Transcription: Q3 Report 2020

Title: Cloetta Q3 Report 2020
Date: 10/22/2020
Speakers: Henri de Sauvage Nolting, Frans Ryden, Nathalie Redmo
Conference Ref. No: EV00114303
Duration: 00:58:16

PRESENTATION

Nathalie Redmo

Good morning and thank you for joining us on the Q3 conference call for Cloetta. My name is Nathalie Redmo and I'm Head of Investor Relations. With me here today are Henri de Sauvage Nolting, CEO of Cloetta, and Frans Ryden, CFO. Henri and Frans will take you through our third quarter results and we will then move on to a Q&A session. I will now hand over to you Henri.

Henri de Sauvage Nolting

Very good. Thank you, Nathalie. Some key messages to start with for Q3. Very pleased and good to see that we are back to having growth in our branded business so, a good quarter driven by both marketing, investments, innovation but also increased traffic in the non-food retail stores.

A continued recovery for pick and mix, but consumer demands still very subdued, minus 30%. Of course, it was minus 60% in quarter two. Traffic is coming back, but still quite some work to be done in order to get that back to where we want this to be.

Because of the COVID situation, we put in even stronger cost controls, pulled a lot of things forward, and that has been able to give us some good savings. Part of that we have reinvested into marketing expenditure, and there's also a provision of incentives which is positively contributing to the result. Still a good strong balance sheet, which also means that the board has decided to propose a dividend, which we will have in an EGM in two weeks’ time for approval.

A lot of work went into maintaining the business continuity and supply. Both the suppliers are own factories and of course warehousing and distribution. No major disruptions due to COVID. And also, our commerce units in all the countries have been able to keep on working to a large extent from home, but most of the offices are partly open for team meetings and planning’s.

And we see still a continued volatility in particular in the pick and mix area and, of course, while we're speaking, we can see the wave two in particular the middle European countries starting to have an impact, and that of course gives a certain uncertainty within our business. So, in general, a continued recovery in the challenging environment.

If we look at the sales results. As I said, total is down 7%. Organic sales quite different. Branded business plus 1.7%. I'll unpack this a little bit further and the pick and mix business, minus 31.4%. That's of course an enormous figure. Better than last quarter but not where we want to be, and you can see also the months that it is slowly getting better in September but still very volatile between the months.

If we look at the branded business. 2019 as a reference: 70% in food and 30% in other channels. And other channels is everything from kiosks to travel retail, to do-it-yourself stores, etc. What we what we have been seeing in this quarter is that the demand in the food channel including e-commerce is still very high.

Shoppers have returned gradually to other channels, in particular during the summer months. We have seen an uplift over there, but we still have a negative product mix that we see. Refreshment, that's chewing gum, and pastilles still being lower than the candy bag business. And those products are predominantly sold in checkout areas in food, but also of course very much an on-the-go product in the other channels.

So, actions we have taken is actually to continue with our strategy to strengthen the top 25 brand positions of Cloetta, adjusting the marketing and innovation programmes. But also, we step up in e-commerce. Of course, that already was part of our strategy. We were just bolstering that and also investing over there and then continue with the journey on valorisation. Take pricing where possible, but also look at value for money given the economic uncertainty.

If we then look at pick and mix, we try to make it even more transparent. There's basically three things which needs to happen for pick and mix to really recover, and the first one of course is that the channels are open, so that the stores are open, that the shelves are open for sale. And then we show you a bit in Q2, where we have two markets where we still had problems, both in Denmark and in the UK and that has gradually improved, as you can see.

In Denmark, now most of the stores are open. There’s still a few which we need to help to open again. In the UK, however, we have been able to work together with our customers in food, retail and high street to open up but we still see like the leisure channel, including the cinemas, very much not seeing the footfall and therefore together with them we also decided not to open the pick and mix. So, that's quite an important market. Still very much impacted by the closure of channels.

So, that's step one, and step two is that in pick and mix our customers do and we facilitate that they do a lot of price promotions. And so, when it is the weekend, for example they are giving a good deal to shoppers and as you can see in most markets, we are still not seeing price promotions back. So, the UK, Finland, Denmark and Sweden, it’s a bit of a mixed picture, but we cannot say that price promotions are back. And in Norway, we did not have any price promotions from before. So, over there it is activations and that is why it is in a green situation.

So, that's the next step. And then of course the consumer demand is something we need to bring back. There is a number of consumers who are either spending less time in stores, they’re either spending less time in front of our fixture, or the consumers who we have to bring back into pick and mix because they went over into packed business and that you can see is still very much something which is ongoing, which we’ve also communicated before; that it will take several quarters to bring that back and the good thing is that we're now in full flex roll out with the CandyKing 2.0 concept, which is more premium but it also has increased emphasis on hygiene which will help consumers to return to pick and mix.

So, that's basically what is happening in pick and mix. And then we can have a further look into the financials. Frans.

Frans Ryden

Thank you, Henri. So as usual I'll start with net sales. So, in the quarter our business continued to recover from the impact of COVID-19, as Henri said, with organic growth now down at least it’s single-digit compared to last year, while of course year to date with a very soft quarter two it is remaining down double digits.

So, the improvement in quarter three was both on the branded package business and in pick and mix, with the branded package business growing 1.7% over last year, despite the still very weak travel retail and the lower consumer footfall in

the out-of-home channels. And for pick and mix, while this is down, of course 31%, at least when we compare to Q2 if you remember, we started out with roughly down 70% in April and then gradually improved then, so it is a step forward.

Nonetheless, if we look at branded and pick and mix on an over and under, so the gradual recovery is evident on the right, that also that pick and mix in the quarter. And if you look at the pie chart at the bottom left, it now represents 20% of our sales, up from 15% in Q2. Although this is still short of the 30% of sales it represented last year.

And we have previously shared that within the branded side of the business, we have a challenging mix on account of lower sales in the refreshment category, including due to less sales in out-of-home. But also, less sales in the checkouts when people are socially distancing. And with pick and mix declined compared to last year, only half of what we saw in quarter two, we naturally will see an impact on the gross margins quarter to quarter and I will come back to that little bit later on.

But starting then with the operating profits adjusted here, we are making the drivers for the variance to prior year visible, and I followed this up with more details specifically on the selling and the general and admin. But overall, for the quarter operating profit adjusted total 130 million for a margin of 8.8% of sales, and that is a significant reduction versus last year.

But half of this reduction of 70 million is due to the facing of costs from quarter two, as we previously have shared. And together with this profit loss due to lower volumes also in the quarter, that accounts for this full 100 million. Against this volume driven impact, we do have that partially offset, which is in the middle column, and that consists of lower sales, general and admin, on account of the strong cost control, and also the release of accruals relating to performance incentive programmes.

And then part of all of this has been reinvested into higher A&P than last year, and as mentioned by Henri previously. But before we look on those indirect, I want to clarify the gross margin. So, the Q3 gross margin compared to last year needs to be understood by keeping three things in mind. Firstly, and I think we were quite transparent about this in quarter two, there's a phasing of certain costs into this quarter and obviously in Q3 we see those 35 million costs hitting the gross margin.

Secondly, at the start of Q3, basically, in July we have executed a number of planned production shuts. We've mentioned that also in the past and here you have to remember that we built up inventory at the end of Q1 to protect the business if we would have had to shut plants or had major disruption of raw and packaging materials supply on account of COVID-19. And now, of course with better visibility, we were able to start to bring those inventories down.

This has been good for freeing up working capital and I'll come back to that later, but also reducing the risk of write-offs. But it did mean much higher manufacturing cost per kilo of the products we produced during that period, and this has also affected the quarter.

And thirdly, we do have items affecting comparability relating to the Helsingborg plant closure in quarter three. Now the good thing is on that closure, we've actually now found a way of accelerating the closure somewhat, so it should be coming in closer towards the year-end than what we had originally anticipated.

Now, this is clearly a one-off drop in gross margin, these three drivers. And as you’ve heard, we have chosen to reiterate the outlook that we will return to double-digit operating profit margin by end of the year and given that our sales general

and admin normally ranges between, let's say 24 and 26%, that obviously means that we are saying that gross margins will get back to at least 34 to 36%.

Now, these three drivers explain most of the change in gross margin, not only versus last year, but also between what you saw in quarter two this year and quarter three. But there's one other factor to plays into that comparison between quarters and that is the mix that I mentioned earlier. So, in both quarters we have a favourable mix versus last year, obviously on account of the higher share of sales coming from package products. And the favourability in Q3 is much less pronounced than it was in Q2, given the recovery of pick and mix.

Now, with that, let me detail out bit more on the sales, general and admin, that offsets the volume impact. So, in this quarter we have continued to accelerate actions within our VIP plus programme, and how to get what we call more bang for our buck. And previously in the quarter we did communicate on the closure of the housing board plot, although that sits in gross margins, savings around 10 million per year. But we have also now taken other VIP plus actions, and that is we have executed a change in the Swedish organisation which will improve the ways of working in the business and also deliver savings. And these savings will be somewhat higher than the savings that we will deliver through the Helsingborg plant closure.

Now, in the quarter, excluding items affecting comparability and forex, which you can see here roughly offset each other, the indirects was down 48 million compared to prior year. Now within that, we released accruals for performance incentive programmes, totalling Swedish krona 45 million. And that's a year to date number. But then we also stepped up our A&P investment and the reason that you don't see that in the profit and loss here is because we were able to fully offset those investments as well as annual merit increase for employees since last year through the continued VIP plus savings.

And in quarter two I had mentioned that out of the reduced indirect costs, about half related to savings, some sustainable and some one-off. A quarter related to lower merchant item costs and a quarter related to lower marketing spend. Now, year-to-date quarter three, the proportion has changed: excluding the incentive programme release, VIP plus savings now account for almost three quarters of the reduction that we have and merchandising cost for a bit over a quarter because marketing spend is now close to what we had last year, despite the volume reduction as we are protecting our brand equity.

Now, moving on to cash. And as you know, as a company we tend to generate most of the cash in the second half of the year and Q3 is, from that point of view, not an exception. But we did deliver very strong on the working capital this quarter, as you see in the second column from the left, so 151 million Swedish krona was freed up, which is 145 million better than last year. And with capex investment similar between the two years, our Q3 free cash flow of 252 million, as you see in the middle of the top waterfall graph, is 53 million better than last year. And this is despite the lower operating profits.

So, in summary, we had a very strong quarter on cash, and you should also note that year-to-date our working capital is significantly better than year-to-date Q3 last year, so it's not just for the quarter, it is also an overall improvement.

Then looking a little bit closer to the working capital, so obviously only inventories we had shared in Q2 that we would bring them down in Q3 and which we have done. So, we reduced inventories to below 1 billion Swedish krona, which is lower than we were at quarter one end and certainly lower than we were at quarter two end, and we have also improved the days inventory on hand from 108 days down to 93.

It does remain higher than last year and we will continue to manage this in a careful way. We will build appropriate stock for seasonal product, such as Christmas, and we're going to safeguard our ability to bounce back as societies open up again. But we're also going to make sure we can safeguard production and keep an eye on the cash, so that's the balance we're taking.

Now payables also increased versus quarter two, but that's of course because production has been ramping up again towards the end of the quarter, and then receivables also increased because sales also ramped up towards the end of the quarter, but both remain below last year both in value and in terms of days.

So, the next piece here, also on the capex. So, despite the travel restrictions we've had and other challenges with COVID-19, we have preceded quite well with our capex project, in total, executing to value of 61 million in the quarter, which is actually higher than last year. And as I mentioned in quarter two, we expect that this year's spend will be higher than last year and year-to-date spend is actually already higher than last year, so that's good progress. And assuming we can continue as per current thinking to get things done, which of course costs money, spend will probably land around 5% for this year.

And then moving on to my last slide. As you know, leverage is one of our key financial targets next to sales and EBIT and dividend. And here I'm trying to capture that in our debt position. So, first you can see top left our total utilised credit facilities and commercial papers of 2.4 billion, and then to the right we're holding 330 million in cash, including for the upcoming dividend payment. But we have access to another 1.3 billion in additional unutilised facilities as well as 750 million in commercial papers that are not yet on the market.

Hence our conclusion that our financial position is strong. Now, our financial strength is also reflected in the leverage where the year-end target is to be around or below 2.5x EBITDA. And we have stayed below that at prior year-ends, but normally of course we exceed it in quarter two, which is the quarter when we pay out our dividend. Now, with the dividend payment in quarter four instead, we expect to end this year higher than normal for the year-end, but not to stray too far from the targets or too far from around 2.5.

And that concludes my part of this presentation, and I hand back to you, Henri.

Henri de Sauvage Nolting

Thank you, Frans. A few words on what we're doing going forward. As we have already at the outset of Q3 looked at our strategic priorities and adjusted where needed. The overall picture remains very much the same. It's to keep on focusing on the organic growth of the branded business. Really important. Above average profitability.

It is of course to restore the profitability in the pick and mix business by sustainable value growth. And of course, number three, as you can see is focusing on cost and efficiency. And so, on the branded business, I think the things we are doing are very much in line with what I told you already before. Maybe one thing is to bring sustainability into our brands. It's something which we will probably talk about in the coming months in a bit more specific way. And to increase the A&P investment into our main brand positions to make them really competitive and to be able to keep on growing our business and the brands in a profitable way.

On the pick and mix, of course that's where we have the biggest impact, as you are aware. That's also where we did the biggest changes, so it's good to see that the repositioning of CandyKing to a more premium concept is in the roll out phase. We're doing that, for example, in Sweden with all the previous communication in stores and also improving the assortment, but also very much improving the price towards the customer and the customer towards the consumer.

It is of course rebuilding the profitability through scale after the volume drops out. And that is of course an issue we are managing. The fact that we are raising prices, of course, is good for the kilo price, but then the merchandising cost per kilo are going up because we lose so much of the scale, then a lot is being eaten up by that. So, we need to bring back the scale because the cost and the savings in merchandising are not linear with the volume drop.

We're working still on the price increases that's happening basically month after month in the different markets, so I cannot tell you exactly what we are planning, but there are further plans to work on pricing and bring profitability into the pick and mix business. And then we are looking at really building a brand around CandyKing. So, there are certain activation programmes on a small scale from a cost perspective. You can see that, for example, in the Swedish market already from two weeks ago.

And number three. I think Frans already talked about the reorganisation in Sweden, to take resources out and make savings. It's these savings for the nut manufacturing in Helsingborg. It's a lot of initiative, both for sustainable cost savings, plans we already have for executing, being faster and then the last point on the working capital management.

A few highlights on the marketing agenda. We are going into adjacent categories, so here you see a candy brand, going also in chocolate tablets, quite important, and I think also making use of the Plopp brand to give us a USP over the existing other brands in this market. It also very much trying to strengthen the top brands we have in Cloetta.

And then of course looking at value. How can we price up? How can we preimmunize, bring more value to our products. Two Finnish examples but they could as well have been in the Netherlands. So, how can we create an extra price platform on top of the existing ranges in order to basically get more euros per kilo by premiumisation.

The purpose of the Power Of True Joy, really bringing that and bringing that alive, also in our in our brands and the decisions we take is something we are working on throughout the company. Given the time, we will not go into that right now. It will be something which we'll be communicating on a separate notice towards our shareholders and analysts, but I think it's an important programme, also from stakeholder management. Both internally but also our customers want to cooperate with this, and it's also very much in that light a business opportunity. We decided also to join the science-based targets initiative, which is quite important on the climate action elements in this programme.

Q4. Key expected impacts on the branded sales. We think we will be around last year's level. Of course, very much focusing to keep the momentum we have and also for the mix to gradually improve with chewing gum and pastilles slowly coming back due to channel and checkout mix.

On pick and mix. We are planning to gradually improve a further step, but it will take several quarters before the full consumer demand comes back. So, the first thing now is to get promotions back into place and to work with the CandyKing 2.0 roll out to bring the consumers or all consumers back into this business. And then the operating profit adjusted. We expect it to be gradually stronger and ending the year on double-digit margins in a way to get back to the journey we are on. And with having that said, I think we open up for questions.

Q&A

Operator

Ladies and gentlemen, should you have a question please press 01 on your telephone keypad. It’s zero and one on your telephone keypad. If you feel that your question has already been answered, you can press 02 to remove yourself from the Q&A session. Ladies and gentlemen, if you have a question, please press 01 on your telephone keypad.

First question from Michael Löfdahl from Carnegie, please go ahead.

Michael Löfdahl

Yes hi. Maybe I'm a bit slow here, but when you went through the EBIT bridge, or the adjusted EBIT bridge, and also spoke about the gross profit and the gross margin impact. I'm a bit curious. First of all on the SG&A bridge, to start with, when you speak about this release of accrual, so these incentive programmes, this is a big number; 45 million, and you report that in this quarter, and I understand that this should probably have been then lower amounts provisioned in Q1 and Q2, obviously, and now you release that, but isn't the full impact of the 45 million included in the adjusted EBIT for the quarter and if so, if you extract that when you look at the net cost reductions of 48, that makes it only 3 million then, on a year on year basis. Or am I wrong here?

Frans Ryden

Well thanks, Michael, for asking the clarifying questions. So, the first piece is that yes, you’re correct. This is the year-to-date number, and generally speaking if we go back a couple of years, given our business and, let's say, that the still fairly limited span of growth rates we have, it's normally only around quarter three that we have felt that we have sufficient visibility on where we're going to land that we would start either to provide more, or to release. And this year with even, let's say starker fluctuations up and down that has not been different, so it is in Q3 that we have felt that we had enough visibility to this to make the decision. So, that's one thing, it is a year-to-date number.

The other aspect of this is that remember when we report SG&A here, it's not only that the indirect in the sense of people cost and non-people cost, it's also the marketing spend, so the advertisements and promotions. So, the way you should think about this is that 48 - yes 45 there is the release. Then you would have expected to have an increase versus last year on account of merit and you should have expected to see a pretty big step-up in cost on account of the increased A&P investment. And the reason that you don't see an increase there is because we’re offsetting all of that with various VIP plus savings. Did that answer your question?

Michael Löfdahl

Okay. Yeah, I guess it does, but when you look at the Q1 and Q2 numbers then, then I guess A&P was significantly lower in those quarters then, because you don't have the same kind of mitigating factor from A&P increases in those quarters.

Frans Ryden

What I meant was that when we are at Q3, year to date, we are roughly in line with what we spent Q3 year to date last year on A&P, because we have stepped it up in quarter three even versus last year. And you remember that was also a bit of a step up with marketing et cetera, whereas in Q2, earlier we held back a bit given the fact that the volatility we had in the market, we pulled back on outdoor advertisement and we re-directed some of that spend.

So, yeah, if you imagine if there was one more column here that just talked about marketing, then on the third quarter you would see a big red. And as a result, we would show the 48 would have been a higher number to get back to the same place, whereas on the nine-month basis the marketing one would be fairly small, that box, and the cost reduction would as a result look fairly similar to what you see here.

Michael Löfdahl

Okay, so on a year on year basis in Q3, the marketing spend is basically not -

Frans Ryden

Higher. So, on quarter it’s stepped up. Yeah, higher. Year to date it's roughly in line with last year.

Michael Löfdahl

Okay, so it's a third quarter thing. Okay, but as we move into the fourth quarter now, obviously A&P will remain at roughly the same level, I would assume, but you don't have the positives from these, really, some of the accruals. So how then - and still you’re guiding for an adjusted EBIT margin of above 10% so how is that achievable? I know that you also spoke about then the gross margin coming up so significantly, so could you specify that a bit more on then - I guess it's on the gross profit side. How should that, or how will that be able to rise so much from one quarter to another?

Frans Ryden

Okay, no, great. So, I think the easiest one which is very transparent that is also of course the exceptionals with the closure of the Helsingborg plant, where the exceptional is slightly higher than what we originally thought. But that's also because we've moved the closure a little bit. It's happening a little bit earlier than what we originally envisaged, so obviously we’re not closing the plant one more time in Q4, so there already you have it. That's an impact.

But beyond that, in simplified terms, one could say that this quarter is helped on the bottom line by the, let's say, one-timer of releasing these performance incentive provisions. But we are hurt by arguably a one-timer hit in the gross margin on account of the lower volumes, which has then two aspects. One is the lower volumes and the impact that was carried in from quarter two.

And two, the lower volumes in July where that impact stays within the quarter because it happened so early. So, in a way, you could imagine that in Q2, our worst month in terms of production was at the end of the quarter, whereas in Q3 our worst month in terms of production was at the beginning of the quarter, so therefore we take a big hit there.

We have also used some of those plant closures to ramp up on the maintenance, get even more focused on perfect factory programme, which of course will deliver some good numbers going forward, but as a result costs are quite high at the beginning of the quarter against very low volumes. So, in a way, you could think of that as more or less a one-off drop on the gross margin and we have a one-off gain on the indirect. So, I think still, our reported numbers are probably quite representative to what the number should be.

Michael Löfdahl

Okay, another question on the, call it, guidance on the packaged sales for Q4 being, as you say, probably unchanged year-on-year, for Q4. Does that mean that you still expect the positive impact from higher retail sales to be fully mitigated then by reduced sales in other sales channels? Or is it something else there, because you are at the same time speaking about more normalisation, and so on, which the net impact should or could even be positive for the packaged side which you saw in this quarter growing, actually, on a year-on-year basis. But now you're saying that it's expected to be unchanged. So, what is behind that guidance?

Frans Ryden

Well, so here you must excuse that when we say around last year's level - I would say if you're a per cent up or down, that's still around last year's level, so it's not the major deviation from what we're seeing here.

Obviously there's a couple of things you have to think about there is that when consumers exit, when they choose not to buy pick and mix obviously, and they walk over to the packaged products, we have many more competitors there, and if they move back into pick and mix, we will lose some of that, but our competitors will also lose some of that. And that's between, let's say, these two aspects of the business.

But then also within the branded business, while probably recovering the travel retail is still some way off, as society hopefully opens up again and we're not going to have a very strong second wave, then you also have more footfall in out-of-home channels where we are arguably quite strong. And so, overall, what we're saying is that we had some nice numbers on the branded business growth in Q3 and we’re sort of reaffirming that we will also, in Q4, be around where we were last year.

Michael Löfdahl

Okay, and just to remind me, last year Q3 and Q4 in terms of marketing, you had this very big Läkerol campaign but is that the impact in both Q3 and Q4; the marketing spend? That's one thing, and then I guess the top line effect was probably in Q4 last year from that campaign.

Frans Ryden

Yeah it did impact. So, the spend was in both quarters and you would see, let's say, an effect on the top line in both quarters as well, and then, of course, the tricky part is that there is a difference between the timing when the consumer buys the product versus when we sell it to the retailers as well, in anticipation of the uptick when we advertise.

Henri de Sauvage Nolting

But just to reiterate on that one, of course we made a strategic plan to get organic growth on the brands, start with getting the organic growth on our top brand position, so that is brands per country. Then we looked at the competitive situation of all those brands. And then the first step we did was we were bringing down the non-working media to below 40%, ultimately below 30%.

So, to utilise the money we already had in A and B more efficiently - that journey is still continuing, but we're coming towards the 65% level and then we said okay, when we have done that, the next step will be to also bring up the absolute amount of A and B spent, and that you could see now in quarter three and that is not something which will go away and we will be spending more also in absolute money on A and B to strengthen those brands. In particular, those brands in those countries where we have not had any spend, or far too little versus competition, because that is a necessary investment we need to make in order to keep the organic growth going year after year.

Michael Löfdahl

Okay, thank you.

Operator

Thank you. Next question from Nicklas Skogman from Handesbanken. Please go ahead.

Nicklas Skogman

Yes, hello. The first question is on pick and mix. Q3 was obviously better than Q2, but the sales progression throughout Q3 unfortunately does not actually sort of support the gradual recovery that you guide for, if you will, for Q4. So, my question is, are you seeing improvements now in October, or are we looking at easier comps or what makes you sort of make that statement that you expect a gradual recovery in Q4?

Henri de Sauvage Nolting

Yeah, it's a little bit back to the chart about the three different parameters. The pick and mix business, it is still very volatile, and you can see that from the month-to-month figures. And why are we saying there's a gradual recovery? Because first we work very much on getting the basics back. And the basics are that we get our fixtures open in all the countries, in all the retailers and we've made good progress on that.

Then the second thing is that we are seeing that some retailers are now contacting us and saying, okay, we want to start doing promotions and promotion has a big impact. In some countries, more than 40% of the volume are being sold in promotions, so having a promotion or not having a promotion also gives huge swings, you could say, between months and also you need to think that that is in the comparator of last year. And particularly also Halloween is an important month.

So, we see the basics improving on both openings of all the fixtures and that in some countries we also see retailers starting to look at promotions again. But again, not everywhere. And then of course the third one is those consumers who have left pick and mix or have reduced consumption in pick and mix, those need to be regained and we see good, good first responses of the CandyKing 2.0 implementation in the markets where we're implementing.

So, I think all in all we can say we look with confidence that things are improving, but of course it is still very volatile in that sense.

Nicklas Skogman

Okay, perfect and then on - I'm trying to sort of put together your various pieces of guidance here, so starting out with the double-digit margins for Q4 EBIT, which I take it as it means. And then you've guided for flattish packaged sales and gradual recovery in pick and mix, so we're not going to be minus 30at least. And I think you also said that SG&A costs to sales would be to the tune of 24 to 26%, right?

Frans Ryden

Yeah, actually on that one. I just want to say, without saying if that's correct or not, just want to say that my comment was that if you look historically, if you take, let’s say, 2019, that is normally the range that we are between, sort of 24 to 26%, so it's more if you sort of – it’s sharing what you already have and sort of give some confidence why, what it actually means to say double-digit margin or what it should mean for the gross margin.

Nicklas Skogman

Okay, so then let's say I put in 25.4% in SG&A sales. So, we are then looking at the gross margin year on year deterioration of 100 and - or roughly two percentage points. Am I sort of ballpark right there? Q4 gross margin.

Frans Ryden

Yeah, so we haven't - we're not giving a guidance for Q4 on gross margin, but rather we've given a guidance to say that that we should get back to double-digit EBIT by the end of the year, and if you use your assumption that if that is evenly spread across Q4 and we have normal indirects including then the marketing spend that that should mean that we have to get to at least 34 to 36%. That's as far as I would give guidance.

Nicklas Skogman

Yeah. That's very good. So, where do you think your inventory will be at the end of this year in terms of millions?

Frans Ryden

Yeah, so now we brought it down to 986 million or something, so we're below a billion. And that's, of course, a big reduction. It's less than what we had last quarter and quarter one, but what we're trying to balance here is, on the one hand, we want to be lean on inventories. On the other hand, already last year before COVID, we said that we need to increase our inventories to improve our service levels, and that remains a priority for us as well, to make sure that our customers can sell when there is a demand from the consumer.

And with the uncertainty, and what we're seeing now that there's further action taken by governments relating to COVID, we also have to protect the supply that we have. So, I think that the intention is of course to make sure that we position ourselves at the right place on the inventories.

Henri de Sauvage Nolting

Ballpark, it will be the same as last year.

Frans Ryden

Ballpark, yes. Ballpark, I would say will be the same as we are now.

Henri de Sauvage Nolting

Yes, yeah.

Nicklas Skogman

Okay. Good, very good. And then finally then if I'm allowed to ask: can you give me the breakdown of your inventory in terms of raw materials work in progress versus finished goods in Q3 and then in Q3 last year, would be great.

Henri de Sauvage Nolting

I don't think we have that here.

Frans Ryden

I don't have a couple of months. Obviously, what -

Henri de Sauvage Nolting

Maybe, so what did we do? We, at the beginning of the year we already increased some of the production because we could see that we had the space in our factories to pre-produce certain items which would then go on to sell later on and that we later on can do some more insourcing so to get to fully occupied factories, which is extremely important for the fixed cost coverage.

Then we got into COVID. We built up stock, both of raw material, intermediate, and on the most important SKUs. And then of course we saw in COVID that we were not selling so much pick and mix, and we were not selling so much on out-of-home. So, we stopped the production in Q2 on basically those two items.

We were still getting in stock from third-party providers and that's why we ended up with the relatively high stock levels at the end of Q2, which of course, given the COVID situation and the cash generation being important, we said, ‘Okay, we're going to address this. And how do we address that?’ By reducing the factories’ output and also doing it very much in the summer period, which I think was cost-wise the most beneficial way to do it, because we could ask people to take holidays. In other years we asked them to stay, so we keep our most important lines running but we reduced output a lot in July and August.

Then, of course, there are other things we could, or we had to do in that time and that's why there is quite some supply impact, supply cost impact both from Q2 products already into Q3 and then the Q3 effects which Frans explained. I think that was a good decision, even though it had an impact now on gross margin, because we've really reduced our stock levels to the level where we want it to be, but also to the products where we want that stock to be.

And you can see that from the work in progress and the cash flow statement. That is something which happened in Q3 and now the factories are, let's say, back to where they should be, producing for the demand which we’re also selling.

And we’re looking at further insourcing. We don't talk about that so much, but that's of course still a very nice thing to have; that we can bring in products from the outside to make up for the minus 30% or wherever it will land of the pick and mix business, that we don't sit with fixed costs which have nothing to do. We can just bring in volumes and then on top of that we have to grow projections for the branded business and that's a continuing journey.

The only thing is it takes a bit of time. We cannot respond within a month or within a quarter because a lot of these things have to be pre-planned. We need to cancel contracts with third party to bring it in. We need test the product and see that we can produce the same quality or the same taste. I would say at what we bring in, that's travel restrictions. If it is in Slovakia it is difficult to travel there, so it takes time to adjust. But we have that possibility, which I think is a very nice cushion to have.

Nicklas Skogman

Yeah. My question was more focused on, if I know sort of what proportion is finished goods of your inventory, I can calculate how much you can produce without the finished goods inventory stacking up, but maybe we can take those numbers at a later stage. But you mentioned something very interesting there, the insourcing of volumes. Can you just maybe talk a bit more about how you're viewing this?

Henri de Sauvage Nolting

We have an insourced capacity mainly in moulding, so wine gums, et cetera. And we want to occupy that insourced capacity as financially interesting as we can make it so that's little bit different by plants. Some plants, it is like in Slovakia, is very attractive to produce seven days a week. In other plants it's better to work five days a week 24/7 and then some extra shifts in the weekend if needed.

And that means that if we now have a lower demands on pick and mix items, like you see at the minus 30%, we can bring in more production from the outside, so from third-party producers to compensate for that, so that our factories over a time span, let's say, of 12 months are not going to stand idle because we have less production and that should bring us back to the fixed-cost coverage and the scale benefits which are going to help us in the gross margin journey we've been talking about so much today.

Nicklas Skogman

Okay, but over what time frame do you see this happening? Let's say, by the end of this quarter you're confident on the volumes and where they will develop. Is it a quarter or is it half a year, or - ?

Henri de Sauvage Nolting

No, it's more half a year because as I said it depends very much - we need to cancel some of these contracts with third parties or reduce them. We need to match these parts or if they have been always produced by third parties and now we have to produce them, we need to do tests on those lines, get consumers to taste those products. So, this is not something you can put on and off within a within a month or even within a quarter.

And it also depends, and that may be the last thing, it also depends on the outlook we have. And with pick and mix in particular, for it to be so volatile, it's all the time a balance between putting a lot of more volume in, but then running the risk that we are not going to be able to produce everything and then we have supply chain or customer service issues with the customer.

So, it's that balance we need to strike right. And, of course, if the demand is becoming less volatile, we can then have a better utilisation of the factories. The more uncertainties there are in the demand, the more you need to be able to react within your supply chain network on that volatility, and that's going to gradually improve as well.

Nicklas Skogman

Okay, very good. And my final question is I noticed an Amazon logo in your presentation next to e-commerce. Should I interpret that as you are about to launch direct selling on Amazon's Swedish website?

Henri de Sauvage Nolting

That’s one of the players. So, we’re working both with all the existing omni-channels, as we call them, so the Amazonz kinds of this world. But we're also working together with the pure players in this world, and that whatever in Sweden this is Malton, but there’s also the Amazons of this world. And already we are working with Amazon in the UK, in Germany, and that's of course something we now want to roll out across all the countries. We just got enlistings in Australia for jellybean factories with the two main retailers over there. So, then it also makes a lot of sense if you have 80% distribution in the physical stores to also be available on Amazon in Australia.

So, yes, it is a signal, of course, that we take this seriously. It’s an important trend. It’s one of the key elements of our strategy to get branded growth. And that's the beauty of Cloetta. We can do these sort of things across markets and work then in a central way with the likes of Amazon.

Nicklas Skogman

All right, thank you very much.

Henri de Sauvage Nolting

Thank you. Should we look at the questions which were written?

Operator

We don't have any more questions by phone. Ladies and gentlemen, if you wish to ask a new question, please press 01 on your telephone keypad.

Henri de Sauvage Nolting

There are two questions which have been sent. So, one is from Franz Junger. It's a question about rumours of Orkla. I think that people to ask are the people at Orkla, not at Cloetta. I don't know more than what we read in the newspapers.

And then there is a question from Stefan Stjernholm from Nordea: I think we have answered most of that but on pick and mix, larger contracts are up for renegotiations and if you lost contracts due to price increase. And so, if I answer that we are raising prices in Sweden, on an individual store by store. That is going on. We've lost some contracts, but not more than what we already thought. We won a big contract and implemented that in Finland this year. That's fully operational and there is another contract coming up for negotiation towards the end of this year in another market.

And there's a bit of nature of pick and mix, but so far, so good. And if you say you lose a contract, I would rather say we walk away from certain contracts because we are not in the business to sell with a loss. We're in the business to make money on pick and mix.

Frans Ryden

I'll take the other question. Yeah. So, Stefan, the other question you had here was round the items affecting comparability on the 19 million, and whether that fits in in gross profit or in the SG&A. And the answer is actually it’s both, because there's two 19 million, and I appreciate that that gets a bit not absolutely clear, so let me say it again. So, the first 19 million that sits in gross profit, is related to the closure of Helsingborg, where we previously said it was going to be around 15 and are we going to have a closure during 2021.

It's now 19 because we brought it forwards. It comes earlier than originally anticipated, and then there are certain costs that would then have to take as exceptional, for example rents that will no longer be utilised. So, that's the first 19. It will deliver about 10 million on an annualised basis in savings.

The other 19 million relates to the reorganisation in the Swedish business, which both will improve ways of working and help the business but is also delivering savings. And that's also 19 million coincidentally, and that will deliver savings, which is actually higher on an annualised basis than the Helsingborg plant closure. Slightly higher, I would say.

Henri de Sauvage Nolting

Good. Any more questions? Good. Well then, I thank you all for being here today and we go on to sell more for a higher price. Thank you very much.

Frans Ryden

Thank you. Bye-bye.

Operator

Thank you. This now completes our conference call. Thank you all for attending. You may now disconnect your lines.