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SFM - Q4 2013 Sprouts Farmers Market Inc Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to Sprouts Farmers Market's fourth quarter 2013 earnings conference call. At this time, all participants are in a listen-only mode. Later, we'll conduct a question-and-answer session, and instructions will be given at that time.

(Operator Instructions)

This conference call is being recorded. I would like to turn the conference over to Susannah Livingston, Vice President of Investor Relations. Ma'am, you may begin.

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 fourth-quarter and fiscal year-end 2013 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's Form 10-K, the earnings release announcing our fourth quarter and 2013 results in 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-look 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 earnings release file 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.

Lastly, in comparing our results, the comparable periods in 2012, we discussed the company's results on a pro forma basis as if our May 2012 acquisition of Sunflower Farmers Market, which we refer to as the Sunflower transaction, had occurred at the beginning of our 2012 fiscal year. We believe these pro forma adjusted results provide a good basis to assess the operating and financial results in the performance of the combined 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.

2013 has been an amazing year at Sprouts, and we're very pleased to report another quarter of strong results and a terrific first year as a public company. To quickly hit the EPS for the fourth quarter, we reported adjusted diluted earnings per share of $0.07, a 75% growth in earnings from the same period in 2012. On a GAAP basis, we reported EPS of $0.06 per share compared to $0.03 in the same period in 2012.

The positive momentum driven by the everyday shoppers' growing demand for healthier food choices continued to generate strong top-line growth for Sprouts. Net sales grew 27% during the fourth quarter, thanks to improved same-store sales and the strong performance of our new stores opened in 2013. Our ability to attract a broad customer base was even more evident during this quarter as we widened the gap within the industry.

The fourth quarter ended with an impressive same-store sales increase of 13.8% and 22.4% on a two-year stacked basis, representing our 27th consecutive quarter of positive same-store sales growth. The 13.8% comp was weighed more towards traffic growth during the quarter, where we saw an 8.5% increase in customer traffic and a 5% increase in basket size.

Now, this was obviously an exceptional quarter, and it's important to understand the specific drivers of this performance. First, the sales in the former Sunflower stores accelerated with fourth quarter comps in the high teens. The sales growth at these stores was driven by merchandising and promotional alignment established in late 2012 and improved operational execution we achieved throughout 2013.

Second, we continue to see accelerating comp sales in states experiencing economic recovery, such as California, Nevada and Arizona. And lastly, comp sales growth in our produce department out-paced our overall compo performance, driven by strong promotions and sales growth in organic produce. The benefit from the Sunflower same-store sales, economic recovery and strong produce performance accounted for approximately 400 basis points of incremental comp sales during the quarter.

In addition to our strong comp sales performance, our efforts in innovation, marketing, and operations continue to drive the Sprouts brand forward. Our private label program is delivering results as we ended the year with our best quarter to date in same-store private label sales growth. Our improved holiday offerings and marketing efforts resonated well with customers in the fourth-quarter. Enhanced holiday sales were achieved through a wider assortment of holiday grocery items, special holiday gluten-free offerings, new private-label baked goods and improved and expanded holiday meal offerings.

Fiscal 2013 ended with adjusted diluted earnings per share of $0.48, or 55% higher than 2012, and exceeded the guidance we provided last quarter of $0.45 to $0.46 per share. On a pro forma basis, net sales grew 22% for the year. This was the result of 10.7% same-store sales growth and the addition of 19 new stores during the year.

Our new stores continue to perform above expectations, growing new customers each week as the Sprouts brand continues to gain recognition. For the full year, store traffic increased approximately 6% and the average basket size increased approximately 5%.

These impressive top and bottom-line numbers are record-setting for Sprouts, and I can't overemphasize the strong operational execution that drove our 2013 performance. These results are a direct reflection of the exceptional teams we have within our stores, distribution centers, and support office, and their commitment to help our customers eat well, live better and spend less.

Throughout 2013, we brought forward the best merchandise offering in the history of Sprouts while maintaining our affordable prices that set us apart from the competition. This expanded offering in areas such as organic produce, raw and vegan foods, deli, bakery and private-label successfully broadened our customer appeal and drove success across all stores, including our remodeled stores and new stores opened in 2013. The tailwinds created as the everyday consumer embraces a healthier diet are reflected in our strong customer traffic and growing brand awareness.

Our promotional marketing programs also played a key role in our success in 2013. This year, all stores, including the former Sunflower stores, participated in more than 30 store-wide promotions that we regularly offer at Sprouts. These successful programs drive customer traffic and reinforce our value proposition that's been synonymous with the Sprouts brand since day one.

As our unit growth expands, so does the Sprouts brand. And the additional exposure resulting from our public offering has continued to position our brand for growth. We ended the year with 167 stores and each new store opening brings more opportunities for greater customer engagement, education and loyalty.

As we set the pace for 2014, our dedication to grow the company is no less ambitious. Product innovation, improving the customer experience and new store growth remain our top priorities. We have plans to further enhance our product offerings especially when it comes to specialty, organic, non-GMO and local products. We'll continue to expand our private-label offering, which currently features more than 1,400 items. And in 2014, we're focused on unique, signature products that can only be found at Sprouts.

We'll also continue to reinvest in our stores with at least 15 store remodels during the year, mainly focused in the Texas region. And, of course, we will reinforce our value image by maintaining our competitive pricing structure and promotional strategies, which we communicate to our customers weekly through our print, social, and digital channels.

We also want to address the California drought situation. Our produce team is in continuous dialogue with our growers in and outside of California, and we believe that if the dry conditions persist into the summer, we can expect some tightness in certain categories. But we do not expect a significant issue for 2014. It's important to remember that we deal with weather events including freezes, downpours, and droughts throughout the season, but our supplier relationships on the local, national and international level enable us to secure the volume of produce necessary to support our business.

Of the nearly 60 sites we have approved for the coming years, we plan to open 22 to 24 new locations in 2014, representing 13% to 14% unit growth. And by the end of the year, we will be operating in ten states across the country. To date, we've opened three new stores, including our first new store in Kansas in early January. All new stores are performing well, and our reception by the Kansas market has been impressive. Our next new market is Atlanta, where we will be opening four new stores starting this summer. As we always stated, our unit growth will be very balanced, and in 2014, we'll open new stores at nine of our ten states with less than 25% of these new openings in new markets.

And finally, we will continue to invest in our future growth by enhancing our teams and deepening our bench within each region. This will allow us to serve our existing and new stores as we expand our reach into the Southeast. With the best people, best products and best prices, we're confident that 2014 is going to be another successful year for Sprouts.

With that, I'll turn the call over to Amin to cover our financial results in greater detail and our 2014 guidance.

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

Good afternoon, everyone. During the fourth quarter, we exceeded our expectations and built on our momentum to deliver strong results. Following Doug's discussions on the sales drivers, let me start with gross profit. For the fourth quarter, gross profit increased 28% to $174 million over the same period in 2012. Gross margin rate as a percentage of sales increased ten basis points to 28.6%. This improvement was driven primarily by leverage and occupancy cost and was partially offset by lower merchandise margins from increased holiday promotions. We remain excited about our ability to pass on savings to our customers while leveraging gross margin.

Direct store expenses were $129 million for the quarter. We continue to leverage on variable labor during the quarter. However, direct store expenses, as a percentage of sales, increased 30 basis points, driven primarily by a health care cap reimbursement credit recorded in 2012, which did not repeat in 2013. Selling, general, and administrative expenses were $22 million for the quarter.

SG&A during the quarter included $2 million of secondary offering expenses. In the fourth quarter of 2012, SG&A included $4.1 million of acquisition and integration cost related to the Sunflower transaction. Excluding these items, SG&A decreased as a percentage of sales by 40 basis points, mainly as a result of leverage and corporate overhead and store level advertising cost.

Adjusted EBITDA for the fourth quarter totalled $38 million, up 31% over the same period in 2012. This increase was driven by higher sales, the resulting operating leverage yielding EBITDA margin expansion of 20 basis points. Adjusted net income for the fourth quarter totaled $11.4 million, an improvement of 119% compared to 2012. This increase was driven by strong business performance, as well as a reduction in interest expense from the prior year.

For the full year 2013, gross profit increased 23% to $725 million. The gross margin rate for the full year was 29.7% or an increase of 20 basis points from 2012. The improvement in margin for the full year was driven by leverage in occupancy and buying cost. This was partially offset by first, lower margins in produce driven by inflation in certain commodity items when compared to the exceptional produce growing season we had in 2012. And second, lower margins in vitamins and supplements as a result of markdowns from merchandise alignment during 2013.

Direct store expense for the full year were $496 million. DSE included a loss on disposition of assets of $400,000 in 2013 and $1.4 million in 2012. Excluding these items, direct store expenses as a percentage of sales increased 10 basis points, as we utilized the leverage and payroll to invest in store-level compensation and to fund increased healthcare costs.

Selling, general and administrative expenses were $82 million for the year. SG&A for the year included $2 million of secondary offering expenses and $3.2 million of bonus paid concurrently with our IPO. For 2012. SG&A included $17 million of acquisition and integration cost related to the Sunflower transaction, $600,000 on loss on disposition of assets and a $2.7 million legal settlement charge. Excluding these items, SG&A decreased as a percentage of sales by 40 basis points, mainly as a result of leverage in payroll and store advertising costs.

Driven by leverage and margin and SG&A, adjusted EBITDA for 2013 totalled $195 million, up 33% from the prior year. And EBITDA margin rate expanded by 60 basis points to 8%. Adjusted EBIT for the year totalled $148 million, up 38% as we continue to leverage depreciation and amortization costs throughout the year. Adjusted net income for the year totalled $67 million, a 68% growth. The strong increase in adjusted net income is a reflection of the exceptional business performance and the reduction in interest rate from our April 2013 refinancing.

Moving to balance sheet and liquidity, we continue to find organic growth in the business through our operating cash flows. We generated cash flows from operations of $161 million for 2013 and invested $87 million in capital expenditures, primarily for new stores. In addition to the principal amortization paid during the fourth quarter, we voluntarily paid down an additional $40 million on our debt. And as a result, ended 2013 with a balance on our term loan of $318 million. As a result of this debt pay down, our year-end net debt to adjusted EBITDA leverage ratio, excluding leases, was 1.2 times. We ended the year with cash and cash equivalents of $78 million and $53 million available under our undrawn revolving credit facility.

As this past year has proven, Sprouts continues to maintain significant liquidity and generate strong cash flows to self-fund our future growth. Our strong performance this past year gives us a high level of confidence as we enter 2014. With the strong tailwinds of the natural and organic sector, momentum in our business across geographies and vintages, and our focused 2014 business goals that Doug discussed earlier, our 2014 guidance is as follows.

Net sales growth target of 16% to 18%, driven by 13% to 14% unit growth and same-store sales growth range of 7% to 8 %. Both of which are above our long-term guidance of 6% comp sales growth and 15% sales growth. Adjusted EBITDA growth range of 17% to 20%. Adjusted net income growth of 30%-plus and adjusted diluted earnings per share range of $0.58 to $0.60. We expect CapEx will be in the $110 million to $120 million range funded from cash flow from operations.

A few additional items to note on our guidance. First, we expect our 13% to 14% unit growth to be weighted in the second and third quarters of the year. We plan to open four stores during the first quarter, and the remaining 18 to 20 stores during the second and third quarter. Second, we expect same-store sales growth strong to be strong across the year, but more so than the first half, as we will cycle higher comps in the back half of 2014. Third, EPS guidance assumes a weighted average share count of approximately 154 million shares for 2014 compared to a weighted average share count of 140 million for 2013, driven primarily by shares issued during the IPO.

Fourth, our CapEx guidance for 2014 is higher due to strong store opening schedule during the first quarter of 2015, which will drive higher CapEx in Q4 of 2014. Fifth, we continue to benefit on cash tax payments due to the deductibility of the difference between the strike the price and exercise price as employees exercise options. Sixth, for the year, we expect to have approximately $24 million in interest expense, including capital lease interest, OID amortization, and other interest expense.

One last item to note that EBITDA growth and associated leverage is slightly impacted by increased cost from the Southeast expansion and higher healthcare costs from the Affordable Care Act. These two items, which are embedded in our guidance, impact adjusted EBITDA margins by approximately 20 basis points.

As we are nearly two months into the year, let me specific speak to the first quarter of 2014. We continue to experience strong momentum in sales for the first quarter of 2014. We have opened three new stores to date during this quarter, and the stores are performing very well. We are forecasting same-store sales growth of 10.5% to 11.5% for the first quarter of 2014, which equates to a two-year stacked same-store sales growth of 19% to 20%.

In conclusion, our strong results for 2013 and our expectations for 2014 demonstrate the confidence that we have in the sector momentum, our operations team, our store expansion capabilities and the growing awareness of the Sprouts brand across the country.