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SFM - Q1 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 first-quarter 2015 earnings conference call.

(Operator Instructions)

As a reminder, this call is being recorded. I would now like introduce your host for today's conference, Susannah Livingston, Vice President of Investor Relations. Ma'am, please go ahead.

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

Thank you. And good afternoon, everyone. We are pleased you have taken the time to join Sprouts on our first-quarter 2015 earnings call. Doug Sanders, President and Chief Executive Officer; Amin Maredia, Chief Financial Officer; and Jim Nielsen, Chief Operating Officer, are also on the call with me today. Sprouts' 10-Q, the earnings released announcing our first-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 first quarter ended March 29, 2015, we reported diluted earnings per share of $0.24 and adjusted diluted earnings per share of $0.25. Adjusted diluted earnings per share increased 9% from $0.23 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. We are pleased to report another quarter of strong top-line sales growth as we continue to expand our Healthy Living For Less philosophy to an even greater number of communities across the country.

For the first quarter our net sales grew to $858 million, up 19% from the same period in 2014. Comp store sales for the quarter were 4.8% as we cycled our highest comp quarter of 2014 at 12.8%, resulting in a two-year stack of 17.6%.

This comp sales growth was slightly below our guidance of 5% to 6% and primarily driven by three factors that occurred during the quarter. First, and as we noted on our previous earnings call, we experienced tightness in produce quality and supply early in the quarter, driven by adverse weather conditions and challenges associated with the LA port. This negatively impacted our promotional opportunities in produce which, as you know, is the primarily traffic driver for spouts.

Second, we began experiencing accelerating produce deflation in mid February as supply improved which increased significantly throughout March. While our produce tonnage improved on a comp basis from Q1 of last year, the lower retails impacted our overall camps by over 100 basis points for the quarter versus our guidance.

And third, extreme weather conditions in several markets, including Texas, Oklahoma and Colorado, negatively impacted traffic and sales in late February and early March and impacted our comps by 50 basis points for the quarter versus our guidance. Despite these headwinds, the team did a great job continuing to generate positive traffic through strong promotions and solid execution throughout the store.

For the quarter our comp performance was driven by a 40/60 split between traffic and ticket. This is slightly below our historical 50/50 split, which reflects the impact of the challenges we faced during the quarter. With the port and weather issues now behind us, produce availability and quality are returning to normal levels for this time of year, resulting in improved traffic and sales.

New store productivity for the quarter was near 90%, above our 2015 forecast of 85%. During the quarter we added 10 new stores including our first new stores in Alabama and Missouri. And year to date we have opened 15 new stores at eight markets across the country. We have an additional 12 stores planned for the remainder of Q3 and Q2 including our first new store in Tennessee.

We continue to be pleased with the performance of our new stores and the new states we have entered this year. Our current real estate pipeline includes 65 approved sites and 45 signed leases for the coming years, keeping us well on track to meet our 14% long-term growth target. Our aggressive growth and strong traffic continue to make us an attractive anchor tenant, enabling us to secure great locations as we expand into new markets and grow our market share by expanding deeper into existing markets with a greater number of stores.

Now let me shift to strategic initiatives. Our 2015 initiatives are well underway as we continue to focus on expanding our private-label and specialty product assortment, testing new and expanded deli offerings, growing our digital capabilities improving customer service through training and incorporating many of the offerings from our 2013 prototype into our existing store base.

private-label continues to be a key differentiator, driving customer loyalty and brand awareness, and by offering great quality and value on natural, organic and specialty products. This quarter we introduced 60 new and innovative private-label products like our new Sprouts raw food line, bringing our total count to over 1,600 items throughout the store. We have another 150 items in the pipeline for the rest of this year focused on the key attributes our customers are looking for, including non-GMO, organic, raw, gluten-free and vegan.

This also includes our ongoing efforts around improving our product ingredient standards. And we are excited to report that today over 50% of our private-label packaged foods are now certified non-GMO or organic.

Our attribute-driven specialty categories continue to provide sales momentum throughout the store, experiencing comp growth above the Company average and sales growth that is well outpacing the overall industry. Whether private-label or national-branded, we continue to improve our depth of product offering in these fast-growing categories, staying ahead of emerging trends to meet the needs of our customers today and tomorrow.

We are excited about the early positive response to the new and expanded deli offerings featured in our newest prototype launched earlier this year. New features include a salad bar stocked with ready-to-eat healthy and flavorful salads, as well as prepared protein and healthy side dishes. These new selections offer our customers a convenient selection of innovative products with quality ingredients to satisfy their lunch, dinner and anytime snacking needs.

We plan to introduce these expanded offerings in a select group of new and existing stores this year. And we will determine how best to incorporate them into a greater number of stores in 2016 and beyond.

On the sales initiative and store remodel front we are 75% complete with our 2015 projects. Once done, all of our stores will feature some or all of the expanded product offerings found in our new stores opened since 2013. And we look forward to the sales benefits these investments will produce as the year progresses.

In 2015, we continue to grow our digital marketing technologies to engage with customers in a more meaningful and relevant way. Because we have always targeted the everyday grocery shopper, our print distribution of more than 14 million weekly circulars is still our most impactful advertising vehicle. But we also know that growing our customer engagement outside of print is an extremely important part of connecting with the next generation of shoppers.

Today we actively engage with more than 2 million customers across a variety of digital platforms including social, e-mail, web and mobile. This includes 1.2 million Facebook fans, 750,000 e-subscribers, 250,000 unique weekly visitors to our website, along with approximately 100,000 downloads of our mobile app.

Additional investments include adding NFC functionality throughout the company where we've seen transactions through Apple Pay and Google Wallet grow by more than 250% since January, now representing over 2% of our total credit transactions company-wide. We plan to continue these efforts over the next year as we work to expand our customer engagement both inside and outside the store.

Our strategic investments to enhance the customer experience through team member training is well underway. Providing knowledgeable resources to engage and assist our customers remains one of our core tenets at Sprouts. Therefore, our training programs are focused on improving product knowledge, operational execution and developing leaders to support our continued growth. These programs are being well received by our team members who appreciate the investment we are making to prepare them for the advancement opportunities our aggressive growth continues to afford.

Now let me touch on industry dynamics, as we continue to receive questions and seeing varying reports on competition and pricing. With regards to competition, we have seen a greater number of stores taking varying approaches to natural and organic foods over the past several years. In response to growing consumer demand, certain retailers have made greater investments in the selection and merchandising of natural and organic foods.

On the pricing front, we have also seen certain retailers make price investments within different markets and at different times. But to be clear, we have seen these types of investments periodically over the past two years.

With all that said, operating in a competitive environment is really nothing new to Sprouts. The grocery industry has always been a competitive environment and it's in that environment that we have successfully competed for the everyday grocery shopper for more than 12 years. At Sprouts we remain focused on providing broad assortment of healthy and differentiated products, knowledgeable customer service, a unique customer experience and affordable prices across the store. We continue to invest in all of these areas of our business while adding new and innovative offerings to meet the needs of our growing customer base.

In summary, produce quality and availability is improving, our strategic initiatives and store expansion plans are on track, and we continue to be one of the most dynamic food companies in the retail grocery industry, with a proven business model, broad customer appeal and the ability to successfully compete in both the natural foods and traditional grocery sectors.

With that let me turn the call over to Amin to talk about our financial results and guidance.

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

Thank you, Doug. And good afternoon, everyone. Following Doug's highlights of the business drives, let me cover the operating results and guidance.

For the first quarter, gross profit increased 15% to $258 million, resulting in a gross profit margin of 30.1%, a decrease of 90 basis points compared to the prior-year period. This compression in gross margin was primarily driven by, one, the timing of a greater number of stores still in the first 12 months; two, cycling elevated produce gross margins from the exceptional produce season in the prior year; and three, our continuing investments in price in certain markets to maintain our competitive positioning.

Direct store expenses were $163 million for the quarter. DSE included pre tax loss on disposal of assets of $200,000 in 2015 and $700,000 in 2014. Excluding these items, DSE as a percentage of sales were 19% for both periods. The leverage from higher sales in our pre-2014 vintage stores was offset by higher expenses from stores open less than 12 months. We were very pleased with the continued leverage of our direct store expenses in our pre-2014 vintage stores.

SG&A totaled $24 million for the quarter. SG&A included pretax secondary offering expenses of $300,000 in 2015 and $1.4 million in 2014. Excluding these items, SG&A as a percentage of sales was 2.8%, an improvement of 10 basis points compared to the same period last year. This improvement was driven by lower bonus expense, partially offset by higher advertising expense to support a higher number of new store openings in the first quarter of 2015 compared to the prior year.

Adjusted EBITDA for the first quarter totaled $84 million, up 9% from the same period in 2014. EBITDA margin rate was 9.8%, a 90 basis points decrease compared to the prior year, driven by the store opening timing and the produce impact discussed above. We expect the timing of the new store openings to continue to impact gross margin, DSE and EBITDA margins in the second quarter, and normalized in the back half of the year.

Adjusted net income for the quarter totaled $38.6 million, an improvement of 9% from 2014. This increase was driven by higher sales as well as reduced interest expense as a result of additional voluntary pay-down on our term loan.

Let's shift to balance sheet and liquidity. Our balance sheet remains strong as we continue to generate strong operating cash flows. For the quarter we generated $68 million of cash flows from operations and invested $22 million in capital expenditures net of landlord reimbursements for new stores.

The principal balance on our term loan was $260 million. And our net debt to adjusted EBITDA leverage ratio excluding capital and financing leases was 0.3 times. We ended the quarter with cash and cash equivalents of $178 million, and $57 million available under our undrawn credit revolving facility.

Due to our strong balance sheet and the significant deleveraging we have accomplished over the past few years, last month Sprouts was able to secure a new credit facility at attractive rates. We completed a new five-year, $450 million revolving credit facility that replaced our existing term loan and revolver.

Upon completion of this refinancing, we had approximately $260 million of total debt and $2.5 million of letters of credit outstanding. The revolver has an initial drawn pricing of LIBOR place 175 basis points as compared to LIBOR with a floor of 1% plus 300 basis points under the previous term loan.

At today's interest rates this pricing is expected to reduce our annual interest expense by approximately $5 million. While we plan to continue to self-fund our targeted 14% unit growth, this new facility preserves financial flexibility and reduces our ongoing debt service expense.

Let me now turn to 2015 guidance. Our annual guidance for 2015 remains unchanged with net sales growth of 20% to 22%, driven by 14% unit growth and comp store sales growth of 6% to 7% -- on a 52-week basis this would equate to 18% to 20% net sales growth -- adjusted EBITDA growth of 16% to 19%, adjusted net income growth of 18% to 22%, and adjusted diluted earnings per share with a range of $0.84 to $0.87. And we expect CapEx to be in the range of $100 million to $110 million for the year.

Our focus on driving sales has greatly improved our average weekly sales over the last few years. And we believe our 2015 focus on new product innovation, private-label growth, rolling out initiatives to more stores, and focus on customer education and experience will continue to drive sales and a more profitable store and business model.

Let me add a few additional notes on the 2015 guidance. First, we will continue to make price investments as necessary to maintain our pricing strategy, and have considered that in our guidance.

Second, we are now expecting inflation to be in the 1% to 2% range for the entire year as compared to 2% to 3% stated on our last call. As you will note on a sequential basis overall basket inflation slowed to 1% for the first quarter of 2015 compared to 4% in the fourth quarter of 2014. With the lower inflation range in 2015, it's expected to impact our comp sales. However, we are seeing strong traffic trends into the stores as the produce availability has normalized, and as a result we are maintaining our sales guidance of 6% to 7% comp for the full year.

Third, we continue to expect our pre-2014 store vintages to bring positive leverage to the EBITDA margin line, including leverage in the gross margin and DSE lines for the full year. However, the timing of back-ended 2014 store openings and front-loaded 2015 store openings are expected to offset the leverage from the pre-2014 vintage stores. Based on this, we expect a compression in gross margin, DSE and EBITDA margin rate in the second quarter, which will normalize in the back half, leading to a slight compression in EBITDA margin rate for the full year.

Fourth, with the refinancing of our debt complete, we expect to have approximately $20 million in interest expense, including capital lease and other interest expense. In addition, we will incur a $5.5 million writeoff due to the extinguishment of our former credit facility in the second quarter. And our weighted average share count will be approximately 157 million shares for 2015 and our corporate tax rate will be approximately 39%.

Lastly, for the second quarter of 2015, we expect comp sales growth to be in the 5.5% to 6.5% range as we continue to gain momentum into the spring and summer season. As mentioned earlier on the call, during the second quarter we are still lapping a strong produce season from 2014, the Sunflower store benefit, as well as higher inflation in the prior year which all benefited comps in 2014. Inflation in the second quarter of 2014 was around 3% compared to approximately 1% forecasted for the second quarter of 2015.

Given these items, we are pleased in the comp guidance and momentum driven by strong traffic counts into the stores, demonstrating the desire for more and more repeat customers to come to Sprouts for their everyday healthy grocery shopping.

In conclusion, we are very pleased with our top-line and overall performance for the first quarter, especially in the face of the difficult produce season and lapping the strong performance from 2014. Our focused 2015 initiatives are off to a good start, our development pipeline remains strong and we continue to remain excited about the business as we grow the Sprouts brand across the country.

Doug Sanders - ***Sprouts Farmers Market, Inc. - President & CEO***

Thanks, everyone, for joining us today and for your continued interest in sprouts. have a great day.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude today's program. You may all disconnect. Everyone, have a great day.