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SFM - Q1 2014 Sprouts Farmers Market Inc Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Sprouts Farmers Market first-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 first-quarter 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' Form 10-Q, the earnings release announcing our first-quarter 2014 results and the webcast of this call can be assessed 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 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. 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 release file today.

In addition, our remarks today include reference to non-GAAP measures. The 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. 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. The positive momentum Sprouts experienced in 2013 has certainly continued into the first quarter of this year and I'm proud to report another quarter of strong financial results. We recorded adjusted diluted earnings per share of $0.23, a 64% growth in earnings from the same period in 2013. On a GAAP basis, we reported diluted EPS of $0.22 per share compared to $0.14 in the same period in 2013. These results clearly reflect the power of the Sprouts model and the strong execution of our skilled operations team.

As a growing number of consumers embrace the need for a healthy diet, our focus on health and value continues to generate strong same-store sales, customer traffic and top line sales growth. Our net sales grew to $723 million for the quarter, up 26% from 2013 thanks to improved same-store sales and the strong component of our new stores. The first quarter ended with a robust same-store sales increase of 12.8% and 20.8% on a two-year stacked basis, representing our 28th consecutive quarter of positive same-store sales growth. The 12.8% comp was driven by a 6.5% increase in customer traffic and a 6% rise in the average basket size.

Now let me take a minute to discuss the drivers of our costs sales over the past few couple of years as well as the first quarter of 2014. The broad appeal of our healthy living for less strategy gross more evident with each quarter as Sprouts continues to outpace not only the overall food industry but also the natural and organic sector. Our value-based approach to natural foods appeals not only to the natural lifestyle customer but to the growing number of everyday grocery shoppers who are looking for healthier food choices.

Sprouts delivers a wide selection of healthy foods at affordable prices along with a well-trained staff focused on delivering product knowledge and friendly service in a non intimidating climate. Our focus on health, selection, service and value continues to separate Sprouts from the competition as evidenced by our accelerating customer traffic and comps during 2013 and the continuation of our strong comp performance during this first quarter of 2014.

More specifically to the first quarter, we continue to see tremendous top line and same-store sales growth across departments, geographies and vintages. Our strong comps for this quarter were driven by our ability to aggressively promote fresh produce which gives us that broad appeal with the everyday grocery shopper. A strong produce comp coupled with our store wide and department promotions drove solid traffic and balanced performance across the store.

During the quarter we also continued to see strong performance at the former Sunflower stores delivering same-store sales in the high teens and contributing 160 basis points to our overall comp store sales.

In addition, significant growth in specialty categories such as organic, raw and gluten-free with sales growth of over 30% in each of these categories, continue to drive basket and overall comp growth. The growth in these specialty categories clearly demonstrate the shift in consumer preference toward food attributes and a keen focus on the health benefits on the foods they're eating.

Lastly, our private label category continues to grow as we leverage our scale to innovate and introduce new private label selections. Private label comps during the first quarter grew by 30% over 2013 and our item count increased by 20% over the prior year to more than 1400 items.

Our growing fan base is also evident in social media where our number of Facebook fans increased by more than 180% over the past year as our improved digital strategies successfully engage our customers both inside and outside the store. Our new website, which launched in February, has also seen increased traffic with over 1 million page views on the day it launched.

On the new store front, we've opened five new stores this year, four of which occurred in the first quarter. In addition, we completed the remodel of seven stores during the quarter. With the opening of our first Midwest store in Kansas City in January, we are now operating stores in nine states. Our Kansas City stores performing above our expectations and we continue to receive plenty of enthusiasm from our new customers in Kansas and Missouri. Our successful performance in the Midwest further demonstrates the strength of our brand and our healthy living for less model and we look forward to our continued expansion in Kansas City as well as other existing and new markets across all the states in which we operate in today.

Most of our store openings for 2014 will occur during the middle part of the year. We are on track to open six new stores during the second quarter, including five in existing markets and our first new store in the Southeast region in Atlanta. Our expansion plans over the past decade have been very methodical and our move into the

Southeast will be no different. We engaged in a comprehensive analysis of the Southeast region when developing our expansion plans, including a review of the real estate availability, the labor markets, customer demographics, competitive landscape, distribution costs and the region's economy.

In addition, our category leaders spent significant time studying consumer preferences in produce, meat and grocery and made minor changes to our product assortment to accommodate regional differences. And of course, we reviewed our advertising and marketing strategies across our print, social and digital channels to successfully introduced the Sprouts brand to the Southeast market.

We've also been building a strong Southeast team and infrastructure which includes a number of experienced store managers and other team members who are relocating to the region. As you know, our unique culture and commitment to excellent customer service and product knowledge is extremely important to the sprouts model. These moves give us further confidence in our Southeast expansion and our overall store level execution. Bottom line, we feel confident that the Sprouts brand will be well received in the Southeast as it has been in the numerous markets we've entered over the past several years.

Our tremendous financial performance this quarter, as in the past, is a direct result of our more than 15,000 team members operating our stores everyday. I'm delighted to report that more than 650 of our team members were promoted in the first quarter alone, further strengthening the Sprouts team. Professional development that results in engaged team members will continue to drive the success of our stores and sustain the positive customer focused culture we foster here at Sprouts.

Of course our growth plan, which currently includes more than 69 approved sites and 49 signed leases for the coming years, helps create meaningful career opportunities for our team members. We're on track to open 23 to 24 new locations this year, representing a 14% unit growth. To date, all new stores are performing better than expected as we continue to serve as the healthy grocery store for our customers.

Before handing the call over to Amin, let me quickly touch on commodities and inflation. First, inflation was moderate during the first quarter at approximately 1%. During the past two months, we have started to see acceleration in certain commodities and would expect higher levels of inflation in the these categories during the coming months mainly meats, dairy, some produce and nuts. Overall, we expect inflation for the full year to be approximately 2% to 3%.

Our ability to pass along modest inflation is very similar to the rest of the industry. Historically, the industry has passed along modest and higher levels of inflation accept for the unique period like 2009 when during a recession we saw significant retail deflation. While we aren't seeing signs of retail deflation today, we closely monitor market pricing and competition and maintain our spread to competitors.

Let me specifically touch on produce inflation in both availability and pricing. For the decades of experience we have in the produce business, it's not unusual to see peaks and valleys in this industry driven by freezes, floods and droughts and the resulting impact on availability and price volatility. As many of you know, producer represents approximately 25% of our business and we source quality control and distribute all the produce we sell. Today produce is a global industry and we have dedicated teams throughout the country who have relationships with and source product from a variety of local, regional, national and international suppliers.

The drought conditions in California have resulted in some reduced planting for the Central Valley for this year. The planting in this region represents approximately 5% to 8% of our sales in produce or approximately 1.5% to 2% of our overall sales and is therefore manageable. Now fortunately, the southern parts of the California are producing strong yields due to favorable weather conditions and we expect this trend to continue throughout the traditional growing season into Central and Northern California.

We are seeing modest -- moderate inflation in our overall produce basket and have been passing along the majority of these increases as we've done historically. Given our broad network and strong relationships, we feel very confident comfortable in our ability to secure the volume and quality of produce our customers have come to expect from Sprouts.

So in summary, the success of our healthy living for less strategy and our ability to connect with a very broad and fast-growing customer base truly differentiates Sprouts from our competition and positions us well to increase our EPS guidance for the year. 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're very pleased with our record-setting results for the quarter and our continued out performance to targets. Following Doug's highlights of the business drivers, let me spend a few minutes on the full income statement followed by our 2014 guidance.

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For the first quarter, gross profit increased 29% to $224 million over the same period in 2013. Gross margin rate as a percentage of sales increased 70 basis points to 31%. This improvement was driven by leverage and occupancy, utilities and buying costs. In addition, merchandise margin improved during the quarter despite minor inflationary pressure experienced in certain categories including dairy, nuts, meat and citrus. The strong produce growing condition in the first quarter lead to improved margin in the produce category.

Staying true to our value focused model, we continued our strong promotional activities to set us apart from competition. This is nothing new to Sprouts, as value has always been the foundation of our model and driving traffic and top line growth remains a priority. Direct store expenses was $138 million for the quarter. This included a loss on the disposition of assets of $700,000 in the quarter. Excluding this item, direct store expenses as a percentage of sales decreased by 100 basis points compared to 2013. This in improvement was driven primarily by leverage in payroll, depreciation and lower utilization of medical benefits during the quarter.

Selling, general and administrative expenses were $22 million for the quarter. SG&A during the quarter included $1.4 million of pretax secondary offering expenses. Excluding this item, SG&A as a percentage of sales was consistent to last year as leverage in advertising was offset by higher corporate overhead as we continue to make necessary investments to support our expansion plans.

Adjusted EBITDA for the first quarter totaled $77 million, up 49% over the same period in 2013 driven by higher sales and improved gross profit margin. This, coupled with the resulting operating leverage and lower pre opening expense, lead to EBITDA margin expansion of 165 basis points growing from 9.1% to 10.7%. Starting 2014 with strong EBITDA margin expansion and overall adjusted EBITDA growth of 49% gives us tremendous momentum and flexibility in executing our business plan as we enter the middle of the year with an increasing number of new store openings.

Adjusted net income for the quarter totaled $35.4 million, an improvement of 90% compared to 2013. This increase was driven by strong business performance as well as reduced interest expense as a result of a lower principal balance on our term loan and a decrease in interest rates from our April 2013 refinancing.

Moving to balance sheet and liquidity. We generated $76 million of cash flows from operations. During the first quarter, we invested $18 million in capital expenditures primarily for new stores. We ended the first quarter with a balance on our term loan of $317 million and a net debt to adjusted EBITDA leverage ratio excluding leases at 0.8 times.

We ended the quarter with cash and cash equivalents of $149 million and $53 million available under our undrawn revolving credit facility. Sprouts continues to maintain significant liquidity and generate strong cash flows to self fund our future growth and also creating flexibility in uses of excess free cash flow for store level initiatives and repayment on our debt.

As you can see, our strong financial performance over the past few years continued into the first quarter of 2014. The robust top line performance leveraged in the business and tremendous growth and profitability in cash flows gives us a high level of confidence as we continue to grow the business. This strong growth in the natural and organic sector, which is well outpacing the overall grocery industry, our broad demographic appeal to a wide range of customers, our solid business performance across geographies and vintages, strong performance in our new stores in both existing and new markets, gives us tremendous confidence to increase our full-year 2014 guidance as follows.

Net sales growth of 18% to 20% driven by 14% unit growth and same-store sales growth range of 8.5% to 9.5%. Adjusted EBITDA growth range of 23% to 25%. 40%-plus growth in adjusted net income and adjusted diluted earnings per share range of $0.63 to $0.65, a targeted growth of 31% to 35% over 2013.

Let me review a few additional items regarding our full-year guidance. First, in our guidance we expect same-store sales growth to moderate in the back half of the year as we are cycling higher same-store sales from the back half of 2013. We expect a two-year same-store sales stack to be in the 19% to 20% range. This 19% to 20% two-year stack comp sales still remains amongst the best in retail and well outpaces the grocery sector.

Second, as Doug said, over the past several months we have started to see increases in commodities and expect higher levels of inflation in certain categories. With a full year 2% to 3% inflation expectation, we assume the ability to pass on inflation in the normal course of business and have reflected this in our guidance.

Third, in 2014 our store openings are more weighted to the second and third quarter and therefore we expect higher pre opening costs during these quarters compared to the first quarter of 2014. Further, as you know, in our model our newest stores start off with a lower gross margin than our mature stores and we have built in the compression to our overall margins from the new store openings for the remainder of the year in our guidance.

Fourth, we continue to build our team to support our future growth in our Southeast expansion. We expect to see some increases in SG&A as a percentage of sales for the remainder of the year to support this growth in both advertising expense as well as store level overhead, and again have considered this in our guidance. After taking this into account, including the increased cost for expansion into a new region of the country, we are very pleased in our ability to continue to grow top line sales and bottom line profitability while above our long-term guidance and at levels separating us from competition. Specific to the second quarter of 2014, we are forecasting same-store sales growth of 8% to 9%, which would lead to a two-year same-store stack comp of 19% to 20%.

In conclusion, our strong results for the first quarter of 2014 gives us confidence as we continue to expand the brand. Sprouts' growth comes from the fastest-growing segment of the natural and organic sector, the everyday grocery shopper who recognizes that eating healthy no longer has to be expensive. This broad appeal, in addition to our low-cost new store economic model, and our significant white space opportunity gives our leadership great confidence in our ability to continue to deliver on our business results and financial targets. With that, we would like to open up the call for questions. Operator?