HERSHEY CO
Form 10-Q
July 28, 2017

---

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended July 2, 2017

OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period
from ______to_______

Commission file number 1-183

THE HERSHEY COMPANY
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Delaware | 23-0691590 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

100 Crystal A Drive, Hershey, PA
17033
(Address of principal executive offices)
(Zip Code)
717-534-4200
(Registrant’s telephone number, including area code)
Not Applicable
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company” and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer x Accelerated filer ¨ Smaller reporting company ¨

Non-accelerated filer ¨ (Do not check if a smaller reporting company) Emerging growth company ¨

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

Indicate the number of shares outstanding of each of the registrant's classes of common stock as of the latest practicable date.
Common Stock, one dollar par value—151,827,032 shares, as of July 21, 2017.
Class B Common Stock, one dollar par value—60,619,777 shares, as of July 21, 2017.

THE HERSHEY COMPANY
Quarterly Report on Form 10-Q
For the Period Ended July 2, 2017

TABLE OF CONTENTS

PART I — FINANCIAL INFORMATION
Item 1. Financial Statements.
THE HERSHEY COMPANY
CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except per share amounts)
(unaudited)

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | July 2, 2017 | July 3, 2016 | July 2, 2017 | July 3, 2016 |
| Net sales | $1,662,991 | $1,637,671 | $3,542,669 | $3,466,483 |
| Cost of sales | 899,781 | 890,273 | 1,872,899 | 1,901,709 |
| Gross profit | 763,210 | 747,398 | 1,669,770 | 1,564,774 |
| Selling, marketing and administrative expense | 445,888 | 462,531 | 907,788 | 934,265 |
| Long-lived asset impairment charges | — | — | 208,712 | — |
| Business realignment costs | 1,981 | 22,105 | 45,998 | 28,238 |
| Operating profit | 315,341 | 262,762 | 507,272 | 602,271 |
| Interest expense, net | 24,126 | 21,338 | 47,867 | 42,343 |
| Other (income) expense, net | 10,098 | 8,128 | 9,927 | (13,097) |
| Income before income taxes | 281,117 | 233,296 | 449,478 | 573,025 |
| Provision for income taxes | 78,390 | 87,340 | 148,503 | 197,237 |
| Net income including noncontrolling interest | 202,727 | 145,956 | 300,975 | 375,788 |
| Less: Net loss attributable to noncontrolling interest | (774) | — | (27,570) | — |
| Net income attributable to The Hershey Company | $203,501 | $145,956 | $328,545 | $375,788 |
| | | | | |
| Net income per share—basic: | | | | |
| Common stock | $0.98 | $0.70 | $1.58 | $1.79 |
| Class B common stock | $0.89 | $0.64 | $1.44 | $1.64 |
| | | | | |
| Net income per share—diluted: | | | | |
| Common stock | $0.95 | $0.68 | $1.53 | $1.74 |
| Class B common stock | $0.89 | $0.64 | $1.44 | $1.63 |
| | | | | |
| Dividends paid per share: | | | | |
| Common stock | $0.618 | $0.583 | $1.236 | $1.166 |
| Class B common stock | $0.562 | $0.530 | $1.124 | $1.060 |

See Notes to Unaudited Consolidated Financial Statements.

THE HERSHEY COMPANY
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands)
(unaudited)

| | Three Months Ended | | | | | | Six Months Ended | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | July 2, 2017 | | | July 3, 2016 | | | July 2, 2017 | | | July 3, 20 |
| | Pre-Tax Amount | Tax (Expense) Benefit | After-Tax Amount | Pre-Tax Amount | Tax (Expense) Benefit | After-Tax Amount | Pre-Tax Amount | Tax (Expense) Benefit | After-Tax Amount | Pre-Tax Amount |
| Net income including noncontrolling interest | | | $202,727 | | | $145,956 | | | $300,975 | |
| Other comprehensive income (loss), net of tax: | | | | | | | | | | |
| Foreign currency translation adjustments | $4,322 | $— | 4,322 | $1,420 | $— | 1,420 | $18,273 | $— | 18,273 | $13,586 |
| Pension and post-retirement benefit plans: | | | | | | | | | | |
| Net actuarial loss and prior service cost | — | — | — | (29,806) | 11,350 | (18,456) | (196) | 74 | (122) | (29,806 |
| Reclassification to earnings | 7,091 | (10,984) | (3,893) | 25,625 | (9,781) | 15,844 | 14,244 | (13,695) | 549 | 34,305 |
| Cash flow hedges: | | | | | | | | | | |
| Losses on cash flow hedging derivatives | (707) | 703 | (4) | (21,072) | 7,283 | (13,789) | (2,206) | 882 | (1,324) | (54,981 |
| Reclassification to earnings | 2,379 | (1,282) | 1,097 | (3,867) | 1,692 | (2,175) | 5,412 | (2,448) | 2,964 | (11,776 |
| Total other comprehensive income (loss), net of tax | $13,085 | $(11,563) | 1,522 | $(27,700) | $10,544 | (17,156) | $35,527 | $(15,187) | 20,340 | $(48,672 |
| Total comprehensive income including noncontrolling interest | | | $204,249 | | | $128,800 | | | $321,315 | |
| Comprehensive loss attributable | | | (698) | | | (213) | | | (27,154) | |

| | | | |
|---|---|---|---|
| to noncontrolling interest | | | |
| Comprehensive income attributable to The Hershey Company | $204,947 | $129,013 | $348,469 |

See Notes to Unaudited Consolidated Financial Statements.

THE HERSHEY COMPANY
CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

| | July 2, 2017 | December 31, 2016 |
|---|---|---|
| ASSETS | (unaudited) | |
| Current assets: | | |
| Cash and cash equivalents | $214,062 | $296,967 |
| Accounts receivable—trade, net | 417,457 | 581,381 |
| Inventories | 936,437 | 745,678 |
| Prepaid expenses and other | 343,573 | 192,752 |
| Total current assets | 1,911,529 | 1,816,778 |
| Property, plant and equipment, net | 2,033,790 | 2,177,248 |
| Goodwill | 818,068 | 812,344 |
| Other intangibles | 378,271 | 492,737 |
| Other assets | 182,980 | 168,365 |
| Deferred income taxes | 55,590 | 56,861 |
| Total assets | $5,380,228 | $5,524,333 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | $471,545 | $522,536 |
| Accrued liabilities | 641,743 | 750,986 |
| Accrued income taxes | 6,863 | 3,207 |
| Short-term debt | 621,965 | 632,471 |
| Current portion of long-term debt | 89 | 243 |
| Total current liabilities | 1,742,205 | 1,909,443 |
| Long-term debt | 2,349,756 | 2,347,455 |
| Other long-term liabilities | 397,204 | 400,161 |
| Deferred income taxes | 21,081 | 39,587 |
| Total liabilities | 4,510,246 | 4,696,646 |
| | | |
| Stockholders' equity: | | |
| The Hershey Company stockholders' equity | | |
| Preferred stock, shares issued: none at July 2, 2017 and December 31, 2016 | — | — |
| Common stock, shares issued: 299,281,967 at July 2, 2017 and December 31, 2016 | 299,281 | 299,281 |
| Class B common stock, shares issued: 60,619,777 at July 2, 2017 and December 31, 2016 | 60,620 | 60,620 |
| Additional paid-in capital | 904,588 | 869,857 |
| Retained earnings | 6,187,409 | 6,115,961 |
| Treasury—common stock shares, at cost: 147,487,088 at July 2, 2017 and 147,642,009 at December 31, 2016 | (6,240,629) | (6,183,975) |
| Accumulated other comprehensive loss | (355,964) | (375,888) |
| Total—The Hershey Company stockholders' equity | 855,305 | 785,856 |
| Noncontrolling interest in subsidiary | 14,677 | 41,831 |
| Total stockholders' equity | 869,982 | 827,687 |
| Total liabilities and stockholders' equity | $5,380,228 | $5,524,333 |

See Notes to Unaudited Consolidated Financial Statements.

THE HERSHEY COMPANY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

| | Six Months Ended | |
|---|---|---|
| | July 2, 2017 | July 3, 2016 |
| Operating Activities | | |
| Net income including noncontrolling interests | $300,975 | $375,788 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 132,079 | 156,779 |
| Stock-based compensation expense | 24,557 | 26,208 |
| Deferred income taxes | (44,484) | (5,615) |
| Impairment of long-lived assets (see Note 7) | 208,712 | — |
| Write-down of equity investments | 10,263 | 15,061 |
| Gain on settlement of SGM liability (see Note 2) | — | (26,650) |
| Other | 26,418 | 32,479 |
| Changes in assets and liabilities, net of business acquisitions: | | |
| Accounts receivable—trade, net | 163,924 | 118,932 |
| Inventories | (190,759) | (110,987) |
| Prepaid expenses and other current assets | (40,162) | (32,909) |
| Accounts payable and accrued liabilities | (174,004) | (140,937) |
| Accrued income taxes | (74,638) | (38,301) |
| Contributions to pension and other benefits plans | (19,449) | (16,544) |
| Other assets and liabilities | 12,302 | 15,406 |
| Net cash provided by operating activities | 335,734 | 368,710 |
| Investing Activities | | |
| Capital additions (including software) | (84,687) | (104,109) |
| Proceeds from sales of property, plant and equipment | 865 | 1,657 |
| Equity investments in tax credit qualifying partnerships | (22,415) | (16,763) |
| Business acquisitions, net of cash and cash equivalents acquired | — | (285,374) |
| Net cash used in investing activities | (106,237) | (404,589) |
| Financing Activities | | |
| Net (decrease) increase in short-term debt | (13,696) | 630,121 |
| Repayment of long-term debt | (150) | — |
| Payment of SGM liability (see Note 2) | — | (35,762) |
| Cash dividends paid | (256,128) | (243,139) |
| Repurchase of common stock | (99,992) | (452,580) |
| Exercise of stock options | 54,826 | 39,147 |
| Net cash used in financing activities | (315,140) | (62,213) |
| Effect of exchange rate changes on cash and cash equivalents | 2,738 | 1,748 |
| Decrease in cash and cash equivalents | (82,905) | (96,344) |
| Cash and cash equivalents, beginning of period | 296,967 | 346,529 |
| Cash and cash equivalents, end of period | $214,062 | $250,185 |
| Supplemental Disclosure | | |
| Interest paid | $49,565 | $42,005 |
| Income taxes paid | 265,756 | 239,501 |

See Notes to Unaudited Consolidated Financial Statements.

THE HERSHEY COMPANY
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
(in thousands)
(unaudited)

| | Preferred Stock | Common Stock | Class B Common Stock | Additional Paid-in Capital | Retained Earnings | Treasury Common Stock | Accumulated Other Comprehensive Income (Loss) | Noncontrolling Interest in Subsidiary | Total Stockholders' Equity |
|---|---|---|---|---|---|---|---|---|---|
| Balance, December 31, 2016 | $ — | $299,281 | $60,620 | $869,857 | $6,115,961 | $(6,183,975) | $(375,888) | $41,831 | $827,687 |
| Net income (loss) | | | | | 328,545 | | | (27,570) | 300,975 |
| Other comprehensive income | | | | | | | 19,924 | 416 | 20,340 |
| Dividends (including dividend equivalents): | | | | | | | | | |
| Common Stock, $1.236 per share | | | | | (188,961) | | | | (188,961) |
| Class B Common Stock, $1.124 per share | | | | | (68,136) | | | | (68,136) |
| Stock-based compensation | | | | 23,243 | | | | | 23,243 |
| Exercise of stock options and incentive-based transactions | | | | 11,488 | | 43,338 | | | 54,826 |
| Repurchase of common stock | | | | | | (99,992) | | | (99,992) |
| Balance, July 2, 2017 | $ — | $299,281 | $60,620 | $904,588 | $6,187,409 | $(6,240,629) | $(355,964) | $14,677 | $869,982 |

See Notes to Unaudited Consolidated Financial Statements.

THE HERSHEY COMPANY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data or if otherwise indicated)

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Basis of Presentation

The unaudited consolidated financial statements provided in this report include the accounts of The Hershey Company (the “Company,” “Hershey,” “we” or “us”) and our majority-owned subsidiaries and entities in which we have a controlling financial interest after the elimination of intercompany accounts and transactions. We have a controlling financial interest if we own a majority of the outstanding voting common stock and the noncontrolling shareholders do not have substantive participating rights, or we have significant control over an entity through contractual or economic interests in which we are the primary beneficiary.

The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial reporting and with the rules and regulations for reporting on Form 10-Q. Accordingly, they do not contain certain information and disclosures required by GAAP for comprehensive financial statements. The financial statements reflect all adjustments which are, in our opinion, necessary for a fair presentation of the results of operations, financial position, and cash flows for the indicated periods.

Operating results for the quarter ended July 2, 2017 may not be indicative of the results that may be expected for the year ending December 31, 2017 because of seasonal effects on our business. These financial statements should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2016 (our “2016 Annual Report on Form 10-K”), which provides a more complete understanding of our accounting policies, financial position, operating results and other matters.

### Reclassifications

Certain prior period amounts have been reclassified to conform to current year presentation. Specifically, this includes amounts reclassified to conform to the current year presentation in the Consolidated Statements of Cash Flows.

### Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, Revenue from Contracts with Customers, which outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers that supersedes most current revenue recognition guidance. This guidance requires an entity to recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance also requires additional financial statement disclosures that will enable users to understand the nature, amount, timing and uncertainty of revenue and cash flows relating to customer contracts. The new standard was originally effective for us on January 1, 2017; however, in July 2015 the FASB decided to defer the effective date by one year. Early application is not permitted, but reporting entities may choose to adopt the standard as of the original effective date. The standard permits the use of either the full retrospective or modified retrospective transition method.

In 2017, we have substantially completed our assessment of the new standard and we do not expect our adoption of the new standard to have a material impact on our consolidated financial statements. We currently plan to adopt the requirements of the new standard in the first quarter of 2018 utilizing the modified retrospective transition method.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). This ASU will require lessees to recognize a right-of-use asset and lease liability for all leases with terms of more than 12 months. Recognition, measurement and presentation of expenses will depend on classification as a finance or operating lease. This ASU also requires certain quantitative and qualitative disclosures. Accounting guidance for lessors is largely unchanged. The amendments should be applied on a modified retrospective basis. ASU 2016-02 is effective for us beginning January 1, 2019. We are in the process of developing an inventory of our lease arrangements in order to determine the impact that the adoption of ASU 2016-02 will have on our consolidated financial statements and related disclosures. Based on our assessment to date, we expect adoption of this standard to result in a material increase in lease-related assets and liabilities on our Consolidated Balance Sheets; however, we do not expect it to have a significant impact on our Consolidated Statements of Income or Cash Flows.

THE HERSHEY COMPANY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data or if otherwise indicated)

In March 2016, the FASB issued ASU No. 2016-09, Compensation—Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. We adopted the provisions of this ASU in the first quarter of 2017. This update principally affects the recognition of excess tax benefits and deficiencies and the cash flow classification of share-based compensation-related transactions. The requirement to recognize excess tax benefits and deficiencies as income tax expense or benefit in the income statement was applied prospectively, with a benefit of $7,228 recognized during the six months ended July 2, 2017. Additionally, within the Consolidated Statement of Cash Flows, the impact of the adoption resulted in a $14,551 increase in net cash flow from operating activities and a corresponding decrease in net cash flow from financing activities for the six months ended July 2, 2017. These classification requirements were adopted retrospectively to the Consolidated Statement of Cash Flows for the six months ended July 3, 2016, resulting in a $21,612 increase in net cash flow from operating activities and a corresponding $21,612 decrease in net cash flow from financing activities.

In March 2017, the FASB issued ASU No. 2017-07, Compensation-Retirement Benefits (Topic 715). This ASU will require an employer to report the service cost component of net benefit cost in the same line item as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit cost are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations, if presented, or disclosed separately. In addition, only the service cost component may be eligible for capitalization where applicable. The amendments should be applied on a retrospective basis. ASU 2017-07 is effective for us beginning January 1, 2018, with early adoption permitted as of the beginning of a financial year. We currently plan to adopt the requirements of the new standard in the first quarter of 2018 and expect the adoption to impact only classification within our Consolidated Statement of Income.

No other new accounting pronouncement issued or effective during the fiscal year had or is expected to have a material impact on our consolidated financial statements or disclosures.

## 2. BUSINESS ACQUISITIONS

Acquisitions of businesses are accounted for as purchases and, accordingly, the results of operations of the businesses acquired have been included in the consolidated financial statements since the respective dates of the acquisitions. The purchase price for each of the acquisitions is allocated to the assets acquired and liabilities assumed.

### 2016 Acquisition

Ripple Brand Collective, LLC

On April 26, 2016, we completed the acquisition of all of the outstanding shares of Ripple Brand Collective, LLC, a privately held company based in Congers, New York that owns the barkTHINS mass premium chocolate snacking brand. The barkTHINS brand is largely sold in the United States in take-home resealable packages and is available in the club channel, as well as select natural and conventional grocers. Our consolidated net sales for the year ended December 31, 2016 included approximately $35,600 attributed to barkTHINS.

The purchase consideration was allocated to assets acquired and liabilities assumed based on their respective fair values as follows:

| | |
|---|---|
| Goodwill | $128,110 |
| Trademarks | 91,200 |
| Other intangible assets | 60,900 |
| Other assets, primarily current assets, net of cash acquired totaling $674 | 12,375 |
| Current liabilities | (7,211) |
| Net assets acquired | $285,374 |

Goodwill is calculated as the excess of the purchase price over the fair value of the net assets acquired. The goodwill resulting from the acquisition is attributable primarily to the value of leveraging our brand building expertise, consumer insights, supply chain capabilities and retail relationships to accelerate growth and access to barkTHINS products. Acquired trademarks were assigned estimated useful lives of 27 years, while other intangibles, including customer relationships and covenants not to compete, were assigned estimated useful lives ranging from 2 to 14 years.

The recorded goodwill, trademarks and other intangibles are expected to be deductible for tax purposes.

THE HERSHEY COMPANY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data or if otherwise indicated)

Shanghai Golden Monkey (“SGM”)

On February 3, 2016, we completed the purchase of the remaining 20% of the outstanding shares of SGM for cash consideration totaling $35,762, pursuant to a new agreement entered into during the fourth quarter of 2015 with the SGM selling shareholders which revised the originally-agreed purchase price for these shares. For accounting purposes, we treated the acquisition as if we had acquired 100% at the initial acquisition date in 2014 and financed the payment for the remaining 20% of the outstanding shares. Therefore, the cash settlement of the liability for the purchase of these remaining shares is reflected within the financing section of the Unaudited Consolidated Statements of Cash Flows.

The final settlement also resulted in an extinguishment gain of $26,650 representing the net carrying amount of the recorded liability in excess of the cash paid to settle the obligation for the remaining 20% of the outstanding shares. This gain is recorded within non-operating other (income) expense, net within the Unaudited Consolidated Statements of Income.

3. GOODWILL AND INTANGIBLE ASSETS

The changes in the carrying value of goodwill by reportable segment for the six months ended July 2, 2017 are as follows:

| | North America | International and Other | Total |
|---|---|---|---|
| Balance at December 31, 2016 | $792,190 | $ 20,154 | $812,344 |
| Foreign currency translation | 3,975 | 1,749 | 5,724 |
| Balance at July 2, 2017 | 796,165 | 21,903 | 818,068 |

The following table provides the gross carrying amount and accumulated amortization for each major class of intangible asset:

| | July 2, 2017 | | December 31, 2016 | |
|---|---|---|---|---|
| | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| Intangible assets subject to amortization: | | | | |
| Trademarks | $270,383 | $ (30,953) | $317,023 | $ (30,458) |
| Customer-related | 127,414 | (30,729) | 200,409 | (36,482) |
| Patents | 16,725 | (14,822) | 16,426 | (13,700) |
| Total | 414,522 | (76,504) | 533,858 | (80,640) |
| | | | | |
| Intangible assets not subject to amortization: | | | | |
| Trademarks | 40,253 | | 39,519 | |
| Total other intangible assets | $378,271 | | $492,737 | |

As discussed in Note 7, in February 2017, we commenced the Margin for Growth Program which includes an initiative to optimize the manufacturing operations supporting our China business. We deemed this to be a triggering event requiring us to test our China long-lived asset group for impairment by first determining whether the carrying value of the asset group was recovered by our current estimates of future cash flows associated with the asset group. Because this assessment indicated that the carrying value was not recoverable, we calculated an impairment loss as the excess of the asset group's carrying value over its fair value. The resulting impairment loss was allocated to the asset group's long-lived assets. Therefore, as a result of this testing, during the first quarter of 2017, we recorded an impairment charge totaling $105,992 representing the portion of the impairment loss that was allocated to the distributor relationship and trademark intangible assets that had been recognized in connection with the 2014 SGM acquisition.

THE HERSHEY COMPANY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data or if otherwise indicated)

Total amortization expense for the three months ended July 2, 2017 and July 3, 2016 was $5,407 and $5,964, respectively. Total amortization expense for the six months ended July 2, 2017 and July 3, 2016 was $12,558 and $11,144, respectively.

4. SHORT AND LONG-TERM DEBT

Short-term Debt

As a source of short-term financing, we utilize cash on hand and commercial paper or bank loans with an original maturity of three months or less. We maintain a $1.0 billion unsecured revolving credit facility, which currently expires in November 2020. This agreement also includes an option to increase borrowings by an additional $400 million with the consent of the lenders.

The credit agreement contains certain financial and other covenants, customary representations, warranties and events of default. As of July 2, 2017, we were in compliance with all covenants pertaining to the credit agreement, and we had no significant compensating balance agreements that legally restricted these funds. For more information, refer to the Consolidated Financial Statements included in our 2016 Annual Report on Form 10-K.

In addition to the revolving credit facility, we maintain lines of credit with domestic and international commercial banks. We had short-term foreign bank loans against these lines of credit for $142,521 at July 2, 2017 and $158,805 at December 31, 2016. Commitment fees relating to our revolving credit facility and lines of credit are not material.

At July 2, 2017, we had outstanding commercial paper totaling $479,444, at a weighted average interest rate of 1.1%. At December 31, 2016, we had outstanding commercial paper totaling $473,666, at a weighted average interest rate of 0.6%.

Long-term Debt

Long-term debt consisted of the following:

| December 31, | July 2, 2017 | December 31, 2016 |
|---|---|---|
| 1.60% Notes due 2018 | 300,000 | 300,000 |
| 4.125% Notes due 2020 | 350,000 | 350,000 |
| 8.8% Debentures due 2021 | 84,715 | 84,715 |
| 2.625% Notes due 2023 | 250,000 | 250,000 |
| 3.20% Notes due 2025 | 300,000 | 300,000 |
| 2.30% Notes due 2026 | 500,000 | 500,000 |
| 7.2% Debentures due 2027 | 193,639 | 193,639 |
| 3.375% Notes due 2046 | 300,000 | 300,000 |
| Lease obligations | 84,890 | 83,619 |
| Net impact of interest rate swaps, debt issuance costs and unamortized debt discounts | (13,399) | (14,275) |
| Total long-term debt | 2,349,845 | 2,347,698 |
| Less—current portion | 89 | 243 |
| Long-term portion | $2,349,756 | $2,347,455 |

THE HERSHEY COMPANY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data or if otherwise indicated)

Interest Expense
Net interest expense consisted of the following:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | July 2, 2017 | July 3, 2016 | July 2, 2017 | July 3, 2016 |
| Interest expense | $25,299 | $22,997 | $50,253 | $46,522 |
| Capitalized interest | (875 ) | (1,386 ) | (1,859 ) | (3,561 ) |
| Interest expense | 24,424 | 21,611 | 48,394 | 42,961 |
| Interest income | (298 ) | (273 ) | (527 ) | (618 ) |
| Interest expense, net | $24,126 | $21,338 | $47,867 | $42,343 |

5. DERIVATIVE INSTRUMENTS
We are exposed to market risks arising principally from changes in foreign currency exchange rates, interest rates and commodity prices. We use certain derivative instruments to manage these risks. These include interest rate swaps to manage interest rate risk, foreign currency forward exchange contracts and options to manage foreign currency exchange rate risk, and commodities futures and options contracts to manage commodity market price risk exposures. In entering into these contracts, we have assumed the risk that might arise from the possible inability of counterparties to meet the terms of their contracts. We mitigate this risk by entering into exchanged-traded contracts with collateral posting requirements and/or by performing financial assessments prior to contract execution, conducting periodic evaluations of counterparty performance and maintaining a diverse portfolio of qualified counterparties. We do not expect any significant losses from counterparty defaults.

Commodity Price Risk
We enter into commodities futures and options contracts and other commodity derivative instruments to reduce the effect of future price fluctuations associated with the purchase of raw materials, energy requirements and transportation services. We generally hedge commodity price risks for 3- to 24-month periods. Our open commodity derivative contracts had a notional value of $423,345 as of July 2, 2017 and $739,374 as of December 31, 2016. Derivatives used to manage commodity price risk are not designated for hedge accounting treatment. Therefore, the changes in fair value of these derivatives are recorded as incurred within cost of sales. As discussed in Note 11, we define our segment income to exclude gains and losses on commodity derivatives until the related inventory is sold, at which time the related gains and losses are reflected within segment income.  This enables us to continue to align the derivative gains and losses with the underlying economic exposure being hedged and thereby eliminate the mark-to-market volatility within our reported segment income.

Foreign Exchange Price Risk
We are exposed to foreign currency exchange rate risk related to our international operations, including non-functional currency intercompany debt and other non-functional currency transactions of certain subsidiaries. Principal currencies hedged include the euro, Canadian dollar, Japanese yen, and Brazilian real. We typically utilize foreign currency forward exchange contracts and options to hedge these exposures for periods ranging from 3 to 12 months. The contracts are either designated as cash flow hedges or are undesignated. The net notional amount of foreign exchange contracts accounted for as cash flow hedges was $114,870 at July 2, 2017 and $68,263 at December 31, 2016. The effective portion of the changes in fair value on these contracts is recorded in other comprehensive income and reclassified into earnings in the same period in which the hedged transactions affect earnings. The net notional amount of foreign exchange contracts that are not designated as accounting hedges was $2,791 at July 2, 2017 and December 31, 2016. The change in fair value on these instruments is recorded directly in cost of sales or selling, marketing and administrative expense, depending on the nature of the underlying exposure.

THE HERSHEY COMPANY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data or if otherwise indicated)

Interest Rate Risk
We manage our targeted mix of fixed and floating rate debt with debt issuances and by entering into fixed-to-floating interest rate swaps in order to mitigate fluctuations in earnings and cash flows that may result from interest rate volatility. These swaps are designated as fair value hedges, for which the gain or loss on the derivative and the offsetting loss or gain on the hedged item are recognized in current earnings as interest expense (income), net. At July 2, 2017 and December 31, 2016, we had interest rate derivative instruments in fair value hedging relationships with a total notional amount of $350,000.
In order to manage interest rate exposure, in previous years we utilized interest rate swap agreements to protect against unfavorable interest rate changes relating to forecasted debt transactions. These swaps, which were settled upon issuance of the related debt, were designated as cash flow hedges and the gains and losses that were deferred in other comprehensive income are being recognized as an adjustment to interest expense over the same period that the hedged interest payments affect earnings.
Equity Price Risk
We are exposed to market price changes in certain broad market indices related to our deferred compensation obligations to our employees. To mitigate this risk, we use equity swap contracts to hedge the portion of the exposure that is linked to market-level equity returns. These contracts are not designated as hedges for accounting purposes and are entered into for periods of 3 to 12 months. The change in fair value of these derivatives is recorded in selling, marketing and administrative expense, together with the change in the related liabilities. The notional amount of the contracts outstanding at July 2, 2017 and December 31, 2016 was $23,440 and $22,099, respectively.
The following table presents the classification of derivative assets and liabilities within the Consolidated Balance Sheets as of July 2, 2017 and December 31, 2016:

| December 31, | July 2, 2017 | | December 31, 2016 | |
|---|---|---|---|---|
| | Assets (1) | Liabilities (1) | Assets (1) | Liabilities (1) |
| Derivatives designated as cash flow hedging instruments: | | | | |
| Foreign exchange contracts | $398 | $ 1,853 | $2,229 | $ 809 |
| Derivatives designated as fair value hedging instruments: | | | | |
| Interest rate swap agreements | 1,941 | — | 1,768 | — |
| Derivatives not designated as hedging instruments: | | | | |
| Commodities futures and options (2) | 14,050 | 179 | 2,348 | 10,000 |
| Deferred compensation derivatives | 645 | — | 717 | — |
| Foreign exchange contracts | 3 | — | — | 16 |
| | 14,698 | 179 | 3,065 | 10,016 |
| Total | $17,037 | $ 2,032 | $7,062 | $ 10,825 |

(1) Derivatives assets are classified on our balance sheet within prepaid expenses and other as well as other assets. Derivative liabilities are classified on our balance sheet within accrued liabilities and other long-term liabilities.

(2) As of July 2, 2017, assets and liabilities include the net of assets of $52,895 and liabilities of $41,337 associated with cash transfers receivable or payable on commodities futures contracts reflecting the change in quoted market prices on the last trading day for the period. The comparable amounts reflected on a net basis in liabilities at December 31, 2016 were assets of $140,885 and liabilities of $150,872. At July 2, 2017 and December 31, 2016, the remaining amount reflected in assets and liabilities relates to the fair value of other non-exchange traded derivative instruments, respectively.

13

THE HERSHEY COMPANY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data or if otherwise indicated)

Income Statement Impact of Derivative Instruments

The effect of derivative instruments on the Consolidated Statements of Income for the three months ended July 2, 2017 and July 3, 2016 was as follows:

| | Non-designated Hedges | | Cash Flow Hedges | | | |
|---|---|---|---|---|---|---|
| | Gains (losses) recognized in income (a) | | Losses recognized in other comprehensive income ("OCI") (effective portion) | | Gains (losses) reclassified from accumulated OCI into income (effective portion) (b) | |
| | 2017 | 2016 | 2017 | 2016 | 2017 | 2016 |
| Commodities futures and options | $(32,519) | $39,011 | $— | $— | $(399) | $6,139 |
| Foreign exchange contracts | 44 | (253) | (707) | (3,916) | 390 | (761) |
| Interest rate swap agreements | — | — | — | (17,156) | (2,370) | (1,511) |
| Deferred compensation derivatives | (632) | 418 | — | — | — | — |
| Total | $(33,107) | $39,176 | $(707) | $(21,072) | $(2,379) | $3,867 |

(a) Gains (losses) recognized in income for non-designated commodities futures and options contracts were included in cost of sales. Gains (losses) recognized in income for non-designated foreign currency forward exchange contracts and deferred compensation derivatives were included in selling, marketing and administrative expenses.

(b) Gains (losses) reclassified from AOCI into income were included in cost of sales for commodities futures and options contracts and for foreign currency forward exchange contracts designated as hedges of purchases of inventory or other productive assets. Other gains (losses) for foreign currency forward exchange contracts were included in selling, marketing and administrative expenses. Losses reclassified from AOCI into income for interest rate swap agreements were included in interest expense.

The effect of derivative instruments on the Consolidated Statements of Income for the six months ended July 2, 2017 and July 3, 2016 was as follows:

| | Non-designated Hedges | | Cash Flow Hedges | | | |
|---|---|---|---|---|---|---|
| | Gains (losses) recognized in income (a) | | Losses recognized in other comprehensive income ("OCI") (effective portion) | | Gains (losses) reclassified from accumulated OCI into income (effective portion) (b) | |
| | 2017 | 2016 | 2017 | 2016 | 2017 | 2016 |
| Commodities futures and options | $(38,055) | $70 | $— | $— | $(837) | $15,869 |
| Foreign exchange contracts | (51) | (457) | (2,206) | (8,032) | 218 | (1,022) |
| Interest rate swap agreements | — | — | — | (46,949) | (4,793) | (3,071) |
| Deferred compensation derivatives | 645 | 821 | — | — | — | — |
| Total | $(37,461) | $434 | $(2,206) | $(54,981) | $(5,412) | $11,776 |

(a) Gains (losses) recognized in income for non-designated commodities futures and options contracts were included in cost of sales. Gains (losses) recognized in income for non-designated foreign currency forward exchange contracts and deferred compensation derivatives were included in selling, marketing and administrative expenses.

(b) Gains (losses) reclassified from AOCI into income were included in cost of sales for commodities futures and options contracts and for foreign currency forward exchange contracts designated as hedges of purchases of inventory or other productive assets. Other gains (losses) for foreign currency forward exchange contracts were included in selling, marketing and administrative expenses. Losses reclassified from AOCI into income for interest rate swap agreements were included in interest expense.

THE HERSHEY COMPANY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data or if otherwise indicated)

The amount of pretax net losses on derivative instruments, including interest rate swap agreements, foreign currency forward exchange contracts and options, commodities futures and options contracts, and other commodity derivative instruments expected to be reclassified from AOCI into earnings in the next 12 months was approximately $11,017 as of July 2, 2017. This amount is primarily associated with deferred losses relating to interest rate swap agreements.

Fair Value Hedges

For the three months ended July 2, 2017 and July 3, 2016, we recognized a net pretax benefit to interest expense of $732 and $1,137 relating to our fixed-to-floating interest swap arrangements. For the six months ended July 2, 2017 and July 3, 2016, we recognized a net pretax benefit to interest expense of $1,630 and $2,454 relating to our fixed-to-floating interest swap arrangements.

6. FAIR VALUE MEASUREMENTS

Accounting guidance on fair value measurements requires that financial assets and liabilities be classified and disclosed in one of the following categories of the fair value hierarchy:

Level 1 – Based on unadjusted quoted prices for identical assets or liabilities in an active market.
Level 2 – Based on observable market-based inputs or unobservable inputs that are corroborated by market data.
Level 3 – Based on unobservable inputs that reflect the entity's own assumptions about the assumptions that a market participant would use in pricing the asset or liability.

We did not have any level 3 financial assets or liabilities, nor were there any transfers between levels during the periods presented.

The following table presents assets and liabilities that were measured at fair value in the Consolidated Balance Sheets on a recurring basis as of July 2, 2017 and December 31, 2016:

| | Assets (Liabilities) | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| July 2, 2017: | | | | |
| Derivative Instruments: | | | | |
| Assets: | | | | |
| Foreign exchange contracts (1) | $ — | $401 | $ — | $401 |
| Interest rate swap agreements (2) | — | 1,941 | — | 1,941 |
| Deferred compensation derivatives (3) | — | 645 | — | 645 |
| Commodities futures and options (4) | 14,050 | — | — | 14,050 |
| Liabilities: | | | | |
| Foreign exchange contracts (1) | — | 1,853 | — | 1,853 |
| Commodities futures and options (4) | 179 | — | — | 179 |
| December 31, 2016: | | | | |
| Assets: | | | | |
| Foreign exchange contracts (1) | $ — | $2,229 | $ — | $2,229 |
| Interest rate swap agreements (2) | — | 1,768 | — | 1,768 |
| Deferred compensation derivatives (3) | — | 717 | — | 717 |
| Commodities futures and options (4) | 2,348 | — | — | 2,348 |
| Liabilities: | | | | |
| Foreign exchange contracts (1) | — | 825 | — | 825 |
| Commodities futures and options (4) | 10,000 | — | — | 10,000 |

THE HERSHEY COMPANY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data or if otherwise indicated)

(1) The fair value of foreign currency forward exchange contracts is the difference between the contract and current market foreign currency exchange rates at the end of the period. We estimate the fair value of foreign currency forward exchange contracts on a quarterly basis by obtaining market quotes of spot and forward rates for contracts with similar terms, adjusted where necessary for maturity differences.

(2) The fair value of interest rate swap agreements represents the difference in the present value of cash flows calculated at the contracted interest rates and at current market interest rates at the end of the period. We calculate the fair value of interest rate swap agreements quarterly based on the quoted market price for the same or similar financial instruments.

(3) The fair value of deferred compensation derivatives is based on quoted prices for market interest rates and a broad market equity index.

(4) The fair value of commodities futures and options contracts is based on quoted market prices.

Other Financial Instruments

The carrying amounts of cash and cash equivalents, short-term investments, accounts receivable, accounts payable and short-term debt approximated fair values as of July 2, 2017 and July 3, 2016 because of the relatively short maturity of these instruments.

The estimated fair value of our long-term debt is based on quoted market prices for similar debt issues and is, therefore, classified as Level 2 within the valuation hierarchy. The fair values and carrying values of long-term debt, including the current portion, were as follows:

| | Fair Value | | Carrying Value | |
|---|---|---|---|---|
| | July 2, 2017 | December 31, 2016 | July 2, 2017 | December 31, 2016 |
| Current portion of long-term debt | $ 89 | $ 243 | $ 89 | $ 243 |
| Long-term debt | 2,410,532 | 2,579,054 | 2,349,756 | 2,547,455 |
| Total | $ 2,410,621 | $ 2,579,297 | $ 2,349,845 | $ 2,547,698 |

Other Fair Value Measurements

In addition to assets and liabilities that are recorded at fair value on a recurring basis, GAAP requires that, under certain circumstances, we also record assets and liabilities at fair value on a nonrecurring basis. Generally, assets are recorded at fair value on a nonrecurring basis as a result of impairment charges. During the first quarter of 2017, as discussed in Note 7, we recorded impairment charges totaling $105,992 to write-down distributor relationship and trademark intangible assets that had been recognized in connection with the 2014 SGM acquisition and wrote-down property, plant and equipment by $102,720. These charges were determined by comparing the fair value of the assets to their carrying value. The fair value of the assets were derived using a combination of an estimated market liquidation approach and discounted cash flow analyses based on Level 3 inputs.

THE HERSHEY COMPANY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data or if otherwise indicated)

7. BUSINESS REALIGNMENT ACTIVITIES

We are currently pursuing several business realignment activities designed to increase our efficiency and focus our business behind our key growth strategies. Costs recorded during the three and six months ended July 2, 2017 and July 3, 2016 related to these activities are as follows:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | July 2, 2017 | July 3, 2016 | July 2, 2017 | July 3, 2016 |
| Margin for Growth Program: | | | | |
| Severance | $888 | $— | $30,455 | $— |
| Accelerated depreciation | 6,873 | — | 6,873 | — |
| Other program costs | 6,381 | — | 11,203 | — |
| Operational Optimization Program: | | | | |
| Accelerated depreciation and amortization | — | 33,965 | — | 33,478 |
| Severance | — | 9,928 | 13,828 | 17,355 |
| Other program costs | 312 | 3,376 | (917) | 9,408 |
| 2015 Productivity Initiative: | | | | |
| Pension settlement charge | — | 12,646 | — | 12,646 |
| Severance | — | (469) | — | (1,763) |
| Other program costs | — | 2,649 | — | 5,401 |
| Total business realignment costs | $14,454 | $62,095 | $61,442 | $76,525 |

The costs and related benefits to be derived from the Margin for Growth Program relate approximately 80% to the North America segment and 20% to the International and Other segment for the three months ended July 2, 2017. The costs and related benefits to be derived from the Margin for Growth Program relate approximately 40% to the North America segment and 60% to the International and Other segment for the six months ended July 2, 2017. The costs and related benefits to be derived from the Operational Optimization Program primarily relate to the North America segment in 2017 and to the International and Other segment in 2016. The costs and related benefits to be derived from the 2015 Productivity Initiative relate primarily to the North American segment. However, segment operating results do not include these business realignment expenses because we evaluate segment performance excluding such costs.

Margin for Growth Program

In February 2017, the Company's Board of Directors unanimously approved several initiatives under a single program designed to drive continued net sales, operating income and earnings per-share diluted growth over the next several years. This program will focus on improving global efficiency and effectiveness, optimizing the Company’s supply chain, streamlining the Company’s operating model and reducing administrative expenses to generate long-term savings.

The Company estimates that the “Margin for Growth” program will result in total pre-tax charges of $375,000 to $425,000 over the next three years. This estimate includes plant and office closure expenses of $100,000 to $115,000, net intangible asset impairment charges of $100,000 to $110,000, employee separation costs of $80,000 to $100,000, contract termination costs of approximately $25,000, and other business realignment costs of $70,000 to $75,000. The cash portion of the total charge is estimated to be $175,000 to $200,000. At the conclusion of the program in 2019, ongoing annual savings are expected to be approximately $150,000 to $175,000. The Company expects that implementation of the program will reduce its global workforce by approximately 15%, with a majority of the reductions coming from hourly headcount positions outside of the United States.

The program includes an initiative to optimize the manufacturing operations supporting our China business. We deemed this to be a triggering event requiring us to test our China long-lived asset group for impairment by first determining whether the carrying value of the asset group was recovered by our current estimates of future cash flows associated with the asset group. Because this assessment indicated that the carrying value was not recoverable, we calculated an impairment loss as the excess of the asset group's carrying value over its fair value. The resulting impairment loss was allocated to the asset group's long-lived assets. Therefore, as a result of this testing, during the first quarter of 2017, we recorded impairment charges totaling $208,712, with $105,992 representing the portion of the impairment loss that was allocated to the distributor relationship and trademark intangible assets that had been recognized in connection with the 2014 SGM acquisition and $102,720 representing the portion of the impairment loss that was allocated to property, plant and equipment. These impairment charges are recorded within the long-lived asset impairment charges caption within the Consolidated Statements of Operations.

(amounts in thousands, except share data or if otherwise indicated)

During the three and six months ended July 2, 2017, we recognized estimated employee severance totaling $888 and $30,455, respectively. These charges relate largely to our initiative to improve the cost structure of our China business, as well as our initiative to further streamline our corporate operating model. We also recognized non-cash, asset-related incremental depreciation expense totaling $6,873 for the three and six months ended July 2, 2017 as part of optimizing the North America supply chain. During the three and six months ended July 2, 2017, we also recognized other program costs totaling $6,381 and $11,203, respectively. These charges relate primarily to third-party charges for our initiative of improving global efficiency and effectiveness.

2016 Operational Optimization Program

In the second quarter of 2016, we commenced a program (the “Operational Optimization Program”) to optimize our production and supply chain network, which includes select facility consolidations. The program encompasses the continued transition of our China chocolate and SGM operations into a united Golden Hershey platform, including the integration of the China sales force, as well as workforce planning efforts and the consolidation of production within certain facilities in China and North America.

During the three months ended July 2, 2017, we recognized costs of $312. During the six months ended July 2, 2017, we recognized costs of $12,911 primarily related to employee severance associated with the workforce planning efforts within North America. We currently expect to incur additional cash costs of approximately $9,000 over the next two years to complete this program.

During the first quarter of 2017, we reclassified property, plant and equipment and land use rights with a total book value of $20,303 to prepaid and other current assets within the Consolidated Balance Sheets. These represent select China facilities that were taken out of operation in connection with this program and are currently being marketed for sale.

2015 Productivity Initiative

In mid-2015, we initiated a productivity initiative (the “2015 Productivity Initiative”) intended to move decision making closer to the customer and the consumer, to enable a more enterprise-wide approach to innovation, to more swiftly advance our knowledge agenda, and to provide for a more efficient cost structure, while ensuring that we effectively allocate resources to future growth areas. Overall, the 2015 Productivity Initiative was undertaken to simplify the organizational structure to enhance the Company's ability to rapidly anticipate and respond to the changing demands of the global consumer.

The 2015 Productivity Initiative was executed throughout the third and fourth quarters of 2015, resulting in a net reduction of approximately 300 positions, with the majority of the departures taking place by the end of 2015. The 2015 Productivity Initiative was completed during the third quarter 2016. We incurred total costs of $125,031 relating to this program, including pension settlement charges of $12,646 recorded through the six months ended July 3, 2016 relating to lump sum withdrawals by employees retiring or leaving the Company as a result of this program.

Costs associated with business realignment activities are classified in our Consolidated Statements of Income for the three and six months ended July 2, 2017 and July 3, 2016 as follows:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | July 2, 2017 | July 3, 2016 | July 2, 2017 | July 3, 2016 |
| Cost of sales | $5,772 | $33,965 | $6,262 | $33,478 |
| Selling, marketing and administrative expense | 6,701 | 6,025 | 9,182 | 14,809 |

| | | | | |
|---|---|---|---|---|
| Business realignment costs | 1,981 | 22,105 | 45,998 | 28,238 |
| Costs associated with business realignment activities | $14,454 | $62,095 | $61,442 | $76,525 |

THE HERSHEY COMPANY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data or if otherwise indicated)

The following table presents the liability activity for employee-related costs qualifying as exit and disposal costs:

| | Total | |
|---|---|---|
| Liability balance at December 31, 2016 | $ | 3,725 |
| 2017 business realignment charges (1) | 53,591 | |
| Cash payments | (13,394 | ) |
| Other, net | (171 | ) |
| Liability balance at July 2, 2017 (reported within accrued and other long-term liabilities) | $ | 43,751 |

(1) The costs reflected in the liability roll-forward above do not include items charged directly to expense, such as accelerated depreciation and amortization and certain of the third-party charges associated with various programs, as those items are not reflected in the business realignment liability in our Consolidated Balance Sheets.

## 8. INCOME TAXES

The majority of our taxable income is generated in the U.S. and taxed at the U.S. statutory rate of 35%. The effective tax rates for the six months ended July 2, 2017 and July 3, 2016 were 33.0% and 34.4%, respectively. Relative to the statutory rate, the 2017 effective tax rate was impacted by favorable foreign rate differential relating to our cocoa procurement operations, investment tax credits and the benefit of ASU 2016-09, which were partially offset by non-benefited costs resulting from the Margin for Growth Program. The 2016 effective rate benefited from investment tax credits and from the impact of non-taxable income related to the settlement of the SGM liability.

Hershey and its subsidiaries file tax returns in the U.S., including various state and local returns, and in foreign jurisdictions. We believe adequate provision has been made for all income tax uncertainties. We are routinely audited by taxing authorities in our filing jurisdictions, and a number of these audits are currently underway. We reasonably expect reductions in the liability for unrecognized tax benefits of approximately $3,910 within the next 12 months because of the expiration of statutes of limitations and settlements of tax audits.

## 9. PENSION AND OTHER POST-RETIREMENT BENEFIT PLANS

The components of net periodic benefit cost for the second quarter were as follows:

| | Pension Benefits Three Months Ended | | Other Benefits Three Months Ended | |
|---|---|---|---|---|
| | July 2, 2017 | July 3, 2016 | July 2, 2017 | July 3, 2016 |
| Service cost | $5,051 | $5,699 | $66 | $75 |
| Interest cost | 10,200 | 10,999 | 2,204 | 2,429 |
| Expected return on plan assets | (14,344) | (14,832) | — | — |
| Amortization of prior service (credit) cost | (1,455) | (261) | 186 | 144 |
| Amortization of net loss | 8,360 | 8,801 | — | 6 |
| Settlement loss | — | 16,938 | — | — |
| Total net periodic benefit cost | $7,812 | $27,344 | $2,456 | $2,654 |

We made contributions of $293 and $7,580 to the pension plans and other benefits plans, respectively, during the second quarter of 2017. In the second quarter of 2016, we made contributions of $661 and $7,044 to our pension plans and other benefits plans, respectively. The contributions in 2017 and 2016 also included benefit payments from our non-qualified pension plans and post-retirement benefit plans.

THE HERSHEY COMPANY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data or if otherwise indicated)

The components of net periodic benefit cost for the year-to-date periods were as follows:

| | Pension Benefits | | Other Benefits | |
|---|---|---|---|---|
| | Six Months Ended | | Six Months Ended | |
| | July 2, 2017 | July 3, 2016 | July 2, 2017 | July 3, 2016 |
| Service cost | $10,225 | $11,583 | $131 | $149 |
| Interest cost | 20,499 | 21,834 | 4,412 | 4,865 |
| Expected return on plan assets | (28,698) | (29,373) | — | — |
| Amortization of prior service (credit) cost | (2,911) | (523) | 373 | 288 |
| Amortization of net loss (gain) | 16,782 | 17,608 | — | (6) |
| Settlement loss | — | 16,938 | — | — |
| Total net periodic benefit cost | $15,897 | $38,067 | $4,916 | $5,296 |

We made contributions of $4,985 and $14,464 to the pension plans and other benefits plans, respectively, during the first six months of 2017. In the first six months of 2016, we made contributions of $1,836 and $14,708 to our pension plans and other benefits plans, respectively. The contributions in 2017 and 2016 also included benefit payments from our non-qualified pension plans and post-retirement benefit plans.

For 2017, there are no significant minimum funding requirements for our domestic pension plans and planned voluntary funding of our non-domestic pension plans in 2017 is not material.

## 10. STOCK COMPENSATION PLANS

We have various stock-based compensation programs under which awards, including stock options, performance stock units (“PSUs”) and performance stock, stock appreciation rights, restricted stock units (“RSUs”) and restricted stock may be granted to employees, non-employee directors and certain service providers upon whom the successful conduct of our business is dependent. These programs and the accounting treatment related thereto are described in Note 10 to the Consolidated Financial Statements included in our 2016 Annual Report on Form 10-K.

For the periods presented, compensation expense for all types of stock-based compensation programs and the related income tax benefit recognized were as follows:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | July 2, 2017 | July 3, 2016 | July 2, 2017 | July 3, 2016 |
| Pre-tax compensation expense | $12,435 | $14,530 | $24,557 | $26,208 |
| Related income tax benefit | 3,230 | 4,693 | 7,048 | 8,780 |

Compensation costs for stock compensation plans are primarily included in selling, marketing and administrative expense. As of July 2, 2017, total stock-based compensation cost related to non-vested awards not yet recognized was $84,616 and the weighted-average period over which this amount is expected to be recognized was approximately 2.3 years.

THE HERSHEY COMPANY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data or if otherwise indicated)

Stock Options

A summary of activity relating to grants of stock options for the period ended July 2, 2017 is as follows:

| Stock Options | Shares | Weighted-Average Exercise Price (per share) | Weighted-Average Remaining Contractual Term | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Outstanding as of December 31, 2016 | 6,192,008 | $ 82.67 | 6.2 years | |
| Granted | 1,086,175 | $ 108.05 | | |
| Exercised | (908,712 ) | $ 70.13 | | |
| Forfeited | (186,032 ) | $ 103.43 | | |
| Outstanding as of July 2, 2017 | 6,183,439 | $ 88.35 | 6.2 years | $ 150,493 |
| Options exercisable as of July 2, 2017 | 3,870,198 | $ 80.60 | 4.7 years | $ 124,202 |

The weighted-average fair value of options granted was $15.77 and $11.42 per share for the periods ended July 2, 2017 and July 3, 2016, respectively. The fair value was estimated on the date of grant using a Black-Scholes option-pricing model and the following weighted-average assumptions:

| | Six Months Ended | |
|---|---|---|
| | July 2, 2017 | July 3, 2016 |
| Dividend yields | 2.4 % | 2.4 % |
| Expected volatility | 17.2% | 16.8% |
| Risk-free interest rates | 2.2 % | 1.5 % |
| Expected term in years | 6.8 | 6.8 |

The total intrinsic value of options exercised was $36,507 and $49,091 for the periods ended July 2, 2017 and July 3, 2016, respectively.

Performance Stock Units and Restricted Stock Units

A summary of activity relating to grants of PSUs and RSUs for the period ended July 2, 2017 is as follows:

| Performance Stock Units and Restricted Stock Units | Number of units | Weighted-average grant date fair value for equity awards (per unit) |
|---|---|---|
| Outstanding as of December 31, 2016 | 828,228 | $102.66 |
| Granted | 418,369 | $111.06 |
| Performance assumption change | 19,671 | $99.42 |
| Vested | (205,327) | $113.05 |
| Forfeited | (109,328) | $108.44 |
| Outstanding as of July 2, 2017 | 951,613 | $102.89 |

The table above includes 6,410 units of PSUs awarded to participants in a prior period for which the measurement (grant) date occurred for accounting purposes in 2017.

The following table sets forth information about the fair value of the PSUs and RSUs granted for potential future distribution to employees and non-employee directors. In addition, the table provides assumptions used to determine the fair value of the market-based total shareholder return component using the Monte Carlo simulation model on the date of grant.

THE HERSHEY COMPANY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data or if otherwise indicated)

| | Six Months Ended | |
|---|---|---|
| | July 2, 2017 | July 3, 2016 |
| Units granted | 418,369 | 514,089 |
| Weighted-average fair value at date of grant | $111.06 | $92.95 |
| Monte Carlo simulation assumptions: | | |
| Estimated values | $46.85 | $38.02 |
| Dividend yields | 2.3 % | 2.5 % |
| Expected volatility | 20.4 % | 17.0 % |

The fair value of shares vested totaled $22,206 and $18,079 for the periods ended July 2, 2017 and July 3, 2016, respectively.

Deferred PSUs, deferred RSUs and deferred stock units representing directors' fees totaled 468,845 units as of July 2, 2017. Each unit is equivalent to one share of the Company's Common Stock.

11. SEGMENT INFORMATION

Our organizational structure is designed to ensure continued focus on North America, coupled with an emphasis on profitable growth in our focus international markets. Our business is organized around geographic regions, which enables us to build processes for repeatable success in our global markets. As a result, we have defined our operating segments on a geographic basis, as this aligns with how our Chief Operating Decision Maker ("CODM") manages our business, including resource allocation and performance assessment. Our North America business, which generates approximately 89% of our consolidated revenue, is our only reportable segment. None of our other operating segments meet the quantitative thresholds to qualify as reportable segments; therefore, these operating segments are combined and disclosed below as International and Other.

- North America - This segment is responsible for our traditional chocolate and non-chocolate confectionery market position, as well as our grocery and growing snacks market positions, in the United States and Canada. This includes developing and growing our business in chocolate and non-chocolate confectionery, pantry, food service and other snacking product lines.
- International and Other - International and Other is a combination of all other operating segments that are not individually material, including those geographic regions where we operate outside of North America. We currently have operations and manufacture product in China, Mexico, Brazil, India and Malaysia, primarily for consumers in these regions, and also distribute and sell confectionery products in export markets of Asia, Latin America, Middle East, Europe, Africa and other regions. This segment also includes our global retail operations, including Hershey's Chocolate World stores in Hershey, Pennsylvania, New York City, Las Vegas, Shanghai, Niagara Falls (Ontario), Dubai, and Singapore, as well as operations associated with licensing the use of certain of the Company's trademarks and products to third parties around the world.

For segment reporting purposes, we use "segment income" to evaluate segment performance and allocate resources. Segment income excludes unallocated general corporate administrative expenses, unallocated mark-to-market gains and losses on commodity derivatives, business realignment and impairment charges, acquisition integration costs, the non-service related portion of pension expense and other unusual gains or losses that are not part of our measurement of segment performance. These components of our operating income are managed centrally at the corporate level and are excluded from the measure of segment income reviewed by the CODM as well the measure of segment performance used for incentive compensation purposes.

Accounting policies associated with our operating segments are generally the same as those described in Note 1 to the Consolidated Financial Statements included in our 2016 Annual Report on Form 10-K.

As discussed in Note 5, derivatives used to manage commodity price risk are not designated for hedge accounting treatment. These derivatives are recognized at fair market value with the resulting realized and unrealized losses recognized in unallocated derivative (gains) losses outside of the reporting segment results until the related inventory is sold, at which time the related gains and losses are reallocated to segment income. This enables us to align the

THE HERSHEY COMPANY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data or if otherwise indicated)

derivative gains and losses with the underlying economic exposure being hedged and thereby eliminate the mark-to-market volatility within our reported segment income.

Certain manufacturing, warehousing, distribution and other activities supporting our global operations are integrated to maximize efficiency and productivity. As a result, assets and capital expenditures are not managed on a segment basis and are not included in the information reported to the CODM for the purpose of evaluating performance or allocating resources. We disclose depreciation and amortization that is generated by segment-specific assets, since these amounts are included within the measure of segment income reported to the CODM.

Our segment net sales and earnings were as follows:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | July 2, 2017 | July 3, 2016 | July 2, 2017 | July 3, 2016 |
| Net sales: | | | | |
| North America | $1,477,014 | $1,444,841 | $3,154,160 | $3,078,312 |
| International and Other | 185,977 | 192,830 | 388,509 | 388,171 |
| Total | $1,662,991 | $1,637,671 | $3,542,669 | $3,466,483 |
| | | | | |
| Segment income (loss): | | | | |
| North America | $460,382 | $425,723 | $1,013,520 | $955,113 |
| International and Other | 8,368 | (3,462) | 10,091 | (16,695) |
| Total segment income | 468,750 | 422,261 | 1,023,611 | 938,418 |
| Unallocated corporate expense (1) | 123,173 | 126,623 | 242,823 | 248,794 |
| Unallocated mark-to-market losses (gains) on commodity derivatives | 11,556 | (39,886) | (5,532) | (4,940) |
| Long-lived asset impairment charges | — | — | 208,712 | — |

| | | | | |
|---|---|---|---|---|
| Costs associated with business realignment activities | 14,454 | 62,095 | 61,442 | 76,525 |
| Non-service related pension expense | 4,215 | 9,205 | 8,583 | 14,306 |
| Acquisition and integration costs | 11 | 1,462 | 311 | 1,462 |
| Operating profit | 315,341 | 262,762 | 507,272 | 602,271 |
| Interest expense, net | 24,126 | 21,338 | 47,867 | 42,343 |
| Other (income) expense, net | 10,098 | 8,128 | 9,927 | (13,097) |
| Income before income taxes | $281,117 | $233,296 | $449,478 | $573,025 |

(1) Includes centrally-managed (a) corporate functional costs relating to legal, treasury, finance, and human resources, (b) expenses associated with the oversight and administration of our global operations, including warehousing, distribution and manufacturing, information systems and global shared services, (c) non-cash stock-based compensation expense, and (d) other gains or losses that are not integral to segment performance.

23

THE HERSHEY COMPANY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data or if otherwise indicated)

Activity within the unallocated mark-to-market (gains) losses on commodity derivatives is as follows:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | July 2, 2017 | July 3, 2016 | July 2, 2017 | July 3, 2016 |
| Net losses (gains) on mark-to-market valuation of commodity derivative positions | $32,519 | $(39,011) | $38,055 | $(70) |
| Net losses on commodity derivative positions allocated to segment income | 20,963 | 875 | 43,587 | 4,870 |
| Net losses (gains) on mark-to-market valuation of commodity derivative positions remaining in unallocated derivative losses (gains) | $11,556 | $(39,886) | $(5,532) | $(4,940) |

As of July 2, 2017, the cumulative amount of mark-to-market losses on commodity derivatives that have been recognized in our consolidated cost of sales and not yet allocated to reportable segments was $157,492. Based on our forecasts of the timing of the recognition of the underlying hedged items, we expect to reclassify net pre-tax losses on commodity derivatives of $91,119 to segment operating results in the next twelve months.

Depreciation and amortization expense included within segment income presented above is as follows:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | July 2, 2017 | July 3, 2016 | July 2, 2017 | July 3, 2016 |
| North America | $41,751 | $39,844 | $82,988 | $78,786 |
| International and Other | 9,747 | 13,085 | 22,713 | 24,008 |
| Corporate (1) | 15,629 | 43,937 | 26,378 | 53,985 |
| Total | $67,127 | $96,866 | $132,079 | $156,779 |

(1) Corporate includes non-cash asset-related accelerated depreciation and amortization related to business realignment activities, as discussed in Note 7. Such amounts are not included within our measure of segment income.

## 12. TREASURY STOCK ACTIVITY

A summary of our treasury stock activity is as follows:

| | Six Months Ended July 2, 2017 | |
|---|---|---|
| | Shares | Dollars In thousands |
| Shares repurchased in the open market under pre-approved share repurchase programs | — | $— |
| Shares repurchased to replace Treasury Stock issued for stock options and incentive compensation | 886,675 | 99,992 |
| Total share repurchases | 886,675 | 99,992 |
| Shares issued for stock options and incentive compensation | (1,041,596) | $(43,338) |
| Net change | (154,921) | $56,654 |

In January 2016, our Board of Directors approved a $500,000 authorization to repurchase shares of our Common Stock. As of July 2, 2017, $100,000 remained available for repurchases of our Common Stock under this program. We are authorized to purchase our outstanding shares in open market and privately negotiated transactions. The program has no expiration date and acquired shares of Common Stock will be held as treasury shares. Purchases under approved share repurchase authorizations are in addition to our practice of buying back shares sufficient to offset those issued under incentive compensation plans.

THE HERSHEY COMPANY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data or if otherwise indicated)

13. NONCONTROLLING INTEREST

We currently own a 50% controlling interest in Lotte Shanghai Foods Co., Ltd. (“LSFC”), a joint venture established in 2007 in China for the purpose of manufacturing and selling product to the venture partners.

A roll-forward showing the 2017 activity relating to the noncontrolling interest follows:

| | Noncontrolling Interest |
|---|---|
| Balance, December 31, 2016 | $ 41,831 |
| Net loss attributable to noncontrolling interest | (27,570 ) |
| Other comprehensive income - foreign currency translation adjustments | 416 |
| Balance, July 2, 2017 | $ 14,677 |

The 2017 net loss attributable to the noncontrolling interest reflects the 50% allocation of LSFC-related business realignment and impairment costs (see Note 7). For the six months ended July 3, 2016, the net loss attributable to noncontrolling interests totaled $1,465, which was presented within selling, marketing and administrative expense in the Consolidated Statements of Income since the amount was not considered significant.

14. CONTINGENCIES

We are subject to various pending or threatened legal proceedings and claims that arise in the ordinary course of our business. While it is not feasible to predict or determine the outcome of such proceedings and claims with certainty, in our opinion these matters, both individually and in the aggregate, are not expected to have a material effect on our financial condition, results of operations or cash flows.

15. EARNINGS PER SHARE

We compute basic earnings per share for Common Stock and Class B common stock using the two-class method. The Class B common stock is convertible into Common Stock on a share-for-share basis at any time. With respect to dividend rights, the Common Stock holders are entitled to cash dividends 10% higher than those declared and paid on the Class B common stock. The computation of diluted earnings per share for Common Stock assumes the conversion of Class B common stock using the if-converted method, while the diluted earnings per share of Class B common stock does not assume the conversion of those shares.

THE HERSHEY COMPANY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data or if otherwise indicated)

We compute basic and diluted earnings per share based on the weighted-average number of shares of Common Stock and Class B common stock outstanding as follows:

| | Three Months Ended | | | |
|---|---|---|---|---|
| | July 2, 2017 | | July 3, 2016 | |
| | Common Stock | Class B Common Stock | Common Stock | Class B Common Stock |
| Basic earnings per share: | | | | |
| Numerator: | | | | |
| Allocation of distributed earnings (cash dividends paid) | $94,043 | $34,068 | $88,615 | $32,129 |
| Allocation of undistributed earnings | 55,370 | 20,020 | 18,528 | 6,684 |
| Total earnings—basic | $149,413 | $54,088 | $107,143 | $38,813 |
| Denominator (shares in thousands): | | | | |
| Total weighted-average shares—basic | 152,466 | 60,620 | 152,774 | 60,620 |
| Earnings Per Share—basic | $0.98 | $0.89 | $0.70 | $0.64 |
| Diluted earnings per share: | | | | |
| Numerator: | | | | |
| Allocation of total earnings used in basic computation | $149,413 | $54,088 | $107,143 | $38,813 |
| Reallocation of total earnings as a result of conversion of Class B common stock to Common stock | 54,088 | — | 38,813 | — |
| Reallocation of undistributed earnings | — | (149) | — | (36) |
| Total earnings—diluted | $203,501 | $53,939 | $145,956 | $38,777 |
| Denominator (shares in thousands): | | | | |
| Number of shares used in basic computation | 152,466 | 60,620 | 152,774 | 60,620 |
| Weighted-average effect of dilutive securities: | | | | |
| Conversion of Class B common stock to Common shares outstanding | 60,620 | — | 60,620 | — |
| Employee stock options | 1,229 | — | 973 | — |
| Performance and restricted stock options | 325 | — | 137 | — |
| Total weighted-average shares—diluted | 214,640 | 60,620 | 214,504 | 60,620 |
| Earnings Per Share—diluted | $0.95 | $0.89 | $0.68 | $0.64 |

The earnings per share calculations for the three months ended July 2, 2017 and July 3, 2016 excluded 1,808 and 3,601, respectively, of stock options (in thousands) that would have been antidilutive.

THE HERSHEY COMPANY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data or if otherwise indicated)

| | Six Months Ended | | | |
|---|---|---|---|---|
| | July 2, 2017 | | July 3, 2016 | |
| | Common Stock | Class B Common Stock | Common Stock | Class B Common Stock |
| Basic earnings per share: | | | | |
| Numerator: | | | | |
| Allocation of distributed earnings (cash dividends paid) | $187,992 | $68,136 | $178,882 | $64,257 |
| Allocation of undistributed earnings | 53,180 | 19,237 | 97,737 | 34,912 |
| Total earnings—basic | $241,172 | $87,373 | $276,619 | $99,169 |
| | | | | |
| Denominator (shares in thousands): | | | | |
| Total weighted-average shares—basic | 152,393 | 60,620 | 154,283 | 60,620 |
| | | | | |
| Earnings Per Share—basic | $1.58 | $1.44 | $1.79 | $1.64 |
| | | | | |
| Diluted earnings per share: | | | | |
| Numerator: | | | | |
| Allocation of total earnings used in basic computation | $241,172 | $87,373 | $276,619 | $99,169 |
| Reallocation of total earnings as a result of conversion of Class B common stock to Common stock | 87,373 | — | 99,169 | — |
| Reallocation of undistributed earnings | — | (145) | — | (191) |
| Total earnings—diluted | $328,545 | $87,228 | $375,788 | $98,978 |
| | | | | |
| Denominator (shares in thousands): | | | | |
| Number of shares used in basic computation | 152,393 | 60,620 | 154,283 | 60,620 |
| Weighted-average effect of dilutive securities: | | | | |
| Conversion of Class B common stock to Common shares outstanding | 60,620 | — | 60,620 | — |
| Employee stock options | 1,248 | — | 989 | — |
| Performance and restricted stock options | 324 | — | 162 | — |
| Total weighted-average shares—diluted | 214,585 | 60,620 | 216,054 | 60,620 |
| | | | | |
| Earnings Per Share—diluted | $1.53 | $1.44 | $1.74 | $1.63 |

The earnings per share calculations for the six months ended July 2, 2017 and July 3, 2016 excluded 2,067 and 3,680, respectively, of stock options (in thousands) that would have been antidilutive.

16. OTHER (INCOME) EXPENSE, NET

Other (income) expense, net reports certain gains and losses associated with activities not directly related to our core operations. A summary of the components of other (income) expense, net is as follows:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | July 2, 2017 | July 3, 2016 | July 2, 2017 | July 3, 2016 |
| Write-down of equity investments in partnerships qualifying for tax credits | $10,263 | $9,468 | $10,263 | $15,061 |
| Settlement of SGM liability (see Note 2) | — | — | — | (26,650) |
| Other (income) expense, net | (165) | (1,340) | (336) | (1,508) |
| Total | $10,098 | $8,128 | $9,927 | $(13,097) |

27

THE HERSHEY COMPANY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(amounts in thousands, except share data or if otherwise indicated)

17. SUPPLEMENTAL BALANCE SHEET INFORMATION

The components of certain Consolidated Balance Sheet accounts are as follows:

| | July 2, 2017 | December 31, 2016 |
|---|---|---|
| Inventories: | | |
| Raw materials | $303,553 | $315,239 |
| Goods in process | 123,386 | 88,490 |
| Finished goods | 691,334 | 528,587 |
| Inventories at FIFO | 1,118,273 | 932,316 |
| Adjustment to LIFO | (181,836) | (186,638) |
| Total inventories | $936,437 | $745,678 |
| | | |
| Property, plant and equipment: | | |
| Land | $106,662 | $103,865 |
| Buildings | 1,191,483 | 1,238,634 |
| Machinery and equipment | 2,871,889 | 3,001,552 |
| Construction in progress | 200,411 | 230,987 |
| Property, plant and equipment, gross | 4,370,445 | 4,575,038 |
| Accumulated depreciation | (2,336,655) | (2,397,790) |
| Property, plant and equipment, net | $2,033,790 | $2,177,248 |
| | | |
| Other assets: | | |
| Capitalized software, net | $100,867 | $95,301 |
| Income tax receivable | — | 1,449 |
| Other non-current assets | 82,113 | 71,615 |
| Total other assets | $182,980 | $168,365 |
| | | |
| Accrued liabilities: | | |
| Payroll, compensation and benefits | $194,368 | $240,080 |
| Advertising and promotion | 280,645 | 358,573 |
| Other | 166,730 | 152,333 |
| Total accrued liabilities | $641,743 | $750,986 |
| | | |
| Other long-term liabilities: | | |
| Post-retirement benefits liabilities | $215,802 | $220,270 |
| Pension benefits liabilities | 61,748 | 65,687 |
| Other | 119,654 | 114,204 |
| Total other long-term liabilities | $397,204 | $400,161 |
| | | |
| Accumulated other comprehensive loss: | | |
| Foreign currency translation adjustments | $(92,756) | $(110,613) |
| Pension and post-retirement benefit plans, net of tax | (206,742) | (207,169) |
| Cash flow hedges, net of tax | (56,466) | (58,106) |
| Total accumulated other comprehensive loss | $(355,964) | $(375,888) |

28

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

This Management's Discussion and Analysis ("MD&A") is intended to provide an understanding of Hershey's financial condition, results of operations and cash flows by focusing on changes in certain key measures from year to year. The MD&A should be read in conjunction with our Consolidated Financial Statements and accompanying notes. This discussion contains a number of forward-looking statements, all of which are based on current expectations. Actual results may differ materially. Refer to the Safe Harbor Statement below as well as the Risk Factors and other information contained in our 2016 Annual Report on Form 10-K for information concerning the key risks to achieving future performance goals.

The MD&A is organized in the following sections:

- Overview and Outlook
- Non-GAAP Information
- Consolidated Results of Operations
- Segment Results
- Liquidity and Capital Resources

The Overview and Outlook presented below is an executive-level summary highlighting the key trends and measures on which the Company's management focuses in evaluating its financial condition and operating performance. Certain earnings and performance measures within the Overview and Outlook include financial information determined on a non-GAAP basis, which aligns with how management internally evaluates the Company's results of operations, determines incentive compensation, and assesses the impact of known trends and uncertainties on the business. A detailed reconciliation of the non-GAAP financial measures referenced herein to their nearest comparable GAAP financial measures follows this summary. For a detailed analysis of the Company's operations prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"), referred to as "reported" herein, refer to the discussion and analysis in the Consolidated Results of Operations.

OVERVIEW AND OUTLOOK

Our second quarter 2017 net sales totaled $1,663.0 million, an increase of 1.5%, versus $1,637.7 million for the comparable period of 2016. Excluding a 0.3% impact from unfavorable foreign exchange rates, our net sales increased 1.8%. Net sales growth was driven by the North America segment, which benefited from innovation and the barkTHINS brand acquisition. Additionally, net sales growth benefited from the timing of new stand-up packaging as well as distributor changes by several retailers resulting in increased retail inventory.

Our reported gross margin was 45.9% in the second quarter of 2017, an increase of 30 basis points compared to the second quarter of 2016. Our non-GAAP gross margin increased 160 basis points in the second quarter of 2017, primarily due to lower commodity input costs, supply chain productivity and cost savings initiatives.

Our second quarter 2017 reported net income and earnings per share-diluted (EPS) totaled $203.5 million and $0.95, respectively, compared to the second quarter 2016 reported net income and EPS-diluted of $146.0 million and $0.68, respectively. From a non-GAAP perspective, second quarter 2017 adjusted net income was $233.1 million, an increase of 27.7% versus $182.6 million in 2016, primarily driven by the improvement in our non-GAAP gross margin, as well as a lower non-GAAP effective tax rate, due mainly to a favorable foreign tax rate differential, discrete items and the benefit from the adoption of Accounting Standards Update ("ASU") 2016-09 for the accounting of employee share-based payments. Our adjusted EPS-diluted for the second quarter of 2017 was $1.09 compared to $0.85 for the same period of 2016, with this 28.2% increase attributable to the same factors driving the increase in non-GAAP net income.

Over the remainder of the year, we expect to continue the rollout of Hershey's Cookie Layer Crunch bars, Reese's and Hershey's Crunchers candies and Reese's Crunchy Cookie Cups. Additionally, we have solid Halloween and Holiday plans, and advertising and related consumer marketing expense is expected to be meaningfully higher over the remainder of the year. Despite the inconsistent shopping patterns and behavior that have resulted in a recent slowdown in retail trips, we believe CMG and snacks have inherent advantages such as impulsivity, seasons, and multiple pack

types, or usage occasions.  This facilitates merchandising and display within different parts of the box where there is foot traffic, like the perimeter and at checkout.

However, we expect that the broader industry challenges at the retail level will persist over the remainder of the year. Therefore, we currently estimate that full-year 2017 net sales growth will be approximately 1%. The impact of foreign currency exchange rates is expected to be minimal. We currently expect full-year 2017 reported EPS-diluted to be in the $3.41 to $3.60 range. From a non-GAAP perspective, we expect 2017 adjusted EPS-diluted to be towards the high end of our outlook of $4.72 to $4.81, an increase of 7% to 9%, primarily due to gross margin expansion from lower input costs, and strong productivity and cost savings initiatives, as well as a lower effective tax rate driven by a favorable foreign rate differential and benefit from tax credits. A reconciliation of reported to adjusted projections for 2017 are reflected in the non-GAAP reconciliations that follow.

NON-GAAP INFORMATION

The comparability of certain of our financial measures is impacted by unallocated mark-to-market (gains) losses on commodity derivatives, costs associated with business realignment activities, costs relating to the integration of acquisitions, non-service related components of our pension expense ("NSRPE"), impairment of long-lived assets, and settlement of the SGM liability in conjunction with the purchase of the remaining 20% of the outstanding shares of SGM.

To provide additional information to investors to facilitate the comparison of past and present performance, we use non-GAAP financial measures within MD&A that exclude the financial impact of these activities. These non-GAAP financial measures are used internally by management in evaluating results of operations and determining incentive compensation, and in assessing the impact of known trends and uncertainties on our business, but they are not intended to replace the presentation of financial results in accordance with GAAP. A reconciliation of the non-GAAP financial measures referenced in MD&A to their nearest comparable GAAP financial measures as presented in the Consolidated Statements of Income is provided below.

Reconciliation of Certain Non-GAAP Financial Measures

| Consolidated results | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| In thousands except per share data | July 2, 2017 | July 3, 2016 | July 2, 2017 | July 3, 2016 |
| Reported gross profit | $763,210 | $747,398 | $1,669,770 | $1,564,774 |
| Derivative mark-to-market losses (gains) | 11,556 | (39,886) | (5,532) | (4,940) |
| Business realignment activities | 5,772 | 33,965 | 6,262 | 33,478 |
| NSRPE | 2,705 | 3,271 | 5,565 | 6,512 |
| Non-GAAP gross profit | $783,243 | $744,748 | $1,676,065 | $1,599,824 |
| | | | | |
| Reported operating profit | $315,341 | $262,762 | $507,272 | $602,271 |
| Derivative mark-to-market losses (gains) | 11,556 | (39,886) | (5,532) | (4,940) |
| Business realignment activities | 14,454 | 62,095 | 61,442 | 76,525 |
| Acquisition integration costs | 11 | 1,462 | 311 | 1,462 |
| NSRPE | 4,215 | 9,205 | 8,583 | 14,306 |
| Long-lived asset impairment charges | — | — | 208,712 | — |
| Non-GAAP operating profit | $345,577 | $295,638 | $780,788 | $689,624 |
| | | | | |
| Reported provision for income taxes | $78,390 | $87,340 | $148,503 | $197,237 |
| Derivative mark-to-market losses (gains)* | (847) | (15,117) | 352 | (1,872) |
| Business realignment activities* | 5,783 | 7,295 | 17,200 | 10,833 |
| Acquisition integration costs* | 4 | 554 | 118 | 554 |
| NSRPE* | 1,605 | 3,515 | 3,269 | 5,468 |
| Long-lived asset impairment charges** | (7,227) | — | 37,974 | — |
| Non-GAAP provision for income taxes | $77,708 | $83,587 | $207,416 | $212,220 |
| | | | | |
| Reported net income | $203,501 | $145,956 | $328,545 | $375,788 |
| Derivative mark-to-market losses (gains) | 12,403 | (24,769) | (5,884) | (3,068) |
| Business realignment activities | 8,671 | 54,827 | 44,242 | 65,687 |
| Acquisition integration costs | 7 | 908 | 193 | 908 |
| NSRPE | 2,610 | 5,690 | 5,314 | 8,838 |
| Long-lived asset impairment charges | 7,227 | — | 170,738 | — |
| Noncontrolling interest share of business realignment and impairment charges | (1,296) | — | (27,962) | — |
| Settlement of SGM liability | — | — | — | (26,650) |
| Non-GAAP net income | $233,123 | $182,612 | $515,186 | $421,503 |
| | | | | |
| Reported EPS - Diluted | $0.95 | $0.68 | $1.53 | $1.74 |
| Derivative mark-to-market losses (gains) | 0.06 | (0.11) | (0.03) | (0.01) |
| Business realignment activities | 0.04 | 0.25 | 0.21 | 0.30 |
| NSRPE | 0.01 | 0.03 | 0.02 | 0.04 |
| Long-lived asset impairment charges | 0.04 | — | 0.80 | — |
| Noncontrolling interest share of business realignment and impairment charges | (0.01) | — | (0.13) | — |
| Settlement of SGM liability | — | — | — | (0.12) |
| Non-GAAP EPS - Diluted | $1.09 | $0.85 | $2.40 | $1.95 |

* The tax effect for each adjustment is determined by calculating the tax impact of the adjustment on the Company's quarterly effective tax rate.

** There were no pre-tax impairment charges associated with long-lived assets during the three months ended July 2, 2017. However, the long-lived asset impairment charge in the first quarter of 2017 was not treated as a discrete tax item. Therefore, the tax impact was included in the estimated annual effective tax rate resulting in an EPS-diluted impact for each of the quarters throughout 2017.

In the assessment of our results, we review and discuss the following financial metrics that are derived from the reported and non-GAAP financial measures presented above:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | July 2, 2017 | July 3, 2016 | July 2, 2017 | July 3, 2016 |
| As reported gross margin | 45.9% | 45.6% | 47.1% | 45.1% |
| Non-GAAP gross margin (1) | 47.1% | 45.5% | 47.3% | 46.2% |
| | | | | |
| As reported operating profit margin | 19.0% | 16.0% | 14.3% | 17.4% |
| Non-GAAP operating profit margin (2) | 20.8% | 18.1% | 22.0% | 19.9% |
| | | | | |
| As reported effective tax rate | 27.9% | 37.4% | 33.0% | 34.4% |
| Non-GAAP effective tax rate (3) | 25.0% | 31.4% | 28.7% | 33.5% |

(1) Calculated as non-GAAP gross profit as a percentage of net sales for each period presented.
(2) Calculated as non-GAAP operating profit as a percentage of net sales for each period presented.
(3) Calculated as non-GAAP provision for income taxes as a percentage of non-GAAP income before taxes (calculated as non-GAAP operating profit minus non-GAAP interest expense, net plus or minus non-GAAP other (income) expense, net).

Details of the activities impacting comparability that are presented as reconciling items to derive the non-GAAP financial measures in the tables above are as follows:

Mark-to-market losses (gains) on commodity derivatives
Commensurate with our discontinuance of hedge accounting treatment for commodity derivatives, we are adjusting the mark-to-market losses (gains) on such commodity derivatives, until such time as the related inventory is sold. Since we often purchase commodity contracts to price inventory requirements in future years, we make this adjustment to facilitate the year-over-year comparison of cost of sales on a basis that matches the derivative gains and losses with the underlying economic exposure being hedged for the period. For the three months ended July 2, 2017 and July 3, 2016, unallocated mark-to-market adjustment on commodity derivatives totaled pre-tax losses of $11.6 million and gains of $39.9 million, respectively. For the six months ended July 2, 2017 and July 3, 2016, unallocated mark-to-market adjustment on commodity derivatives totaled pre-tax gains of $5.5 million and $4.9 million, respectively.

Business realignment activities
We periodically undertake restructuring and cost reduction activities as part of ongoing efforts to enhance long-term profitability. For the three months ended July 2, 2017 and July 3, 2016, we incurred $14.5 million and $62.1 million, respectively, of pre-tax costs related to business realignment activities. For the six months ended July 2, 2017 and July 3, 2016, we incurred $61.4 million and $76.5 million, respectively, of pre-tax costs related to business realignment activities. See Note 7 to the Consolidated Financial Statements for more information.

Acquisition integration costs
Costs incurred during the three and six months ended July 2, 2017 and 2016 relate to the integration of the 2016 acquisition of Ripple Brand Collective, LLC as we incorporate this business into our operating practices and information systems.

Non-service related pension expense
NSRPE includes interest costs, the expected return on pension plan assets, the amortization of actuarial gains and losses, and certain curtailment and settlement losses or credits. NSRPE can fluctuate from year to year as a result of changes in market interest rates and market returns on pension plan assets. We believe that the service cost component of our total pension benefit costs closely reflects the operating costs of our business and provides for a better comparison of our operating results from year to year. Therefore, we exclude NSRPE from our internal performance measures. Our most significant defined benefit pension plans have been closed to new participants for a number of years, resulting in ongoing service costs that are stable and predictable. We recorded pre-tax NSRPE of $4.2 million and $9.2 million, respectively, for the three months ended July 2, 2017 and July 3, 2016, respectively. We recorded pre-tax NSRPE of $8.6 million and $14.3 million, respectively, for the six months ended July 2, 2017 and July 3, 2016, respectively.

Long-lived asset impairment charges
For the six months ended July 2, 2017, we incurred $208.7 million of pre-tax long-lived asset impairment charges related to certain business realignment activities. This includes a write-down of certain intangible assets that had been recognized in connection with the 2014 SGM acquisition and write-down of property, plant and equipment. See Note 7 to the Consolidated Financial Statements for more information.

Noncontrolling interest share of business realignment and impairment charges
Certain of the business realignment and impairment charges recorded in connection with the Margin for Growth Program related to Lotte Shanghai Foods Co., Ltd., a joint venture in which we own a 50% controlling interest. Therefore, we have also adjusted for the portion of these charges included within the loss attributed to the non-controlling interest.

Settlement of SGM liability
In the fourth quarter of 2015, we reached an agreement with the SGM selling shareholders to reduce the originally-agreed purchase price for the remaining 20% of SGM, and we completed the purchase on February 3, 2016. In the first quarter of 2016, we recorded a $26.7 million gain relating to the settlement of the SGM liability, representing the net carrying amount of the recorded liability in excess of the cash paid to settle the obligation for the remaining 20% of the outstanding shares.

Constant Currency Net Sales Growth

We present certain percentage changes in net sales on a constant currency basis, which excludes the impact of foreign currency exchange. This measure is used internally by management in evaluating results of operations and determining incentive compensation. We believe that this measure provides useful information to investors because it provides transparency to underlying performance in our net sales by excluding the effect that foreign currency exchange rate fluctuations have on the year-to-year comparability given volatility in foreign currency exchange markets.

To present this information for historical periods, current period net sales for entities reporting in other than the U.S. dollar are translated into U.S. dollars at the average monthly exchange rates in effect during the corresponding period of the prior fiscal year, rather than at the actual average monthly exchange rates in effect during the current period of the current fiscal year. As a result, the foreign currency impact is equal to the current year results in local currencies multiplied by the change in average foreign currency exchange rate between the current fiscal period and the corresponding period of the prior fiscal year.

A reconciliation between reported and constant currency growth rates is provided below:

| | Three Months Ended July 2, 2017 | | |
|---|---|---|---|
| | Percentage Change as Reported | Impact of Foreign Currency Exchange | Percentage Change on Constant Currency Basis |
| North America segment | | | |
| Canada | 6.8 % | (5.6 )% | 12.4 % |
| Total North America segment | 2.2 % | (0.3 )% | 2.5 % |
| | | | |
| International and Other segment | | | |
| Mexico | 13.9 % | (3.0 )% | 16.9 % |
| Brazil | 12.4 % | 9.6 % | 2.8 % |
| India | 5.4 % | 3.7 % | 1.7 % |
| Greater China | (31.2)% | (2.4 )% | (28.8 )% |
| Total International and Other segment | (3.6 )% | (0.1 )% | (3.5 )% |
| | | | |
| Total Company | 1.5 % | (0.3 )% | 1.8 % |

| | Six Months Ended July 2, 2017 | | |
|---|---|---|---|
| | Percentage Change as Reported | Impact of Foreign Currency Exchange | Percentage Change on Constant Currency Basis |
| North America segment | | | |
| Canada | 6.1 % | (1.0 )% | 7.1 % |
| Total North America segment | 2.5 % | — % | 2.5 % |
| | | | |
| International and Other segment | | | |
| Mexico | 6.3 % | (8.5 )% | 14.8 % |
| Brazil | 31.3 % | 20.4 % | 10.9 % |
| India | 11.0 % | 2.3 % | 8.7 % |

| | | | |
|---|---|---|---|
| Greater China | (14.4)% | (2.8 )% | (11.6 )% |
| Total International and Other segment | 0.1 % | (0.3 )% | 0.4 % |
| Total Company | 2.2 % | (0.1 )% | 2.3 % |

2017 Outlook

The following table provides a reconciliation of projected 2017 EPS-diluted, prepared in accordance with GAAP, to projected non-GAAP EPS-diluted for 2017, prepared on a non-GAAP basis, with adjustments consistent to those discussed previously. The reconciliation of 2016 EPS-diluted, prepared in accordance with GAAP, to 2016 non-GAAP EPS-diluted is provided below for comparison.

| | 2017 (Projected) | 2016 |
|---|---|---|
| Reported EPS – Diluted | $3.41 - $3.60 | $3.34 |
| Derivative mark-to-market losses | — | 0.66 |
| Business realignment costs (including Margin for Growth Program costs) | 0.30 - 0.40 | 0.42 |
| Acquisition and integration costs | — | 0.02 |
| Non-service related pension expense | 0.06 | 0.08 |
| Settlement of SGM liability | — | (0.12) |
| Long-lived asset impairment charges | 0.85 | 0.01 |
| Adjusted EPS – Diluted | $4.72 - $4.81 | $4.41 |

Our 2017 projected EPS-diluted, as presented above, does not include the impact of mark-to-market gains and losses on our commodity derivative contracts that will be reflected within corporate unallocated expenses in our segment results until the related inventory is sold, since we are not able to forecast the impact of the market changes.

CONSOLIDATED RESULTS OF OPERATIONS

| | Three Months Ended | | Percent | Six Months Ended | | Percent |
|---|---|---|---|---|---|---|
| | July 2, 2017 | July 3, 2016 | Change | July 2, 2017 | July 3, 2016 | Change |
| In millions of dollars except per share amounts | | | | | | |
| Net Sales | $1,663.0 | $1,637.7 | 1.5 % | $3,542.7 | $3,466.5 | 2.2 % |
| Cost of Sales | 899.8 | 890.3 | 1.1 % | 1,872.9 | 1,901.7 | (1.5 )% |
| Gross Profit | 763.2 | 747.4 | 2.1 % | 1,669.8 | 1,564.8 | 6.7 % |
| Gross Margin | 45.9 % | 45.6 % | | 47.1 % | 45.1 % | |
| SM&A Expense | 445.9 | 462.5 | (3.6 )% | 907.8 | 934.3 | (2.8 )% |
| SM&A Expense as a percent of net sales | 26.8 % | 28.2 % | | 25.6 % | 27.0 % | |
| Long-lived Asset Impairment Charges | — | — | NM | 208.7 | — | NM |
| Business Realignment Costs | 2.0 | 22.1 | (91.0)% | 46.0 | 28.2 | 62.9 % |
| Operating Profit | 315.3 | 262.8 | 20.0 % | 507.3 | 602.3 | (15.8)% |
| Operating Profit Margin | 19.0 % | 16.0 % | | 14.3 % | 17.4 % | |
| Interest Expense, Net | 24.1 | 21.3 | 13.1 % | 47.9 | 42.3 | 13.0 % |
| Other (Income) Expense, Net | 10.1 | 8.2 | 24.2 % | 9.9 | (13.0 ) | NM |
| Provision for Income Taxes | 78.4 | 87.3 | (10.2)% | 148.5 | 197.2 | (24.7)% |
| Effective Income Tax Rate | 27.9 % | 37.4 % | | 33.0 % | 34.4 % | |
| Net Income Including Noncontrolling Interest | 202.7 | 146.0 | 38.9 % | 301.0 | 375.8 | (19.9)% |
| Less: Net Loss Attributable to Noncontrolling Interest | (0.8 ) | — | NM | (27.5 ) | — | NM |
| Net Income Attributable to The Hershey Company | $203.5 | $146.0 | 39.4 % | $328.5 | $375.8 | (12.6)% |
| Net Income Per Share—Diluted | $0.95 | $0.68 | 39.7 % | $1.53 | $1.74 | (12.1)% |

Note: Percentage changes may not compute directly as shown due to rounding of amounts presented above.
NM = not meaningful.

Results of Operations - Second Quarter 2017 vs. Second Quarter 2016

Net Sales

Net sales increased 1.5% in the second quarter of 2017 compared to the same period of 2016, reflecting volume increases of 1.2%, favorable price realization of 0.1% and a 0.5% benefit from acquisitions, partially offset by an unfavorable impact from foreign currency exchange rates of 0.3%. Excluding foreign currency, our net sales increased 1.8% in the second quarter of 2017. Consolidated volumes increased as a result of higher sales volume in the United States, which benefited from innovation and the barkTHINS brand acquisition. Additionally, net sales growth benefited from the timing of new stand-up packaging as well as distributor changes by several retailers resulting in increased retail inventory. These volume increases were partially offset by volume declines in our International and Other segment primarily due to macroeconomic challenges in China. Favorable net price realization was attributed to lower levels of trade promotional spending in the North America segment versus the prior year.

Key U.S. CMG Marketplace Metrics

| For the 12 week period ended | July 8, 2017 | July 9, 2016 |
|---|---|---|
| Hershey's Consumer Takeaway Increase (Decrease) | 5.2 % | (1.1)% |
| Hershey's Market Share Increase (Decrease) | 0.2 | (0.7) |

The consumer takeaway and market share information provided for the twelve week period above are for measured channels of distribution accounting for approximately 90% of our U.S. confectionery retail business. These channels of distribution primarily include food, drug, mass merchandisers, and convenience store channels, plus Wal-Mart Stores, Inc., partial dollar, club and military channels. These metrics are based on measured market scanned purchases as reported by Nielsen and provide a means to assess our retail takeaway and market position relative to the overall category. In 2017, takeaway improved relative to the prior year mainly driven by our core brands at Easter. The amounts presented above are solely for the U.S. CMG category which does not include revenue from our snack mixes and grocery items.

Cost of Sales and Gross Margin

Cost of sales increased 1.1% in the second quarter of 2017 compared to the same period of 2016. The increase was driven by higher sales volume and an incremental $51 million unfavorable impact from marking-to-market our commodity derivative instruments intended to economically hedge future years' commodity purchases, offset in part by supply chain productivity and costs savings initiatives as well as a $28.2 million decrease in business realignment costs.

Gross margin increased by 30 basis points in the second quarter of 2017 compared to the same period of 2016. Lower business realignment costs and supply chain productivity contributed to the improvement in gross margin. However, higher commodity costs, driven by the unfavorable mark-to-market impact from commodity derivative instruments, and higher supply chain costs partially offset the increase in gross margin.

Selling, Marketing and Administrative

Selling, marketing and administrative (“SM&A”) expenses decreased $16.6 million or 3.6% in the second quarter of 2017. Advertising and related consumer marketing expense decreased 0.2% during this period. Excluding these advertising and related consumer marketing costs, selling and administrative expenses for 2017 decreased by 5.2% as compared to 2016. SM&A benefited from lower business realignment costs as well as costs savings and efficiency initiatives, partially offset by higher investments in go-to-market capabilities.

Business Realignment Activities

In the second quarter of 2017 and 2016, we recorded business realignment costs of $2.0 million and $22.1 million, respectively. The 2017 costs related primarily to severance and other program costs associated with the Margin for Growth Program that commenced in the first quarter of 2017. The 2016 costs related primarily to the Operational Optimization Program, as described in Note 7 to the Unaudited Consolidated Financial Statements.

Operating Profit and Operating Profit Margin

Operating profit increased 20.0% in the second quarter of 2017 compared to the same period of 2016 due primarily to the higher gross margin, lower business realignment costs and lower SM&A expenses, as discussed above. Operating profit margin increased to 19.0% in 2017 from 16.0% in 2016 driven by these same factors.

Interest Expense, Net

Net interest expense was $2.8 million higher in the second quarter of 2017 compared to the same period of 2016. The increase was due to higher levels of long-term debt as well as higher interest rates on commercial paper during the second quarter of 2017 as compared to the 2016 quarter.

Other (Income) Expense, Net

Other (income) expense, net totaled $10.1 million in the second quarter of 2017 compared to $8.2 million for the same period of 2016, driven in both periods by the write-down on equity investments qualifying for federal historic and energy tax credits.

Income Taxes and Effective Tax Rate

Our effective income tax rate was 27.9% for the second quarter of 2017 compared to 37.4% for the same period of 2016. Relative to the statutory rate, the 2017 effective tax rate was impacted by a favorable foreign rate differential relating to our cocoa procurement operations, investment tax credits, and the benefit of ASU 2016-09, which were partially offset by non-benefited costs resulting from the Margin for Growth Program. The higher 2016 effective rate reflected the SGM valuation allowance impact.

Net Income Attributable to The Hershey Company and Earnings Per Share-diluted

Net income increased $57.5 million, or 39.4%, while EPS-diluted increased $0.27, or 39.7%, in the second quarter of 2017 compared to the same period of 2016. The increases in both net income and EPS-diluted were driven by the higher gross margin, lower business realignment costs and lower SM&A expenses, as discussed above.

Results of Operations - First Six Months 2017 vs. First Six Months 2016

Net Sales

Net sales increased 2.2% in the first six months of 2017 compared to the same period of 2016, reflecting favorable price realization of 1.1%, volume increases of 0.5% and a 0.7% benefit from acquisitions, partially offset by an unfavorable impact from foreign currency exchange rates of 0.1%. Excluding foreign currency, our net sales increased 2.3% in first six months of 2017. The favorable net price realization was attributed to lower levels of trade promotional spending in both the North America and International and Other segments versus the prior year. Consolidated volumes increased as a result of higher sales volume in North America, driven by a stronger Easter season, as well as benefits from innovation and the barkTHINS brand acquisition. Additionally, net sales growth benefited from the timing of new stand-up packaging as well as distributor changes by several retailers resulting in increased retail inventory. These volume increases were partially offset by volume declines in our International and Other segment primarily due to macroeconomic challenges in China.

Cost of Sales and Gross Margin

Cost of sales decreased 1.5% in the first six months of 2017 compared to the same period of 2016. The improvement was driven by favorable commodity costs, a $27.2 million year-over-year decrease in business realignment costs, and supply chain productivity. These benefits were offset in part by unfavorable manufacturing variances and higher freight and warehousing costs.

Gross margin increased by 200 basis points in the first six months of 2017 compared to the same period of 2016, driven by lower trade promotional spending, lower commodity and business realignment costs and supply chain productivity, partially offset by higher supply chain costs.

Selling, Marketing and Administrative

Selling, marketing and administrative (“SM&A”) expenses decreased $26.5 million or 2.8% in the first six months of 2017. Advertising and related consumer marketing expense decreased 0.3% during this period. Excluding these advertising and related consumer marketing costs, selling and administrative expenses for 2017 decreased by 4.1% as compared to 2016. SM&A benefited from lower business realignment costs as well as costs savings and efficiency initiatives, partially offset by higher investments in go-to-market capabilities.

Long-lived Asset Impairment Charges

In the first six months of 2017, we recorded long-lived asset impairment charges of $208.7 million. This relates to a first quarter write-down of certain intangible assets that had been recognized in connection with the 2014 SGM acquisition and write-down of property, plant and equipment. See Note 7 to the Unaudited Consolidated Financial Statements.

Business Realignment Activities
In the first six months of 2017 and 2016, we recorded business realignment costs of $46.0 million and $28.2 million, respectively. The 2017 costs related primarily to severance and other program costs associated with the Margin for Growth Program that commenced in the first quarter of 2017. The 2016 costs related primarily to the Operational Optimization Program, as described in Note 7 to the Unaudited Consolidated Financial Statements.
Operating Profit and Operating Profit Margin
Operating profit decreased 15.8% in the first six months of 2017 compared to the same period of 2016 due primarily to the long-lived asset impairment charges and higher business realignment costs, partially offset by higher gross margin and lower SM&A expenses, as discussed above. Operating profit margin decreased to 14.3% in 2017 from 17.4% in 2016 driven by these same factors.
Interest Expense, Net
Net interest expense was $5.5 million higher in the first six months of 2017 compared to the same period of 2016. The increase was due to higher levels of long-term debt as well as higher interest rates on commercial paper during the second six months of 2017 as compared to the 2016 period.
Other (Income) Expense, Net
Other (income) expense, net totaled expense of $9.9 million during the first six months of 2017 versus income of $13.1 million for the same period of 2016. The 2016 income included an extinguishment gain of $26.7 million related to the settlement of the SGM liability. Additionally, in 2016, we recognized a $15.1 million write-down on equity investments qualifying for federal historic and energy tax credits, compared to a $10.3 million write-down in the first six months of 2017.
Income Taxes and Effective Tax Rate
Our effective income tax rate was 33.0% for the first six months of 2017 compared with 34.4% for the same period of 2016. Relative to the statutory rate, the 2017 effective tax rate was impacted by a favorable foreign rate differential relating to our cocoa procurement operations, investment tax credits and the benefit of ASU 2016-09, which were partially offset by non-benefited costs resulting from the Margin for Growth Program. The 2016 effective rate benefited from the impact of non-taxable income related to the settlement of the SGM liability and investment tax credits.
Net Income attributable to The Hershey Company and Earnings Per Share-diluted
Net income decreased $47.2 million, or 12.6%, while EPS-diluted decreased $0.21, or 12.1%, in the first six months of 2017 compared to the same period of 2016. The decreases in both net income and EPS-diluted were driven by the long-lived asset impairment charges and higher business realignment costs, as noted above.

SEGMENT RESULTS

The summary that follows provides a discussion of the results of operations of our two reportable segments: North America and International and Other. The segments reflect our operations on a geographic basis. For segment reporting purposes, we use “segment income” to evaluate segment performance and allocate resources. Segment income excludes unallocated general corporate administrative expenses, unallocated mark-to-market gains and losses on commodity derivatives, business realignment and impairment charges, acquisition integration costs and NSRPE that are not part of our measurement of segment performance. These items of our operating income are largely managed centrally at the corporate level and are excluded from the measure of segment income reviewed by the CODM and used for resource allocation and internal management reporting and performance evaluation. Segment income and segment income margin, which are presented in the segment discussion that follows, are non-GAAP measures and do not purport to be alternatives to operating income as a measure of operating performance. We believe that these measures are useful to investors and other users of our financial information in evaluating ongoing operating profitability as well as in evaluating operating performance in relation to our competitors, as they exclude the activities that are not integral to our ongoing operations. For further information, see the Non-GAAP Information section of this MD&A.

Our segment results, including a reconciliation to our consolidated results, were as follows:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | July 2, 2017 | July 3, 2016 | July 2, 2017 | July 3, 2016 |
| Net Sales: | | | | |
| North America | $1,477,014 | $1,444,841 | $3,154,160 | $3,078,312 |
| International and Other | 185,977 | 192,830 | 388,509 | 388,171 |
| Total | $1,662,991 | $1,637,671 | $3,542,669 | $3,466,483 |
| | | | | |
| Segment Income (Loss): | | | | |
| North America | $460,382 | $425,723 | $1,013,520 | $955,113 |
| International and Other | 8,368 | (3,462) | 10,091 | (16,695) |
| Total segment income | 468,750 | 422,261 | 1,023,611 | 938,418 |
| Unallocated corporate expense (1) | 123,173 | 126,623 | 242,823 | 248,794 |
| Unallocated mark-to-market losses (gains) on commodity | 11,556 | (39,886) | (5,532) | (4,940) |

| | | | | |
|---|---|---|---|---|
| derivatives (2) | | | | |
| Long-lived asset impairment charges | — | — | 208,712 | — |
| Costs associated with business realignment activities | 14,454 | 62,095 | 61,442 | 76,525 |
| Non-service related pension expense | 4,215 | 9,205 | 8,583 | 14,306 |
| Acquisition and integration costs | 11 | 1,462 | 311 | 1,462 |
| Operating profit | 315,341 | 262,762 | 507,272 | 602,271 |
| Interest expense, net | 24,126 | 21,338 | 47,867 | 42,343 |
| Other (income) expense, net | 10,098 | 8,128 | 9,927 | (13,097) |
| Income before income taxes | $281,117 | $233,296 | $449,478 | $573,025 |

(1) Includes centrally-managed (a) corporate functional costs relating to legal, treasury, finance and human resources, (b) expenses associated with the oversight and administration of our global operations, including warehousing, distribution and manufacturing, information systems and global shared services, (c) non-cash stock-based compensation expense and (d) other gains or losses that are not integral to segment performance.

(2) Reflects gains and losses on commodity derivative instruments that are excluded from segment income until the related inventory is sold. See Note 11 to the Consolidated Financial Statements.

40

North America

The North America segment is responsible for our chocolate and non-chocolate confectionery market position, as well as our grocery and growing snacks market positions, in the United States and Canada. This includes developing and growing our business in chocolate and non-chocolate confectionery, pantry, food service and other snacking product lines. North America accounted for 88.8% and 88.2% of our net sales for the three months ended July 2, 2017 and July 3, 2016, respectively. North America results for the three and six months ended July 2, 2017 and July 3, 2016 were as follows:

Three
Months
Ended