets - Analyst*

Okay. And then going into 2016, the idea that you could get at least 10% growth, can you talk about what are your key assumptions to get you there? Because it seems again, not that it's a lay-up, but it seems a little bit easier maybe than what you're saying. I'm just trying to figure out exactly how you're getting to that at least 10% growth in 2016.

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

Sure. We'll be in the second year of our synergy capture, and as we said a little earlier, that's got a little better. So we see improvements there as we continue to reset the cost structure in prepared foods. For the first time in 18 months, we've now got the capacity to increase fully-cooked chicken sales, and next year, 2016 will be the first year where we have an incremental year-over-year ability to have a full year of sales growth in fully-cooked chicken. If we are right, and we've seen the trough in the beef supply cycle, then our beef numbers should improve sequentially next year, over this.

By the way, back on chicken, we're starting up the tray pack plant in South Georgia this month, so we'll have a full year of those results in our number next year. I would think that pork is set up to have a pretty good year next year, and we think that's going to provide good raw material prices for us in our prepared foods business, not to mention the fact we are going to be generating a lot of cash, so we'll get to pay down debt. We'll have opportunities to continue to invest in our business, that type thing.

And again, we've got great brands, and we've got them in great categories that are growing. And we'll be using our brand growth to continue to drive this expectation of having stable, consistent earnings growth over time.

Kenneth Zaslow - *BMO Capital Markets - Analyst*

So is the at least 10% just a stab to just start there? It sounds like that's -- because you are going to lap all these -- the $20 million this quarter, there's probably going to be $15 million to $20 million next quarter as well, and then you have all these things. Is the at least 10% is just as a starting point to say, look, this is in line with our long-term growth target. It's not really a true projection of where we're going to go? It could be higher than that? Is that a fair statement?

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

I can tell you, for us, Ken, it's early. But I'm not -- I wouldn't go so far as to say I'm taking a stab. We feel comfortable about our ability to deliver 10% EPS growth next year, with a lot of reasons to do so, but it's hard to get any more granular than what we've said this early in 2015.

Kenneth Zaslow - *BMO Capital Markets - Analyst*

All right. Great. I appreciate it.

Operator

Farha Aslam, Stephens Inc.

Farha Aslam - *Stephens Inc. - Analyst*

Just building on Ken's discussion about next year and 10% EPS growth. I think why Ken is focusing in on that, because you'll have probably $150 million of incremental synergies next year, so that's 7% of EPS growth right there. So perhaps you could just share with us your outlook into 2016, about the performance of the core business, and clearly there is concern that is it's only 10% EPS growth? Because you think that poultry is going to feel pressure from increased pork and beef on the market? Can you address your 10% EPS growth targets, with relation to how your various divisions, how you are expecting them to flow into next year?

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

Okay. So I'll just breakdown through segments. So we would certainly see the opportunity in our prepared foods segment to approach our normalized range.

In chicken at this point, if we project the current soft leg quarter prices into next year, we're still at or above the top end of our normalized range in chicken. Again, beef should get a little better than this year. We think pork will improve next year over this year, so there's good -- we feel comfortable that 2016 is set up to be a very good year for us.

Farha Aslam - *Stephens Inc. - Analyst*

That's very helpful. And then just focusing on operations within particularly chicken and prepared foods. This quarter, your volume in chicken was flat year-over-year, and the market was growing.

If you look out into the second half of the year, and into 2016, what do you expect Tyson's volume growth to be in chicken? And particularly in your cooked divisions? Are all your plants now up online?

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

I'm going to start at the back and go up. Yes, we have full capacity to produce fully cooked items now. So, we are all up and online.

In terms of next year's growth, I'm going to -- Farha, it is really, really early. But I would say somewhere, 1% to 2% sales volume growth; don't know that I would predict any production volume growth.

Next year, my guess is we'll do a lot more of buy versus grow. Which by the way, there is some in that in the flat volume of this year, because this year, we bought about 50% more loads a week, as part of our buy versus grow program, than we did last year.

So we don't have the sales or the volume of the back half of those birds, but that's a good thing. So yes, we'll have sales growth next year, and I would predict the revenue growth to outpace the sales growth. But in terms of production, we currently wouldn't see our production up.

Farha Aslam - *Stephens Inc. - Analyst*

That's very helpful. Thank you.

Operator

Adam Samuelson, Goldman Sachs.

Adam Samuelson - *Goldman Sachs - Analyst*

Digging a little bit more into the Hillshire synergy pieces, the 20% increase to the 2017 targets, can you walk through those buckets, the synergy upside you think it would come from? And along the same lines, if you think about $600 million of synergies and incremental $350 million off of what you're expecting to realize in 2015, would you be at the high end of your 10% to 12% normalized compared to margin ranges? This is fully incremental, assuming flat sales (technical difficulties)?

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

Adam, you were cutting out just a little bit. I think I got the gist of your question, so if I missed it, please ask a follow-up. But a reminder, our synergies number is all of prepared foods.

And so, we've talked about four primary categories. That being operational improvements, procurement, let's call it logistics, and then some organizational and fiduciary type stuff. But the big three categories were in operational improvements, procurement and manufacturing, and logistics.

So the over delivery so far in the first two quarters has been in the operational improvements, as we've been able -- and by the way, primarily, but not exclusively impacted the legacy prepared foods Tyson business. We've seen some improvement, as we've been able to move some of our product mix between plants, to streamline our cost structure, streamline our operational efficiencies, and by the way, get on top of some service issues that we had in Q1.

So we feel great about our abilities from this point forward to service our customer. As we go forward, what you'll really see is some improvement in the operations category, more improvement in the logistics, and in the purchasing categories over time. And those will -- a lot of that becomes what we are calling a reset of our prepared food cost structure.

So as we take that improved cost structure, and what we believe will be improved raw materials in prepared foods, into 2016, along with the great capabilities we have to launch new innovation, and multiple levers to adjust our pricing and volume and trade and map spend, we see a great opportunity to have that business up into its normalized range, as we move forward.

Adam Samuelson - *Goldman Sachs - Analyst*

And Donnie, just on that point, don't you think, doesn't the incremental $350 million of synergies beyond 2015, wouldn't that get you north of 12%, or do you think that new normalized range could actually prove to be conservative?

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

Adam, it's too early to tell, because of what -- some of those types of synergies that we would use to spend back to grow volume in those categories. Remember, we've got advantaged brands in advantaged categories. And as these categories are growing, we want to make sure that we maintain strong market share in them, to capture the growth as we move forward.

So we'll manage that carefully. And certainly, if there's a way to improve margins, we'll do that. But we feel comfortable now saying that a normalized range of that business should be in the 10% to 12% range.

Adam Samuelson - *Goldman Sachs - Analyst*

It seems (technical issue) like you're implying about 10% for the chicken in the second half of the fiscal year. A, is that accurate and B, does it (technical issue).

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

Adam, I'm sorry. I didn't catch 10%. I caught 10% of your message, which was the word 10%, so I'm not sure --

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Adam Samuelson - *Goldman Sachs - Analyst*

The second half chicken margin, it seems (technical issue).

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

I'm sorry, Adam. Operator, we'll follow-up Adam. I'm sorry, we just can't get the question.

Operator

Michael Piken, Cleveland Research Company.

Michael Piken - *Cleveland Research Company - Analyst*

Just wanted to touch base here on the chicken, and get your view on how we should be interpreting some of the recent pullet data, and specifically your thoughts on how much of the broiler eggs going to Mexico versus in the past, and how much you think is staying here?

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

Sure, Michael. So we are seeing about, round numbers, 7% growth in pullets. We think about 3% of that is going to Mexico. Probably a percent of that is getting spent back to lower the hen age, which leaves about 3% as the growth in the actual breeder flock.

And by the way, so far, year-to-date, I'm just looking at fresh retail, but obviously, we've got great opportunities in food service. You're seeing growth there, as well. But demand for chicken at -- fresh chicken at retail, just using a category that we can get numbers around, is up about 3%, 3.5% versus a year ago.

So there's good, strong demand growth, and we think that will continue, because we don't really see the beef pricing halo changing. There's have ample opportunities, particularly at retail, to drive a lot more pork volume, and not hurt chicken volume at all. So we see a very favorable environment coming out this year coming into 2016, in terms of demand.

Michael Piken - *Cleveland Research Company - Analyst*

Terrific. That's really helpful.

And then following up on that, I know you talked a little bit about some of the issues with the ports and port's life on exports. But it seems like with all these lower cost hogs available, it would seem like projecting to 2016, that there might be some incremental margin opportunities in pork, with all that excess supply for you to run your plants at higher utilization rates? So how should we think, net-net about the increase in pork supplies over your entire business? It sounds like you think there's enough demand out there to support the increased pork and chicken.

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

Certainly, that is a favorable environment for our Business. I would probably be a lot more comfortable talking about the impact to our pork margins overall a quarter from now, when we've seen some of this export, West Coast port issue get resolved. And you'll start seeing freight flow more traditionally than what it has over the last 90 to 120 days, of course. So we'll feel better about having a lot better commentary, more specific commentary about that in our next quarter, but certainly the environment is set up well for our pork business.

And again on the chicken demand, we see strong chicken demand, at least through next year, and I think carrying on. Because and a good reason for that as the millennials enter the marketplace, they over index to chicken, and so we think you're going to see good, strong, chicken growth and we also think you're going to see that beef Halo continue. All that sets up very well for our Business.

Michael Piken - *Cleveland Research Company - Analyst*

Terrific. And then lastly, if you could give us any quantification on how much of a raw material benefit you might expect in the back half of the year in prepared foods from lower commodity prices, recognizing that you are investing more into the brands? Thanks.

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

Let me quantify that this way. The pork cut out is down about 40% versus a year ago. And the items within the cutout that are showing the most weakness are the further processing items.

So if you look at those, hams, delis, trim, those are the items that have shown the most weakness. And certainly, that's favorable for our prepared foods business. So hopefully, that gives you enough color around --

Now, one thing to add. we do over index a little bit versus our competitors on beef, because our hot dog business and others, a couple other businesses in our portfolio. But still this weakness in the pork cut out, particularly among the grinding meats, is very favorable for our Business.

Michael Piken - *Cleveland Research Company - Analyst*

All right. Thank you.

Operator

Robert Moskow, Credit Suisse.

Robert Moskow - *Credit Suisse - Analyst*

Donnie, I was wondering if I could ask you just to go a little bit deeper on the incremental step up next year, on the synergies in prepared foods. You said it's logistics savings and a reset of the cost structure in prepared foods, but I'm still a little unclear as to what that really means.

Is it a function of procuring raw materials from your internal supplies, that is something that you're not doing now, but you plan to do next year? Is there something else happening, in terms of new processes, or are you taking more steps in your supply chain footprint? Can you go a level deeper for us?

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

Sure. It's not in buying raw materials, or moving raw materials within the portfolio. Because none of that is factored in.

The big improvements are this: As we've been able to combine the footprint, if you'll think back, we had a lot of latent capacity in the Tyson prepared foods footprint. And when we bought Hillshire, we had a perfect opportunity to then take all of that latent capacity out of the system and run more volume, by the way, more branded, not private label volume, through a smaller footprint, and lower our cost structure.

There's still some opportunities now to go through those facilities, and increase efficiencies. Remember, some of them are running new products they've not run before, so we'll see incremental benefits, as we continue to work on continuous improvement, and the operational efficiencies in those plants.

And that will re-rate our cost structure, and then that lower cost structure, obviously, will be selling a lot more branded items than it was before, which is the big move in the prepared foods normalized range from where we were, up into that 10% to 12% range.

Robert Moskow - *Credit Suisse - Analyst*

Okay. I think I get it. And as far as new products, you mentioned the snacking platform. Hillshire also introduced a frozen platform.

Are those platforms going to be running through legacy Tyson plants? And if so can you give us a little update on how well the frozen one's doing? I saw it on shelf. Is it doing okay?

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

So overall, very well. The sandwich items probably didn't have the pull that we wanted them to so, what we're doing is focusing that launch on -- that was a 16 item launch, that might have been a little much. So we're concentrating that launch down to those items that are going to give us the best growth opportunities going forward.

The bowls: if you remember, we had sandwiches and we had bowls. The bowls are doing great. We still think by the way, that will be one of the best launches of the year.

So we feel good about it. It's not exactly like what we thought it would be. But, still, we've been able to manage it to a point it's going to do very well, and we are very optimistic about the platform launches that we have.

By the way, back to the Hillshire platform, both the naturals and the classics are going very, very well, driving great incremental growth to the categories. We feel super about all of the innovation that we've launched, and then what we will be launching in new categories in Q4.

Robert Moskow - *Credit Suisse - Analyst*

Great. Thank you.

Operator

Akshay Jagdale, KeyBanc Capital Markets.

Akshay Jagdale - *KeyBanc Capital Markets - Analyst*

So I want to continue on the prepared foods. You're doing really well, obviously on the cost side. I wanted to focus on the revenue side. Can you tell us what the organic growth was this quarter in prepared foods, if you exclude the acquisition impact? What was organic growth?

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

I can tell you that both the legacy prepared foods business, and let's call it, the legacy Hillshire business, just for clarity, both were over plan on both volume and on operating income, so we feel very good about how the prepared foods business is performing.

Akshay Jagdale - *KeyBanc Capital Markets - Analyst*

Okay. And just on innovation, and more so broadly on reinvesting these cost savings into future growth, can you give us a little bit more color on the innovation pipeline? It was helpful that you talked about the launch into launch, if I may, sandwiches, and that it didn't go as well as planned.

Can you give us some more broader and longer term view on innovation? Because from what I remember, one of the best parts about this acquisition was the R&D and innovation team at Hillshire feeling much better about their prospects, as part of Tyson. Can you give us an update on that? Sure. It's been exciting to see both of the R&D teams come together, combined with all of the innovation and business unit teams come together, and find a lot of opportunities between food service and retail, to be able to grow our business through innovation. One of the primary tools that we use to measure whether or not we've got enough innovation in the pipeline is what we call a vitality index.

What we do, we look at products that were created over the last three years, and we determine our percentage of revenue that comes from these new products. So, for 2015, we're expecting to retail to be at about 14% of vitality index. And by the way, that's in the best in class range. And for food service, we are currently expecting more than 20%.

So these are very aggressive goals, but we have a great team that continues to focus on looking at insights and creative innovative solutions to fill the consumer gaps, so that we are always relevant. We know we're in relevant categories, and this way we know we've got relevant innovation inside those categories. Okay. And then what one last one on chicken. Just broadly speaking, longer-term, is it your contention that the industry is not cyclical anymore?

Obviously, historically, the industry would oversupply the market and margins would flip around within a year. It's not been the case this time around. It looks like that process might be starting now, but you're saying it's not going to impact you in 2016?

So can you talk a little bit broadly about, do you think the industry is not cyclical anymore? If so, why? And it if it is cyclical, when the cycle does turn, when the industry will over produce, which, none of us really know when that will happen, do you still believe you can grow EPS 10% when that happens?

Thank you.

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

Okay, Akshay. So we are certainly working very hard not to be cyclical. That's our whole path forward. So if you look at our Business, and you look at over the last two or three years, our improvement in our sales mix.

By the way, even with the operational issues we had in our fully-cooked retail chicken business, our branded chicken business, we're back to within a share point or two of where we were before that happened. So the Tyson brand at retail is very meaningful. It's very resilient, and we think it's got lots of opportunities to continue to grow.

We've got a great, broad portfolio. We've got a great innovation pipeline. And by the way, new and improved innovative capability for the future.

We've seen a lot of operational improvements. We've got plenty of cash flow to do whatever CapEx we need to do, as illustrated by taking the South Georgia plant, and taking it from an unprofitable product mix into one of our most profitable categories, our fresh tray pack business.

So those are some of the things that we're doing to decrease our cyclicality, to give our investors a consistent, stable earnings growth over time. And yes, we do believe we can see 10% growth.

Akshay Jagdale - *KeyBanc Capital Markets - Analyst*

But what about the industry? What's your view on the industry?

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

We spend all of our time, Akshay, focusing on what we are going to do. And if you'll remember, we put a forward demand picture out 12 to 15 months, and then we build a production plan based on that demand curve, so that we know how we can manage our business, and our production. That keeps us in a position to buy versus grow.

So in a period of increased industry supply, then we'll simply buy that raw material, add value to it, and as long as we are focusing on the customer and growing our value-added sales, we've got a great footprint to do that, within, by the way, with plenty of value-added capacity over the next year or two. So we are very comfortable that in the scenarios that we can paint forward, we've got a great outlook.

Akshay Jagdale - *KeyBanc Capital Markets - Analyst*

Okay. Thank you.

Operator

Brett Hundley, BB&T Capital Markets.

Brett Hundley - *BB&T Capital Markets - Analyst*

Donnie, I wanted to stay on the topic actually, and maybe ask Akshay's question a different way, as well. When you think about your strategy in chicken, specifically buy versus grow, can you discuss the level that you're comfortable taking your portfolio, as far as buy versus grow, as a percentage of your portfolio?

And as the chicken cycle potentially slides off here in coming periods, I think there's more of a view today that we could see a slide, instead of that sharp fall-off we've traditionally seen across the industry. As the chicken cycle potentially slides off, or in that type of scenario, is Tyson's chicken business equipped to return margins in line with what you're looking for today, 11% or so?

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

So if I understood the question right on the front end, we think we've got the opportunity, depending on the part that we're buying, to buy up to as much as 10% of our sales, of the product that would go into our sales. So we feel very good about the flexibility that we have within our network, to manage buy versus grow. If you remember a couple quarters ago, I think, wasn't it, Dennis, when we raised our normalized range in chicken?

Dennis Leatherby - *Tyson Foods, Inc. - EVP & CFO*

Yes.

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

And certainly, we've had great favorability in the marketplace for this year. It's certainly our intention to continue raising our margin expectations. And with the work we've done to balance our portfolio across the various bird classes, increasing our value-added sales, right-sizing our small bird business, we under index to big birds, but that's fine for us, because there's a lot of that product available on the marketplace to buy.

We have great Tyson brands. We're number one at frozen retail, number one in frozen snacking chicken. We're number one in fresh tray pack, number one in IQF, number one in Cornish, so we've got a great brand presence in categories that are very meaningful to consumers. So that gives us the confidence to be able to look at our business forward and feel very good about our ability to deliver.

Brett Hundley - *BB&T Capital Markets - Analyst*

Okay. And then my second question is two parts here. One near-term, and one longer-term, higher level.

First, starting with the question on your beef business. You mentioned at the outset, that results were softer than expected in a tough environment. And surely, when we look at your out performance relative to a beef industry margin that we calculate, your out performance that we've traditionally seen has come in a little bit during the quarter, and you mentioned a couple different things with the West Coast port and your plant in Dakota.

Can you give us a sense of what percentage of the impact was from Dakota, and maybe how long that would be expected to last? You gave some assumptions on the port clearance, but can you talk a little bit more about your beef plant there? And then longer-term, and somewhat related, how important and necessary is it for you, Donnie and your team, to remain a multi-protein company, offering everything that you do today?

Thank you.

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

So if I look at the impact of our Dakota City start up, to the rest of -- well, to our Q2 results, if I think about our index, it may have been about, I don't know, 40% to 45% of the change in how our index performed, versus where we had been performing in the previous couple of quarters. Now remember, in that quarter, cattle supplies were very, very tight.

So well, it had a huge capital investment. We needed to start the plant up, so we did it, but we started the plant up in the quarter when we probably had the lowest cattle supply, so that didn't help matters any. But the good news is, the plant started up fine. We're working through the startup issues on Q3, and it will help give us access to bigger cattle, which was what the whole process was well all about.

So yes, that had an impact. As we look forward, we think it's very important that we have a presence in the whole broad array of meat protein and as you know in our portfolio, some non-protein items that are very complementary to protein. So yes, you should expect us to continue to have that in the portfolio.

Brett Hundley - *BB&T Capital Markets - Analyst*

Thanks, Donnie.

Operator

Diane Geissler, CLSA Limited.

Diane Geissler - *CLSA Limited - Analyst*

I had a question about your comments on buy versus grow, and wanted to make sure I understood them. You said you had the capability of buying up to 10% of your sales on the outside market?

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

For that part. I'm sorry. For that part. So if it's breast meat, we can buy about 10% of the breast meat that we sell, and run it through our plants.

Diane Geissler - *CLSA Limited - Analyst*

Okay. So just thinking forward, and obviously it's pretty clear to everybody that we're moving through a period where there's going to be significantly more production, whether or not you think 3% of the eggs are going to Mexico, or whatever that percentage is. You raised your expectations for total poultry availability this year, from the time you reported your last quarter.

So I guess the question is and I think this is the investors are often asking me, so how we should we think about buy versus grow? Pretty clear, you have probably been raising most your own sales here recently, but as you look into the second half of 2015 and into 2016, can you talk about what your production plans are versus the industry, to help give us a better idea about how exposed you're going to be to leg quarter prices here going forward, and how exposed you will be to the boneless skinless breast meat price as we move through the summer and into 2016?

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

Sure. For the year our production this year versus last will be flat. We've been up a little bit in the front half of the year. And after July 4, our production will be declining versus year-over-year.

So for the total fiscal year, our production volume will be flat. Which, by the way to your point, does reduce risk of export vulnerability, and that type of thing.

Of course, let me hasten on to add, because I don't think I've mentioned this before, and I think it's really important. Over the last three years, we've reduced the amount of export leg quarters we sell, every bit of 30%. And if you go back to probably FY10, sometime in late FY09, FY10, we are probably down in half. So we feel very good about, and these are the things that we're doing to provide a more consistent, stable return that grows over time. And so we feel very good about our ability to maintain production flexibility and to improve our mix.

Diane Geissler - *CLSA Limited - Analyst*

And then in 2016?

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

I think our production will be basically flat in 2016. We think we'll be buying more raw material in 2016 than we do this year, and by the way, we're up 50% this year over last year.

We think our sales volume will be up. I think I mentioned earlier, about 1% or 2%. Our dollar sales will be up a little bit higher than that. But, feel very comfortable that we can buy the raw material we need, and add value to it, and be able to maintain our margin structure.

Diane Geissler - *CLSA Limited - Analyst*

Okay. Then I wanted to ask about the cash priorities, which are pretty consistent period-to-period in terms of your list of items that you're spending your cash on. But I wanted to ask about share repo, which I'm generally not a big fan of share repo. But I think there was a big disconnect between the sell side recommending your stock, and you seeming very confident in your ability to generate 10% plus EPS growth.

And the buy side, just if you look at the fact that the stock has not done much over the last 12 months. Given your level of confidence in your ability to increase earnings 10% from here on out, why is share repo not higher on that list of priorities, if you really feel that the shares here are undervalued?

Dennis Leatherby - *Tyson Foods, Inc. - EVP & CFO*

Great question, Diane.

But remember, it's important for us to maintain an investment grade rating. And so what we are trying to do is get down below net debt to EBITDA of about 2 times, and we think the sweet spot for us would be in that 1.5 to 2 times area. So when we get there, then throwing off $1 billion and growing in free cash flow, that opens up the door for returning cash to shareholders, in the absence of major growth opportunities. I would hurry on to say that growing is, first and foremost, most important to us, but that being said, certainly we can start buying back stock at that time. I would see that as an opportunity, at the start of 2016, should be a good time to get started at the rate we're running.

Diane Geissler - *CLSA Limited - Analyst*

Okay. So you think you'll be sub 2 times by the end of this fiscal year?

Dennis Leatherby - *Tyson Foods, Inc. - EVP & CFO*

Yes.

Diane Geissler - *CLSA Limited - Analyst*

Okay. Terrific. Thank you.

Operator

David Palmer, RBC Capital Markets.

David Palmer - *RBC Capital Markets - Analyst*

At your analyst day, you mentioned that you believe Tyson's chicken segment market margin would be 5%, if the industry margin were to go to zero. Were you implying that 5% would be your best thinking for a worst-case margin for that segment? How did you arrive at those numbers? Thanks.

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

So what we did is we just looked at our incremental improvement over the last four or five years in relative benchmarking services. The real point is, I think, looking forward, is we feel great about where our business is. Yes, we benchmark ourselves consistently, but for next year, we think we'll be at or above the upper end of our range, and our guys are running a great chicken business.

David Palmer - *RBC Capital Markets - Analyst*

When you think about the export bans, typically, I don't know how many case studies there are or similar situations, how fast do those bans lift typically, after an avian flu issue subsides?

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

Typically, and I'm emphasizing typically, 60, probably more likely, 90 days. And so for us, Arkansas has been hit a little bit more than the other states, because of our production footprint. And we saw an AI event in Arkansas in early in the first week of March.

But as we continue, those countries that ban the United States, and not on a state-by-state basis, as you continue to see AI infections in turkey and table leg flocks in the northern Midwest, you can pretty well figure a timeline no sooner than 60 to 90 days out front before the ban will be lifted.

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David Palmer - *RBC Capital Markets - Analyst*

And then one last one, removing human antibiotics seems to be a restaurant industry move, at least, that will play out probably through the end of 2016, if you're using McDonald's as an indicator. What does this mean? Will this be the new price to play for the food service side, and perhaps increasingly in the supermarket side? What ultimately will this mean for your chicken segment margins over the next couple of years? Thank you.

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

David, it really won't have a margin impact. Our view is that by eliminating the human-used antibiotics out of our poultry production, by September of 2017, that is the most reasonable and responsible approach to balancing a global health concern about antibiotic resistance, with our core value of taking care of the welfare of the animals that are entrusted to us. So that was the impetus about what we're doing.

It wasn't necessarily in reaction to anything any customers were doing. It was a matter of, we've been working on this effort for several years. We've reduced human-used antibiotics in our supply chain by over 80% in the last four years. And we now think we can see a point in the future a couple years from now when we can not have to use human-used antibiotics in a poultry production. But I don't think that, back to the original point, it will not have a material impact on our cost.

David Palmer - *RBC Capital Markets - Analyst*

Thank you.

Operator

Tim Tiberio, Miller Tabak.

Tim Tiberio - *Miller Tabak - Analyst*

Moving beyond some of the near-term export challenges, I wanted to get your thinking about medium-term global poultry or chicken demand growth. One of your global peers in Brazil recently stated that they felt that supply growth within Brazil, unlike the US, was still fairly benign. And I guess, looking out into 2016, if we're not seeing the supply growth come back as quickly from one of your global export competitors, do you think that this could actually create a relief valve, or a window of opportunity if we can get that passed some of these export bans?

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

So certainly that would be a favorable development. As we look forward, we think protein demand globally is going to continue to grow at about 2% a year, maybe just a tad under that. We think chicken probably outpaces the other proteins, just because it's the most efficient converter of feed into meat.

That could be a headwind. So there's still time for that dynamic to change. So it's a little bit too early for us to call it, but certainly, that being the case, that would be helpful to the back half of our 2016 year.

Tim Tiberio - *Miller Tabak - Analyst*

Great. And just lastly, the USDA mentioned that they're starting testing within animals of this potential vaccine for the AI strain. I know it's very difficult to handicap at this point, but have you had initial conversations with the USDA and FDA, I would assume, and do you have a high confidence level that we could get that into production, potentially before we start seeing the southern migratory path of some of the wild water fowls, which I guess have really been the issue with the spread of AI this year?

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

It's really too soon to say, Tim. We've got lots of contacts in what I will call animal pharma that we work with. And it's just too early to say whether or not we'll have an effective vaccine.

Tim Tiberio - *Miller Tabak - Analyst*

Okay. Thanks.

Operator

Tim Ramey, Pivotal Research Group.

Tim Ramey - *Pivotal Research Group - Analyst*

A little bit of a follow-up on the last question. Donnie, it's been a spectacular couple of years, but it wasn't spectacular for some of the reasons we thought it would be, which relates back to the feeding the world, growing middle class, where we are going to see more protein demand globally. Do you think that's just demand deferred or is that demand denied? Is that still part of the long-term story here?

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

I really think it is. As we look across the globe, you've got economies in some of the key growth areas, that have slowed down, maybe more than we hear about. And so I think that demand growth is temporary.

As we continue to look, and we've just spent a lot of time over the last several months looking at population growth, income growth, those regions of the countries where that will happen, how much of the growth in food consumption, and how much of the growth in value-added food consumption is going to happen outside of US. And it is significant over the next several years.

So, I think maybe near-term, we've seen a little unexpected softness. But I think, as we look out about three, four, five years from now, we'll look back on this time as a small dip in a period of time where we still saw about 2% consumption growth in protein worldwide.

Tim Ramey - *Pivotal Research Group - Analyst*

Great. And then just on food service, wondering if you're seeing any mix change in reaction to perhaps limited supply of liquid eggs, or the beef supply being so difficult? QSRs, is there incremental shift in what the menu looks like?

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

We think that, of course, 50s have been very soft, but 90s have remained very, very high. So we think, and it seems to us that the cut out is shifting a bit and you've seen 50s prices firm back up. So as we look at that, what we think that's going to do is drive incremental growth, particularly at QSR, in chicken.

We also are seeing fortunately, because the QSR Mexican category is growing the most. So QSR chicken is probably up 8%, QSR Mexican is up 11%. And QSR Mexican favors our portfolio in a couple of ways. It uses dark meat, and then also is a pretty heavy user of tortillas. So that's good for our business too, so as we look at the trend going through the summer, we feel very good about it being favorable to our business.

Tim Ramey - *Pivotal Research Group - Analyst*

Excellent. Thanks.

Donnie Smith - *Tyson Foods, Inc. - President & CEO*

So before we go, I'd like to say again that we are building momentum in prepared foods. We are capturing synergies, and we're transitioning to a less volatile, higher return business, that gives us the confidence that we'll achieve our annual guidance of $3.30 to $3.40 adjusted EPS this year, and at least 10% EPS growth next year. Thanks for your time today, and have a great week.

Operator

Thank you, speakers. That concludes today's conference. Thank you for participating. You may now disconnect.