MORGAN-DEMPSEY
CAPITAL MANAGEMENT, LLC

Hershey | Ticker: HSY| Initiate 1.25% Position **March 2024**

Company Overview

Iconic though this enterprise is, we'll still provide a little introduction. Hershey is organized into three segments: **North America Confectionary**, 82% of sales in 2024, brands ranging from *Reese's* (which now slightly outsells the Hershey brand) to *Twizzlers* and *Ice Breakers*; **North America Salty Snacks**, 10% of sales, which is the result of several acquisitions beginning in 2017 (*Skinny Pop*, *Pirate's Booty*, and *Dot's Homestyle Pretzels*), and **International**, 8% of sales, reflecting operations outside of the U.S. and Canada.

Founded in 1894, Hershey is to this day still controlled by the nonprofit Hershey Trust, which owns a ~27% economic stake in the business but holds 79% control through super voting shares. While the Trust's entrenched control has not led to obvious deficiencies in the success of the business across time, we note that this and several related factors all but foreclose the possibility of a takeover—whether or not it might be in the interest of public shareholders.

Positives

1) Hershey has established itself as a truly dominant business, with generations of shareholder value creation to prove it. In the last decade or so, pretax returns on tangible invested capital (that is, excluding cash and goodwill/intangibles) have run in the 70%-80% range. Though there is a limited amount of incremental capital that can be reinvested on such attractive terms, this nevertheless reflects the company's impressive brand value and pricing, scale in its field, the plump margins arising from the combination, and its staying power across time.

2) Though the company has—like many of its peers—a certain long-cycle pattern of growth, complacency, reinvention, and reacceleration—we nevertheless applaud the progress the company has made under CEO Michele Buck. Since she became CEO in March 2017, growth has accelerated (both internal and with acquisitions), margins have expanded, and the stock has strongly outperformed both the S&P 500 Staples sector as well as the Russell 1000 Value index—even after a very sharp drawdown in 2023.

3) The company's newest platform in the salty snacks category leverages existing SG&A infrastructure and access to retail channels, and—now with over $1bn in annual revenue—we think it has reached critical scale to introduce new innovations, gain market share, scale, and bolt-on small acquisitions to maximum benefit. Hershey also seems to be gaining a bit more traction (for the first time in forever) in its overseas operations, led now by *Reese's* as opposed to other Hershey brands. It's said in the business that chocolate doesn't travel well—in fact, even Canadians have distinct tastes relative to Americans, to say nothing of Europeans or far-flung emerging markets.

4) The company has fairly significant restructuring and integration activities under way to mitigate near-term cost pressures and sustain operating profits (at least in terms of dollars, if not necessarily margins).

Negatives & Risks

1) ***Commodity price inflation.*** This is headline risk #1, as spot cocoa futures have gone from ~$2,500/ton on average in recent years to $10,000 a ton today. Catastrophically bad weather and other growing conditions in key African producing regions have played a role, as (of course!) are speculative positions in the commodity. The futures curve is heavily backwardated, but even the furthest-out contracts still indicate cocoa being twice as expensive as it had been prior to 2023. (Sugar, nuts, and other raw material inflation haven't exactly been a picnic, either.)

   We doubt Hershey buys any significant quantities of its raw material bill on the front-month futures contract—its filings disclose long-term relationships and forward purchases designed to insulate the business from commodity-price volatility. But another part of the cocoa story comes from reports that the key growing regions are small, inefficient, and have been lacking proper maintenance-level investment for some time. What today manifests itself as a weather-induced price spike could give way to a longer period of volume shortage.

2) ***Uncertain limits to pricing power.*** Hershey has already demonstrated immense pricing power across time, as its items are (a) low-cost in an absolute sense, even after inflation, (b) generally impulse purchases, and (c) are a big help in driving retailer traffic and revenue. But while 2023—again—showed the top- and bottom-line benefits of such power, volumes turned negative, and the company shed a minor amount of North American market share in both Confectionary and Salty Snacks.

   After taking large price hikes in recent years, management is now cagey about the course for 2024—maybe that's just to keep competitors off balance, or maybe it's because they aren't sure that further price hikes (even to recover higher commodity costs) will help sales or operating profit.

3) ***Broader health & sustainability concerns***. This is where I finally mention the GLP-1 drugs (weight loss drugs). In general, I think a bet *against* human stupidity has been a rather poor one—we shouldn't even eat chocolate, let alone smoke cigarettes, and drink whiskey. Hershey's corporate motto is actually centered around the idea that its mission is to provide "life's little pleasures;" is that maybe what Chesterfield cigarettes would have written 80 years ago? So, we are more than willing to take this part of the bet—but there is headline risk, and perhaps even a 1% chance of actual risk underlying the changes associated with the impact weight loss drugs will have on future human impulsive spending behavior.

Dividend Characteristics

One could hardly find a more ideal candidate for our portfolio in terms of its dividend characteristics: A/A1 credit ratings, 2.82% yield with the board recently increasing the dividend by 15%. The company has a long-term track record of dividend growth with 15 straight years of increases and a 5-year annualized dividend growth rate of 11.2%. Hershey's dividend policy is for the dividend to increase in line with earnings.

Current & Historical Valuation

Where we are now is about as cheap as Hershey ever gets. Even though it would only quite dubiously and erroneously be assigned any kind of acquisition premium—and there's no evidence of that being discounted today—the market has long given Hershey a top-tier valuation thanks to its dominant market position, high ROICs (Return On Invested Capital), impressive cash flow, and recession-resilient nature.

The last time Hershey was in strategic-reset mode, 2016-2017 (right before Buck became CEO), well, that was also the last time Hershey's stock came to have a dividend yield like the one it has right now.

On a P/E basis, we find an even more tantalizing picture. The forward P/E of 20x is not quite the lowest on record, but it's definitely one of the lowest in the company's history. More interesting to me is the *relative P/E* (this being the P/E of Hershey—in this case on a trailing basis—relative to the S&P 500). On a relative basis this is the cheapest Hershey has been over the last 25 years.

<u>Current & Historical Valuations</u>

Valuation Matric	Current	5-Year High	5-Year Low	Average	Vs. Industry
Trailing PE	20.2	34.8	19.3	26.6	1.2
Forward PE	18.8	28.5	17.6	23.6	1.1
Price to Book Value	9.1	23.8	9.1	15.7	3.3
Price to Cash Flow	16.1	24.5	13.1	19	1.2
Price to Sales	3.4	5.5	2.9	4.2	1.9
Enterprise Value to EBITDA	13.4	22.1	13.4	17.9	1
Enterprise Value to Sales	3.7	5.6	3.6	4.6	1.6
Dividend Yield	3.0	3.0	1.4	1.9	1.2

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<u>Definitions</u>
PE (Price-to-Earnings Ratio): PE is a financial metric that measures the valuation of a company by comparing its stock price to its earnings per share. It indicates how much investors are willing to pay for each dollar of a company's earnings. Trailing refers to the past 12 months and forward is on expected next 12 months of earnings.

Book Value: Book value is the net asset value of a company, calculated by subtracting its total liabilities from its total assets. It represents the theoretical value of a company's equity if all its assets were sold, and its debts were paid off.

Cash Flow: Cash flow refers to the money that flows in and out of a business. It's the difference between the cash generated from operating activities and the cash used for investing and financing activities. Positive cash flow indicates a healthy financial position.

Enterprise Value to EBITDA (EV/EBITDA): EV/EBITDA is a financial ratio used to assess a company's overall value in relation to its earnings before interest, taxes, depreciation, and amortization (EBITDA). It provides a more comprehensive view of a company's value, accounting for its debt and other financial factors.