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SFM - Q2 2016 Sprouts Farmers Market Inc Earnings Call

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PRESENTATION

Operator

Good day ladies and gentlemen. Welcome to the Sprouts Farmers Market second quarter 2016 earnings conference call.

(Operator Instructions)

As a reminder this conference call is being recorded. I would now like to turn the conference over to Susannah Livingston. You may begin.

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 our second quarter 2016 earnings call. Amin Maredia, Chief Executive Officer; Jim Nielsen, President and Chief Operating Officer; and Brad Lukow, Chief Financial Officer are also on the call with me today.

Sprouts' 10-Q, the earnings release announcing our second 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 certain forward-looking statements, including statements regarding our future performance and 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 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 a reconciliation of our non-GAAP measures to the GAAP figures, please see the tables in our earnings release. For 2015, we have presented adjusted income, adjusted earnings per share, and adjusted EBITDA with adjusted measure stated in the reconciliation tables in our earnings release. For the second quarter of 2016, such adjustments would be immaterial.

As such, we have presented net income, earnings-per-share and EBITDA without adjustments. For the second quarter, diluted earnings per share of $0.25 increased 14% from adjusted diluted earnings-per-share of $0.22 in the same period in 2015. With that let me now hand it over to Amin.

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

Thank you, Susannah. Good morning, everyone, and thanks for joining us today. We are pleased to report solid top-line sales growth and bottom-line results in the second quarter. For the quarter, Sprouts net sales grew to $1 billion, up 14% compared to the prior year.

Comp store sales for the quarter were 4.1%, led by traffic up 3.5% during the quarter and higher tonnage. Comp store sales and overall sales were impacted by deflation of 1% during the quarter. Our team remains laser focused on managing the business during this deflationary environment, and is equally focused on our strategic priorities around product innovation, customer engagement, and building an organization for scale and long-term growth.

I'm very proud of our sales operations and store teams who continue to focus on driving top-line sales and traffic to our stores. All departments within the store experienced positive comp store sales growth, despite significant deflation in proteins and recent deflation in certain other categories.

To briefly expand on deflation, during the quarter dairy and bulk became progressively more deflationary, protein remained at similar deflationary rates to the first quarter, and produce became less inflationary in the back half of the quarter. This resulted in 1% deflation for the entire quarter, which was slightly worse off than our original expectation.

We expect the deflationary environment to continue through the back half of the year and Brad will cover this in detail. The competitive environment for the second quarter was more promotional. As we noted on our last call, during a period of sustained deflation, it is not uncommon for grocers to start beginning more promotions to drive sales.

We have managed through these deflationary environments before and have seen the business rebound strong coming out of these periods in the past. The entire team is collectively focused on our proposition of help, value, customer engagement and service as anchors in our business. And during deflationary periods we recognize these assets become greater opportunities to differentiate Sprouts from the competition.

On the new storefront, we added 12 new stores in the second quarter and three more to date this quarter to bring a current total store count of 243 stores. Our new stores continue perform well with our new store productivity in the [mid-70s] range. Our pipeline remained strong with 58 approved sites and 37 leases signed for the coming years.

After attending the annual ICSC real estate conference and speaking with many of our development partners, we are confident in our ability to partner with the best developers in the country. They recognize the strength of the Sprouts brand and our ability to drive significant traffic to their centers, allowing us to continue to develop in secure, strong locations. Let me now shift to our 2016 priorities.

Let me start with product innovation. Our private label items continue to outpace our Company average in both sales growth and comps. We have launched more than 200 new items year to date, already meeting our goal of 2,000 private label items in 2016 and we still have more to come this year.

In the second quarter, we launched exciting items like our organic Kombucha product line, our Sprouts Essential Body Care line, and continue to build our Sprouts Market Corner Deli with more grab and go meals. We continue to roll out our expanded deli offerings into our existing stores as well as in many of our new stores. To date, 32 existing stores and 23 new stores, for a total of 55 stores, include our expanded components such as salad bars, protein service case, fresh juice, specialty coffee and soup stations.

These enhancements continue to be well received by our customers and enhance our position as a ready-to-eat destination. Our focused priorities in private label, deli offering, expanded local program, and our meat and seafood program, continue to resonate with our customers and even better position Sprouts to be an everyday healthy grocery and food destination. Let me shift to priorities around our team.

Every day, our more than 23,000 team members inspire, educate, and empower our guests to live healthier lives. And customers response indicate that the team is doing a fantastic job, as our overall customer service scores continue to go up. At Sprouts we want to continue to raise the bar in food retail and in 2016 committed to deeper product and leadership training. We are seeing the benefits of this training with stronger operational conditions and greater customer engagement in our stores.

Additionally, we had our first ever national hiring day in the second quarter. This event was a huge success by any measure, enabling us to hire more than 1,000 team members. We welcome these team members and we look forward to their contribution and growth at Sprouts. Lastly on technology and infrastructure, we completed and successfully implemented a new HRIS system, as well as rolled out an automated labor management system to all of our stores.

The labor management system will enable our stores to have appropriate staffing levels during peak times, driving greater customer engagement and service levels. Our technology team today is spending more time than ever focusing on supporting customer experience. During the quarter, we also continued to expand our partnership with Amazon Prime Now, with Dallas becoming the fourth major metro area with the Sprouts delivery service, and we are continuing to explore further expansion of this program.

Our focus in our strengthening the Sprouts brand and engaging with the customers in meaningful ways, whether that be through our mobile app, social digital communities, email, and other ways we connect with our more than 3 million digital customers. We are developing deeper plans for customer engagement and will share more in the coming months as we roll out these platforms.

In summary, I'm extremely proud of what our team has delivered in the current environment. We know our opportunities are even greater and we remain focused on our strategic initiative to drive sales, further brand loyalty and build a platform for longer-term growth. 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. Let me spend a few minutes discussing some of the business drivers for the second quarter and guidance for the remainder of the year. As Amin stated, we are pleased with our top and bottom line results for the second quarter of 2016. And in particular, with our comp sales growth of 4.1% with overall deflation coming in at 1%.

For the second quarter, gross profit increased by 16% to $306 million and our gross margin rate improved 40 basis points to 29.6%, compared to the same period in 2015. This leverage was primarily due to deflation in certain categories, including protein, driving higher margins, as well as improvements from Shrink. Direct store expense was $207 million for the quarter, and as a percentage of sales was 20.1%, an increase of 40 basis points compared to the same period in 2015.

This was primarily due to higher payroll expense from planned wage increases and training costs implemented at the beginning of the year, as we continue to invest in our team members in 2016. SG&A totaled $31 million for the quarter and as a percentage of sales was 3%, an increase of 40 basis points compared to the same period last year.

This was primarily due to higher stock-based compensation expense, due to executive changes made in the third quarter of 2015, higher bonus expense compared to the prior year, and higher corporate overhead, as we continue to build the foundation to support our growth. The second quarter was the heaviest investment quarter for 2016.

The implementation of our new HRIS and labor management systems together with the formation and development of our business intelligence team, position us well to improve operations and leverage our data in order to better serve our customers and sustain our growth. EBITDA for the second quarter totaled $84 million. This was an improvement of 8% when compared to adjusted EBITDA in the same period last year.

EBITDA margin came in at 8.1%, 50 basis points lower than the second quarter last year. And this was primarily driven by planned investments made during the quarter and higher pre-opening costs driven by a greater number of stores opened in the second quarter versus the same period last year, as well as additional expenses associated with the four Hagen stores to be opened in the third quarter.

Net income for the second quarter was $37 million, an increase of 6% from adjusted net income in the same period last year. For the second quarter, diluted earnings per share of $0.25 increased 14% from adjusted diluted earnings per share of $0.22 in the same period in 2015. These results were driven by top-line sales growth and margin improvement, lower interest expense, as a result of last year's voluntary pay down on the revolving credit facility, and share repurchase activity also contributed to EPS growth.

Shifting now to the balance sheet and liquidity. Our balance sheet remains strong as we continue to generate solid operating cash flows. Through the first half of 2016, we generated $148 million of cash from operations, up 22% from the same period last year, and invested $79 million in capital expenditures net of landlord reimbursement primarily for new stores.

During the second quarter we repurchased $65 million, or roughly 2.5 million shares, fully utilizing our $150 million share repurchase authorization. We ended the quarter with $78 million in cash and cash equivalents. With our strong operating cash flows and low debt levels we are well-positioned to self fund our growth plan and build upon our strong liquidity position.

Let me now turn to 2016 guidance. As a result of the deflationary environment, we are adjusting our guidance for the year to the following: Net sales growth of 13% to 14%. On a comparable 52-week basis, this equates to net sales growth of 15.5% to 16.5% from the previous 52-week basis range of 17% to 19%. Comp store sales growth in the range of 3.5% to 4.5% for the year and we remain on track to open 36 new stores. EBITDA growth of 5% to 7%, or 8% to 10%, on a 52-week basis when compared to adjusted EBITDA in the prior year.

We expect diluted earnings per share to be in the range of $0.92 to $0.94. Despite the deflationary and promotional environment, this remains a growth rate of between 10% and 12% over adjusted diluted earnings per share in the prior year on a 52-week basis. CapEx of $155 million to $165 million, net of landlord reimbursements, a slight increase due to spend for 2017 new stores.

A few additional items to note on the 2016 guidance. As the second quarter progressed, bulk, dairy and produce became more deflationary. We anticipate that this environment will continue for the balance of 2016, with deflation in the range of 1% to 2% for the back half of the year.

Second, as it relates to margins, as we have done in the past, we will continue to make price investments, as necessary, to drive traffic and top-line sales and to maintain our competitive position. We expect that any gross margin leverage in the back half of the year will be at the lower levels than we experienced in the first half.

Third, on the direct store expense line, our investments in our team members through training and strategic wage increases will continue to delever DSE as a percentage of sales throughout the year compared to 2015. We continue to believe that these strategic investments are important to develop our team members and to build a strong pipeline of future leaders.

As well, we expect higher labor costs associated with a greater number of stores being opened in Q3 this year versus the comparative period last year. Fourth, on the SG&A line we still expect some compression in the third quarter from our investments in systems and infrastructure. However, as I stated earlier, the second quarter represents the period of largest investment spend during the year.

Looking out, the SG&A compression will start to level out in the back half of the year. Below the EBIT line, we expect interest expense to be approximately $15 million including capital leases and other interest expense, a weighted average diluted share count of approximately 151 million shares for the year, and a corporate tax rate of roughly 38%. Lastly, for the third quarter of 2016, we expect comp store sales growth to be in the range of 3% to 4%, which would be in line with the two-year stack from the second quarter.

In conclusion, we are pleased with our financial and operating performance in the second quarter in light of the challenging operating environment and we remain focused on driving top-line sales growth. While the deflationary environment has impacted our sales, we remain confident in our business model, our solid balance sheet and our strategic investments, which will position Sprouts for future growth.

With that we would like to open up the call for questions. Operator?

QUESTION AND ANSWER