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SFM - Q2 2015 Sprouts Farmers Market Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and welcome to the Sprouts Farmers Market second-quarter 2015 earnings conference call. At this time all participants are in a listen only mode. Later we will conduct a question and answer session and instructions will be given at that time.

(Operator Instructions)

As a reminder, today's call is being recorded. I would now like to turn the conference over to your host today, Miss Susannah Livingston. Ma'am, you may begin.

Susannah Livingston - *Sprouts Farmers Market Inc - IR*

Thank you good afternoon, everyone. We're pleased you have taken the time to join Sprouts on our second quarter 2015 earnings call. Doug Sanders, Amin Maredia, and Jim Nielsen are also on the call with me today.

Sprouts' 10-Q the earnings released announcing our second quarter 2015 results and the webcast of this call can be accessed through the Investor Relations section of our website at Sprouts.com. During this call, Management may make certain forward-looking statements including statements regarding our future performance and growth, product expansion, new store openings, and 2015 expectations and guidance. These statements involve a number of risks and uncertainties that could cause actual results to differ materially from those described in the forward-looking statements. For more information, please refer to the risk factors discussed in our filings with the Securities and Exchange Commission, along with the commentary on forward looking statements at the end of our earnings release filed today.

In addition, our remarks today include references to non-GAAP measures. For reconciliation of our non-GAAP measures to the comparable GAAP figures, please see the tables in our earnings release. We believe these adjusted results provide a good basis to assess the operating and financial results of the Company period over period.



For the second quarter ended June 28, 2015, we reported deluding earnings per share of \$0.20 and adjusted diluted earnings per share of \$0.22. Adjusted diluted earnings per share increased 10% and \$0.20 in the same period in 2014. With that, let me now hand it over to Doug.

Doug Sanders - Sprouts Farmers Market Inc - President & CEO

Thank you Susannah. Good afternoon, everyone, and thanks for joining us today. For the second quarter our net sales grew to \$902 million up 21% from the same period in 2014. Driven by the strong performance of our new stores and comp store sales growth of 5.1%. We remain very pleased with our top line revenue growth as we continue to focus on our core principles of health, selection, value, and service to connect with today's growing number of health-conscious consumers.

Our comp growth accelerated to 5.1% from 4.8% in Q1 despite a number of headwinds. During the quarter we saw deflation of approximately 200 basis points compared to Q1. In addition, we continue cycling a strong [produce] season from 2014, the 80 basis points benefit from Sunflower from Q2 of last year, along with higher than normal cannibalization in some of our more mature markets. The swing from 1% inflation in Q1 to 1% deflation in Q2 was driven primarily by significant deflation in produce which, as you know has a greater impact on Sprouts due to the high volume of produce we sell. The strong tonnage growth we achieved during the quarter was offset by the deflation of nearly 10% in April which improves to mid-single digits in the letter weeks of the quarter. We expect the level of produce deflation to begin to settle as we work through the rest of the summer months.

As we've noted in the past the broad appeal of our healthy value focus model allows us to operate a greater number of stores in a trade area than any other natural foods retailer in the industry. Our unique ability to connect with the everyday grocery shopper has been the catalyst for our tremendous growth over the years and continues to fuel our aggressive expansion across the country. Our current growth plan targets 14% annual unit growth with a continued focus on growth in existing markets to offset the investment in our new market expansion strategy. This growth in existing markets has historically led to cannibalization in the 75 to 100 basis points range, however in our second quarter comp was impacted by a higher cannibalization of 175 basis points as we continue to take advantage of infield opportunity in several key markets.

We see this as an effective long-term strategy for several reasons. One, new stores in existing markets open with higher productivity and achieve expected returns much more quickly than the new stores in new markets. Two, we were able to gain leverage in existing distributions, advertising, and supervision costs which increases the overall profitability of the market. And three, we're able to expand both our market share and brand recognition with a greater number of stores in the trade area. We expect the cannibalization experienced in the second quarter to settle down in the back half of the year as we cycle a greater number of openings over the last 12 months. From an industry perspective we saw increased promotional activity in the second quarter as retailers continue to make price investments in response to consumer and industry change. Based on what we've seen today we would anticipate this level of promotional activity to continue for the remainder of the year.

Now operating in a competitive environment is nothing new to Sprouts and we remain focused on providing our customers on a broad assortment of differentiated products, knowledgeable customer service, and engaging customer experience, and affordable pricing across the store. In doing so we have continued to make price investments in various regions to maintain our competitive positioning and remain focused on our strategy of providing healthy living for less. In strong promotions and solid execution we continue to drive strong top line sales and traffic ending the quarter with improving traffic and comp sales growth that was balanced 50/50 between traffic and ticket.

New store productivity continues to be strong at just over 85% as we've added 8 new stores during the quarter including our first new store in Tennessee. Year to date we've opened 22 new stores in 11 states and are now operating stores from coast to coast. We have an additional 5 stores planned for the remainder of 2015 bringing us to 27 new stores for the year and a total of 217 across the country. Our current real estate pipeline includes 62 approved sites and 47 signed leases for the coming years keeping us well on track to meet our 14% unit growth target. Based on the positive feedback we received at the ICSC real estate convention in May I'm even more confident in our ability to secure great location as we expand healthy living for less into a greater number of markets over the coming years.

We continue to make solid progress on our 2015 strategic initiatives which are focused on broadening our appeal with an even greater number of everyday grocery shopper's across age groups and demographics. This includes growing our social and digital capability, expanding our private-label and specialty product assortment, introducing new and expanded deli offerings, updating our legacy stores with the expanded offerings introduced since 2013, and improving customer engagement through team member training. Engaging with our customer in more meaningful and relevant ways through social and digital marketing continues to be a focus.

To this end it was extremely important to find a talented experienced and innovative Chief Marketing Officer to separate the Sprouts brand into the future. Even though Shawn Gensch has only been with the team for a few weeks, I can already see that his deep retail experience in marketing, loyalty, and digital will have a positive impact on how we engage and support our customers along with their journey to better health. In addition to Shawn we continue to strengthen our Senior Management team with experienced leaders including Dan Sanders who joined the team as Executive Vice President of the store operations in June and Dan Bruni who joined the team as Chief Information Officer earlier this year. Both bring a wealth of knowledge and industry experience to our Company and will play a vital role in our continued success.



As many of the large natural and organic brands become main stream product innovation through Sprouts private-label continues to be a priority. In this year alone we've introduced more than 150 new private-label items and continue to view this as an important growth category for the long-term. Our comp and sales growth in private-label exceeded the Company average for the quarter as we continue to add new and innovative products and categories across the store. Items like our new Sparkling Lemonades for the summer have been a big hit with customers while innovative products like our Sprouts Organic Sracha Lime Kale Chips were recently recognized by a gourmet retailer as a better for you snack and a stepping stone for shoppers of all ages who are trying out a natural and organic lifestyle. As for our attribute driven specialty categories we continue to expand strong sales growth that is outpacing the industry. With our depth of products in these categories we believe Sprouts offering attracts a greater number of customers as we continue to see our sales well outpacing those of our conventional peers.

Following a successful test we are adding our new and expanded deli offerings into four additional stores, this includes features like a new salad bar; stocked with ready to eat, healthy and flavorful salads, prepared proteins, healthy side dishes, and an improved assortment of entree meals and side dishes. Following the rollout of these additional stores we will be looking to incorporate many of these offerings into a greater number of stores in 2016 and beyond. We continue to reinvest in our current stores maintain superior store conditions and have remodeled four stores this year and have completed nearly 100% of our 2015 sales initiative projects. Once done all of our stores will feature some or all of the enhanced product offerings found in our new stores opened since 2013 including expanded offerings in package grocery, and frozen foods, fresh made sushi and Boar's Head among other improvements.

At Sprouts we believe every meal is a choice and our team members play an essential role in educating and inspiring our customers to eat healthy. To that and our investment in team member training is more important today than ever. As one customer recently wrote, good customer service is the life blood of any business, this year we are focusing on improving customer engagement, increasing overall product knowledge, and developing future leaders to support our rapid growth. We continue to reap the benefit of these efforts and one recent online survey showed our customer service ranking as the highest attribute of our stores. I continue to be very optimistic of the future of our Company and tremendous growth still in front of us. Our unique accommodation of health and value with a proven reputable business model continues to make Sprouts one of most dynamic growth companies in grocery today. I'm extremely proud of all of our team members who deliver on our mission to inspire healthy living for all each and every day.

Now before I turn the call over to Amin, I'd like to say a few words about the announcement made today regarding my transition to Executive Chairman of the Sprouts Board of Directors. Sprouts has been part of my life for 13 years during which time I've had the privilege of seeing the Company grow from a single store into one of the largest and fastest growing natural foods retailers in the country. This planned transition from CEO to Executive Chairman will afford me the opportunity to continue to work with the Board and Management in providing strategic guidance.

We're very fortunate to have an exceptional Management Team and I am honored to be passing CEO leadership to Amin and a President role to Jim. As most of you know Amin I'm sure you would agree that his proven leadership, strategic vision, and strong business skills will successfully carry the Company forward. With Jim stepping up to the President role Sprouts is on solid ground as it continues on its exceptional growth trajectory. It's been a real privilege to have led this vibrant and dynamic company for the past decade and I look forward to the remaining part of its continued success. With that let me turn the call over to Amin, to talk about our financial resulting guidance.

Amin Maredia - Sprouts Farmers Market Inc - CFO

Thank you, Doug and good afternoon. Following Doug's highlights of the business drivers let me cover the operating results and guidance. For the second quarter gross profit increased 18% to \$264 million resulting in a gross profit margin of 29.2%, a decrease of 90 basis points compared to the prior-year period. This reduction in gross margin was primarily a result of cycling a strong produce season from last year as well as investments and price to maintain our competitive positioning. These were partially offset by leverage in buying costs and continued leverage in occupancy from our pre 2014 vintages.

As Doug mentioned we continue to be aggressive in making smart price investments to bring healthy living for less to our customers every day. We also continue to see good traffic from expansion of differentiated offerings across the store. Direct store expenses were \$177 million for the quarter and as a percentage of sales was 19.7%, an increase of 50 basis points compared to the prior year. The leverage from higher sales in our pre-2014 vintage stores was offset by higher expenses from stores open less than 12 months. In the second quarter we also experienced increased healthcare costs as we cycled the lower utilization from last year.

SG&A totaled \$23 million for the quarter and as a percentage of sales were up 2.6% an improvement of 50 basis points compared to the same period last year. This improvement was primarily driven by lower bonus expense partially offset by higher advertising expense to support a higher number of new store openings in the second quarter of 2015 compared to the prior year. Adjusted EBITDA for the second quarter totaled \$78 million, up 12% for the same period in 2014. Adjusted EBITDA margin rate was a 8.6% a 70 basis point decrease compared to the prior year, driven by the timing of new store openings as well as price investments. Adjusted net income for the second quarter totaled \$35 million and improvement a 16% from 2014. This increase was driven by higher sales as well as lower interest expense as a result of additional voluntary pay down on our revolver and a decrease of interest rates from our April 2015 refinancing.



Shifting to balance sheet and liquidity, our balance sheet remains strong as we continue to generate robust operating cash flows. Year-to-date we generated \$121 million of cash flows from operations and invested \$61 million in net capital expenditures primarily for new stores. As you are aware during April we secured a new credit facility, a five-year \$450 million revolver at attractive rates which will replace our term loan. As a result of this transaction the Company reported a loss on extinguishment of debt including by \$5.5 million related to the write off deferred financing cost and issued discount. During the second quarter we voluntarily paid down an additional \$100 million of outstanding debt resulting in a balance of \$160 million on this revolver and ended cash and cash equivalents for the quarter and \$97 million. As a result of the voluntary pay down the interest rates on the revolver will drop to LIBOR plus 1.25% effective in the middle of August.

Let me now turn to 2015 guidance. Due to the increased competitive environment and an inflation environment close to zero, we are adjusting our guidance for the year to the following, net sales growth change slightly to 19% to 21%, comp sales growth up 4% to 5%, adjusted EBITDA growth of 10% to 12%, adjusted net income growth of 13% to 15% and adjusted diluted earnings per share of \$0.80 to \$0.82. We expect no change to CapEx which will be in the range of \$100 million to \$110 million. In addition we are guiding comp store sales growth for the third quarter and the 4% to 5% range.

A few additional items to note on our 2015 guidance. First, comps for the third quarter and full year assume near zero inflation to the Sprouts basket, lower retails from a higher promotional environment, and higher cannibalization through the third quarter. Our full year inflation near 0% to 1% range compares to a 3% inflation rate last year. Keep in mind the 4% to 5% comp from a near zero inflationary environment is above our long-term comp sales target when adjusted for normal inflation. We continue to generate increased traffic and tonnage volume growth, as well as continue to outpace both the conventional and specialty channels in natural and organic product sales which is a clear indication that our value proposition is resonated with our customers.

Second, as it relates to margins we will continue to make price investments during the back half of the year to maintain our pricing strategies. We expect the third quarter gross profit margin to be slightly less compressed than the first half and start to level out in the fourth quarter. The leveling off in the fourth quarter is driven by cycling the significant number of stores open less than 12 months which have a lower gross margins, as well as coming off the exceptional produce season in the first half and early part of the third quarter of last year. Third given the number of new stores opened over the last 12 months, we expect continued pressure in DSE for the third quarter of approximately 50 basis points and expect this trend to normalize in the fourth-quarter.

The above items are expected to yield an overall EBITDA margin for the year of approximately 8.2% to 8.3% bringing our EBITDA margin closer to a 2013 EBITDA margin of 8% and believe this range is appropriate for Sprouts at this point in our growth phase and overall environment. And at EBITDA margin equivalent to our guidance for this year our cash and cash returns by year three to four still remain healthy and consistent at 35% to 40% returns. This is both in line with our long-term economic model and shows that resiliency of the Company to maintain the strong economic model in an competitive environment. Lastly our weighted average share count will be approximately 156 million shares for 2015 and our corporate tax rate will be approximately 38% as we have received enhanced deductions for our food donation initiatives.

In conclusion our focus remains on driving top line sales growth for our broad healthy product offering, affordable prices, and knowledgeable team members providing good customer service. Despite the impact of the inflationary and promotional environment on our guidance we feel confident about our business given the strong customer traffic, comp sales well above sector average, our ongoing strategic initiatives, and continued unit growth across the country. Our balance sheet is healthy, our business model is solid, and we look forward to delivering a great growth opportunity that lies ahead.

Lastly, I'm honored to succeed Doug as CEO of Sprouts and I know we will continue to be nimble, innovative, and customer focused to deliver on our mission of healthy living for less. I'm excited about having Jim as a partner in his new role as President and Chief Operating Officer and to continue to work with Doug in his new role as Executive Chairman of the Board. Over the past few years Doug and I have spent significant time in the field and the office discussing Sprouts mission, strategy, and culture as well as customers evolving expectations of grocery stores and we have great confidence in the future of this Company. I look forward to working with the Board of Directors, Sprouts exceptional leadership team, and our committed 20,000 team members to grow the brand successfully and profitably. With that we would like to open up the call for questions. Operator?

