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SFM - Q2 2013 Sprouts Farmers Market Inc Earnings Conference Call

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PRESENTATION

Operator

Ladies and gentlemen, good afternoon. At this time, I would like to welcome everyone to the Sprouts Farmers Market second quarter conference call. During the presentation, all participants will be in a listen-only mode. A question-and-answer session will follow the Company's formal remarks.

(Operator Instructions)

Today's conference call is being recorded. And now, I would like to turn the call over to Susannah Livingston, Vice President Investor Relations and Communications. Please go ahead.

Susannah Livingston ***- Sprouts Farmers Market Inc - VP of IR & Communications***

Thank you, Sayid, and good afternoon, everyone. We are pleased you have taken the time to join Sprouts on our second quarter 2013 call. Doug Sanders, President and Chief Executive Officer, and Amin Maredia, Chief Financial Officer, are also on the call with me today. The earnings release announcing second quarter 2013 results and the webcast of this call can be accessed through the Investor Relations section of our website at Sprouts.com. In addition, Sprouts Form 10-Q will be filed within the next few days. During this call, Management may make certain forward-looking statements. These statements are based on Management's current expectations and are subject to change. Our actual results may differ materially.

Please read our commentary on forward-looking statements at the end of our release and in our filings with the SEC. In addition, our remarks today include reference to non-GAAP measures. For reconciliations of our non-GAAP measures to GAAP figures, please see the schedules in our news release. Lastly, we have provided summary sales and adjusted EBITDA results on a Company pro forma basis, as if the Sunflower transaction had occurred at the beginning of our fiscal year 2012. We believe these pro forma adjusted results provide a good basis to look at the operating and financial results and the performance of the combined Company on a year-over-year basis. Now let me hand it over to Doug. Doug?

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

Thank you, Susanna, and good afternoon everyone. We enjoyed speaking with many of you while out on the road earlier this month, and look forward to transparent communications as we move forward as a public Company. We're very pleased to have started off our initial earnings is a public Company with such strong results. To quickly hit the EPS for the quarter, we reported adjusted diluted earnings per share of $0.14, a significant improvement of 56% from pro forma adjusted diluted earnings from the same period in 2012. The drivers of our strong performance include new store opening, continued momentum in comparable same store sales, and the resulting operating leverage. Amin Maredia, our CFO, will discuss these in more detail shortly. For those of you who are new to our story, I would like to take a few minutes to explain Sprouts Farmers Market.

Sprouts is a fresh, natural and organic retailer with a model that is built to make healthy eating easy, understandable and, most importantly, affordable. Two of the biggest trends in the US today are health and wellness and value. So put simply, consumers want to feel better about the foods they are eating, but they don't want to feel like they paid too much. At Sprouts, we offer the right combination of health, selection, value and service that successfully meets the needs of today's consumer. First, we sell healthy products because we are a natural food store. We don't sell Coke, Tide, or Lucky Charms, so we're not a traditional grocery store that just happens to sell natural foods. Second, we're a full-line healthy grocery store, with a great selection of everything you need for a healthy diet all in one place. Including a wide selection of natural and organic packaged groceries, a scoop-your-own-bowl foods department, a vast assortment of vitamins and natural body care items, a fresh meat and seafood, deli, and bakery department, and an expansive fresh produce department. Third, we make healthy eating affordable because is that our mission at Sprouts.

And that's what separates us from our competitors and gives us the broad feel that no other natural foods retailer can match. And lastly, we provide knowledgeable and engaging customer service. There's a lot to know about natural foods. Spending time educating our customers is how we eliminate many of the challenges they face when trying to improve their diet. Overwhelmingly, the main questions we received on our IPO road show were, how are you different from other natural foods retailers? And how do you sell your produce at reduced prices and still make money? The answer lies in our go-to-market business strategy. Most natural foods retailers go to market with natural and organic package foods or vitamins, basically limiting their appeal to the lifestyle customer. The conventional supermarkets go to market with their center store CPG offering, focusing solely on price as their primary differentiator, then depend on higher margins in their perimeter departments, like produce, to offset their price investment in center store.

At Sprouts, we go to market in a completely different way. We attract both the lifestyle customer and everyday supermarket customer by featuring fresh produce at prices that are significantly lower than the commercial supermarkets. We use produce for several reasons. Produce is good for you, so it fits our healthy mission. Produce drives the repeat traffic, because you can't pantry-fill with produce. Produce is easy to understand, because everyday understand apples and bananas. But most of all, it is because produce is relevant. It's something the everyday consumer is buying every single week, so they know the prices and can see that Sprouts offers far more value for their money than any other store in the market. This gives us something that no other natural food retailer has, the ability to take market share from the $600 billion supermarket industry by targeting the everyday grocery customer with a product they understand and buy every week. Now, we still make good, margins on produce so it's not a loss leader, and we accomplish this by flipping the conventional supermarket model.

We use our massive fresh produce department in the center of our store to drive traffic, and then offset our price investment in produce by surrounding it with differentiated departments such as bulk foods, packaged grocery and vitamins, to blend to a solid margin that still allows us to offer the best prices in the markets we serve. The broad appeal of produce also attracts a wide range of customers from a variety of demographics. We then utilize our weekly promotions across the entire store to promote trial of our fresh, natural and organic products, and to prove that healthy eating doesn't have to be expensive. Through the education delivered by our knowledgeable team members, our customers gradually begin shopping more departments throughout the store, transitioning a greater portion of their food spend away from the traditional supermarket. Over time, many of our customers will actually begin using Sprouts as their primary grocery store. This transition doesn't happen overnight, but it can be seen in our store financials. As a new store matures, sales will increase 20% to 30%, and gross margins will increase 150 to 200 basis points over the first three to four years, as the store sales mix shifts towards higher-margin departments.

Another competitive advantage is our relatively simple store design. On average, we only spend approximately $2.8 million per store. This low-cost investment allows us to be the value leader in our segment, while achieving industry-leading cash on cash returns of 35% to 40% within three to four years after opening. We have been able to successfully generate these strong returns across varying demographics and geographies across the country, which excites us about our future growth. Being one of the leaders in an evolving industry like natural and organic food requires tremendous industry and product knowledge. Our recent acquisitions have allowed us to assemble the finest talent from all three companies to create one of the strongest and most experienced teams in the business. In addition, our executive Management team brings a wealth of expensive in both high-growth and large publicly-traded companies. As we told everyone on the road, growth is in our DNA at Sprouts.

During the recession, when most retailers were cutting growth, we actually accelerated our growth plans. From June 2009 to September 2010, we opened 23 stores in just 16 months on a base of only 32 stores, all while maintaining positive comp sales growth throughout the recession. Since 2011, we have completed two major acquisitions, integrating and rebranding more than 70 stores, adding four new states to our portfolio, and adding another new 20 new stores during the same time period, while again posting industry-leading comp sales growth. Our proven ability to grow, coupled with the tremendous whitespace opportunities and compelling new store economics, make Sprouts one of the most dynamic growth companies in retail today, with more than 15 years of growth runway ahead of us. Speaking of growth, during the second quarter we opened six new stores, four in California and one each in Oklahoma and Texas.

In addition, by the end of August, we will have opened an additional 6 stores since the end of the second quarter, bringing our new store count to 18, with 1 remaining to be opened in September as we continue to invest in our future growth. The 19 stores represent a split of 68% of stores in existing markets and 32% in new markets. This will position our unit growth at 13% for 2013, slightly ahead of our 12% long-term target. The positive response we have received from our customers during grand openings has been amazing. Our compelling prices, knowledgeable customer service, and differentiated retail format presents an exciting new shopping experience that resonates well with today's consumers, not to mention we have continued to raise the bar on grand opening day sales throughout this year. In fact, our new stores opened this year have sustained weekly sales above our expectations and historical measurements, as our improved merchandise offering and more recognizable brand has bolstered our sales even in new markets like Houston and Oklahoma.

We have also experienced enhanced profitability from our new stores in existing regions, as they leverage our current infrastructure. As for the future, our new store pipeline remains robust, with well over 40 sites approved for the coming years and plans to open 20 stores for 2014. Of course, none of these accomplishments would be possible without the tremendous efforts of our more than 14,000 team members. We continue to build a successful organization, with a deeper bench and additional skills needed to run a public company, putting Sprouts in an even stronger position to continue improving the health of the communities we serve. With that, I will turn the call over to Amin to speak about our second-quarter financials. Amin?

Amin Maredia *- Sprouts Farmers Market Inc - CFO*

Thank you Doug, and thank you for everyone for joining us on the call today. Before I start, as reminder, in our comparisons, we will refer to 2012 financial results on a pro forma basis, giving effect to our May 29, 2012 acquisition of Sunflower Farmer Market as if it had occurred at the beginning of our fiscal 2012. Net sales for the second quarter of 2013 increased to $622 million, up 22% over the same period in 2012 on a pro forma basis. Pro forma comparable same-store sales growth was 10.8%, as we continued to accelerate comps from recent quarters with balanced transaction count and ticket growth. As a result of our great brand recognition, tailwinds from the natural and organic industry, a more robust merchandise offering, and an improving economy in many of the states in which we operate, Sprouts achieved comparable store sales growth on a two-year stack basis of 21% for the quarter. This is the 25th consecutive quarter that stores that we manage have seen positive comparable same-store sales, including through the recessionary years of 2008 and 2009.

These sales were driven by continued strong performance in our core stores, and new store openings performing above expectations, as a result of brand building efforts which were focused on accelerating the maturity curve of stores in new markets. In addition, same-store sales momentum remained strong on a year-over-year basis across geographies, vintages and departments, as the increasing focus on health and wellness trend remains intact. We continued to see solid performance in not only our core departments, including produce, bulk, vitamin and supplements, but also in other departments, including grocery, meat and seafood, and bakery. These strong sales were a result of our efforts to continue to innovate, expand our offerings, and broaden our value positioning to create an even better shopping experience throughout the store. In addition, we are seeing the benefits of our brand building efforts ahead of our new store openings that we started this year, particularly in the social media arena.

Shifting to gross profits, gross profit for the second quarter, which includes occupancy, buying, and utility cost, increased 23% to $187 million over the same period in 2012 on a pro forma basis. Gross margin as a percentage of sales increased 10 basis points to 30.1% over 2012 on a pro forma basis. The increase of ten basis points was driven by leverage of occupancy and buying costs, which was offset by two items. First, normalization of produce cost in the first half of 2013 versus the prior year. And second, alignment of pricing in our vitamin department across the Sprouts and legacy Henry's and Sunflower stores. Direct store expenses of $123 million decreased as a percentage of sales by 50 basis points over 2012 on a pro forma basis, driven by leverage in labor cost and other direct store expenses, up 20 basis points and a $1.3 million or 30 basis points charge from the loss on disposal of assets in the second quarter of 2012.

Selling, general and administrative expenses of $21 million decreased as a percent of sales by 120 basis points over 2012 on a pro forma basis, as a result of leverage in corporate infrastructure and advertising cost of 30 basis points, and $4.3 million or 90 basis points, of acquisition and integration costs in 2012. Excluding the one-time items, adjusted EBITDA for the second quarter totaled $53 million, up 27% over the same period in 2012 on a pro forma basis. This increase was driven by higher sales and improved margins from leverage in occupancy, labor and SG&A. Adjusted EBIT for the quarter totaled $41 million, up 33% over the same period in 2012 on a pro forma basis. On a GAAP basis, net income for the second quarter was $12.5 million, up $7.2 million, or 135%, from the same period in 2012. Adjusted net income for the second quarter totaled $18 million, an improvement of 51% compared to 2012 on a pro forma basis. This increase was driven by continued momentum in business performance, including strong sales on new stores opened and the operating leverage at store level and corporate costs from higher comparable store sales.

Year-to-date, for the 26-week period ended June 30, 2013, net sales increased 19% to $1.2 billion when compared to pro forma net sales for the same period in 2012, driven primarily strong performance in the core stores, as well as new store openings performing above expectations. Gross profit increased 18% to $361 million when compared to pro forma gross profit for the same period in 2012. Our gross margin rate of 30.2% decreased 30 basis points from the same period in 2012 on a pro forma basis. This decrease in margin year-to-date is attributable primarily to produce inflation in the first five months of 2013. Again, 2012 was a great produce year, a very moderate winter and an early growing season. We have seen a more normal produce year in 2013, with a few freezes, and hence, produce inflation over 2012. Year-to-date, adjusted EBITDA totaled $105 million, up 21% compared to the prior year, driven by improved business performance discussed earlier. In summary, our sales and growth and profitability continue to be anchored by strong traffic to our stores, underwritten by our laser focus on providing healthy living at the best prices in every market we serve.

Moving to the balance sheet and liquidity, we continue to build a strong balance sheet and improve our liquidity. Year-to-date, for the 26-week period, we generated cash from operations of $101 million and reinvested $52 million in capital expenditures, primarily from new stores. The Company ended the quarter with principal balance on its term debt of $700 million, had $66 million in cash and cash equivalents, and $52 million available under its undrawn revolving credit facility. On August 6, 2013, Sprouts closed its initial public offering of 21.3 million shares of common stock, including 2.8 million shares issued as a result of the exercise of the underwriters' option to purchase additional shares. The Company received net proceeds from the offering of approximately $345 million, after deducting underwriter discounts and offering expenses, and paid down $340 million of outstanding debt under our term loan facility. After the payment, our current principal balance on our existing term loan is $360 million.

Additionally, as a result of this debt pay-down, the interest rate on our term loan will drop 50 basis points, to LIBOR plus 3%, in the fourth quarter of 2013. We are extremely pleased with our cash flow from operations and a stronger capital structure following the IPO. The strong performance in the first half of 2013 gives us great confidence for the remainder of the year in achieving our targets. We expect to open 19 stores in 2013 and generate pro forma comparable store sales growth of 8.5% to 9%. We expect to generate full-year 2013 sales growth of 19% to 21%, compared to pro forma 2012 sales. Keep in mind that our average sales and gross profit margin are typically lowest in the fourth quarter of the year, due to seasonally slower produce sales in the winter months and increased promotional activities during the holiday season, which have an adverse impact on our overall margins. We expect to generate adjusted EBITDA of $180 million to $185 million, a growth range of 22% to 26% versus the prior year on a pro forma basis.

Lastly, our net income is expected to be in the $44 million to $47 million range, and adjusted net income in the $57 million to $60 million range, and adjusted diluted earnings per share of $0.41 to $0.43. Based on the issuance of shares in the IPO, weighted average diluted shares outstanding will be approximately 145 million for the third quarter, 153 million for the fourth quarter, and 140 million for the full-year 2013. In addition, the Company forecasts approximately $70 million to $75 million on capital expenditures. I will now pass it back to Doug for some closing remarks. Doug?

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

Thank you, Amin. 2013 has been a very exciting time for our Company. Our mission to bring fresh, natural, and organic products at compelling prices to more and more communities continues to drive our Company today as much as it did on day one back in 2002. With strong sector tailwinds, our dedicated team is focused on our customers, and a strong operations and management team in place, we're very pleased with the results in the first half of 2013 and confident in delivering on our financial results for the remainder of the year. We will now open it up for questions. Operator?