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SFM - Q3 2013 Sprouts Farmers Market Inc Earnings Conference Call

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PRESENTATION

Operator

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

(Operator Instructions)

As a reminder this conference call is being recorded.

I would now like to turn the conference over to Ms. Susannah Livingston, Vice President of Investor Relations and Communications.

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

Thank you, and good afternoon, everyone. We are pleased you have taken the time to join Sprouts on our third-quarter 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' form 10Q, the earnings release announcing third-quarter 2013 results, and the webcast of this call can be accessed through the investor relations section of our website at Sprouts.com.

During this call management may make certain forward-looking statements. These statements involve a number of risks and uncertainties that could cause actual results to differ materially. Please note that these forward-looking statements reflect our opinions only of the date of this call. And we undertake no obligation to revise or publicly release the results of any revisions to these forward-looking statements in light of new information or future events. 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 reconciliations of our non-GAAP measures to GAAP figures, please see the schedules in our earnings release. Lastly, in comparing our results to the comparable period in 2012, we discussed 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 in the performance of the combined Company year over year.

Now, let me hand it over to Doug.

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

Thank you, Susannah.

Good afternoon everyone, and thanks for joining us today. It's definitely an exciting time at Sprouts, and we are very pleased to report strong third-quarter results. To quickly hit the EPS for the quarter we reported adjusted diluted earnings per share of $0.13, a significant improvement of 117% from the same period 2012.

On a GAAP basis we reported EPS of $0.08 per share, compared to $0.01 in the same period of 2012. The third quarter continued to benefit from our growing brand awareness, new product innovation, improved merchandising, strong operational performance and improving economies in the states in which we operate. Our performance this quarter further illustrates that Sprouts is sitting at the intersection of two big trends in America today; health and value. And our model continues to deliver strong topline growth.

Revenues grew 24% during the quarter driven by new store openings and continued momentun in comparable same-store sales, which ended the quarter at 10.2% and 20.2% on the two year [stag] basis, underscoring the everyday consumer's desire for healthier foods at affordable prices. As you know, the foundation our value proposition is fresh, high-quality produce, which we offer at prices we believe are significantly below those of conventional food retailers.

Our produce offering attracts a wide range of consumers to our stores, giving us the opportunity to showcase our extensive assortment of natural organic and fresh foods and knowledgeable customer service. Over time, we believe our value pricing, extensive product offering and differentiated customer experience transition many of these trial customers into loyal lifestyle customers who shop Sprouts with greater frequency and across an increasing number of departments.

Our customers responded positively to our promotional activity this quarter, as evidenced by the increase in store traffic and average basket size. Traffic increased approximately 5.5% during the quarter. We also saw more customers purchasing discretionary items, such as premium meats and wines, artisan breads and cheese, and packaged groceries, including Sprouts private label items. Our Sprouts private label products continued to gain traction with sales growth of 19% during the quarter on a comparable store basis. Our focus on the quality and value of our private label products is clearly resonating with our customers.

The natural and organic space continues to grow, reflecting the health and wellness movement across the country. With that growth comes more innovation, and this year we've introduced 100s of new items to our stores including more than 250 new private label items. In addition we have made improvements to our product quality, ingredient standards and overall assortment in areas such as packaged grocery, frozen foods, bulk, bakery and deli, as we align the three banners of Sprouts, Henry's, and Sunflower.

Organic store growth remains a top priority and in the third quarter we opened 7 new stores; 4 in Texas, 2 in Arizona, and 1 in Colorado. This brings our new store count to 19 for the year and completes our new store openings for 2013, ending with 167 stores and 13% unit growth. The new stores continue to exceed our expectations driven by increased awareness of our brand and a more robust product offering. In fact, 8 of the 15 biggest opening days in the history of our Company happened in 2013, and we also set a new opening day sales record, not once, but twice in two weeks, at stores in Colorado and Texas.

The majority of these stores opened in existing markets with the benefit of our brand awareness. The stores in new markets are performing at or above expectations and the 2012 stores that are not yet in our comp base are just starting to hit their stride and performing extremely well. In addition, we continue to reinvest in our current stores and have remodeled nine stores this year with three more to go by year end. The customers' response to these remodels has been positive, and early analysis has shown an incremental 2% to 4% lift in comp sales in these stores. That's an incremental positive and it allows us to maintain superior store conditions, which is one of our core promises to our customers.

Our real estate pipeline remains robust as we continue to invest in future growth. To date we have more than 55 sites approved for the coming years and have signed 30 leases for stores to be opened in 2014 and 2015. We're very excited about our planned 2014 entry into the Atlanta market and we believe our concept will be well-received as it has been in previous new markets.

We will develop Atlanta similar to our strategy we used when entering the Texas market in 2005, and the Colorado market in 2008. We will start with a small cluster stores, set up regional supervision, and eventually look to open a produce distribution center as part of our Southeast expansion. We have always been very methodical about our store openings and will continue this discipline as we work hard to grow our brand across the Southeast.

The growth we're achieving is not only bringing healthy living for less to more and more communities, but it is bringing jobs as well. We have already grown our team by 28% this year, with more than 14,000 Sprouts team members to date. We take training and support of our team members very seriously as they are the front line to our customers every day. That said, internal promotions are vital to protecting our brand and our bottom line. This year we have already promoted more than 2,000 team members, with over 700 of those occurring in the third quarter alone.

It is clear to us that our Company's accomplishments are the result of strong teamwork, and that was especially evident this quarter. As many of you know, Colorado fell victim to heavy rains and flash floods in September, and one of our stores in Boulder, Colorado, sustained major flood damage and was closed for 11 days. Now, fortunately, all of our team members were safe, but I bring this up to demonstrate the strength of our team. Keep in mind the store sustained about three feet of water, and everything in the store had to be cleared, rebuilt, and inspected prior to reopening. All products and damaged fixtures were replaced, from groceries to gondolas, and I am proud to announce that we were able to salvage 2.5 semi trailers of non-perishable food and paper products that we donated to local food banks.

In the days following the store's reopening, we continued to give back to the community through a 72 hour sale, a grab and give promotion, and a cash donation to the Foothills United Way. But even more impressive is what our team accomplished working 24/7 to get the store reopened and serving the Boulder community as they rebuilt after this tragic event. This is a true testament to the Sprouts organization and I couldn't be more proud of what our team accomplished in such a short time.

With that, I will turn the call over to Amin to speak about our third-quarter financials.

Amin Maredia *- Sprouts Farmers Market Inc - CFO*

Thank you, Doug, and thank you all for joining us today on the call.

Before I start I want to remind you that I will refer to our 2012 financial results on a pro forma basis, giving effect to our May 2012 acquisition of Sunflower Farmer's Market as if it had occurred at the beginning of 2012.

Let me first start with Q3 performance. Net sales for the third quarter of 2013 ended higher than our expectations and increased to $634 million, up 24% over the same period in 2012. Once again, we have been able to build on our momentum from the first half of 2013 and deliver another strong quarter. New stores continue to perform above expectations through our brand-building efforts and a more robust product offering. Comparable same-store sales of 10.2% continued to be strong on a year-over-year basis and were consistent across all departments, geographies, and [vintages.]

Our more recent vintages in our comp base also continue to perform very well. The 10.2% comp increase was driven by approximately 5.5% rise in traffic and approximately 4.5% boost in average basket size. This basket size included inflation of approximately 2% with the remaining increase driven by an improved product mix. Inflation continued to be relatively modest across the board, with a strong quarter comp performance, a two year stacked comparable store sales growth totaled 20.2% for the quarter.

Gross profit for the third quarter, which includes occupancy, buying, and utility costs, increased 30% to $190 million over the same period in 2012. Gross margin as a percentage of sales increased 130 basis points to 30% over 2012. This increase of 130 basis points was driven by the cycling of certain promotions and product markdowns related to merchandise realigment that we implemented in the third quarter of 2012 during the integration of Sunflower. And also leverage in occupancy and buying cost driven by the strong comp sales performance. This leverage was partially offset by lower margins in produce due to tighter supplies in certain fruit and vegetable items compared to the prior year.

Direct store expenses of $129 million decreased as a percentage of sales by 10 basis points over 2012, driven by lower noncapitalizable store development costs, as well as leverage in store supplies and depreciation cost. This leverage in DSE was partially offset by higher healthcare costs and higher bonus payouts based on our strong Company's results.

Selling, General, and Administrative expenses, or SG&A, were $23 million for the quarter. SG&A during the quarter included a $3.2 million bonus payout to our team members in connection with our IPO. In the third quarter of 2012, SG&A included $5.6 million from costs associated with the Sunflower integration and a $2.7 million legal settlement charge. Excluding these items, SG&A decreased as a percentage of sales and leveraged by 10 basis points, mainly as a result of leverage in advertising cost. In support of our group's future growth plans, including expansion into the Southeast, we continue to invest in people and infrastructure for future growth. Adjusted EBITDA for the third quarter totaled $53 million, up 63% over the same period in 2012. This increase was driven by higher sales margins, and the resulting operating leverage. Adjusted EBIT for the quarter totaled $40 million, up 83% over the same period in the prior year as we continued to leverage depreciation and amortization costs.

On a GAAP basis, net income for the third quarter was $11.5 million, up $10.2 million from the same period in 2012. Adjusted net income for the third quarter totaled $19.5 million, an improvement of 160% compared to the prior year. This increase was driven by the explanations I mentioned earlier, as well as a reduction in interest expense from the partial payout of our term loan with the proceeds of our IPO, and reduction in interest rate versus the prior year from our April 2013 refinancing.

For the 39-week period ended September 29, 2013, on a pro forma basis, net sales increased 21% to $1.8 billion driven by strong performance in the core stores as well as new store openings, which are performing above expectations. Gross profit for the year increased 22% to $551 million over the same period in 2012. Gross margin rate of 30.1% increased by 20 basis points from the same period in 2012. Adjusted EBITDA totaled $157 million year to date, up 33% from the same period in 2012, demonstrating our ability to continue to drive the business with a laser focus on bringing our customers quality and innovative healthy product offerings and strong customer engagement through service and education.

Moving to balance sheet and liquidity, our focus remains on funding organic growth in our business through our operating cash flows. We generated cash flows from operations of $143 million year to date, through the end of the third quarter, and reinvested $75 million in Capital Expenditures, primarily for new stores. We ended the quarter with a principal balance on our term loan of $360 after paying down $340 million of outstanding debt with proceeds from the IPO of 21.3 million shares of common stock. As a result of this debt pay down, our net debt to adjusted EBITDA leverage ratio on an LTM basis is now at 2.1 times, and as a result the interest rate on our term loan dropped 50 basis points post-IPO to LIBOR plus 3%. In addition, cash and cash equivalents totaled $92 million at the end of the third quarter, and we had $52 million available under our undrawn revolving credit facility.

Our sustained strong performance this quarter gives us confidence to increase our guidance for the year to adjusted diluted earnings per share of $0.45 to $0.46 from our previous estimate of $0.41 to $0.43. Our previous guidance -- our EPS guidance for the year assumes a weighted average share count of approximately 140 million shares. We project diluted earnings per share from $0.05 to $0.06 for the fourth quarter, which assumes a share count of approximately 153 million for the fourth quarter. As noted on our last earnings call, our average sales and gross profit margins are typically lowest in the first quarter -- fourth quarter -- 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 in the fourth quarter compared to the first three quarters of the year. Â¶

Embedded in our full-year guidance, we expect to generate comparable store sales growth of 9% to 9.5% for the full year, higher from our previous guidance of 8.5% to 9%. We expect full-year 2013 sales growth of 20% to 21% compared to -- again, higher from our previous range of 19% to 21%. We also expect to generate adjusted EBITDA of $188 million to $192 million, higher than our previous range of $180 million to $185 million. Our net income is expected to be in the $48 million to $50 million range, and adjusted net income in the $63 million to $65 million range from our previous adjusted net income range of $57 million to $60 million. Lastly, we expect to spend approximately $70 million to $75 million on Capital Expenditures net of landlord reimbursements, consistent with our previous guidance.

This solid growth not only demonstrates the strength of our operations team, our successful store expansion capabilities, and growing awareness of the Sprouts brand across our geographies, but it also further defines our growth plans for the future. We are currently in the middle of the planning process for 2014 and we will provide you full-year 2014 guidance on our year-end call. However, we would like to give our shareholders some insight into 2014. THe encouraging results that we're seeing in 2013 and the continued momentum in health and wellness trends and growth trends in the natural and organic sector, gives us confidence to believe our 2014 plan will fall within our stated long-term guidance of 15%-plus sales growth, 17% to 20% EBIT growth, and over 20% net income growth.

We are closely monitoring the potential impact of the Affordable Care Act as we are now in our benefits enrollment period, and we will share any potential impact of this on our 2014 guidance during our year-end call.

Lastly, as you may have seen, earlier today we filed a form S-1 registration statement relating to the proposed sale of our common stock held by Apollo and certain other shareholders. Sprouts will not be receiving any proceeds from the sale of stock in this offering.

With that, let me now pass it back to Doug for some closing remarks.

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

Thank you, Amin.

As seen in the third-quarter results, our sales strength remained strong and profitability remains on track. We continue to attract more and more everyday consumers wanting to eat healthier through our investment in healthy products at affordable prices. The natural and organic sector remains robust, our dedicated team is focused on operations, we've mapped out a clear path for growth and we are confident and excited about the remainder of this year and the years to come.