Nomad Foods Limited

Second Quarter 2022 Earnings Call

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Jason English, *Goldman Sachs*

Robert Moskow, *Credit Suisse*

Steve Powers, *Deutsche Bank*

John Baumgartner, *Mizuho Securities*

Cody Ross, *UBS*

Daniel Moore, *CJS Securities*

PRESENTATION

Operator

Good day and welcome to the Nomad Foods' Second Quarter 2022 Earnings Call.

After today's presentation, there will be an opportunity to ask questions. Please note that this event is being recorded.

I would now like to turn the conference over to Anthony Bucalo, Head of Investor Relations. Please go ahead.

Anthony Bucalo

Hello and welcome to the Nomad Foods' second quarter 2022 earnings call.

I am Anthony Bucalo, Head of Investor Relations, and I am joined on the call by Stéfan Descheemaeker, our CEO, and Samy Zekhout, our CFO.

Before we begin, I would like to draw your attention to the disclaimer on Slide 2 of our presentation. This conference call may include forward-looking statements that are based on our view of the Company's prospects, expectations, and intentions at this time. Actual results may differ due to risks and uncertainties which are discussed in our press release, our filings with the SEC, and this slide in our investor presentation which includes cautionary language.

We will also discuss non-IFRS financial measures during the call today. These non-IFRS financial measures should not be considered a replacement for and should be read together with our IFRS results. Users can find the IFRS to non-IFRS reconciliations within our earnings release and in the appendices at the end of the slide presentation available on our website.

Please note that certain financial information within this presentation represents adjusted figures for 2021 and 2022. All adjusted figures have been adjusted for exceptional items, acquisition-related, share-based payment and related expenses, as well as non-cash FX gains or losses. Unless otherwise noted, all comments from hereon will refer to those adjusted numbers.

With that, I will hand you to over to Stefan.

Stéfan Descheemaeker

Thank you Tony.

Good afternoon everyone and thank you for joining us on the call today. We're pleased to review our results for the quarter.

We performed well in Q2 despite difficult macro conditions across Europe. We began the year already addressing the inflationary environment and we adapted quickly to meet additional challenges brought on by the Ukraine war, both inflationary and otherwise. We're encouraged by the resilience of our brands, our people, our consumers, and our customers.

Our revenues grew 17% while our organic sales strength improved sequentially from Q1. Our value share was stable while we passed price increases to mitigate cost inflation. Our supply chain provided excellent service to our customers with fill rates improving materially in the half year. Year-to-date, service levels have improved 160 basis points. We will continue making crucial supply chain improvements while integrating and introducing new products to further drive organic growth in our newly acquired Adriatic business.

We are now through the most challenging period of the year on input costs and we have covered nearly all of our raw material costs for 2022. Additionally, we have worked effectively with our retail partners to set our pricing at levels that address input cost increases and achieve gross margins, which will allow us to appropriately support our brands. As a result, we expect our business performance to improve materially as the year goes on.

As all of you know, Nomad has been navigating an extraordinary environment that includes high consumer uncertainty, inflation, as well as the outbreak of the war in Ukraine. The normal cadence of our business will be to have price discussions annually with our retail partners, executing the increases in Q1, but given the rapid change in input costs, our pricing actions have become far more dynamic given the realities of the dramatic cost inflation.

As we pass price increases this year, we expect pricing to fully offset volume declines, leading to low single-digit organic sales growth for the year, which we see as a relatively good outcome and a testament to the strength of our brands.

We believe further price increases will be necessary to recoup cost inflation and maintain our margins. This should allow us to exit the year with the gross margins and cash flow appropriate to maintain the proper investment in our business.

With that, I'd like to recap our second quarter key financial metrics, beginning with reported revenues of €687 million, which increased by 17%, driven primarily by the first-year inclusion of our newly acquired Adriatic business. Organic revenue declined by 3.2%, a sequential improvement from Q1 but still reflecting the lingering impact of COVID lockdown comparisons and category weakness across Europe.

We delivered an adjusted gross margin of 28.2%, 260 basis points lower year-on-year, reflecting soft organic sales and higher raw material costs. Adjusted EBITDA of €127 million represents a 3% increase compared to last year as higher input costs offset other positive factors. Finally, adjusted EPS was €0.40 per share, flat year-on-year.

Turning to Slide 4, our 17% revenue growth benefited from strong ice cream sales in the Adriatic region while we realized 2.5% net pricing for the Company in the quarter. In July, we saw a recovery in organic sales strength as our pricing was delivered to the market and we lapped more normalized results.

Q2 represented the most unfavorable mismatch of price and cost for this year and this weighted on our margins, but we are now turning this favorably. As we discussed in Q1, there is always a time lag between COGS increases, which are linear, and our price increases to the retailer, which are staggered. We are now better matching our pricing to total inflation, and we are maintaining our dialog with retailers about further price initiatives which will recover our gross margin towards long-term average levels. Additionally, we have good visibility on cost as we are more than 95% covered for the rest of the year, up from 85% in Q1. On energy, we are covered for this year and well covered for 2023.

In H1, we landed our pricing in the market. In a dynamic pricing environment, our overall value share was stable while we gained 60 basis points in must-win battles. Our must-win battles are in the categories and markets where we define our success, and we are pleased with this performance. When looking at the challenging consumer environment, high inflation as well as the consequences of the Ukraine war across Europe, we are taking a more conservative posture.

As a result, we are amending our adjusted EPS guidance range for 2022 to €1.65 to €1.71 from our previous €1.71 to €1.75. This represents high single-digit growth. Longer term, our business strategy is on track and we are confident we are still on plan to deliver our 2025 adjusted EPS guidance of €2.30.

Turning to Slide 5, Nomad is a Company that is always learning and evolving through new challenges. We have done this as an organization many times. As we discussed at the top of our remarks, the war in Ukraine exacerbated the already rising inflation in Europe and disrupted global supply chains, especially in agriculture and energy. We adapted quickly and in Q2, we accelerated our fish diversification strategy, grew Green Cuisine, and moved quickly to fully integrate our rapidly growing Adriatic unit.

First, we are aggressively de-risking our fish supply. We had plans to address this issue before the war, but we have picked up the pace in Q2 as the volatile global macro environment is threatening fish supplies. We are securing new sources of farmed fish as well as adding geographic sources and species to augment our current supply. We remain committed to sustainability and we are staying within MSC and ASC guardrails in these plans.

Second, Green Cuisine had a strong half year with mid-single-digit organic growth despite negative headwinds in the category. Green Cuisine has grown market share nearly 300 basis points in the trailing

52 weeks. In Q2, Green Cuisine won multiple trade awards in the U.K. and one in Italy. We recently launched an advertising campaign in the U.K. which is being well-received by consumers and retailers.

Finally, Q2 sales growth in our newly acquired Adriatic business was well ahead of plan with strong volumes in Croatia and Bosnia and Herzegovina. In May, ice cream sales had a good early start to the season and benefited from historically high temperatures. Food service was strong as COVID restrictions were lifted and traffic returned to restaurants, bars, and hotels on the coast. Our integration is ahead of schedule and we are excited about the future of this new acquisition.

With that, I will turn the remarks over to Samy. Samy?

Samy Zekhout

Thank you, Stéfan, and thank you all for your participation on the call today.

Turning to Slide 6, I will provide more detail on our key second quarter operating highlights. We reported revenues of €697 million in the second quarter, a growth of 17% year-on-year, driven primarily by the acquisition of our Adriatic business. As a reminder, that transaction was finalized in September 2021 and will become fully integrated into our organic numbers in Q4. Second quarter revenues also had a small benefit from favorable FX. These revenue components were offset by a 3.2% decline in organic revenues due mostly to lockdown comparisons and a generally weak performance across the category.

Gross margins were 28.2% during the second quarter, reflecting a 260-basis point decline versus last year. The inclusion of the Adriatic, whose gross margins are seasonally higher at this time of the year, helped offset gross margin pressure.

Moving to the rest of the P&L, second quarter COGS increased 21.4%, an increase of €88 million versus last year. Our adjusted gross profit grew 7.2% to €197 million. Adjusted operating expense of €92 million was up 19% year-over-year. This rise in operating expense was due exclusively to the inclusion of the Adriatic division in our numbers. As a percentage of sales, operating expense was 13.2% this quarter versus 12.9% last year, an increase of 30 basis points.

Our EBITDA and EPS performances were impacted negatively by the rapid rise in input costs. Second quarter Adjusted EBITDA of €127 million was up 3% versus last year and our adjusted EPS of €0.40 was flat.

Turning to cash flow on Slide 7, we generated €36 million of adjusted free cash flow in the half year, equating to 25% adjusted free cash flow conversion. This is below last year, due mostly to a build-up of raw material inventories as well as the inclusion of a seasonal working capital outflow of the Adriatic business which was not in the (inaudible). Change in working capital was €125 million use of cash, up sharply from last year as we built raw material inventories in anticipation of possible shortages. We believe this was prudent considering the disruption risk in the raw material market. The inclusion of the Adriatic also impacted this result.

Capex of €34 million was flat versus a year ago. As we mentioned in Q1, we do expect higher Capex for the year as we support strategic investment decisions and incorporate the Adriatic into our broader spending plan. Change in cash tax decreased €6 million to €25 million, while cash interest was stable at €38 million. We expect to deliver improving free cash flows through this year but with delivery weighted heavily towards Q4; however, the combination of stepped-up Capex, higher raw material inventories, and the first-year implementation of the E.U.'s Unfair Trading Practice directive, we delivered short of our typical 90% to 100% long-term conversion target.

With that, let's turn to our final slide, Slide 8, to review our 2022 guidance, which we are adjusting from CAGNY and our Q1 earnings report in May. Our guidance on sales and EPS is based on our best projections of cost inflation and other factors in the second half of 2022.

As Stéfan mentioned in his remarks, we plan to recover cost inflation through pricing in the back half of the year, and thus we expect an improving gross margin profile over the course of the second half. To be clear, we expect a sequentially better financial performance in the back half of the year based on improving margins as our pricing takes hold.

We expect organic revenue growth in the low single-digit range for 2022. This will be driven by price increases in half two. Low single-digit growth is consistent with what we guided in May. We expect a significant spread between price and volume, but we expect price to fully offset volume declines. We expect the Adriatic division contribution to drive reported revenue guidance of high single-digits for the full year.

For capital allocation, it is our top priority this year to use our cash to support operations. We still see share buyback as central to driving shareholder value; however, in Q2 we did not repurchase shares after moderate repurchases in Q1. Our $500 million share buyback program remains in place until August 2024.

For the balance of 2022, we are taking a cautious stance in consideration of a volatile consumer outlook and other factors such as the impact of the Ukraine war across Europe. As a result, we are amending our adjusted EPS guidance to a range of €1.65 to €1.71 per share from the previous €1.71 to €1.75. We believe that we remain on track to reach our 2025 adjusted EPS target of €2.30.

That concludes our remarks. I will now turn the session over to Q&A. Thank you.

Operator, back to you.

Operator

Thank you. We will now begin the question-and-answer session.

Our first question today will come from Andrew Lazar with Barclays. Please go ahead.

Andrew Lazar

Great. Thank you so much.

Nomad's running organic sales down about 4% in the first half, and this implies obviously more than 4% growth in the back half. I appreciate more pricing is to come and, as you said, comps are easier, but I guess mid-single-digit organic seems maybe somewhat of a tough task in light of the macro environment in Europe. Can you discuss a little bit of the bridge on how you get there? Is it mostly pricing kicking in with an expectation that volume elasticity does not worsen from here?

Then pricing, as you mentioned, didn't accelerate much in 2Q but it sounds like more is going to become visible in the P&L. What's your expectation for the benefit of pricing for the full year? Thanks so much.

Stéfan Descheemaeker

Good morning, Andrew. Thanks for the question. Let me handle the question and let me dissect a bit the numbers to your point.

I think H1 was really representative of the end of the COVID comparisons, and in terms of price, however, we successfully negotiated our price increases, it really comes at the end of the quarter. When I see, for example July, July excluding the Adriatic in terms of sales is around plus-7%, which is really representative of COVID is behind us, and indeed the price increases that we have negotiated during the first half are really starting to kick in.

Then moving forward to the full year, what we see is we're expecting pricing in the region of mid-teens. Elasticity is in line in terms of market share and obviously we need to (inaudible) volumes will decline as a result, and obviously with that, we know we're going to be there. That's the combination. It's really about end of COVID, market share, and more importantly, it's pricing.

Samy, any other add ons?

Samy Zekhout

No, I think effectively there will be an acceleration over Q3 and Q4, that's for sure.

Andrew Lazar

Great, and just to make sure I heard it right, you said July, sort of on an organic basis was up 7, I think, and then…

Stéfan Descheemaeker

Yes.

Andrew Lazar

…and I think on a full year basis, you said you'd expect mid-teens pricing? Did I hear that right?

Stéfan Descheemaeker

Correct.

Andrew Lazar

Great. Thank you.

Operator

Our next question will come from Jason English with Goldman Sachs. Please go ahead.

Jason English

Hey guys. Two quick questions.

First, a follow-up on that pricing. It sounds like you have most of it already negotiated and locked in, but I think I did hear you say in prepared remarks that you believe you're going to need further price increases to cover the cost pressure, so can you clarify?

Stéfan Descheemaeker

Yes, hi Jason.

Yes, absolutely. We have gone through let's say a first wave, as we have discussed previously, and successfully, and as we alluded to earlier, what we had said is effectively that we would consider a third wave towards the end of the year on pricing, which is primarily an advancement of the Q1 pricing into Q1 of next year. That's clearly now in the plan, for sure, yes.

Jason English

Thank you. That makes a lot of sense. Appreciate the clarification.

The acquisition, the Adriatic region, the M&A contribution continues to exceed our own expectation every quarter. It looks like the business is doing quite well. If it were included in your base, what would your organic sales growth look like through the first half of the year?

Stéfan Descheemaeker

It's a very good question, and indeed it's working extremely well, to your point, ahead of expectations, and market share-wise as well, by the way. They also have increased their pricing, so all is green in the Adriatic. When you compare, let's say, the minor 3.2% that we have, excluding the Adriatic, for the existing business in terms of sales, we would do a pro forma of Q2 for the Adriatic and we would include it obviously in the business, we would be just short of plus 1% for the full business. That's what it is.

Jason English

Wow, quite a swing.

Stéfan Descheemaeker

Yes, it's a sizeable difference.

Jason English

Yes, for sure. Do you think that's durable or is this just unique because of the warm weather boosting ice cream, or is this really kind of reflective of what this business can contribute to you?

Stéfan Descheemaeker

Well, obviously weather is playing a role, don't get me wrong. God knows, Jason, what's going to happen next year in terms of heat; nobody knows this. The only thing we know is also we're gaining market share, and we also know that, well, we could sell even more. So we're learning for us in quarter four, okay, can we also even produce ahead of time? We're learning all these things, so difficult to know.

Let's not forget that the heat wave is playing a negative role for the rest of the business, much less pronounced, to be fair, but it's a bigger business. So yes, all in, we're very, very pleased with what we see with the business. We're learning ice cream and we love ice cream, Jason.

Samy Zekhout

Maybe Jason, what I would just add to Stéfan's point is the fact that effective this year, we have seen as well an acceleration of the business driven by the fact that tourism has caught up as well, which effectively has pushed the impulse category probably even further, so there is a bit of advancement of effectively what we had anticipated in the (inaudible) year into this year. But let's say from a health standpoint, this is a very healthy business with good growth potential, definitely.

Jason English

Great to hear. Thank you all. I'll pass it on.

Operator

Our next question will come from Rob Moskow with Credit Suisse. Please go ahead.

Robert Moskow

Hi, thanks.

Your guidance assumes mid-teens pricing for the year, which means a rapid ramp in the back half, but I think it also means a 15% decline in volume for the year with an equally rapid decline by the end of the year. You said that you've loaded up on a lot of raw materials to prepare for shortages, so what's the impact of a decline in volume like this on your operating leverage and also on your balance sheet?

Stéfan Descheemaeker

Yes, I think, Rob, the net of all of that is effectively going to give a low single-digit growth for sure. There is pricing, there is mix, and there is volume as well, so when you combine the totality of that, we are not getting to a mid-teens volume decline, we are getting to probably a high single-digit volume decline. Those costs are being factored into our operating, let's say, costs overall. We've been planning for that as we effectively entered into this year with the significant pricing (inaudible) at some point, and that's reflected in our gross margin projections.

Robert Moskow

That implies a pretty significant mix benefit. What's driving the mix benefit?

Stéfan Descheemaeker

Well, we clearly are having most of the categories that have higher margins, the countries that have higher margins that are clearly executing pricing and driving those categories with higher margins that are pushing, that are going faster than the rest. The fact that, for instance, we are starting with the U.K., very much all of the pricing wave is a significant contributor as well to this acceleration, which explains effectively the fact that there is a mix factor on the category side and on the country side as well.

Robert Moskow

Okay. Thank you.

Operator

Our next question will come from Steve Powers with Deutsche Bank. Please go ahead.

Steve Powers

Yes, hey. Good morning. Can you hear me okay?

Stéfan Descheemaeker

Yes.

Steve Powers

Okay, great.

Just on that last—just to clarify, is mix expected to be positive on the year or is it expected to be negative on the year, such that you have mid-teens pricing, negative high single-digit volume, and sort of a bit of negative mix to get you back to low single-digits for the year? I'm a little confused if it's positive of negative mix you're expecting on the year.

Stéfan Descheemaeker

No, actually it's—the pricing range on average is about, let's say the mid-teens that we have just talked. The volume is going to be in the range of about, as I said, high single-digits, I would say on that one, and there is effectively a balance of things, from a mix standpoint and there is as well an increased support being driven by the promotion that we need to put in place in order to drive the business overall, which effectively equates to the low single-digit growth for the business.

Steve Powers

Understood. Promotions. Okay. Thank you.

Is there an ability for you, given your visibility and some of your hedge positions into '23, is there—is it too early to talk about an early expectation of inflation for '23 at this point? Any color you can offer us as to what '23 looks like from a cost inflation standpoint?

Stéfan Descheemaeker

I think it's too early, I would say, at this stage. There's a lot of moving parts, as you have seen. Some of the commodities are going down now for some of the items, even though effectively those represent a tiny portion of our portfolio. There is effective a downward trend on those. On the others, there is a stabilization at the peak point and we are effectively as well continuing extending some of the hedging activities we have in our areas like energy in order to cover for the next year. So, I think expect more as we provide guidance for 2023.

Steve Powers

Understood. Okay.

Then if I could, I wanted to ask about operating expenses. They came in higher than I think we and consensus was expecting this year. I understand a lot of that is probably Fortenova and that rolling through ahead of schedule. From your perspective, were the operating expenses in line with your expectations? To the extent they came in ahead, is it really only Fortenova, or are there other inflationary aspects impacting that line of the P&L as well that we should be thinking about?

Stéfan Descheemaeker

No, there is clearly—I think this is the area, as we have talked in the past, on COGS and on operating expense, where we clearly have pretty good visibility on, and except Fortenova, there hasn't been any kind of noticeable item that would be of importance for you guys.

Steve Powers

Okay, very good. Thank you very much.

Operator

Our next question will come from John Baumgartner with Mizuho. Please go ahead.

John Baumgartner

Good morning. Thanks for the question.

Samy or Stéfan, I'd like to ask about the positioning for your frozen categories here at retail. From a pricing perspective, the price gaps relative to shelf stable and fresh, they seemed to have widened even compared to the credit crisis 15 years ago, and I'm curious, A, how do you think about consumers trading down to frozen in this environment where the price gaps would seem to be pretty favorable for relative value, and then, B, what are you seeing from retailers?

Do you expect them to manage the frozen category differently over the next six to nine months? Are they increasing visibility for your categories? Are they supporting non-price promotions for these categories? How do you think about frozen versus fresh and then ambient in this environment? Thank you.

Stéfan Descheemaeker

Well overall, to your point, John, I think this is a category that has done well in recession time, and at this stage we're seeing the same. In terms of fresh versus the others, I think it's still very difficult to read, John, because at the same time we see that some people are increasing price later, so let's see a bit where things stand. But what we see at this stage, we haven't seen any significant difference with the other categories.

I think the big piece to remember is, A, we're getting out of COVID and additional new consumers are coming, and, B, we can see some people coming from, let's say, out of home to restaurants and moving down back to the retailers, and obviously again this category is doing well.

I think what we will also do together with the retailers is to explain how great this category is, not only in terms of affordability but also in terms of waste, for example. This is great in terms of cost of living. This is a category where you can keep it, it doesn't lose anything, and so these are the kinds of things we're going to do much further in the future. Are we confident with the long-term future of this category, especially in recession times? Absolutely.

John Baumgartner

Okay. Thanks for that.

Then Samy, a question for you on the guide for 2022. You've lowered EPS but maintained net sales in that high single-digit range. Can you discuss maybe where in the P&L you're taking a more conservative stance, tied back to the macro comment? Is it more gross margin, is it more OpEx, you may have to re-invest back more? Just any clarity on the incremental change to the outlook. Thank you.

Samy Zekhout

Yes, it's not on the OpEx, to be very clear, and on the COGS we have increased visibility overall. The reality is that we are really simply reflecting a cautious view on the fact that the economic environment is becoming quite uncertain there, so there are pressures on effectively the top line that would require probably further strengthening of the business in order to make sure that the pricing is going through over the full year.

John Baumgartner

Okay. Thank you very much.

Operator

Our next question will come from Cody Ross with UBS. Please go ahead.

Cody Ross

Good morning. Thank you for taking the questions.

I just want to follow up on that last question there. It sounds like you're taking a more cautious stance on top line view, but you didn't alter your organic sales outlook. Can you just comment further there what's driving that?

Stéfan Descheemaeker

The margin, as you see, the margin change that you see from one guidance to the other is effectively within the range of what is low, let's say when we talk about high single-digit revenue growth, which remains the case at this stage, is effectively continuing to be the case. The only element there, as I said, is to marginal impact overall. What we see is effectively we see some constraints, some element that potentially could affect our top line progress overall for the year, but that would still leave us in the range of high single-digits overall. That's not going to change from that perspective, but effectively there would be some movement there. This is what effectively is creating the level of uncertainty that is impacting our EPS guidance.

Simply put, it takes probably more effort to execute three price increases than what we had anticipated.

Cody Ross

Got you. So it sounds like you're still in the range, just at the lower end of the range now. Understood.

Stéfan Descheemaeker

We are determined to have the price right, but let's say to get there, it might be a bit more difficult, but definitely for us, it's a priority number one.

Samy Zekhout

And Cody, the one thing I would add as well on this one is we clearly have a plan to get to the higher end of the range; simply there is uncertainty which we felt important to reflect, but the 171, if we're leaving it within the guidance range is clearly within reach as well, so this is the range we're talking about.

Cody Ross

Understood. That's helpful. Thank you very much for that.

Then just last question from me, you didn't repurchase any shares in the quarter, which is in line with your prior guidance as you work to secure inventory. Can you talk about your potential to increase share repurchases going forward, especially given where the stock is trading at? Thank you.

Stéfan Descheemaeker

At the very stage—you're right, all the points you've just made are absolutely correct. What we clearly stated, we will continue to support the operations, which is clearly our number one objective there. In an environment of supply constraints, this is really critical for us to make sure that we have the product we need at the right price in order for us to clearly serve our consumers.

From a share repurchase standpoint, this is effectively something that we have (inaudible), as you know, in terms of returning (inaudible) to our shareholders. It's taken into consideration within the grand scheme of other options that we have. So at this stage, clearly this is one possibility but for the time being, the focus remains supporting the operations.

Operator

Our next question will come from Jon Tanwanteng with CJS Securities. Please go ahead.

Daniel Moore

Thank you. Good morning. This is Dan Moore in for Jon. A lot of the questions have been covered.

Maybe just any updates on the strategic alternatives process, one. Two, any detail additionally that you can share in terms of securing alternative supply for fish? You mentioned that in your prepared remarks. Any specificity there would be great. Thank you.

Stéfan Descheemaeker

Let me cover—I think you're talking about fish most—that's the key question, I understand.

From that standpoint, we've taken a lot of steps, we've made a lot of improvement where the risk has definitely gone down since last time, so we've increased purchase from outside of Russia, we've gone to other species, and also very importantly, we're starting to reduce our reliance by going with farmed fish, obviously of the high quality, but we're starting with this piece and we've made a lot of progress. We've made all the testing sessions, the consumers are very pleased with the outcome, and we're going to start very soon the industrial production.

So, these are exactly the kinds of things we said we would do, and we're doing it. On top of that, the last piece is we also said that the fish-less part, which is part of Green Cuisine, is really on fire, so this combination makes it that definitely we are reducing our reliance on that part of the fish.

Samy Zekhout

On your first question, (inaudible) I think there's no more additional comments to provide, other than the ones that you're aware of at this stage.

Daniel Moore

Understood. Thank you.

Operator

Our next question will come from (inaudible) with Citi. Please go ahead

Male Speaker

Hi, thanks for taking the question.

I also wanted to ask on the frozen category, what impact you're seeing, if any, from private label just amidst the price hikes, and as you move forward, do you expect to see additional pressure from the private labels? Thanks.

Stéfan Descheemaeker

Overall, as you have seen, we have maintained our market share, so given the environment, it's not something easy but we've been able to do this really, really well. In terms of must-win battles, you probably know what our must-win battles are, that's really the categories where we want to win and also in the countries where we want to win. In this, we've increased market share in the course of the last quarter, and especially in H1.

Now, obviously with what we have, we want to grow and increase the market share in the future. I think we have the right brands, we have the right programs, and we're doing well vis-à-vis private label. Let's never forget that all these guys are going through the same kind of purchase and cost of goods increase like us. The only difference is, which is obviously we're moving ahead, we are the price leaders, and most of the time, we are ahead of the curve in terms of pricing. The other thing we don't know by definition if and when these guys are going to increase price, but they will, obviously. They should at some stage, but again I'm not in their shoes.

So overall, you know, the brand equity is stronger than ever, and we're very pleased with what we're doing, but the priority number one, as we said, is to make sure that we're going to have the right gross margin and we're going to be in a position to start 2023 exactly at the level we wanted to be able to reinforce our brands.

Male Speaker

Great. Thank you. Appreciate the color. I'll pass it on.

Operator

Our next question will come from Brian Giffney with Neuberger Berman. Please go ahead.

Brian Giffney

Great. Thanks a lot for the call. Just a couple questions on cash flow, if you don't mind.

Can you just sort of break down the cash flows relating to exceptional items? They're about $29 million year-to-date. I know historically, they've been running over $15 million for effectively the last four quarters. Can you just give us an idea when you'll get them below 15, or maybe some sort of color for the full year would be great?

Also working capital, there's quite a large outflow year-to-date, and I know that's inventories and receivables. Any sort of guidance on where you see working capital for the year end and ultimately what the drivers are for that large outflow?

Then maybe just one final question then, just in terms of the fish sourced from Russia. Can you actually quantify what percentage is sourced from Russia, either maybe at the end of FY21 and where you are today? Great. Thank you.

Samy Zekhout

Yes, I would suggest that, let's say, on the offline item, we took this one offline I think in the follow-up session. I think it makes more sense to do this.

On the working capital, clearly there has been effectively a significant rise in working capital driven by the investments we have made in inventory, particularly in raw materials and packing materials, in order to secure the supply. There has been effectively as well the inclusion of Fortenova in there that is driving, let's say, a part of the substantial rise in working capital and that we expect over time in the year, we're taking a very aggressive look at our cash flow in order to make sure that we deliver a cash performance that's consistent with the plan that we have in place by revisiting our Capex, our inventory approach to make sure that, frankly, we clearly have what we need in order to safeguard the year, enter the year with the right level of inventory.

On the other side, it's a key goal in the journey of, let's say, taking it down as we move forward on that, so we clearly expect substantial improvements in the fourth quarter in particular and taking into account all the investments we have to make in Q3 in working capital.

Stéfan Descheemaeker

As far as the Russian fish is concerned, you understand that for commercial reasons, we are—it is significant, but for commercial reasons, we are not disclosing the percentage or the amount, but as I said, for all the reasons I mentioned, like going to other species which are not Russian, what's more (inaudible) which is more going to (inaudible) use, which is also about plant protein, we see that it's starting to go down, and it will go down and down over the next quarters and years.

Still, I think we believe that in the future, we will still work with our Russian suppliers, but we have now and we will be in a position to move to switch them faster and easier from one category to another.

Brian Giffney

Okay, that's great.

Can you just put in context the level of cost inflation you're seeing for fish because obviously you're changing suppliers and there's obviously general cost inflation anyway, so just what level of inflation you're seeing? Thank you.

Samy Zekhout

We see broad-based inflation in virtually all of our ingredients, I would say on that one, and it's in the double-digit range, as we have talked. I would say overall, depending on the species, depending on the category, that it's effectively broad-based inflation that we see overall.

Brian Giffney

Appreciate the color. Thank you.

Operator

Our next question will come from Adi Arya with HPS. Please go ahead.

Adi Arya

Hi, good morning. Thank you for taking my questions. Can you hear me okay?

Stéfan Descheemaeker

Yes.

Adi Arya

Awesome. Thank you.

Just to finally round off on the fish point, and I know a couple of people have asked, I appreciate you might not be able to disclose the exact percentage and I appreciate obviously the fish-less side is doing well and you're moving to other species. It clearly represents a material part of the fish sourcing. I'm just curious, was there no sanctions impact on the Russia side, and then maybe could you speak to fish sourcing in China, has that been okay?

Maybe directionally, maybe if you, say, in the next year or so, do you see kind of—it says U.S., Russia and China, what will be the majority region providing your fish? Maybe you could talk directionally towards those regions and what you've seen.

Stéfan Descheemaeker

Let me start with the first part of the question, which is the sanctions. From the European standpoint, EU, low sanctions vis-à-vis whitefish, which makes by the way a lot of sense because they've checked also what the impact would be for the consumers and they've come to the conclusion that for the consumers, it would be much more negative than for anybody else, so that's one piece.

As you may know, some tariffs, 35% have been levied in the U.K., but we've taken some strategic decisions and for us, this is just negligible, so it doesn't impact really our fish in the U.K. Let's not forget we have several factories and obviously several ways to source the fish, so that's one thing.

As I said, looking forward, we believe that we're going to reduce our reliance on Russian fish. The Chinese processing, well, you know, it's been a bit—during end of Q1, early Q2, you may remember with the Shanghai lockdown, it was a bit chaotic, but we know it's back on track. I would say if I—again, I could see looking forward, it's going to be really a combination of white fish between the U.S., Russia or Chinese-Russia, but also let's say the farmed fish mostly coming from Vietnam at the right level will be very important for us, and we are in the process to secure long-term supply at the right level with the right quality.

Very much in the way that this Company did something like 20 years ago, with MSC, Marine Stewardship Council, we're doing the same now with the ASC, which is the equivalent for farmed fish, and we're going to set the standards. The standards will be high because that's exactly what we are, which is obviously good value and great value and great quality.

Adi Arya

Okay. Thank you very much.

Moving just to the cost base, what percentage of sales does energy represent, and again helpful, like you said, double-digit increase on fish prices, it'd be interesting to know what kind of range of increase have you seen on your energy costs. Obviously it's material given your cold chain requirements.

Samy Zekhout

Yes, we don't disclose the share of energy in the total costs. What we can tell you is that it is of importance, of course, because of all of the cooking and the whole thing that is associated with that. What we've done on energy is we have taken a hedging approach to that, that we started since the beginning of the year, that has enabled us to level up the costs this year and be well ahead, if you want, throughout the middle three-fourths of the next year.

So, we've been managing it quite well overall in order to impact the impact this and next year.

Adi Arya

Okay. Thank you.

Have you considered the availability of energy, obviously for example in Germany and France and some European countries? For example, if you weren't able to get gas, would that have any material impact?

Stéfan Descheemaeker

It's a very good question.

As you can imagine, to your point, there is price and there is also availability, so we see—and that's one of the reasons, by the way, over the last two months, consumer (inaudible) obviously significantly worse, but that's something else. In terms of availability, what we're checking is obviously the ability for us to move from gas to other energy, and we're working very hard on this piece but we've made a lot of progress in terms of ability to switch from one to another.

Adi Arya

Okay, that's really helpful. Thank you.

Then finally from me, I just read in the materials that Fortenova revenue of about €298 million in 2019 and then €216 million in 2020, and that EBITDA declined in that same period from €59 million to €50 million, could you please give some color on that? Why did it decline, and obviously you've mentioned it's growing very well organically in the most recent period, so why did that happen between '19 and '20?

Stéfan Descheemaeker

There was a clear impact driven by COVID because this is an area where tourism is of importance. As you know, it's directly proportionate to tourism. As we see clearly COVID now, let's say, in the back, in the base period, and we see tourism going back, and combined with a very hot summer, we see a perfect combination of, let's say, the moon and the stars are aligned and the business is doing very well this year compared to the prior year.

Samy Zekhout

If you don't mind, there is another thing, which is something we could see from the start, is the former owner was no longer considering that part of the business as strategic, so it was very much based on retail, and we've seen that several times. We've purchased a series of frozen foods businesses that were no longer considered as strategic for the previous owner, and then we've seen a difference when it's really the focus for the whole organization, and so we're starting to see already on top of, obviously as we said, the end of COVID, the resource (inaudible), we're making progress in market share, so these are the kinds of things when you are fully focused behind one category, what it does.

Adi Arya

Okay, understood.

Sorry, do you think, for example then for 2022, the 2019 pre-COVID level is a decent number to go by and then they'll carry on growing from there, or is there a different kind of—just on a kind of revenue level, different ballpark we should look towards?

Samy Zekhout

No, I think the business will continue. This year is on a roll and growing really well, double-digit growth, and clearly we'll end up the year within the range of double-digit growth as well. The volume will be a key contributor to the rest of the business as we have alluded to that. As we said, I think earlier in one of the earlier questions, there is a bit of forward impact of the fact that the acceleration of tourism that we had planned to be spread over the outer years is concentrated more this year, exacerbated by the summer, so we probably have a bit of an exceptional acceleration of growth this year in Fortenova, but it will continue to grow in the outer years.

Adi Arya

Okay, and finally from me, would it be reasonable to assume—do you make any change to your guide? I think you guided towards €2.9 billion revenue as your expectation for the year in the Q1 call. Is that directionally still where you expect to come out, or would you make any change to that?

Stéfan Descheemaeker

We've maintained the guidance on that side, that we said effectively high single-digit revenue fully included, so I think that's unchanged in terms of the guidance that we gave on sales.

Adi Arya

Okay, I'll jump back in the queue. Thank you very much.

Operator

This will conclude our question-and-answer session. I'd like to turn the conference back over to Stéfan Descheemaeker for any closing remarks.

Stéfan Descheemaeker

Thank you, Operator.

We are adapting quickly to a dynamic and challenging marketplace. Our world has been changed by the back-to-back crises of COVID and the Ukraine war, and I'm very pleased with the determination of our people and how well we have adjusted. We have strong plans in place for the back half and we are well prepared for 2023.

Thank you very much.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect your lines at this time.