Cloetta

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Presentation

Jacob Broberg

Good morning and welcome to the Cloetta Conference Call. My name is Jacob Broberg, Head of Investor Relations. And as previous quarters, I have David Nuutinen, CEO, and Danko Maras here with me today. And I will leave the floor for David to start. Please go ahead, David.

David Nuutinen

Thank you very much, Jacob. Good morning, everyone. It's David here. On our Q2 highlights we've seen good sales growth and improved profit. Our Cloetta sales were up in the quarter both organically and through acquisitions. Total sales growth was 6.4%; organic growth, plus 2%; and through acquisitions was 4.9%. Our operating profit increased by 9.2% and amounted to SEK142 million. Our cash flow from operating activities amounted to SEK114 million and our net debt/EBITDA ratio decreased to 2.82 and was stable compared to quarter one despite our dividend payment.

If I move over to market and sales development, as you will remember, our long-term target is to grow at least in line with markets and historically, that has been between 1% to 2%, thus the organic growth of 2% I'm very pleased with. Overall, when we look at our markets and how the markets have developed in the quarter, we have seen somewhat negative market developments in most of the markets except for Sweden and Italy. In Sweden, we saw the markets in slight growth and Italy – in the Italian market, we saw the market development stabilising, no longer decline. As you will remember that when we speak about market developments at the end of the quarter there can be swings. The market development is highly dependent on the market players: what type of launches are we doing? What type of campaigns and promotions are we driving? And also, to a certain extent, the weather can have an impact, particularly in the summer periods. If the weather is hot, that tends to have a somewhat negative impact on chocolate sales. And if it is cooler, chocolate will be up.

In terms of our own sales, we saw our sales growing in the Nordic markets, in Sweden and then Norway. And in Denmark, it was unchanged. In Sweden, there is basically no one story line for market development and market growth. In Sweden, we have experienced growth through improved distribution. As you will remember in 2015 in Q2, we were in some customer negotiation challenges but those have been solved. And now we have seen an improvement in our distribution. Another driver for the Swedish sales is Pick & Mix. And as you will remember that as beginning of this year, we have Ö&B and Bergendahls as our customers for the Pick & Mix business. In the Finnish market, our sales growth was fuelled by Pick & Mix. And in Finland also, we have captured in the beginning of the year some new customers. And another driver for the – in the Finnish market was pastilles, a segment where we have had new launches and very good brand activation. We have seen sales decline in the Italian market, which was slightly down, also decline in the UK and Netherlands and export markets. In the UK, the sales were – the drop in sales was partly attributable to weaker British pound following the Brexit referendum. Our sales in the UK is, however, less than 5% of total group and the future impact of the Brexit is not expected to be material for Cloetta. In the Dutch market, we saw some market decline and therefore we saw also a decline in our sales. However, from a market share point of view, we were not losing.

And with that sort of quick overview on our sales and market developments, I will hand over to Danko.

Danko Maras

Thank you, David. Good morning, everyone. And perhaps before I start going through the numbers, you might have noticed that in our quarterly report, we have introduced the – voluntarily introduced the E-S-M-A or ESMA guidelines on our alternative performance measures, the APMs. And hopefully, that will give you a lot of answers to specific questions. We'll see how this turns out in the long run, but we have introduced it. And hopefully, I would expect that there perhaps would be a bit less questions today given that you have a little bit more insight on the report. But we will see. I look forward to the Q&A session anyway.

But if we go back to page 4 and we look at the top line, I'll come back to the 6.4%. What is particularly satisfying in this quarter is that we have a gross margin or a gross profit of SEK572 million where the margin is 42%. That is an enhancement of the margin of about 110 basis points, so a significant good structural improvement continuing. And getting the benefits from our supply chain strategy, as you know, is coming through quite well in our performance. This should also be noted that the inclusion of Lonka is actually diluting our margin with a continued 110 basis points compared to last year. So we are actually even stronger on the gross margin and development than what you are seeing there. And Lonka, as you know, we will deal with in terms of getting full run rate of savings in 2017 and 2018. So very good delivery on our gross margin that continues to follow through in the rest of the line items.

Our operating profit at – adjusted at SEK150 million is 11% margin. That's also an enhancement of 12.8% and continues to increase our operating profit margin, so that if you go in and look at the rolling 12 months, you can see that we are making our steps towards the 14%. It is now moving from 12.4% to 12.5%, slowly but steadily increasing. The operating profit is SEK142 million. And the difference between the two, you can actually see in the tables that we are forwarding. But for awareness and information, it is related to the Dieren closure, the factory closure, and a small stint of the final payment for the earn-out of The Jelly Bean Factory. That has now been paid on the 4th July. So Cloetta, today, owns 100% of The Jelly Bean Factory and the execution is over and done with.

Our net financial item continues to decline because of the affected interest rates, but also lower debt. And our profit before tax is SEK110 million. The profit for the period of SEK77 million, is better than last year, with SEK11 million. But the corporate tax rate, I am sure you have reflected on seeing that it is 30%. It comes back to the fact that we still have a non-tax deductibility of earn-out which is considered to be part of the purchase price. And we also have a one-off item in Italy whereby we are not acknowledging tax credits to the same extent that we normally would do, and those two are one-off in event. And then we also have some international rate differences that are affecting the tax rate versus the 22% that you should see from Sweden.

If I then move on and go to page 5, you can see that organic growth rate is very nice. To come back to growth, 2% organic growth also makes 0.6% growth full – on a year-to-date basis. Our structural changes, 4.9%, relates to Lonka. It's both in the quarter and year-to-date. And for those of you who follow us closely, please remember as of Q3 onwards, all the growth will be reported as organic because the acquisition of Lonka was done in July last year so that no more structural changes, unless there will be an acquisition coming through, will be reported in Q3 going forward. We still see a weakening of the euro, affecting our exchange rate with 50 points. And that sounds contrary to the effect of Brexit where the SEK actually had a significant impact both to the euro and the pound. But please remember all, again, that the reporting is on an average rate. And therefore, you don't see the immediate effect that did affect us a lot in the closing rates for the balance sheet but not in the income statement. So if this holds, you will see actually a return to growth on FX if the devaluation that occurred will continue.

On page 6, if we just look at the graph, I continue to say it's a good depiction of the contribution by quarter. It's nice to see the step-up that you can see in Q2 for three years in a row, both on top line sales, operating profit and operating profit adjusted. We continue to drive the enhancement of margin and we continue to do it sequentially. And obviously, we also like the fact that if you look at the convergence between the adjusted operating profit and the operating profit, it's a very slight difference there.

Moving into cash flow, you can see a continued strong cash flow delivery whereby at the end of 2015, we had SEK927 million. The current rolling number is SEK908 million. And if we just move straight in to page 8, you can see that a very good cash flow delivery from operating activities before changes in working capital, SEK149 million versus SEK100 million. On a year-to-date basis, we are actually SEK100 million ahead of last year on good EBIT delivery, less interest cost, less tax cost and delivering a lot of good cash flow from the income statement. Our working capital, we are still positive on a year-to-date basis with SEK97 million. But in the quarter, we had a negative movement of SEK35 million. That relates to production planning, the fact that we are building up seasonal products. And that's not for Italy, it's actually for Juleskum in Ljungsbro. And that is a production that we are not – that we did not do in the prior year. We are also building up sales stock for the Dieren closure that we have announced. So it's going according to plan entirely. Our internal target number of days-on-hand are spot on, so this is just in line with what we are expecting in our operating plan.

You can see that our CAPEX is in line with last quarter, slightly above but not a lot. The big item you see in this table is the SEK232 million on the financing activities, and that relates to the SEK144 million of dividend that we did in the quarter and also an amortisation of debt of SEK90 million that we did in the quarter. And those two with some slight smaller items is the total number for the quarter.

If we then continue to the next page before I finish off, you can see that we are holding 2.8 times net debt/EBITDA, slightly above 2.78 we had in Q1. Had we not done the dividend payment, we would have been very close to our financial long term strategy. We need to come up to an EBITDA of SEK1 billion, we are closing in on that. And our net debt being at SEK2.5 billion, then the ratio would be achieved. So we feel comfortable with the delivery of cash. Even though we might have had a negative movement on working capital, we still feel strong about cash-generating capabilities.

And with that, I give the word back to David.

David Nuutinen

Thank you, Danko. So going forward, in focus areas, it is of course on profitable growth. That is our bread and butter. It is all about the – building the plans, delivering the plans, everyday execution, driving for quarterly growth, monthly growth, daily growth. The second one is the implementation and driving the initiatives within Pick & Mix. As you know, we have – we are now number one in Sweden in this area.. And of course through the new customers and our experience, we are gaining momentum, and of course, then want to drive that initiative further.

As Danko also mentioned, the closure of factory in Dieren is moving according to plan. It is absolutely going according to plan and the production in Dieren will cease towards the end of this year and then the production will be transferred to Levice in Slovakia.

And the fourth focus area is the operational excellence in supply chain after having gone through a major restructuring process. Now, it's all about the daily operations and working on that. And Lean 2020 is very much focussed on line efficiencies, waste management and etc.

On the last page, not – definitely not the least, is of course the end product, the products that we are then delivering to our customers and consumers. Here, you can see a selection of product launches during the second quarter. This category is characterised by the fact that there are a lot of launches and a lot of news to both consumers and customers. You can see here that we have line extensions in the various markets taking place, also including some channels like travel retail. And what is very, very delightful to see is that we are very, very active in all of the main categories, being enjoyment, gum, pastilles and chocolate across all markets.

Jacob Broberg

Okay. Thank you, David. With that, we open up for questions. So please go ahead, operator.

Operator

Thank you. Ladies and gentlemen, if you wish to register for a question, please press 0 followed by the 1 on your telephone keypad. If you wish to cancel your request, you may do so by pressing 0 followed by the 2. Once again, to register for a question is 0 followed by the 1 on your telephone keypad.

The first question comes from Mikael Holm from Danske Bank. Please go ahead. Your line is now open.

Mikael Holm

Yeah. First, a question on the gross margin, adjusted up 140 basis points. If you've confirmed that there was 110 basis points dilution from Lonka, I think you said that. But explaining this, I mean, underlying improvement then on 260 basis points, you mentioned supply chain improvement. But could you also mention other factors if there are positive net between, for example, raw materials and your net price is in the quarter? That's the first question.

I have a second one and that's basically related to the OPEX development. I think underlying OPEX was basically flat in the first quarter despite that in Lonka and now costs are growing, I think, 9%. Was there a bit of timing in some cost between these two quarters or are there some other explanations why you didn't have that cost growing again in this quarter?

Danko Maras

Okay. That's – good morning, Mikael. It's Danko here. Let me just go through and see if I remember all three of them, I think so. The gross margin, when it comes Lonka, yes, it's confirmed that we have a dilution from Lonka of 110 basis points, it's year-to-date equal. So the impact on the fact that we are including Lonka in our reporting and we did not have it in the first half here last year is a dilution of 110 points on a year-to-date basis as well. So clearly, that is something we are working on to improve. At the same time, the underlying gross margin is even better than what we are reporting and we thought that was important to highlight.

There is a – in the supply cost, it means there can be a multitude of items that are structurally improving. It can be anything from input cost to conversion cost to coverage, the fact that you're producing more and get a lower cost per unit. We have a good distribution of those items in total. Clearly, the whole manufacturing footprint was about margin expansion through improvement in the conversion cost. And we can see that the delivery of our strategy is yielding a lower conversion cost per kilo in line with our strategy. Clearly, we are also of course in a situation where we don't have significant high input costs, so that is also benefitting us. And our coverage, as you can see, the growth we are showing is predominantly on volume. So the fact that Pick & Mix is doing well is also helping the supply chain and the cost per unit.

On the OPEX part, you have seen, if we look at the quarter and year-to-date, the direct selling is flat on a year-to-date basis. Despite us investing in merchandises for our Pick & Mix, the G&A is going up. But please remember, and you can see that in these tables that we are introducing now, that the earn out adjustments both in the quarter and year-to-date is quite significant and is booked in G&A. The other part that is also affecting the comparator is the fact that we are not having Lonka in the prior year. It is now in the current year indirect but it was not part of it last year. Our scrutiny on selling expenses in G&A is very firm and we have a good control of the cost in our indirect structure. As you know, the value creation is predominantly coming from margin expansion and gross margin but we need to hold firm of our OPEX as well and I would say we feel we have a good control of that.

Hopefully, that answers your three questions.

Mikael Holm

Yeah, that's fine. Thank you.

Operator

Thank you. The next question comes from Alexander Koefoed from Nordea. Please go ahead. Your line is now open.

Alexander Koefoed

Yes. Hello, gentlemen. Thanks for taking my questions. The first one would be on working capital. Would you say that the trend in Q2 of negative cash effect from working capital is likely to continue for the remainder of the year?

Danko Maras

Hello, Alexander. It's Danko here again. I'll take that one as well. If you look at working capital as a percent of net sales, you can see that we're still below the 10% which has been our strategy. We continue to build inventory because in the third quarter, we are actually starting to produce the whole nougat production for our seasonals campaign in the fourth quarter and that's very normal in our line of business. We have done that every year. So we are doing a build-up of inventory. At the same time, I think that the big reference point that should be there is, where is our working capital as a percent of net sales And we are actually below the 10% currently. We intend to stay there. We do not intend to increase it. So the working capital movement on a full-year basis, you will see swings between the quarter, but we will stay below the 10%.

Alexander Koefoed

Okay. And I think you mentioned that you have some effect from building up stock because of the factory moved to Slovakia. Is there something extra that you might see there compared to previous quarters?

Danko Maras

Absolutely, we are stopping production in there, and during the time we are moving and setting up the lines in Slovakia there will be no production of those products and we need to ensure that we have sufficient safety stock to deploy and dispatch those products to the markets. So that build-up is something that we are doing as we go along. And then of course, we will have to make sure that we revert back into this normal production in Levice as the lines starts working. All of that are a little bit unknowns but we feel we are in a good position. We have some experience fortunately and unfortunately, the closed factories. And therefore, we know that we need our time to make sure that the calibration of the line efficiency will be up and running again.

Alexander Koefoed

Okay. And on the payable side, could you add some colour on the development there? It's my understanding that that has also affecting your cash flow negatively.

Danko Maras

There's nothing specific on the accounts payable that is affecting it either way, it is a result of the different supplier payables that we are having. We haven't seen any specific trend of it. As you've seen, we have a significant improvement in receivables and they are sort of offsetting each other. So no particular event that drives the payables more than the effects of any given quarter. Please keep an eye on the 10%, that's the benchmark that we are holding firm to.

Alexander Koefoed

Okay. Fair enough. So there is not an effect, for example, from higher cocoa prices or other raw materials in that?

Danko Maras:

Not really, no.

Alexander Koefoed

Fair enough. And then just one last question if I may. On UK, do you see any changed behaviour with your customers, retailers in that markets?

David Nuutinen

I mean, since the Brexit referendum, I think that it's too short period of time yet to say and see. I think it remains to be seen and we are monitoring it of course closely. But so far, nothing spectacular or important.

Alexander Koefoed

Okay. Very clear. Thank you very much for taking my questions.

Operator

Thank you. The next question comes from Anna Patrice from Berenberg. Please go ahead. Your line is now open.

Anna Patrice

Yes, hello. Well, thank you very much for all the questions already provided and also for more information on the restructuring charges. That all was very helpful. So thank you very much. Just a couple of questions from my side – well, five questions. First one is again on organic growth. So you had an amazing quarter despite the market weakness. Could you maybe elaborate maybe why do you think the markets were weak and what are your expectations going forward for the markets? And should we expect these kind of 2% organic growth going forward for the rest of the year?

Second question again on the growth, on Lonka. I understood – maybe I was wrong, but my – I thought that Lonka in 2014, before acquisition, it did something like 300 million of sales. So in this first half of the year, you did higher 137. Last year in the second half, it was roughly I think 150 million, if I'm not mistaken, right? So if I put those together, that will be still below 300 million that Lonka did in 2014. So what are the drivers here and how do you expect the growth for Lonka going forward?

Third question is on the tax rate. I understood why the tax rate is a bit elevated in the first half of the year. If I adjusted those one offs, the underlying tax rate is in range of 25% I believe. So is that a good a proxy for the second half of the year?

The fourth question is on – again, on the working capital, this is a follow-up question. I understood that there are some build-ups that you have to do ahead of the closure of the Lonka facilities in the second half. Do you think that it will inflate significantly more your working capital or do you think what you have seen as a [inaudible] capital is kind of sustainable so that shouldn't much of their further cash flow, the cash outflow from the build-up and working capital?

And then the last question is on the G&A because there was a substantial increase in G&A in the first half of the year and also in the second quarter, even if I adjust for one-offs. So what is the driver behind this increase in the G&A and how should I think about it going forward? Thank you.

David Nuutinen

Okay. Anna, it's David here. So I'll take the two first questions. You were – the first question was referring to the organic growth of 2% in market development and elaborating a bit on that. I think on the market developments as we've seen over the years that there can be some swings between the quarters. As you will remember that I have also mentioned that the market development per se can be driven by launches, campaigns, promotions, how do they fit last year in quarter 2, we saw somewhat of an upswing in the market development. Those drivers then are different this year. The market developments in terms of when we are saying that they're somewhat negative are not significantly negative, we just see that – those swings. Our sales development, and particularly in some of the Nordic markets where have – where we're seeing a strong – stronger growth development is particularly then explained and drivers are, as mentioned, the – in Sweden and Finland, the Pick & Mix, and Sweden also – as I've said, that last year we had a customer contract negotiation challenge, that was then solved and now we're seeing the positive impact of being back in business. And then in Finland, we see the Pick & Mix and the pastilles and the strong launches.

So there is no sort of one clear sort of driver for the – a generic driver for the market. It varies from market to market. Then when we speak about the development of Lonka sales in 2014, we have announced that the sales was about SEK300 million. Our plans going forward and how we have been executing the plans, we are moving in accordance with plans. We have seen, for instance, in Norway where we have – one of our customers has lost their contract and thus – and the – in the Pick & Mix area and the new Pick & Mix aggregator there has not taken Lonka in. So we have some swings here and there but overall, we're moving according to plan.

Donka Maras

Okay. So if I take the last three then, Anna.

Anna Patrice

Sorry. So just a quick follow-up on Lonka. So what are your expectations? Do you expect that the Lonka overall will grow in line with the markets, in line with your guidance of 1%, 2%? And then this last contract, did – do you recover it? Or should we expect to feel some slightly lower growth or slightly lower sales in Lonka in 2016 versus what it did before you bought it?

David Nuutinen

Well, Anna, as you remember, when we announced the Lonka acquisition, we said that it will particularly strengthen our position in the Dutch market, but also in the Nordic markets and the UK in Pick & Mix. And it will – and it also gives us access to new technology and with that new technology, we do see overtime further opportunities in that type of product, which is then soft nougat and toffee and fudge. In terms of what we have communicated to the market that with the black factory closure and the synergy realisations into 2017, this business will contribute to the 14% EBIT margin target.

Anna Patrice

Okay. Thank you.

Danko Maras

Okay. So then actually, quick answers to your last three questions, Anna. On the tax rate, I'll give you some numbers for all of you so that, you know, it's about 29% year-to-date. Italy is 290 points of that which is extra above our corporate rate. The earn out is about 170 points and international rate difference is about 170 points. So the two first ones are a bit one-off in nature. It would be then reasonable to assume somewhere to 23% to 24% at the corporate tax rate for our company. Please remember also in the actual cash tax paid year-to-date is 1 million.

On the working capital, I would just simply say that we are working on this 10% benchmark, Anna. So hold it to that; we'll hold ourselves accountable to achieve that strategy. We are below that level. We should not go above that level. And then on the G&A, again, the significant parts that are relevant for analysis is that if they started with the earnout adjustment and Lonka, then there are some other minor parts. But I don't feel the merit of going through them in detail here. Okay?

Anna Patrice

Okay. Thank you very much. So that means that for G&A as it is – as adjustments are out already, the earn out are out and Lonka already was consolidated in the second half. That means in G&A, in the second half, we should seek a stabilisation of the growth in G&A, right?

Danko Maras

Specifically to Lonka, you are absolutely right.

Anna Patrice

And – sorry. On the earn outs are there more to be seen?

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Danko Maras

What – the fact that we now own The Jelly Bean Factory means that we only have one more ear nout to work on and that relates to the Nutisal business. The actual payout of that is planned for next year in the second half of the – sorry, in the second quarter. Currently, the expectation is that we will do the actual payout and the adjustments to that, I don't see any particular or major issues regarding the earn out as we see it today.

Anna Patrice

Okay. All clear. Thank you very much.

Operator

Thank you. Ladies and gentlemen, as another reminder, to register for a question please press 0 followed by the 1 on your telephone keypad.

The next question comes from Stefan Cederberg from SEB. Please go ahead. Your line is now open.

Stefan Cederberg

Thank you and good morning. I have question on Lonka. If I have done the calculation correctly it seems that you are saying the gross margin in Lonka is 25%. And the first question is, why is it so low?

And the second question is, is there any reason to believe why not Lonka gross margin will approach group average? And if that is the case, it looks like your 35 million in synergies seems a bit low.

Danko Maras

Hi, Stefan. This is Danko. I'll take your question. The 35 million improvement that you will see coming through, of course, we can debate whether it's too low or too high or in line with strategy, but it will contribute to the 14% EBIT margin. You are absolutely right that the margin in Lonka is lower than our average 40% margin. I don't want to be specific about exactly how much it is but you are right. And the synergy realisation that you will see from the Lonka restructuring with, both the fact that we will produce the products in Levice, but also the fact that we will insource third-party production because we now have a line in Levice that can do those products, will contribute in gross margin predominantly. So almost – virtually all the synergy realisation that we have announced will come through in the gross margin for Lonka. And why it's so much lower than our general margin, I think that has to do with the heritage of market share positioning, that we have such a strong brand positioning in our countries, it's the fact that it's not easy for a smaller player to hold good margins even though they've been very, very efficient in their supply chain, it's still very difficult towards the trade to hold the right pricing. And all of that, we are reviewing now with a completely different go-to market capability than what we had in the past.

Stefan Cederberg

Okay. And second question, on – I think you are the current CEO of your Italian market and I guess you're in the midst of planning for the seasonal product sales. What is your plan on the instance price level and do you anticipate to regain some market share in Italy in Q4 and also how that correlates to the nut prices?

Danko Maras

Yes, Stefan. I am down in Milano and Cremona quite a lot nowadays. It's a fantastic team in Italy. And you're absolutely right. It is very interesting for me to be part of this process. You are right in that there's a lot of work for us in preparing the seasonal sales which is a big event. So we're already now approaching our central customers on pricing. Clearly hazelnuts and almonds have gone down in pricing and you know that our policy is very consistent about the 14%. It should be unaffected by input cost. So we will make a price decrease for the season of 2016; that is in line with the decline of almonds and hazelnuts and we are expecting a volume recovery because of that.

It's too early to tell. We are in June. The first indications are according to plan but perhaps I should just be a bit refrained from saying anything more than that. It is a risk considering the fact that we've lost a lot of volume last year. So I don't want to give any positive or negatives at this point. It's just very interesting for me to see a great team working and preparing for the seasonals execution. It takes almost half a year to get it right and they have started well and that is our key focus in Italy at the moment.

Stefan Cederberg

Okay. Thank you.

Operator

Thank you. There appear to be no further questions. I'll return the conference back to you.

Jacob Broberg

Okay. Thank you everyone for listening in and we will say thank you for now and speak to you next time. Thank you and have a nice summer.