

Hershey has an action plan to protect forests and restore forest cover in the cocoa-growing regions in West Africa. THE HERSHEY COMPANY

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Hershey Has a Cocoa Problem. Buy the Stock Anyway.

The price of cocoa has more than tripled over the past year, squeezing Hershey's profits and pushing its share price down. Now is a golden opportunity to get in.

By Jacob Sonenshine Follow

March 28, 2024, 1:00 am EDT

Surging cocoa prices have hit Hershey ↑ HSY 1.47% —hard. But prices won't stay high forever. It's time to buy the chocolate maker's beatenup stock.

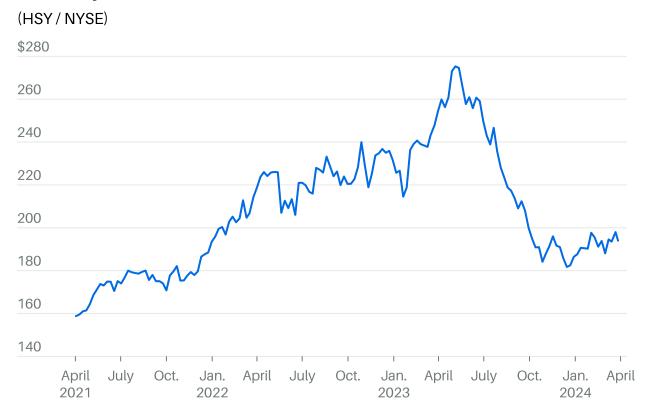
Shares of Hershey have dropped 23% over the past 12 months, underperforming the S&P 500 index ↑ SPX 0.86%, which has gained 31%, and even the Consumer Staples Select Sector SPDR ↑ XLP 1.05% exchange-traded fund, which is up 4%. The problem: The price of cocoa, which comprises roughly a fifth of Hershey's cost of goods, has more than tripled 🗷 over the past year, squeezing the company's margins and causing investors to flee its typically stable stock.

Cocoa's rise has been extraordinary. As it approaches \$10,000 per metric tone, it is now more expensive than copper. The run-up has been driven by supply constraints in Africa, as dry weather and wildfires reduced the stock of beans available for sale.

Underinvestment and plant disease have also hurt crop yields.

At some point along the way, though, the mechanics of futures trading took over, causing the price to more than double during the first three months of 2024, its best quarter on record. To Walter Zimmermann, chief technical analyst at ICAP Technical Analysis, that signals that sentiment is "extreme...the cocoa market is clearly overheated."

Hershey



Source: FactSet

It's unlikely to stay that way. Commodity prices tend to overshoot—in both directions. Whether it was the surge in <u>silver prices in 2011</u> or the tumble in oil prices in 2020, extreme moves reversed—and suddenly. It didn't matter that there was no catalyst—the outsize moves became the reason. In a recent note, Citigroup analyst Aakash Doshi cited the spike in grain prices following Russia's invasion of Ukraine as another example of an extreme move that eventually reversed.

But high prices bring fundamental changes. In the case of cocoa, the industry is likely cutting back on its use and dipping into reserves, while waiting for new crops to come to market, Doshi writes. "Our base case remains that cocoa terminal prices will enter a bear market by end-2024, off a historically rich nominal price area," he explains.

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That would be fantastic news for Hershey. The company has lifted Picks & Pans

prices, but it can't do so enough to offset the higher commodity

costs. Since the end of 2023's first half, analyst estimates for gross margins for this year and next have dropped from 45% to 43.5%, which caused earnings-per-share estimates for 2024 to drop 7.4%, according to FactSet estimates. That's even as Hershey works to reduce other costs, mainly employee-related expenses.

Key Data

Hershey (HSY)	Confectionery maker
Headquarters	Hershey, Penn.
Recent Price	\$193.65
YTD Change	3.4%
Market Value (billion)	\$39.5
2024E Sales (billion)	\$11.5
2024E Net Income (billion)	\$2.0
2024E EPS	\$9.58
2024E P/E	20.2
Dividend Yield	2.8%

Source: FactSet

The cocoa pain, however, has masked the strong underlying performance of Hershey's business. Sales grew by just over 7% in 2023 to \$11.2 billion, and the company said it expects revenue to grow by 2.5%, at the midpoint of its guidance range this year. Business in the U.S. has been strong—Hershey saw only a mild decline in the number of confectionary items sold, even as it raised prices, while salty snack volumes, most from Skinny Pop, grew.

The real growth opportunity, though, is overseas, where Hershey's gets only a tenth of its sales. The company and its Reese's, gummy, and legacy Hershey chocolate brands will need to take just a small sliver of share away from the major players, including Mondelez

International ↑ MDLZ 0.70% and Nestlé ↓ NESN -0.18%. "Although Western Europe's chocolate market is fiercely competitive, even small share growth can be impactful," writes Mizuho Securities analyst John Baumgartner.

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Hershey is rarely this cheap. The stock, at \$193.71, trades at 20.2 times 12-month earnings expectations of \$9.58 a share, well below its five-year average of 23.6 times. The only time it has been cheaper during the past 20 years has been during

market dislocations, such as in 2009, 2018, and 2020. What's more, Hershey's high quality and predictability of earnings typically means that it trades at a premium to the S&P 500 and to other staples. Now it trades at a discount to both.

Hershey is also paying investors well to wait for cocoa prices to come down. The company produces well over \$1 billion in annual free cash flow, which allows it to repurchase stock. It bought back \$25 million worth of shares in the fourth quarter—and still has \$370 million remaining in its share repurchase authorization. It continues to grow its dividend, which has increased for 48 consecutive years. The stock now yields 2.8%.

Commodity prices just need to cooperate. "If cocoa prices come down, you'll see investors step in, long-only investors wanting to buy more of the stock," says RBC Capital Markets analyst Nik Modi.

We already do.

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