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SFM - Q3 2016 Sprouts Farmers Market Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Sprouts Farmers Market third quarter 2016 earnings conference call. (Operator instructions).

I would like to hand it over to Susannah Livingston. Please go ahead.

Susannah Livingston - ***Sprouts Farmers Market Inc - IR***

Thank you and good morning, everyone. We are pleased you have taken the time to join Sprouts on the third quarter 2016 earnings call. Amin Maredia, Chief Executive Officer; Jim Nielsen, President and Chief Operating Officer; and Brad Lukow, Chief Financial Officer, are also not the call with me today.

Sprouts' 10-Q, the earnings release announcing our third quarter 2016 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 forward-looking statements including statements regarding our future performance in growth, product expansion, new store openings and 2016 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 issued today.

In addition, our remarks today include references to non-GAAP measures. For reconciliation of our non-GAAP measures to GAAP figures please see the tables in our earnings release. For 2015 we have presented adjusted net income and adjusted earnings per share and adjusted EBITDA with adjusted measures stated in the reconciliation tables in our earnings release.

For the third quarter of 2016, such adjustments would be immaterial. As such we have presented net income, earnings per share and EBITDA without adjustments. For the third quarter 2016 diluted earnings per share was $0.16.

With that let me hand it over to Amin.

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

Thank you, Susannah. Good morning, everyone, and thanks for joining us today.

In the third quarter we remain focused on driving top line sales and strategically building our business for long-term growth while managing the current environment. Sprouts net sales grew to $1 billion up 15% compared to the prior year. We are pleased with our 2016 new stores, which are performing well with new store productivity above 80% for the third quarter.

Comparable store sales for the quarter were 1.3% comprised of 1.2% increase in basket and traffic of 0.1%. Comp sales were impacted primarily by cost and retail deflation as well as higher canibalization. Cost deflation was approximately 2% during the quarter and led by protein, dairy, bulk and produce, which also turned deflationary during the quarter..

Nearly 60% of our business is fresh which is on trend, drives frequency and adds strength in our business model, however, today all of these departments are deflationary and impacted our sales and same store sales this quarter. When deflation expands across multiple categories and extends for several quarters it's not uncommon to see higher promotional activity in our industry, which leads to retail deflation higher than cost deflation and this is what we saw during the third quarter. The last time the industry experienced deflation and investments similar to the current environment was in 2009.

Historically we have seen that when deflation turns comp sales, sales and margin follow a similar positive movement. Based on what we are seeing today, we expect the promotional environment to continue in the near term. We continue to remain competitive and invest as appropriated. Based on the slightly better than expected third quarter sales performance we are raising the bottom of the full year same stores sale growth guidance to 2%. Brad will discuss the guidance in detail later.

Outside the impact from the deflationary environment, I remain confident in the core of our business, our business model and bring our ability to continue to bring fresh and healthy foods at value prices to more customers every day. Let me touch on the progress of our key initiatives and why I remain excited about our core business.

First we continue to expand our trusted natural and organic private label program based on strict ingredient standards and a great taste profile. Our private label program now accounts for over 10% of our revenue and continues to significantly outpace our company average in both sales growth and comps. We currently have over 2100 private label items and plan on continued growth in this area for years to come.

Second, our small box format remains an advantage for Sprouts allowing quick in-and-out service, which provides opportunity to expand convenience offering such as our fresh food and deli work. We have implemented food and deli expansion in 73 new and existing stores this year with a few more stores to go during the balance of the year. This expansion includes a freshly prepared protein and sides full service case, a salad bar, fresh juices and soup station.

I recently reviewed the plans for 2017 and I'm excited about adding our food and deli initiative to more existing and new stores and also leveraging this platform to enhance our fresh offering even further. Third, innovating with our vendor partners has enabled us to build and broaden our partnerships and also launch new unique and exciting products and programs like a Hatch Chili program released earlier this summer and new holiday items like chipotle cranberry salsa and dark chocolate drizzled kettle corn.

We look forward to the holiday season and building on our past success. Our sales teams have worked hard to bring forward both branded and private label products that will provide a healthier holiday season for our customers. Fourth, service remains a top priority for our more than 24,000 team members.

We continue to have one of the best customer service (inaudible) in the industry and continue to receive great feedback from our customers every day. Our commitment to increased training investment, has a strategic priority in 2016, was based on feedback from our team members survey.

Our team members in the store desired more product knowledge to better serve our customers as we have recognized this knowledge and service separates us from others in the industry. These training programs are also building our next generation store leader as we continue to grow coast to coast. We are also starting to see the benefits of this program with better customer service numbers today.

On the digital front we have more than 3 million digital customers online and we continue to increase our engagement with them through e-mails and social media and the Sprouts app, which is increasing functionality such as mobile coupons. All of these digital initiatives are focused on driving customer engagement and improving their experience across all touch points.

We also continue to expand our partnership with Amazon Prime now with the addition of two more locations capitalizing on Sprouts' strength of fresh and affordable products. On the infrastructure front, our technology and infrastructure priorities for scale are progressing very well. I'm pleased with the foundation our newly formed business intelligence team is building.

We have put some of our best resources at the company in this area and our priorities are fully aligned with our overall business plan and we look forward to leveraging this platform in the future to better understand our customer preferences and enhancing overall customer experience, engagement, and loyalty. Lastly, on the new storefront we added 10 new stores in the third quarter with an additional three in the fourth quarter and remain on track for a total count of 253 stores by year end.

Our 2016 vintage performance reflects our on going efforts to refine our site selections coupled with consistent operational performance. Our pipeline remains strong with 57 approved sites and 38 signed leases for the coming years. Atlanta will be the home to our fourth produce distribution center opening later this quarter.

We also look forward to bringing healthy living to two new states in 2017, Florida and North Carolina, which increases our reach to 15 states. Before I hand it over to Brad, I want to say that I'm extremely proud of our teams in the stores and the office as they continue to manage the near term while staying laser focused on what makes Sprouts Sprouts.

Innovating great tasting, healthy products at valued prices, excellent store locations and knowledgeable and approachable customer service. Our team is more connected and focused than ever before in navigating the current environment while focusing on our strategic initiatives to enhance our healthy living business that will continue to resonate and excite our customers for years to come.

With that let me turn the call over to Brad to speak about our financial results and guidance.

Brad Lukow - ***Sprouts Farmers Market Inc - CFO***

Thank you, Amin.

I'll begin by discussing some of the business drivers for the third quarter and then review our guidance for the remainder of the year. For the third quarter, sales were up 15% with comp sales growth of 1.3%, slightly better than we expected in light of the competitive environment higher cannibalization and the ongoing deflation of nearly 2%, the highest we have experienced all year.

For the third quarter, gross profit increased by 11% to $292 million and our gross margin rate decreased 80 basis points to 28.1% compared to the same period in 2015. 60 basis points of this reduction was due to price investments in certain categories in order to maintain our competitive pricing position along with slightly higher shrink from lower comp sales growth.

In addition, occupancy expense deleveraged 20 basis points, including the negative impact related to a credit received in the prior year period. As we have stated in the past, we will continue to be a sales minded company and we'll be aggressive when necessary to drive our traffic as we look to build this business over the next five to ten years.

For the third quarter, direct store expense was $217 million and as a percentage of sales was 20.9%, an increase of 130 basis points after excluding the pretax loss on disposal of assets in the third quarter of 2015, 30 basis points of this increase related to cycling a lower medical expense from the prior year. The remaining increase was primarily due to deleverage from lower comp sales growth, higher payroll expense from planned increases in wages, and training costs implemented at the beginning of the year and the impact of opening a greater number of new stores in 2016.

SG&A totaled $30 million for the quarter and as a percentage of sales was 2.9%, an improvement of ten basis points compared to the same period last year. This was primarily due to lower bonus expense, partially offset by higher stock-based compensation expense related to executive changes made in the third quarter of 2015.

EBITDA for the third totaled $63 million this was a decrease of 14% when compared to adjusted EBITDA in the same period of last year. This reduction was primarily driven by lower margins as a result of the stepped up promotional environment during the quarter, increased labor costs and higher pre-opening costs driven by additional expenses associated with the Hagen stores that we opened this quarter.

Net income for the third quarter was $24 million a decrease of 27% from the adjusted net income in the same period last year. Diluted earnings per share was $0.16 from the quarter a decrease of 24% from adjusted diluted earnings per share of $0.21 in the same period of last year.

Shifting to the balance sheet and liquidity, we continued to utilize our solid operating cash flows to fund our business and, in combination with our strong balance sheet, return capitol to our shareholders. On a year to date basis we have generated $196 million of cash from operations up 9% from the same period last year and invested $135 million in capital expenditures net of landlord reimbursement primarily for new stores.

Through the third quarter we repurchased $188 million or approximately 8.2 million shares under our share repurchase authorizations. Subsequent to the end of the quarter and through October 31st we repurchased an additional 2.9 million shares for a total investment of $249 million for the year. We ended the quarter with $50 million in cash and cash equivalence and $205 million borrowed on our revolving create facility.

On an LTM basis net debt to EBITDA was 0.9 times at the end of the quarter. With our strong operating cash flows and low debt levels we are well positioned to continue to self-fund our growth plan and maintain our strong liquidity position. Let me now turn to 2016 guidance. Given our third quarter performance we have raised the lower end of the range for full year comp sales growth and we are maintaining our EPS guidance as updated on September seventh.

Guidance for these elements and others are as follows, we expect comp sales growth in the range of 2% to 2.5% for the year. This would imply roughly a flat fourth quarter comp slightly better than we thought back on September seventh.

Diluted earnings per share in the range of $0.83 to $0.86 and net sales growth of 14.5% to 15% on a comparable 52 week basis and in line with our September guidance update. EBITDA growth 0% to 2% on a 52 week basis when compared to adjusted EBITDA in the prior year. We remain on track it to open 36 new stores and CapEx will be in the range of $160 million to $165 million, net of landlord reimbursements.

A few additional items to note on the 2016 guidance. As many of you know we will experience a tough compare in the fourth cycling our highest comp quarter for 2015 of 7.4%. The competitive environment has remained consistent over the past few months and we continue to maintain a cautious outlook. We anticipate that the deflationary environment will continue for the balance of 2016 with cost deflation of approximately 1% for the fourth quarter.

As it relates to margins we will continue to make price investments as necessary to drive traffic and to maintain our competitive position. For the full year we would expect gross margins to be flat on a 52-week basis. On the direct store expense line we expect to continue to delever DOC as a percentage of sales through the rest of the year due to higher store payroll expense and deleverage from our expected comp sales growth.

On the SG&A line in the fourth quarter we expect continued leverage similar to the third quarter as many of our investments for this year are now complete. Below the EBIT line we expect interest expense to be approximately $15 million, including interest related to financing and capital leases. We also expect a weighted average and diluted share count of approximately 150 million shares for the year and a corporate tax rate of roughly 38%.

In conclusion, in the face of the current competitive environment, we are pleased with our ability to drive top-line sales growth. We remain steadfast with our strategic initiatives while managing the day-to-day competitive environment to best position Sprouts for long-term growth.

With that, we'd like to open up the call for questions. Operator.