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SFM - Q4 2015 Sprouts Farmers Market Inc Earnings Call

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PRESENTATION

Operator

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

(Operator Instructions)

I would now like to introduce your host for today's program, Ms. Susannah Livingston. You may begin, ma'am.

Susannah Livingston *- Sprouts Farmers Market, Inc. - VP of IR and Treasury*

Thank you and good morning, everyone. We are pleased you have taken the time to join Sprouts on our fourth quarter and year-end 2015 earnings call. Amin Maredia, Chief Executive Officer, and Jim Nielson, President and Chief Operating Officer, are also on the call with me today. Sprouts' 10-K, the earnings release announcing our fourth quarter and FY15 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 2016 expectations and guidance. These statements involve a number of risks and uncertainties that could cause actual results to differ materially from those described in our 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 issued 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 adjusted results provide a good basis to assess the operating and financial results of the Company period over period.

Also, please note that FY15 was 53 weeks, with the extra week falling in the fourth quarter, making it a 14-week quarter. For the fourth quarter ended January 3, 2016, we reported diluted and adjusted diluted earnings per share of $0.18. Adjusted diluted earnings per share increased 50% from $0.12 in the same period in 2014. On a 13-week comparable basis, adjusted diluted earnings per share increased 33%, to $0.16. For the full year 2015, we reported diluted earnings per share of $0.83 and adjusted diluted earnings per share of $0.86, a 19% increase from 2014. On a comparable 52-week basis, adjusted diluted earnings per share increased 17%, to $0.84. With that, now let me hand it over to Amin.

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

Thank you, Susannah. Good morning, everyone, and thanks for joining our call today. We are excited to end the year with a great quarter and momentum into 2016.

I could not be more proud of our team and the remarkable year we achieved through a near zero inflationary environment, challenges in produce in the first half of the year, and an evolving industry. Throughout the year, the business accelerated and our strength in the industry continued to grow, with our focus principles of health, selection, value and customer engagement. During the fourth quarter, Sprouts net sales grew to $930 million, up 27% from the same period of 2014 and up 17% on a comparable 13-week basis, driven by improved comp store sales of 7.4% that well exceeded our expectation and guidance.

While produce remains an important traffic driver, our merchandising and operations teams' ability to drive sales growth across the store in all departments is really starting to differentiate Sprouts. We have competed in both the natural foods and traditional grocery sector for more than a decade. Operating in this environment has formed our business and execution strategy and sharpened our know-how. This experience in buying, sales and merchandising, and marketing, coupled with a great product assortment, value prices, and friendly customer engagement, are continuing to resonate with customers, as demonstrated by our results for the quarter and the year.

The 2015 holiday season contributed to our strong fourth quarter comps, as we applied learnings from holiday seasons past to deliver a compelling merchandise selection for our shoppers. Online ordering of turkeys and complete holiday meals more than doubled in November over the same period last year and increased in the triple digits in December, as Sprouts continues to establish itself as a healthy holiday destination. This resulted in a strong traffic to the stores above our historical rates for the fourth quarter. I want to recognize our sales and merchandising team for the exceptional work on our holiday program and the operations team for the excellent execution in the stores which drove this success.

Regional sales performance remained strong in the fourth quarter. We experienced a small benefit of approximately 25 basis points in our comps from our California stores which overlapped with closed Haggen locations.

Let me shift to inflation. Inflation in produce increased in the fourth quarter and was partially offset by deflation in other categories, such as poultry, leading to an inflation of 1% for the fourth quarter. In addition, cannibalization from new Sprouts openings remained consistent with the third quarter, in the 140 basis point range, and we expect this to hold in the 125 to 150 basis points range in 2016.

For the full year 2015, sales grew to $3.6 billion, up 21%, and 19% on a comparable 52-week basis, with comp store sales of 5.8% and solid performance from our 27 new stores. We ended the year with adjusted EPS of $0.86, the high end of our guidance range set at the very beginning of the year.

No doubt the year had its challenges in produce and deflation, but in true Sprouts form, our team worked tireless to deliver in all areas of the business. They worked closely with our vendors, furthered innovation in products, including expansion of our private label program, continued to enhance our deli offering, deepened our connections with our customers through digital engagement, and deepened our bench, as we successfully expanded to the Southeast.

On the new store front, we ended 2015 with a total of 217 stores. Year-to-date 2016, we have opened 7 new stores in 4 states for a total store count of 224 stores. Our pipeline remains strong, with 58 approved sites and 45 signed leases for the coming years. Our new stores continue to perform well, with new store productivity in the mid-70s.

Let me shift to 2016. 2016 is focused on three distinct areas of priority that will continue to maintain our relevance with our customers. These priorities are focused on sales growth, investment in infrastructure, and investments in our team.

Let me start with sales growth. We continue to enhance our product offering each year by listening to our customers and responding to their healthy living needs. As you know, we tested an improved deli offering in a few stores in 2015, featuring an extensive prepared salad offering, prepared food service case, fresh juices and specialty coffee. We plan to add the new deli offering in approximately 70% of our new stores, as well as over 30 existing stores in 2016.

We will continue to evolve our other parts of our deli, as well, including enhancements to our home meal replacement offering with even better ingredients, more selections, and improved packaging. We believe these deli enhancements will increase our daytime traffic and bring more relevance to our customer shopping experience without adding a tremendous amount of capital to our new store buildout.

Private label will continue to be a key area of focus in 2016. Our private label brands grew by more than 30% in 2015 and represent now over 9% of our sales today, and we believe this category still has plenty of room to expand for years to come. When asked in a recent study of thousands of customers what they like best about our private label, the top areas were quality and taste. Given this customer response, we will continue to invest in this area in both human capital and innovation of new products.

We are proud of our position as a partner of choice with our vendors, thanks to many years of collaboration. As we scale and grow, so do our partners, and together we are focused on continued innovation and compelling promotional opportunities that attract and engage our customers to Sprouts. We look forward to building on our 2015 successes.

The second area of focus is our investment in infrastructure. To support our unit growth and remain an innovator in the industry, we will invest in improved technology for our teams. Some of the key investments include a business intelligence function which will help our merchandising and marketing teams become even more effective and efficient in our promotional and pricing strategies. Second, our new human resource systems will give our team members the information they need at the tip of their fingers. Third, we will continue our journey to increase our customer connections through a focus on digital engagement. We will share our plans in this area in the near future. Collectively, these and other technology enhancements will allow us to continue building a company which is well-positioned to benefit our customers, team members and shareholders.

The third and final area is continued investment in our team. We just wrapped up our first all-store managers summit a few weeks ago. This was a great time to align all of our store leaders with our 2016 priorities. Each store leader left with a clear understanding of the future of Sprouts and specific 2016 initiatives for their stores. Personally, what equally excited me from the summit is the first name basis, personal connections and engagement with team members that we made. This is an open team member culture that we want to continue to cultivate at Sprouts.

We also have launched a very busy 2016 training calendar for our stores and I look forward to seeing the results of these initiatives on sales and customer experience. We look forward to sharing the result of our three areas of focus in sales growth, investment in infrastructure, and investments in our team, as the year unfolds.

Before I turn it over to Susannah, I want touch on the other announcements released this morning. I am thrilled to have Brad Lukow join us as our new CFO. Brad comes to us with over 20 years of experience in retail, 6 of those years as a public company CFO. Brad's strong business acumen, experience in scaling retail businesses, ability to work closely with merchants and operators, experience in leading real estate and technology functions, and a strong financial acumen will bring even greater capability to our leadership team. We look forward to having Brad join us soon. I want to thank Susannah for providing strong leadership in her role as interim CFO for the past six months and working closely with Brad as he joins the Company.

I would also like to thank Andy Jhawar for his guidance and leadership to the Sprouts brand and the Board over the past four years. Andy has been an incredible business partner for Sprouts, as we brought three companies together in 2011 and 2012 and then transitioned to a public company. We wish him continued success.

Lastly, I am humbled to be serving Sprouts as the newest member of its Board of Directors. With that, let me turn the call to Susannah to speak about our financial results and 2016 guidance.

Susannah Livingston *- Sprouts Farmers Market, Inc. - VP of IR and Treasury*

Thank you, Amin. As Amin stated, we are pleased with our strong results for the quarter and the outstanding year in 2015. We targeted sales growth of 19 % to 21% and unit growth of 14%, and we delivered on these targets with top line growth of 21% and the unit growth of 14%. Our comps came in at 5.8%, within our long-range guidance, despite a year with near zero inflation and challenging produce environment in the first half of the year. We also met our adjusted EPS range set at the beginning of the year by achieving $0.86, with a strong acceleration in the business in the back half of the year.

Let me spend a few minutes discussing some of the business drivers for Q4 2015 and guidance for 2016. For the fourth quarter, gross profit increased to $269 million, a 27% increase, and our gross margin rate improved 10 basis points, to 28.9%, compared to the same period in 2014. This compared to compression in each of the first three quarters of the year. This leverage was primarily driven by the 53rd week, in addition to lower utility costs and higher margins in certain categories due to deflation, partially offset by price investment.

Direct store expense was $187 million for the quarter, and as a percentage of sales was 20.2%, an improvement of 40 basis points compared to the same period in 2014. Excluding the loss and disposal of assets, direct store expense as a percentage of sales decreased 50 basis points to 20.1%. This was primarily due to leverage of store level expense and the 53rd week, partially offset by higher payroll costs, due to an extra holiday in the quarter, and increased training initiative cost, as we continue to invest in our team members.

SG&A totaled $32 million for the quarter and as a percentage of sales was 3.4%, an improvement of 10 basis points compared to last year. This was primarily due to leverage in the 53rd week and lower corporate expense, partially offset by higher stock compensations due to executive changes and higher bonus expense for the quarter.

Adjusted EBITDA for the fourth quarter totaled $67 million, up 25% from 2014. EBITDA margin rate was 7.2%, a 10 basis point decrease compared to the prior year. As we noted on our call last year, a change in methodology of capitalization of new store development costs positively impacted our fourth quarter for 2014 EBITDA by $3.6 million, or 50 basis points, and we cycled that impact this quarter. Adjusted net income for the fourth quarter totaled $28.4 million, an improvement of 57% from 2014. On a comparable 13-week basis, adjusted net income increased 34%.

For the full year 2015 review, gross profit increased 19%, to $1.052 billion, resulting in a gross margin rate of 29.3%, or a decrease of 50 basis points from 2014. Direct store expense as a percentage of sales for the year, excluding adjustments, was consistent with 2014 at 19.6%. And SG&A as a percentage of sales, excluding adjustments, improved 10 basis points to 3% compared to 2014. Adjusted EBITDA totaled $302 million, up 14%. EBITDA margin rate decreased 50 basis points to 8.4%, compared to 2014, slightly better than we expected.

Adjusted net income for the year totaled $135 million, an improvement of 21%. On a comparable 52-week basis, adjusted net income increased 17%. These results were driven by the strong top line sales partially offset by price investments and increased promotional activities, in addition to lower interest expense as a result of voluntary paydown on our revolver, a decrease of interest rate from our April 2015 refinancing, as well as a lower effective tax rate due to increased charitable donations.

Shifting to balance sheet and liquidity, our balance sheet is stronger than ever as we continue to generate robust operating cash flows which reduced our debt during 2015. For the year, we generated $240 million of cash flow from operations and invested $104 million in capital expenditures net of landlord reimbursements, primarily for new stores. In addition, due to our strong cash flow generation, we voluntarily paid down $100 million of our outstanding debt during the second quarter of 2015.

As well, in the fourth quarter we repurchased $26 million of common stock under our $150 million share repurchase authorization and another $59 million of common stock in the first quarter, totaling a repurchase of 3.5 million shares in the fourth quarter of 2015 and the first quarter of 2016. With our strong operating cash flows and low debt, we are well positioned to self fund our growth plan and build on our strong liquidity position.

Now let me turn to 2016 guidance. We believe our strategic focus on the primary initiatives laid out by Amin will continue to drive sales and efficiency to our business while remaining relevant to our customers.

For the full-year 2016, we expect net sales growth of 16% to 19%, driven by 36 new stores and comp store sales growth of 4% to 6%. On a comparable 52-week basis, this would equate to net sales growth of 18% to 21%. Adjusted EBITDA growth of 9% to 11%. On a comparable 52-week basis, this would equate to 12% to 14%. Adjusted diluted earnings per share of $0.96 to $0.98, all in line with our mid-term targets. And we expect CapEx net of landlord reimbursements to be in the range of $145 million to $155 million.

In regards to store opening, due to Haggen bankruptcy proceedings, we picked 4 of their sites. These are expected to open in 2016 and will be additive to our 14% unit growth for 2016. As we have always stated, we will be opportunistic when these situations present themselves, especially when they occur in markets where we have deep bench strength and solid teams, in addition to strong brand recognition. For 2016, we would expect to open up 36 stores, but keep our long-term growth rate at 14% unit growth.

A few additional items to note on the 2016 guidance. First, we would expect moderate inflation for the year of approximately 0% to 2%, aided by the current inflation we are seeing in produce. Second, as we have done in the past, we will continue to make price investments as necessary to drive top line sales and have considered that in our guidance. This will result in our overall 2016 gross profit margin to be in line with that from 2015. In addition, with our established store base in the Southeast, we plan on opening our new produce warehouse in Atlanta area mid- to late in the year. This will be a third-party logistics site and therefore, will not incur CapEx for this facility.

Third, on the direct store expense line, while we expect to benefit from leverage from our pre-2015 vintage stores, we plan to invest in our team members with additional training and strategic wage increases. This will lead to a compression in DSE as a percentage of sales compared to 2015 by approximately 20 to 30 basis points. We feel this investment is important to continue to strengthen and differentiate our in-store experience and build a strong pipeline of future leaders, given our unit growth across the country.

Fourth, in SG&A we have laid out today, we plan to make investments in infrastructure as we grow the company. These investments are expected to result in SG&A expense as a percentage of sales to be flat to modest compression of approximately 10 basis points when compared to 2015.

Both SG&A and DSE investments will be more front-end loaded for 2016. Based on the components of margin, DSE and SG&A above, we expect compression of approximately 40 to 50 basis points to EBITDA margins for 2016, primarily driven by the strategic investments in direct store expense laid out in the call today. Below the EBIT line, we expect to have approximately $15 million in interest expense, including capital leases and other interest expense, a weighted average diluted share count of approximately 154 million shares for 2016, and a corporate tax rate of 38%.

Lastly, for the first quarter of 2016, we expect comp store sales growth to be in the range of 4.5% to 6%. The heavy rains that occurred on the West Coast impacted the January produce crop. While this does not compare to the tightness we experienced last year, it has impacted both quality and availability of produce for the month of January and also led to some inflation on produce. As we look out, these rains have eased and we don't see any significant headwinds to produce availability in the near term. These factors have been taken into consideration in the Q1 comp guidance.

In conclusion, we are very pleased with our financial and operating performance in 2015, especially as these results have exceeded industry averages. We are on good footing with a strategic 2016 plan focused on top line growth, developing our team members, and appropriate investments in infrastructure and technology to position Sprouts to be relevant with our customers and build an organization for sustainable growth for the long term. With that, we'd like to open up the call for questions.

QUESTION AND ANSWER