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SFM - Q3 2015 Sprouts Farmers Market Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to Sprouts Farmers Market third-quarter 2015 earnings conference call.

(Operator Instructions)

As a reminder, today's program is being recorded. I would now like to introduce your host for today's program, Susannah Livingston. Please go ahead.

Susannah Livingston - ***Sprouts Farmers Market, Inc. - IR***

Thank you and good morning, everyone. We are pleased you have taken the time to join Sprouts on our third-quarter 2015 earnings call.

Amin Maredia, Chief Executive Officer; and Jim Nielsen, President and Chief Operating Officer are also on the call with me today. Sprouts' 10-Q, the earnings release announcing our third-quarter 2015 results and the webcast of this call can be accessed through the Investor Relations section of our website at www.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 a reconciliation of our non-GAAP measures to the comparable GAAP figures, please see the tables in our earnings release. We believe these adjustments -- adjusted results provide a good basis to assess the operating and financial results of the Company, period over period.

For the third quarter ended September 27, 2015, we reported diluted earnings-per-share and adjusted diluted earnings-per-share of $0.21. Adjusted diluted earnings-per-share increased 17% from $0.18 in the same period in 2014.

With that, let me now hand it over to Amin.

Amin Maredia - ***Sprouts Farmers Market, Inc. - CEO***

Thank you, Susannah. Good morning, everyone, and thanks for joining us today. The last three months in my new role as Chief Executive Officer have been fast paced.

I have spent a significant amount of time with our leadership, walking stores including competition and meeting many of our great vendor partners. I have had an opportunity to visit many of our markets, gaining even deeper insights into how we can best advance our brand differentiated and attract new customers. I joined Jim and our merchandising team at several industry expos and events, and we all walked away truly energized by the continued innovation in the natural and organic sector.

Jim and I have also had a chance to travel together extensively and connect with key members from coast to coast and continue to see their commitment to the Sprouts passion inspiring, educating and empowering our customers to eat healthier and live a better life. Our team of 20,000 plus is stronger and more passionate than ever and I could not be more proud to lead this Company on our growth trajectory. Let me now shift to the third quarter.

During the third quarter, the strong execution in sales, merchandising and operations helped grow our sales 18% compared to the prior year. Reflected by strong comps growth and solid performance from our new stores. Our comps sales for the third quarter exceeded our expectations and accelerated to 5.8% from 5.1% in the second quarter of 2015.

Attaining a 5.8% comp in a zero inflationary environment is a testament to our business model and our ability to continue to be even more relevant to our customers every day. Our traffic ticket split was 75% traffic and 25% ticket for the quarter, demonstrating our ability to contract -- attract new customers into our stores with great products, strong merchandising and exceptional execution. Importantly, the increase in comps was realized in departments across the store.

During the quarter, inflation begin to normalize leading to a near zero inflationary environment. Low levels of produce inflation were offset by protein deflation.

From an industry perspective, promotional activity in the third quarter was relatively consistent with the first half of the year, and we remain committed to maintaining our competitive positioning. The competitive environment is a constant for the grocery space. We have long had processes in place to monitor the changing environment and quickly respond to competitive moves and are getting even better in studying and learning from the resulting customer response.

Our continued momentum and industry-leading traffic and comp sales are driven by a number of factors. Our laser focus on providing both health and value continues to attract new customers. Our convenient and easy shopping experience and approachable and knowledgeable customer service continues to separate Sprouts from the competition.

Our vendor relationships have continued to strengthen. Vendors, whether small or large, understand Sprouts focus and commitment to the natural and organic sector and our win-win mindset.

I will now turn to our strategic priorities. We recently updated our strategic priorities and one outcome from this process was the confirmation of our annual unit growth of 14%. Year-to-date, we have opened 26 new stores in 13 states and have 1 more opening in the fourth quarter, to end our year with 27 new stores for a total of 217 stores in 13 states. Our strong real estate pipeline includes 53 approved sites and 46 signed leases for the coming years.

Our 2016 pipeline is full, keeping us on track to meet our 14% unit growth and the real estate team is focused on our pipeline for 2017 and beyond. We will continue to keep balanced growth with approximately 70% of our growth in existing markets and 30% of our growth in new markets. We continue to believe this focus is an effective strategy as it leads to strong financial returns, with existing markets offsetting the investment in new markets as new markets take longer to mature.

For the third quarter, cannibalization improved to 240 basis points from 175 basis points in the second quarter of 2015. We expect cannibalization to continue to normalize into 2016 and 125 basis points range.

New store productivity came in at 75%, on target with our long-term model. As I mentioned, it is typical for stores in new markets to open up at a lower productivity than stores in existing markets, due to lower initial brand recognition. And they typically take four to five years to reach maturity, rather than two to three years in well established markets. We have seen this process for many years, including in places like Dallas, Denver, San Diego and other cities.

This quarter our new store productivity included a high number of stores in new markets. The mix will improve in the future and we expect new store productivity to be in the 75% to 80% range going forward.

Our Southeast expansion is meeting our expectations and we look forward to building on our momentum. Jim and I were in the markets a few weeks ago and left excited with the passion, energy and focus of our team and the customer feedback and response. It is great to hear customers continuing to say, I love Sprouts, across the country. I'm excited about the current year progress.

We have been focused on introducing new and expanded deli offerings, expanding our private-label and specialty product assortment, growing our social and digital interactions, improving customer engagement through team member training, and updating our legacy stores with the expanded offerings we first implemented in 2013.

This year, we have rolled out our new and expanded deli offerings into a select number of new stores and existing stores. These enhancements include features like a new salad bar, stocked with ready to eat, healthy and flavorful salads, a full-service deli case with prepared proteins and healthy side dishes and an improvement and expanded assortment of component meals and side dishes. We are pleased with the results from this test and are currently planning to incorporate many of these offerings into a greater number of new stores in 2016, and will also begin to roll out to some of our existing stores in 2016.

These enhancements require an elevated level of customer service in the store, so the expansion will include a keen focus on customer service training for our team members. Sprouts private-label continues to be an important growth category for the long-term. In the third quarter we exceeded 1700 private-label items, and we continue to introduce new and innovative products focused on unique flavor profiles and specialty attributes. These products continue to resonate with our customers driving our brand, driving comps and sales growth well above Company averages.

As we turned the corner into the fall, our favorite private label pumpkin items are back in our stores, building on our success from the prior years. As for attribute driven specialty categories, we continue to experience sales growth well above Company and industry averages. This is a clear indication that our authenticity, value proposition, in-store experience and knowledgeable service is resonating with existing and new customers. As more and more customers embrace the need for a healthy diet, we believe our depth of products, and our knowledgeable services in these categories, will continue to result in sales growth that is outpacing the grocery and specialty channels.

We are excited about the opportunity to increasingly engage with our customers through digital, marketing and other channels. During the third quarter we launched a partnership with Amazon Prime Now to offer some Los Angeles and Orange County area Prime Now members Sprouts' fresh, natural and organic food with home delivery in one or two hours. We have been very thoughtful about working with the right partner for eCommerce delivery. A partner who has a strong customer service philosophy and an unmatched technology and operations infrastructure to reach new customers.

We will continue to work on our mobile, digital and in-store strategies, which we believe will attract new customers and enhance our relationship with our existing guests. We will share our plans on this front early next year.

Of course, there's no better way to connect to our customers than in our stores. This year we will -- we have continued to invest in training to build on our great customer service program and further expand team member knowledge -- product knowledge. This program will further enhance the engagement with our customer that they expect and give our customers even more reason to say, I love Sprouts. Given our aggressive growth plans, developing our team and future leaders who are ready for growing responsibilities, is exciting for our team members and their families.

And lastly on the sales initiatives and store remodel front, we are near completion on our 2015 initiatives. We have remodeled five stores to date with one more to be completed this quarter and all sales initiative projects are now complete. These investments continue to help drive comp sales and improve the overall shopping experience for our customers.

As we turned the corner into Q4, we just finished training for this year's holiday program and look forward to building on a very successful 2014 season. We have refined our assortment of holiday items of this year based on prior years' learnings, while adding some new and unique items giving our customers everything they need for healthy, happy holiday.

Before I conclude, I want to provide more context on our midterm targets in our release this morning. Our business fundamentals remain strong and our current strategic initiatives continue to drive those solid momentum in our stores, as demonstrated by our results in the third quarter. Our Management team and I are laser focused on keeping Sprouts an innovator in the natural and organic sector, becoming even more relevant to our customers and their healthy living journey and positioning us to maintain a leadership position in this industry for years to come.

And we believe investing even further when we have momentum is the right thing to do for Sprouts. These midterm investments are primarily in two areas.

First, as Jim and I traveled the country over the past two months and spent countless hours with our sales, merchandising and marketing team, it is very clear to us that building greater human resource capacity and bringing more technology to our sales, merchandising and marketing team is critical. This will allow them to continue to focus on broad category innovation, as well as promotions and pricing excellence. To support this effort, as well as getting ready to analyze data expected from our out of store customer digital experience to be introduced in the next 9 months to 12 months, requires technology and business intelligence capability investments, and we are going to do just that.

Second, given our rapid unit expansion, I firmly believe that positioning our team members better to engage with customers and building a career with Sprouts requires even more training and better wages in certain critical positions at the store.

Jim and I actively engaged our incredible Board of Directors in our vision and direction of Sprouts and we are appreciative of their support for us to build a Company with, one, a strong team of innovators, two, team members positioned for exceptional customer engagement, service and grow professionally and personally and, three, a Company that can deliver solid consistent results year after year. As a result of these plans, we have adjusted and broadened our EBITDA and EPS targets, which gives me even greater confidence to underwrite our expansion plans, comp sales growth and total sales growth targets which we are leaving intact at 14% unit growth, mid single-digit comp target and 15%-plus sales growth target.

In conclusion our third-quarter results speak for themselves. Our fourth quarter is off to a great start and we recognize that today the grocery industry is innovative, dynamic and competitive. But with our plans in product and category innovation, plans to enhance our in-store and out of store experience, and spending significant time maintaining our culture, which is a personal priority for me, we believe we can continue to be a strong player in the grocery space.

With that, I'll turn the call back to Susannah to talk about our financial results and guidance.

Susannah Livingston *- Sprouts Farmers Market, Inc. - IR*

Thank you, Amin. Following Amin's highlights of the business drivers, let me cover the operating results and guidance.

Third-quarter gross profit increased 16% to $262 million, resulting in a gross profit margin of 29%, a decrease of 50 basis points compared to the prior year period. This compression in gross margin improved significantly when compared to the 90 basis points compression in the second quarter, mainly as a result of coming off the exceptional produce season in the first half and early part of the third quarter from last year, as well as cycling the significant number of stores opened less than 12 months. We expect this compression to continue to improve in the fourth quarter.

Direct store expense was $178 million for the quarter, DSE included $900,000 of pretax loss on disposal of assets in the third quarter of 2015. Excluding this item, DSE as a percentage of sales de-leveraged 20 basis points to 19.6%. The most significant drivers were the timing of capitalization of store development expense, higher investment in employer training, as well as higher labor costs at new stores.

Our continued investment in training for our team members is key, so that they can continue to engage and assist our customers. This was partially offset by lower utilization and medical benefits and lower bonus expense when compared to the prior year.

SG&A totaled $27 million for the quarter. SG&A included pretax secondary offering expenses of $900,000 in the third quarter of 2014. Excluding this item, SG&A as a percentage of sales remained unchanged at 3%, compared to the same period last year.

A few factors impacted this neutral result. Lower bonus expense was a benefit to SG&A, in addition a decrease in the number of new stores opened in the third quarter lead to lower advertising cost as a percentage of sales, compared to the prior year. This was offset by higher stock competition expense due to the recent management transition and higher corporate overhead, as we continue to build out infrastructure to support our continued growth.

Adjusted EBITDA for the third quarter totaled $74 million, up 12% from the same period in 2014. Adjusted EBITDA margin rate was 8.1%, a 40 basis points decrease compared to the prior year, mainly driven by gross margin rate.

Adjusted net income for the third quarter totaled $33 million. An improvement of 19% from 2014. This increase was driven by higher sales, as well as lower interest expense as a result of additional voluntary paydown on a revolver, a decrease of interest rate from our April 2015 refinancing, as well as lower effective tax rate due to increased charitable donations.

Shifting to balance sheet and liquidity. Our balance sheet remains strong as our business model continues to generate robust operating cash flows. Year-to-date we generated $179 million of cash flows from operations and invested $79 million in net capital expenditures. Primarily for new stores.

We ended the quarter with a balance of $160 million on our revolving credit facility and with $132 million of cash and cash equivalents. With robust returns on investment, and strong cash position, our first priority will continue to be investment in opening new stores. Continuing to enhance our business through innovative sales initiatives and maintaining superior store conditions.

With that said, given our strong cash generation, we also have the opportunity to establish a share repurchase plan. We announced today that the Board approved a share repurchase authorization for $150 million to be used over a two-year period. This authorization amount allows us to continue on our aggressive growth plan, while protecting against dilution through share repurchase, all while maintaining financial flexibility.

Let me now turn to 2015 guidance. Net sales growth is unchanged at 19% to 21% for the year, including the 53rd week.

Based on the strength of our third quarter we are increasing are annual guidance for the following: comp store sales growth of 5% to 5.5%, adjusted EBITDA growth to 11% to 13%, adjusted net income growth of 16% to 18%, adjusted diluted earnings per share of $0.83 to $0.84 and we expect CapEx to be in the range of $100 million to $110 million. In addition, we are guiding comp store sales growth for the fourth quarter in the 5% to 6% range.

A few additional items to note on the 2015 guidance. First, we assume a full year inflation of near 0% to 1%. Which compares to a 3% inflation last year.

Second, as it relates to margins, we expect fourth-quarter's gross profit to come back in line to slightly negative when compared to last year's margin rate, as we come off the exceptional produce season experienced in 2014 and we will have cycled the significant number of stores open less than 12 months of age.

The above items are expected to yield an overall EBITDA margin for the year of approximately 8.3%, and around 8.2% on a 52 week basis. I think it is worth reiterating at this margin our cash and cash return by year three to four still remain healthy and consistent at 35% to 40%. Reinforcing the strength of our model.

Also as we noted on our call last year, a change in methodology of capitalization of new store development cost positively impacted our EBITDA by $3.6 million, or 50 basis points, in the fourth quarter of last year and we will be cycling that impact this quarter. Lastly, our weighted average share count will be approximately 156 million shares for 2015 and our corporate tax rate will be approximately 38%, as enhanced deductions for our food donation initiative positively benefit our tax rate.

In conclusion, our broad consumer appeal, coupled with our promotional approach continues to drive traffic to our stores, resulting in solid performance and giving us confidence as we plan for future years. With that, we would like to open up the call for questions. Operator?