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SFM - Q2 2014 Sprouts Farmers Market Inc Earnings Call

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PRESENTATION

Operator

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

(Operator Instructions)

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

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

Thank you operator, and good afternoon everyone. We are pleased you have taken the time to join Sprouts on our second-quarter 2014 earnings call. Doug Sanders, President, Chief Executive Officer; Amin Maredia, Chief Financial Officer and Jim Nielsen, Chief Operating Officer are also on the call with me today. Sprouts' form 10-Q and the earnings release announcing our second quarter 2014 results and the webcast of this call can be assessed 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 2014 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 reference to non-GAAP measures. For reconciliation of our non-GAAP measures to GAAP figures, please see the schedules in our earnings release. We believe these adjusted results provide a good basis to assess the operating and financial results of the Company year-over-year.

For the second quarter ended June 29, 2014 we reported diluted and adjusted diluted EPS of $0.20. Adjusted diluted earnings per share increased 43% from $0.14 in the same period in 2013. With that, let me 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.

2014 continues to be an exciting year for Sprouts as the broad appeal of our healthy living for less strategy continues to win new customers and create opportunities for growth. With the opening of our first stores east of the Mississippi in Atlanta, Georgia we're now operating stores in ten states from coast to coast. All of this excitement continues to produce strong top line and bottom line growth and we are very pleased report another quarter of strong financial results.

Our net sales grew to $744 million for the quarter, up 20% from 2013, thanks to the strong performance of our new stores and approve comp store sales. The second quarter represents our 29th consecutive quarter of positive comp store sales growth ending with comps of 9.5% and 20.3% on a two-year static basis, as Sprouts continued to outperform the grocery industry.

Before I share some thoughts around the business drivers for the second quarter, let me reiterate what we see clearly distinguishes Sprouts from our competitors. As many of you know, Sprouts attracts the everyday grocery shopper by offering fresh high-quality produce at the best prices in town.

Why produce? It's because produces a healthy product the everyday grocery shopper understands and buys every week. With approximately 25% of our revenue coming from the produce department we continue to benefit the consumers growing interest in improving their diet by making healthier food choices.

In addition, Sprouts promotional approach and our ability to communicate our competitive prices week in and week out through our distributed ad circulars and social networks, continue to drive traffic to our fresh, natural and organic offerings across the store. This differentiated model has created a broad appeal that continues to separate Sprouts from the competition, giving us the ability to take market share from both our conventional supermarket and specialty retail competitors.

The consumer purchasing landscape and food retail continues to evolve as shoppers embrace the need for healthier diet. Studies today show that the most rapidly growing segment of Americans adopting healthier eating habits is primarily middle income consumers.

For years, price and availability have long been viewed key barriers to attracting this middle income shopper, but Sprouts unique combination of health and value offered in a friendly, easy to shop environment has allowed us to break down these barriers and become one of the fastest growing food retailers in the country. It's a strategy unlike any other natural foods retailer and has given us the ability to compete in the broader $600 billion supermarket industry and not just the natural and organic sector.

Bottom line, we believe the growing health movement driven in part by aging baby boomers, millennials, and young families focused on what they're feeding their children is reshaping the food industry as we know it. And Sprouts is change the way people perceive and shop for fresh, natural and organic foods.

Specific to the second quarter business drivers, our comp performance was strong across all departments with great strength in our fresh departments. In addition, the former Sunflower stores continue to perform well, posting second quarter comps above the Company average. Consumer demand for our fresh, healthy product offering continues to be strong which led to a nice balance of a 5% increase in customer traffic and a 4% rise in basket size for the quarter.

In addition, we continue to see significant growth in specialty categories such as organic, raw, gluten-free, and non-GMO verified, with sales growth of more than 20% in each of these categories. Our Sprouts private label program also continues to grow in both variety and sales. We're now up to over 1,500 private label SKUs and comp sales in the second quarter increased by 30% over last year.

On the expansion side, we opened six new stores in the second quarter and have opened an additional five new stores in the third quarter to-date. Two of the stores are in the Atlanta area, representing our initial entry into the Southeast region. The Atlanta openings have started off well above our expectations with continued momentum past the opening week as we bring affordable healthier food choices to these communities.

The level of consumer anticipation around these openings was far more than we had ever experienced in a new market. That excitement was evident in the 40,000 Atlanta Facebook fans we amassed before even opening our first store the market, and the more than 1,000 customers that signed up for Tuesday night preview event in less than one hour. Our impressive early performance in the Southeast clearly demonstrates the strength of the Sprouts brand and our ability to excel in new markets.

Our healthy living for less model continues to generate broad customer appeal, allowing us to successfully operate in natural lifestyle markets as well as markets where healthy living is in its in early phases of adoption. We reinforced our commitment to the local communities and businesses in the Atlanta area by offering more than 170 local products, from Georgia grown peaches, to local handcraft beers and barbecue sauces. You can learn more about these unique local items, as well as the stories and people behind them, in our growing Meet the Brand video series found on the Sprouts Farmers Market YouTube channel.

As with any new market, it was extremely important to build our Southeast team with experienced internal candidates who understand our healthy living for less philosophy and how to on-board new team members who aren't quite as familiar with our brand. We were fortunate to have more than 30 team members, including store managers and department managers relocate to the Southeast to support our expansion. With their help the transition has been very successful and we look forward to developing future leaders as we continue our expansion into the region.

As part of our team member development program, we will be hosting our annual Sprouts Fest this month in Phoenix, Arizona, which will include more than 400 team members from a support office, field operations, and store level teams. Throughout the three day event, team members will be treated to industry speakers, product and leadership training sessions and vendor exhibits to help them stay up-to-date on the latest trends in the ever evolving natural and organic industry.

We're on track to open a total of 14 stores during third quarter, putting us at 24 stores the calendar year, or 14% unit growth. Our growth plans currently includes 67 of pre-sites, and 42 signed leases for the coming years. All of our new stores are performing better than we expected, as we continue to serve as the healthy grocery store for our customers.

In addition to investing in new store growth we continue to reinvest back into our business through our remodel program and have completed 13 remodels this year on top of 12 completed last year. To-date approximately 60% of our entire chain is reflective of our newest store prototype, and in a disciplined manner we will continue to remodel those stores with opportunities to improve merchandising and store conditions over time.

Now let me quickly touch on commodities and inflation. During the second quarter, as expected, we experienced higher inflation in certain commodities. Despite this higher inflation, we continue to maintain our pricing strategy by closely monitoring pricing activity within the markets we serve. Our successful promotional strategies during the quarter, coupled with our aggressive produce pricing, continue to deliver strong traffic and comps across the departments as we navigate through these inflationary periods.

Overall, on an average Sprouts basket we saw acceleration in cost inflation during the second quarter of approximately 3% and expect inflation to remain at current levels throughout the end of the year. As we've said before value has been part of the Sprouts DNA since day one. So we're constantly monitoring the competitive environment to ensure we are delivering on our commitment to providing healthy foods at affordable prices every day.

Before closing, I'd like to take time to recognize the tremendous effort of all our team members throughout the Company and especially those involved in our numerous new store openings. Our Southeast expansion involved combined efforts of countless team members from across the Company, and I cannot thank our entire team enough for all their hard work and dedication. Our commitment to healthy foods, affordable prices, and engaging service continues to connect us with new customers everyday and truly differentiates Sprouts from the competition.

With that let me pass the call to Amin to cover our financial results and full-year guidance.

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

Thank you, Doug, and good afternoon everyone.

We are very pleased with our strong results for the second quarter. Following Doug's highlights on the business drivers, let me cover our operating results and updated guidance. For the second quarter, gross profit increased to $224 million or 20% over the same period in 2013. Our gross margin rate of 30.1% was consistent with the same period in 2013. Leveraging occupancy, utilities, and buying costs were offset by lower merchandise margins resulting from higher inflation in certain categories including produce, dairy, and certain protein items.

We continue to maintain discipline in our commitment to invest in margins, to drive traffic and sales and bring value prices to our customers. Value has always been the foundation of our model and being competitive and making necessary price investments, even during inflationary times is a core part of our strategy to drive traffic, comp, and revenue growth.

Direct store expenses were $143 million for the quarter. Direct store expense as a percentage of sales was 19.2%, an improvement of 60 basis points compared to 2013. This improvement was driven primarily by leverage in payroll, depreciation, as well as a decrease in insurance expense.

Selling general and administrative expenses were $23 million for the quarter. SG&A as a percentage of sales was 3.1%, representing an leverage of 20 basis points compared to 2013. This benefit was mainly driven by leveraging advertising.

Adjusted EBITDA for the second quarter totaled $69 million, up 31% over the same period in 2013, driven by higher sales and operating leverage leading to EBITDA margin expansion of 80 basis points from a 8.5% to 9.3% during the quarter. Adjusted net income for the second quarter totaled $30.2 million, an improvement of the 68% compared to 2013. This increase was driven by the strong business performance, as well as reduced interest expense as a result of a lower principal balance on our term loan and a lower interest rate from our April 2013 refinancing.

For the 26-week period ended June 29, 2014 net sales increased to $1.5 billion, up 23% compared to 2013, driven by 11.1% increase in comp sales growth and new store openings performing well above expectations. Gross profit increased 24% to $448 million, resulting in a gross margin rate of 30.5%, or an increase of 30 basis points from 2013. Adjusted EBITDA totaled $147 million, up 40% from the same period of 2013, well above our long-term guidance.

We are very excited about our performance year-to-date, above our long-term guidance, which are driven by a number of levers including our ability to continue to drive traffic to our stores with our strong value proposition, strength of our new store productivity, staying relevant to our customers through our advertising and promotional strategies, and disciplined investments and management of direct store expenses, G&A and CapEx.

Moving to balance sheet and liquidity, we continue to build a strong balance sheet and improve our liquidity. For the 26-week period we generated $138 million of cash flows from operations and invested $58 million in capital expenditures, primarily for new stores. We ended the second quarter with a principal balance on our term loan of $350 million and a net debt to adjusted EBITDA leverage ratio, excluding capital and financing leases at 0.6 times. We ended the quarter with cash and cash equivalents of $184 million and $53 million available under our undrawn revolving credit facility.

As we mentioned earlier in the year, and due to the strong cash flow generation year-to-date, during the third quarter we expect to pay down an additional $50 million of principal balance on our term loan. With a strong cash position, robust return on investment, and ample real estate opportunities opening new stores, maintaining superior store conditions, and new sales initiatives continue to be an investment priority.

As we can see, our strong financial performance has continued into the second quarter of 2014. Another solid top line performance and continued leverage in the business gives us a high level of confidence to increase our full-year 2014 guidance as follows. Net sales growth target of 19% to 20%, adjusted EBITDA growth range of 25% to 27%, 45% plus growth in adjusted net income, and adjusted diluted earnings per share range of $0.65 to $0.67, a forecasted growth of 35% to 40% over the prior year. In addition, our guidance range for comp sales growth is a 8.5% to 9.5% for the full year.

Let me review a few additional items regarding our full-year guidance. First, consistent with our view at the beginning of the year, in our guidance we expect comp sales growth to moderate in the back half of the year as we cycle high comps sales from the back half of 2013. We continue to expect the two year comp sales stack to be in the 19% to 20% range, which still remains amongst the best in retail and well outpaces the grocery sector. Specific to the third quarter of 2014, we are forecasting comp sales growth of 8.5% to 9.5%, which would lead to a two-year stack comp sales growth of 18.5% to 19.5%.

Second, we expect to continue to make price investments as necessary to drive top line sales, a strategy that continues to drive high margin dollars. Third, with the opening of 14 new stores for the third quarter, we expect pre-opening cost to be approximately $2 million higher than the prior year. Further, as you know, in our new store model, our new stores start off with a lower gross margin than our mature stores and we have built in the compression to the gross profit and overall EBITDA margins from the new store openings for remainder of the year in our guidance.

This compression is expected to be higher than normal during the third quarter, as we are opening 14 stores during the third quarter compared to four stores in the first quarter of this year and six stores in the second quarter of this year. We expect our existing stores to continue to leverage well from the strong comp sales performance. Overall, we are very pleased in our ability to continue to grow top line sales and bottom line profitability well above our long-term goals for now three consecutive years.

In conclusion, Sprouts' growth is fueled by the everyday grocery shopper who wants to eat healthier and recognizes it no longer has to be expensive to eat healthy. This broad appeal has led to another strong quarter for Sprouts and gives us continued confidence in the business going forward.

With that we would like to open the call for questions. Operator?

QUESTION AND ANSWER