EDITED TRANSCRIPT

SFM - Q4 2014 Sprouts Farmers Market Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen. Welcome to the Sprouts Farmers Market fourth-quarter 2014 earnings conference call.

(Operator Instructions)

As a reminder, today's conference is being recorded. I would now like to turn the call over to Susannah Livingston.

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

Thank you, and good afternoon, everyone. We are pleased you have taken the time to join Sprouts on our fourth-quarter and year-end 2014 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' earnings release announcing our fourth-quarter and FY14 results and the webcast of this call can be assessed through the Investor Relations section of our website at Sprouts.com. In addition, Sprouts' 10-K will be filed tomorrow.

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 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 filed today.

In addition, our remarks today include reference to non-GAAP measures. For a reconciliation of our non-GAAP measures to 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 fourth quarter ended December 28, 2014, we reported diluted earnings per share of $0.11, and adjusted diluted earnings per share of $0.12. Adjusted diluted earnings per share increased 71% from $0.07 in the same period in 2013. For the full-year 2014, we reported diluted earnings per share of $0.70, and adjusted diluted earnings per share of $0.72, a 50% increase from 2013. With that, let me now turn 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 excited to report another great quarter, to end an incredible year for Sprouts. And I couldn't be more proud of our team as they delivered outstanding execution and customer engagement throughout the year. This included bringing new and innovative fresh, natural and organic products to our customers, delivering excellent customer service during our numerous remodels, entries into new markets, new states, and a record 24 new store openings during the year.

Additionally, our support office teams did a fantastic job supporting our growth, while working through bouts of inflation and severe weather by droughts and freezes that occurred throughout the year. The focused execution on our strategic plan in 2014 once again produced strong top-line sales growth and excellent bottom-line financial performance, even surpassing our expectations.

For the fourth quarter, our net sales grew to $735 million, up 21% from the same period in 2013, thanks to improved comp store sales and a strong performance in our new stores. We are very pleased with the 8.5% comp sales growth we achieved for the quarter, especially in the face of a 13.8% comp for the same period in 2013. And a 2014 fourth-quarter season but that was tight in availability and quality, driven by adverse weather conditions.

Despite these headwinds, our financial results exceeded our guidance and generated an industry-leading 22.3% two-year stack, representing our 31st consecutive quarter of positive same-store sales growth. Our comp performance was balanced 50/50 between traffic and ticket, as we continued to gain new customers and increase visits from existing customers. Strong customer traffic, a fantastic holiday campaign, an expanding private label program and continued momentum in specialty categories are just a few of the factors that drove this exceptional performance.

The appeal of the Sprouts brand, especially for the middle-income consumer looking for healthier, affordable food choices, continues to resonate across the country. And during this past holiday season, the desire for healthier holiday choices was even more apparent.

Thanks to the continued growth and success of our holiday campaigns, more and more consumers are beginning to view Sprouts as a holiday destination. From organic turkeys to a wide variety of specialty items like gluten-free stuffing, we continue to strive to meet the customers' needs for healthy and tasty holiday celebration. As result of these efforts, we produced holiday sales that well-exceeded the average Company sales trends for the quarter. And in addition, our Grab 'n Give food drive had a record year that contributed to the $3.4 million we raised for local charities throughout the year.

Sprouts private label also contributed to our successful fourth quarter, with comp and sales growth exceeding our Company average. Innovation continues to be a focus in this area, as we introduced more unique and seasonal private label products during the fourth quarter. We were very pleased to see the enthusiastic response to many of our new pumpkin holiday items for this year, like Pumpkin Snaps, that were such a fan favorite, they were hard to keep on the shelf.

We continue to improve the depth of our product offering in the fast-growing specialty categories that provide strong sales momentum. Specialty categories like organic, raw, non-GMO and allergy-free continued to experience comp and sales growth well-above our Company average throughout the quarter.

As for inflation for the fourth quarter, we continue to see higher levels in certain categories, including produce, nuts, proteins and dairy. While we were able to pass along the majority this inflation, we continue to invest in staples, primarily in the dairy department and nut category, recognizing the importance of certain price points and thresholds close to our customers. As expected, the full-year 2014 inflation rate was approximately 3%.

Lastly, comps for the former Sunflower stores settles to be in-line with the Company average for the quarter. We were very pleased with the additional tailwinds that these rebranded and re-merchandised stores brought to our overall 2014 performance, and look forward to their continued success.

New-store productivity for the quarter was in the mid- to upper-eighties. And while lower sequentially, it remains strong when compared to historical averages' internal expectations of 75%. This was mainly driven by the large number of new stores we opened in the third quarter of 2014.

Typically, new stores that open toward the end of the year perform softer during their initial holiday season, when compared to those that open toward the beginning of the year, when customers have had time to become more familiar with the Sprouts brand and our offering. This same trend has occurred in many of our past vintages over the years, and was magnified in the fourth quarter as 58% of our 2014 vintage opened in the back half of the year.

For full-year 2014, our net sales grew to $2.97 billion, up 22% from the prior year, thanks to impressive comp store sales growth of 9.9% and strong performance from our 24 new stores. Our two-year stack comp store sales remain consistent with 2013 at 20.6%. For the year, our comp performance was balanced 50/50 between traffic and ticket, as we continued to attract a wide variety of middle-income consumers wanting healthier and affordable food choices.

Throughout 2014, we improved our products offering, continued to innovate, and most importantly, grew in all areas of our business. We increased our Sprouts private label offering by 16%, with sales and comps that were well-above the Company average for the entire year.

In addition, we continued to partner with our vendors to bring forward leading and cutting-edge products in the fresh, natural and organic industry, at prices our customers can afford. We experienced significant growth in specialty categories like organic, raw and non-GMO, which drove basket and overall comp growth, clearly highlighting the shift in consumer preferences towards attribute-based foods.

We also successfully opened 24 new stores, including new market entries in Kansas and Georgia. All the new stores are performing well, with new store productivity for the year ended just shy of 100% -- well-above our historical average of 75%.

Each day, the recognition of the Sprouts brand continues to grow exponentially, and our digital and social marketing programs play a key role in this success. We had over 40,000 Facebook fans in Atlanta before even opening our first store. And during this year, we surpassed 1 million fans on our main Sprouts Facebook page.

Our digital and technology strategies continue to engage our customers. With the launch of our new website this past year, enhanced educational content on an array of social channels, and the installation of NFC in all of our stores for Apple Pay and Google Wallet. We also kicked off 2015 with our Every Meal is a Choice Facebook campaign, by giving away an entire year of free groceries to three lucky customers.

We ended of the year with 191 stores in 10 states, and with each new opening, brought more opportunities for greater customer engagement, product knowledge and loyalty. Our more than 18,000 team members deserve tremendous credit for the success we achieved, thanks to their unmatched commitment to inspiring, educating and empowering every customer to eat healthier and live better.

The successful growth we have experienced has also created numerous career advancement opportunities. And I'm proud to say that nearly 20% of our entire workforce was promoted to this past year, a trend that has continued over the past three years. These impressive industry-leading results are a strong indication that our model is resonating with a broad base of consumers across the country. With our knowledge and focus on fresh, natural and organic products across the store, our team members continue to make healthy eating easy, understandable and affordable for all.

Now let me turn to 2015. Our proven success in new markets is bringing new opportunities as we expand into three new states this year. Our 2015 new store program will include the addition of Alabama, Tennessee and Missouri, while we continue to focus 70% of our overall growth in our existing markets. Year to date during 2015, we have already opened seven new stores, including new stores in Missouri and Alabama.

Our current real estate plan includes 62 approved sites and 45 signed leases for the coming years, keeping us well on track with our long-term 14% unit growth target. We remain a very desirable tenant, thanks to our strong customer traffic volume, and continue to have great success obtaining new sites. With a long-range target of 1,200 stores across the country, we are still in the early stages of our growth plan.

Our 2015 growth initiatives are well-underway as we focus on improving our customer engagement to drive repeat traffic and basket growth. Expanding our private label program with a focus on health, uniqueness and value, increasing our specialty product offering, testing new deli offerings in a number of stores. Reinvesting capital to maintain our high standards and building out infrastructure to support our long-term growth.

Our knowledgeable team members do an incredible job engaging and assisting customers, and we hear positive feedback from customers almost daily. As we continue to grow, investing in our team members with the training and the latest products and trends, is of the utmost importance. And as a result, we are expanding our product and service training programs for 2015.

Private-label remains a great growth vehicle for our Company that will only increase with our growing scale. For 2015, we will continue to focus on innovation, to expand our private-label offering with a continued focus on value prices. We will look to attract further loyalty by expanding our private label, non-GMO and organic offerings, as well as building out our private label, raw and imported product lines. And throughout the year, our everyday variety in private label will continue to be enhanced with additional seasonal and holiday items, both new and fan favorites.

We're excited about the continued enhancements across the store, including additional healthy offerings in our delis, to build upon our lunch and evening food service business. We will also continue our aggressive reinvestment program through a variety of sales initiatives. By the end of 2015, we will have updated all stores with the expanded product offerings found in our new stores open since 2013. These efforts have proven to create good returns for the Company, and will also ensure consistent shopping experiences across our stores.

And last but not least, we plan to launch the Sprouts Healthy Communities Foundation in 2015. We have always been a large supporter of autism research and family support services, raising $5 million over the past five years with the support of our customers, vendors and team members. The establishment of the Sprouts Healthy Communities Foundation will allow us to diversify our giving to other worthy causes as well.

Improving the health of the communities we serve has always been at the core of the Sprouts mission. And in 2014, we diverted more than 8 million pounds of food from landfills by partnering with Feeding America and local food banks to make sure the food gets to the people in need. And in 2015, we are launching a zero waste initiative in a number stores to divert produce from landfills that would not otherwise meet our strict food donation criteria. In addition, all of our sites are being built to LEED certifiable standards, utilizing energy-efficient equipment.

I look forward to discussing these growth initiatives and more with you as the year unfolds. And I'm confident that 2015 is going to be another successful year for Sprouts. With that, let me turn the call over to Amin to talk about our financial results and 2015 guidance.

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

Thank you, Doug, and good afternoon, everyone. As Doug stated, we are very pleased with our strong results for the quarter and the outstanding year in 2014. Following Doug's highlights of the business drivers, let me cover the operating results and guidance for 2015.

For the fourth quarter, gross profit increased to $211 million, a 21% increase. And our gross margin rate improved 20 basis points to 28.8% compared to the prior year. Leverage in occupancy and buying costs were partially offset by margin compression in certain categories. During the fourth quarter, inflation was still elevated, though not as high as in the third quarter. We passed on inflation in most of our departments, except in the nuts and dairy categories.

The reinvestment in price as necessary, which provides a strong value proposition to our customers, has continued to drive our top-line sales and margin dollars. Which in turn has provided strong leverage down to the EBITDA margin line. This approach continues to be a productive strategy for Sprouts.

Direct store expense was $152 million for the quarter, and as a percentage of sales, was 20.6%, an improvement of 60 basis points from 2013. This improvement was driven primarily by leverage in payroll and benefits, a decrease in insurance premiums, and leverage of store-level expenses.

SG&A totaled $26 million for the quarter. SG&A included pretax secondary offering expenses in the fourth quarter of $200,000 in 2014, and $2 million in 2013. Excluding these items, SG&A as a percentage of sales increased 30 basis points to 3.5% compared to last year. This increase was primarily due to higher advertising expense from additional promotional activities, as well as the impact of higher corporate expenses as we continue to build out infrastructure to support our growth.

Adjusted EBITDA for the fourth quarter totaled $53 million, up 41% from 2013. EBITDA margin rate was 7.3%, a 110 basis points expansion compared to the prior year. Let me note that $3.6 million, or 50 basis points of the 110 basis points of margin expansion, was driven by a change in methodology of capitalization of new store double-up and cost. The remaining 60 basis points of leverage was driven by the strong comps, resulting leverage and new-store productivity above our historical averages.

Adjusted net income for the fourth quarter totaled $18.2 million, an improvement of 59% from 2013. This increase was driven by strong business performance, as well as reduced interest expense as a result of additional voluntary pay-down on our term loan.

The $3.6 million pretax benefit in new-store double-up and cost capitalization mentioned earlier was offset by a $4.4 million pretax depreciation adjustment. These two adjustments, on a net basis, did not have a material impact to our adjusted net income or adjusted EPS for the quarter. But did positively impact adjusted EBITDA by $3.6 million or 50 basis points, which we did not expect to see in the fourth quarter of 2015.

Now let me recap the full year of 2014. Gross profit increased 22% to $885 million, resulting in a gross margin rate of 29.8%, or an increase of 10 basis points from 2013. Direct store expenses as a percentage of sales for the year, excluding adjustments, improved 70 basis points. And SG&A as a percent of sales, excluding adjustments, was consistent at 3.1% compared to 2013.

Adjusted EBITDA totaled $265 million, up 36%. Adjusted margin rate expanded to a record 8.9%, an improvement of 90 basis points compared to 2013. Adjusted net income totaled $111 million, an improvement of 65%, and well-above our long-term targets. These results were driven by the strong comp sales, resulting operating leverage and strong new-store productivity. And were offset by inflation, price re-investments, increased promotional activities, and our continued investments in growth infrastructure.

Shifting to balance sheet and liquidity, our balance sheet is stronger than ever, as we continue to generate robust operating cash flows, and continued to pay down debt during 2014. For the year, we generated $181 million of cash flow from operations, and invested $108 million in capital expenditures net of landlord reimbursements, primarily for new stores.

Due to our strong cash flow generation, we voluntarily paid down $50 million of our outstanding debt during the third quarter of 2014. At year-end, the principal balance on our term loan was $261 million. And our net debt to adjusted EBITDA leverage ratio, excluding capital and financing leases, was 0.5 times. We ended the year with cash and cash equivalents of $131 million, and $53 million available under our undrawn revolving credit facility. With our strong operating cash flows and lower debt, we are well-positioned to self-fund our growth plans, and continue to build on our strong liquidity position.

Now let me turn to 2015 guidance. First, let me note that 2015 will be a 53-week year, with the extra week following in the fourth quarter. The Company estimates the impact on earnings for the 53rd week to be approximately $0.02 per diluted share.

As we look to the full-year 2015, we expect 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 of $0.84 to $0.87. And we expect CapEx will be in the range of $100 million to $110 million for 2015.

In addition to a strong pipeline of new stores, we remain bullish on the momentum in the natural and organic growth sector, and are targeting our sales growth above our long-term target of 15%. Our focus on driving sales has greatly improved our sales per square-foot over the last few years.

And we believe our focus on new product innovation, combined with rolling out tested initiatives to more stores, will continue to drive comp sales and efficiency in our existing stores. In comparing our 6% to 7 % comp sales guidance for 2015 versus 2014, we expect a leveling out of the Sunflower store comps to impact comps in 2015 by approximately 1%. Second, lower inflation is also expected to impact comp by another 1%.

A few additional items to note on our 2015 guidance. First for 2015, our store openings are front-loaded, as we expect to open approximately 66% of our stores in the first half of the year. In 2014, 14 of our 24 new stores, or 58% of our stores, were opened in the third quarter. Keeping in mind, our new stores start at a lower store-level EBITDA margin in the first couple of years. And as result, the front-loaded opening cadence in 2015, combined with the back-loaded opening in 2014, will compress gross profit, DSE and EBITDA margins in the first quarter. We expect each of these lines to normalize as the year progresses.

I do want to stress that the compression in margin is mainly due to the timing of store openings. To provide further color on this point, we expect our pre-2014 vintage stores to leverage by 30 to 50 basis points down to the EBITDA margin line, including positive leveraging in the gross margin and DSE lines.

Second, as we have done in the past, we will continue to make price investment as necessary to drive top-line sales growth, and have considered that in our guidance. This, along with the previous comments on the timing of new stores, results in our expectation for overall 2015 gross profit margin to be in line with that of 2014.

Third, on the direct store expense line, while we expect to benefit from leverage from our pre-2014 vintage stores, we expect a slight deleverage to overall DSE for the year. This deleverage is mainly driven by the timing of the new stores, as our new stores have a higher labor as a percentage of sales in the first year.

Fourth, in SG&A, we continue to invest in infrastructure as we grow the Company. Based on the components of margin, DSE and SG&A above, we expect a slight compression to EBITDA margin for 2015, primarily driven by the timing of the new-store openings. Below the EBIT line, we expect to have approximately $24 million in interest expense -- including capital leases, OID and other interest expense -- a weighted average share count of approximately 157 million shares, and a corporate tax rate of 39%.

Lastly, for the first quarter of 2015, we expect the comp store sales growth to be in the 5% to 6% range, the lowest of the year, as we cycle the 12.8% comp from the first quarter of 2014. This range still equates to a strong two-year comp stack range of 18% to 19%.

The tightness in availability of produce in the fourth quarter that Doug spoke about continued into January and February. However, we are starting to see improvements in availability and the quality of produce, which will greatly enhance our ability to be more promotional. And we are expecting strong momentum into the spring season. We have taken the produce factors into consideration in our Q1 comps guidance.

In conclusion, we are very pleased with our financial and operating performance in 2014, especially as these results have well-exceeded our long-term targets and the industry targets. We are on good footing for a focused 2015 plan, coupled with the momentum fueled by the everyday consumers' growing interest in eating better.