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FLO.N - Q2 2020 Flowers Foods Inc Earnings Call and to Discuss Strategic Priorities and Long-Term Targets

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OVERVIEW:

Co. reported 2Q20 YoverY sales growth of 5.1% and adjusted EPS of $0.33. Expects FY20 sales growth to be 4-5% and adjusted EPS to be $1.15-1.25.

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PRESENTATION

J. T. Rieck - *Flowers Foods, Inc. - Treasurer and VP of IR & Financial Analysis*

Welcome, everyone, and good morning. Thank you for joining our investor update. Today our CEO, Ryals McMullian, and other members of the leadership team will discuss our second quarter 2020 performance and outline our strategic priorities and long-term growth targets. At any time, you may submit questions using the Q&A function in the Zoom platform. After the prepared remarks, we'll go through the Q&A.

Also, this webcast is being recorded and will be available in the Investor Relations section of flowersfoods.com. We'll also post the slides.

Finally, please note that as part of this presentation, we will make some forward-looking statements about our future performance. While we believe these statements to be reasonable, actual results may differ materially due to the risks and uncertainties. These and other important factors relating to our business are fully detailed in our SEC filings.

Thank you for your attention, and now I'll turn it over to Ryals.

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Director*

Good morning, everybody, and welcome to our first-ever virtual Investor Day. I hope everybody is doing well. It's been one heck of a year. I was just thinking on the drive up from Florida this morning, it seems like just a few days ago, we were all starting to watch the news, initial news coming out of China and then following the spread of the virus from Washington State and California all across the country, but it's been quite a challenging time. And I certainly hope that you and your families are doing well in the midst of all this.

Last night, we issued our second quarter earnings release. And this morning, we issued a release outlining our strategic focus and our updated long-term targets. We originally intended to hold our July Investor Day in New York, but obviously COVID intervened and made that a little bit difficult. But I've been CEO for a little bit over a year now. And while we couldn't host an in-person event, we nevertheless felt it was important for you to have a chance to get to know me better and also some of the management team better as well. So very happy that you're able to join us today.

So today, we're happy to address any questions you have about the quarter or the year, certainly. But the primary goal today is to share with you our path forward in the future. Our aim is to provide you with a very clear understanding of who we are as a company, our culture and the plans we have underway for the future.

So to summarize the agenda, we'll discuss why Flowers offers an attractive investment opportunity. We'll provide you with an update on our long-term targets. And most importantly, we'll detail for you how we intend to reach those targets.

So I'll start out, but you'll also hear from Brad Alexander, our Chief Operating Officer; Debo Mukherjee, our Chief Marketing Officer; Mark Courtney, our new Chief Brand Officer; Mark Gerrish, our Vice President of Corporate Development; and of course, Steve Kinsey, our Chief Financial Officer. I personally believe we've got the best management team in the industry. And so I'm very grateful for the opportunity for you to hear from some of them this morning.

Before we get into the strategic priorities, I want to recognize our talented and dedicated team. Because it's really them that makes achieving all of these goals possible. The pandemic has certainly brought us new challenges, as it has for so many companies. And our thoughts and prayers are certainly with those who've been affected by the disease, including members of our own Flowers team. COVID has affected our operations somewhat. Some of you may have seen, we had to close a couple of bakeries for a short period of time. But thanks to the flexibility of our bakery network, and most importantly the dedication of our team, we have been able to serve our markets uninterrupted throughout the crisis.

Our top priority, of course, remains ensuring the wellness and safety of our team members, because it's their dedication and personal sacrifice, keeping our business operating, that has been nothing short of remarkable, frankly.

So in that regard, I'd like to play you a short video that highlights the collective loyalty, dedication and passion of the Flowers team. Take a look.

(presentation)

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Director*

I'd also like to address the recent tragic events that have spurred protests and discussion, not only in this country, but frankly, around the globe, around racial injustice and discrimination. These events have caused me personally, our leadership team and many, many others at Flowers to really look inward and reflect on our own assumptions and attitudes towards race. We know that both individually and as a company, we've got to do more to ensure that we better represent the communities and consumers that we serve. And at Flowers, one of our core values has always been to respect every person and treat each other with kindness.

But if we can be better, then we should be. So Flowers is committed to building on its long-held values and being part of the solution. So we're establishing a dedicated program that includes partnering with an outside consulting firm to help us improve our ability to nurture a truly diverse workforce.

We're also establishing a committee that's composed of diverse leaders from around our company to help us build that culture. And finally, we've donated $1.5 million this year to 3 organizations that are dedicated to racial equality, inclusiveness and education, and we intend to continue that support going forward. So we're taking this renewed focus on inclusion and diversity very seriously. And the steps we are taking today and the steps we will take tomorrow reflect that decision. And frankly, I think there's no doubt it will just make us a stronger company.

So let me begin by touching on our second quarter performance briefly, and acknowledging that we're giving this strategic update at a very unique time for our communities, our markets and our company. But simply put, the Flowers team continues to rise to the occasion. And the flexibility of our bakery network has enabled us to continue serving our markets uninterrupted throughout the pandemic.

Our results in the quarter reflect the continued impact of the pandemic, with sales rising 5.1%. The positive mix shift to branded retail drove cost leverage and margin improvement, which led to a 32% increase in adjusted earnings per share over the second quarter of last year. Now Steve will give you some more details on the quarter a little bit later this morning. But I mention them now because the results do foreshadow what we'll be talking about in greater detail this morning, particularly around our plans for continuing to evolve our portfolio to a higher branded mix, leading ultimately to margin improvement performance.

Most of the credit, of course, for these excellent results accrues to the Flowers team. Our folks, I can't tell you how hard they worked throughout this entire situation, really extraordinary. They've shown up every day, which has allowed us to be there every day for our customers and our consumers. So we owe them a tremendous debt of gratitude. We also recognize the strong performance by the team has us working from a position of strength.

And we understand that, of course, once the effects of the pandemic diminish, some of the current market dynamics are likely to change again. But the strategic plans that we're going to outline for you today are really focused on positioning Flowers to thrive in the future, to innovate, to drive growth, to operate more efficiently, and ultimately deliver enhanced shareholder value now and in the years to come and under any operating environment.

So with that, let me highlight for you what we think makes Flowers special. We're a leader in a large and attractive category that offers significant growth potential and stability throughout the economic cycle. Through a portfolio strategy process, we're shifting our primary focus to value-added branded retail products that we expect will drive top line improvement and improve our margins. We also expect our optimized portfolio to drive share gains by targeting growth segments with innovative new products. To help offset inflationary pressures, we're continuing the supply chain optimization program that we started under Project Centennial, with comprehensive efficiency improvement and cost reduction plans.

And finally, we allocate our consistently strong cash flows using a rigorous process that's focused on maximizing return. We're very proud of our consistent track record of dividends, dividend growth. And as many of you know, M&A has and will continue to play a vital part in our growth story. And our ample liquidity allows us the flexibility to take advantage of those opportunities as they come our way.

So as we work our way through the presentation this morning, you'll hear more detail around each of those points. But before we move on, I'd also like to point out our consistent track record of delivering long-term shareholder value. If you go back and look over the last 10 years, we've grown this company from a $2.5 billion company to a $4 billion-plus company, and that's a CAGR of about 5.2% over that period. Over the same period, we've been able to deliver total annual shareholder returns of about 11.4%. So over time, we have demonstrated the ability to deliver excellent returns. And by deploying the strategies we'll talk about this morning, I'm tremendously confident that we'll be able to do so in the future.

So let's now turn our attention to our 4 strategic priorities, because they really serve as the underpinning for everything that we're going to talk about today. They are: developing our team, focusing on our brands, prioritizing our margins and proactively seeking out smart, disciplined acquisitions.

When we announced Project Centennial back in 2017, many of you remember, we issued an EBITDA margin goal of 13% to 14%, with the bulk of that margin expansion to come from cost savings. We have made a lot of progress in removing costs from the organization. But as some of you know, we have had difficulty translating those savings to the bottom line, primarily due to inflationary headwinds from things like labor, ingredients, packaging and transportation. But having said that, Centennial has been a tremendous success in many ways.

And most importantly, Centennial marked a significant shift in our culture and our mindset, from a sales and operations-focused enterprise, to a consumer-focused organization that is focused on delivering innovative items to our consumers. Were it not for Centennial and all the changes and challenges that it brought, we'd be starting many, many steps back from where we are today. And several of the initiatives that we'll talk about this morning, most notably portfolio and supply chain optimization, I personally don't think would have been possible at this company, even just 3 or 4 years ago.

Today we've got an organization that's dedicated to the consumer. We've got one that's hyper-focused on growing our brands. We've got 1 that's committed to driving real innovation to drive growth, and 1 with a renewed sense of passion about cost management. And we believe these 4 core strategic priorities will drive the new long-term growth algorithm that we'll talk about today. We believe these plans are realistic. We believe they're achievable and that they will drive meaningful shareholder value over time. So our goal this morning is to provide you with a clear understanding of those plans and our path to future growth and margin expansion.

Before we get to the new algorithm, let me walk you through each of these strategic priorities because they really set the table, and they're the foundation of everything that we're going to do going forward.

Recognizing the importance of our team in meeting our goals, we recently announced an organizational restructuring that's designed to unleash the full potential of our brands and strengthen our product innovation efforts. Some of you may recall that as part of Centennial, we converted to a business unit structure a couple of years ago. And that structure has served us very well, but we've also learned a ton over the last couple of years. So after an intense review of what have worked well and what perhaps needed a bit of improvement, we decided to make some additional changes.

The most significant structural change is consolidating the 2 business units into a single function that's responsible for all of the brands. And Mark Courtney will lead that unit as the new Chief Brand Officer. Our intent here really is to bring additional focus to our branded business. And I also think that this new structure will bring greater collaboration and better resource allocation across our entire branded portfolio. Debo Mukherjee, our Chief Marketing Officer, will guide the development of a new capability dedicated to innovation, to bring new and exciting offerings to our consumers that go well beyond just simple line extensions.

Importantly, this new innovation function will also partner more closely with our corporate development group to seek out acquisition and investment opportunities that fit within the overall portfolio strategy. Innovation is going to be a crucial piece of our growth plans. And so Debo, a little bit later, will provide you some more details about that function and its initial areas of focus.

Appointing David Roach, who is a seasoned operational executive here at Flowers with extensive knowledge of our cake business to President of Cake Operations, really underscores the priority that I'm placing on fixing our cake operations, primarily in our Navy Yard bakery, and should speed the implementation of efficiencies and improve profitability. And our foodservice business will now be housed in our sales function, where it will be used tactically to fill unused capacity where we can do so at an acceptable margin.

Personally, I'm one that believes that organizations should always be evaluating the effectiveness of their structure, to be sure it aligns with their strategy and perhaps even more importantly, that it puts people in the best possible position to succeed. I think we've done that. And I think these moves will accomplish our objectives and highlight the opportunity, particularly that we see related to our portfolio strategy.

Our second strategic priority is focusing on our brands. The good news here is, today Flowers has a very commanding presence in several areas of the market. Nature's Own. It's the #1 brand of soft variety in the United States with 2020 estimated retail sales of about $1.2 billion. DKB, far and away, the #1 brand in organic loaf with estimated 2020 retail sales of around $760 million. And Canyon Bakehouse has become the #1 gluten-free brand in the very short 2-year period that we've owned them, adding another $120-plus million premium brand to our portfolio.

Wonder, strong player in the white loaf segment, and we've been able to leverage its iconic status and its high awareness to give our company a national presence in white loaf, and it's helped us tremendously in the sandwich bun and roll segment as well. So with leading brands in several major categories, we're working from a position of strength. And our goal is to build on these leading positions by placing even more focus on branded growth through targeted strategies and better resource allocation, all of which are encompassed in our portfolio strategy work. We've also added new capabilities to better understand the consumer and how we can leverage those insights to build our brands through innovation and marketing investments.

Prioritizing margins is our third strategic priority. And as you'll see, rather than a distinct, separate initiative, it really goes hand-in-hand with the brand-building work. Our portfolio strategy is designed to shift our sales mix to a greater percentage of branded retail, which in turn will drive stronger margin performance. And as you'll hear, we expect to drive branded growth through a combination of share gains in underdeveloped geographies, but also in underdeveloped segments. We're going to make marketing investments, bring in more truly incremental innovation and, of course, selective M&A that aligns with the portfolio strategy.

Now our recent results this year have given you at least a sense of the dramatic impact that this mix shift can have on our margins, albeit an extreme example, but it does back it up. The recent organizational changes, combined with the strategy of repurposing capacity to support our branded retail products, and then selective exits of low to no margin business over time, should further our progress.

Cost management and efficiency gains will also play an important role in our margin improvement trajectory. We highlighted on our first quarter call that through our portfolio and supply chain work, which we started last November, we expected to drive about $10 million to $20 million in cost reduction around the areas that you see here on the slide. Frankly, I think we'll end up this year exceeding the top end of that range. I also expect that we'll enjoy some further benefits from this work into 2021 as well. So all of this is designed to reduce fixed costs, allowing us to better leverage our cost base and improve margins as we grow the business. I've said many times that it's crucial that our cost structure be in line with the company we are today, but it's also got to remain flexible enough to support the company that we'll become tomorrow.

We also have several important initiatives underway to improve operations at certain underperforming bakeries. Those initiatives will further reduce costs going forward as we put new efficiency programs in place, invest in automation and return those bakeries to operational excellence, which is what we have underway currently at Navy Yard and a few other bakeries.

Finally, our network optimization strategies are designed to ensure that we have the right assets in the right location, supporting the right products, which will bring additional efficiencies.

Now having said all that, while cost containment and cost management are certainly very important, the most critical factor for our future success and ultimately, margin improvement is growth, but the right kind of growth. That's why we're so focused on further shifting our mix over time to branded retail and making investments to drive growth and share, while selectively pulling back on underperforming business and then optimizing that capacity. That shift can be enhanced by innovation and continuing to smartly add to the portfolio through disciplined M&A.

So speaking of M&A, I expect it will continue to play a vital role in our growth story. Since we went public back in 1968, some 50 years ago, we've completed more than 100 acquisitions, which created a tremendous amount of value for our company as we grew from a small regional operation to 1 with a national presence. And the good news here is that opportunities are still aplenty. There's still room for us to grow in our core segments through M&A, perhaps a little fewer than in the past, but they're still there. But there's also many, many more opportunities to grow in underdeveloped segments and adjacent categories. We've enjoyed tremendous success with Dave's Killer Bread and Canyon, and we intend to continue building upon that track record of success going forward.

With our organizational realignment, as I mentioned earlier, we've implemented an exciting new partnership between the Corporate Development Group and the new innovation function, that's designed to identify innovative opportunities beyond the core business that can enhance our growth and margin profile. In short, we intend to be proactive, and we'll see -- we'll be seeking to become a more innovative company, both organically and by leveraging the power of entrepreneurship that smaller companies bring. I'm excited to have Mark Gerrish, our new VP of Corporate Development, to outline these plans for you a little bit later this morning.

So everything that I've talked about has already been underway for some time now. And we're very encouraged by the early returns, and even more so by the promise for this work -- that this work holds for the future. You'll hear more details as we move through the morning, but I want to emphasize the enthusiasm and the optimism with which we're approaching all of this.

So that brings us to the new long-term algorithm, which you can see here on the slide. So our plan is to grow organic sales by 1% to 2%, EBITDA by 4% to 6% and earnings per share by 7% to 9% over the long term. And over time, we expect this plan to deliver meaningful total shareholder returns through a combination of top line growth and bottom line margin expansion.

Important to note again, the top line and EBITDA targets just reflect the organic business growth, but the EPS target does include the effects of potential future M&A and/or opportunistic share repurchases.

We expect sales growth to come from a combination of branded retail, but partially offset by revenue declines as we anticipate exiting certain underperforming pieces of business over time. Similarly, the EBITDA and EPS growth model also assumes the margin-enhancing benefits of a higher branded retail mix and better cost management, but we're expecting that to be partially offset by the contribution losses associated with the exit of that lower-margin business over time.

So now let's tie those long-term goals back to the strategic priorities. Focusing on the right kind of growth will drive the top line. And that means focusing on our branded business. If we can continue to shift our mix more heavily to our most profitable products, that in turn will drive significant margin improvement. And we can do this by growing our share in underdeveloped markets where we can increase the presence of our leading brands. And we'll be looking to further grow in underdeveloped segments where those leading brands have a right to play. We'll invest in innovation.

And finally, over time, we'll manage down certain areas of the business that are unable to deliver an acceptable margin. We will prioritize margin by continuing to focus on cost management, efficiencies at the bakeries and execute on our supply chain optimization program. We'll work to ensure that our capacity is put to its highest and best use, which can have a profound effect on margins. And to the extent we have excess capacity in certain segments of the business, it will be important to manage that down over time as well. If we can do these things, and I certainly believe we can, then this new algorithm provides a much clearer path to our margin goals.

I want to emphasize again, too, that M&A would be incremental to this model on the sales and EBITDA line. And so as we continue to seek out new attractive businesses, there's upside to the model. And we've got a really good track record of M&A, as we've talked about this morning.

So as I've said, our primary goal today is to demonstrate how we'll achieve these targets because I want you to leave this session with a really good understanding of our strategies and how they'll propel the future success of Flowers. The present environment has proved that with the right product portfolio, the right cost structure, the right people, the right focus, the targets are realistic, they're achievable, and we're intent on optimizing all aspects of our business as we move forward.

So with that, I'd like to turn it over to Brad Alexander, our Chief Operating Officer, and he's going to talk to you about our growth imperatives and our supply chain optimization work. Brad?

Bradley K. Alexander - *Flowers Foods, Inc. - COO*

Thanks, Ryals, and good morning. Today, I'm going to discuss 3 key priorities: first, the margin benefit potential offered by our work in optimizing the portfolio and our supply chain. Next, our focus on building our brands. And third, how our portfolio strategy informs our supply chain optimization work to reduce fixed costs and drive operating leverage. Ryals mentioned our initiatives related to the portfolio strategy, which focuses on value-added, branded retail products that we expect to drive top line and improve our margins. Those initiatives are in the early stages. But the current environment offers a glimpse into the effect our initiatives have on our long-term results.

In the second quarter, we saw greater demand for our brands as increased at-home eating and a consumer shift to trusted brands drove a favorable mix shift for us. As a result, margins increased significantly despite a decline in volume, as our more profitable branded retail products grew to a larger percent of our sales. Combining the right portfolio mix with an optimal bakery network can drive meaningful and margin improvement. These results have strengthened our team's resolve to accelerate work in this area and position ourselves to deliver improved margin performance over time.

Two of our key operational priorities are: focusing on brands and improving our margins. Many of our brands have strong and growing market shares, and we are focused on continuing that share growth by remaining relevant with the changing consumer. An important part of improving relevance is innovation that creates products that are meaningful to our consumers and marketing those products to the appropriate segments. In a few minutes, Debo is going to address some of our efforts in that regard. After Debo, Mark will discuss brand presence and our efforts to make our brands available to the right markets and segments and the huge opportunity we have in this area.

As you will hear, we expect our portfolio strategy to help drive margin improvement via mix shift. But first, I'd like to detail some of the work we're doing around supply chain optimization. Supply chain optimization is about more than just cutting costs. It is linked to our portfolio strategy. As we shift our sales to a more profitable mix of products, we must also adjust our asset base to produce the new mix in the most efficient way. Our network is flexible, and our goal is to utilize each part of it to its highest and best use.

Most of the bakeries we produce -- most of our bakeries produce a variety of items, including bread, buns and rolls. That versatility allows us to alter our mix to meet changing consumer demands, including changes due to a hurricane or the current pandemic. The rest of our supply chain is equally flexible, as our depots and independent distributor partners can distribute a variety of products efficiently to the marketplace. It is important to highlight that while the products we produce can vary, many of our costs, whether production or distribution, are largely fixed. Given that network flexibility and the fixed asset base, our portfolio strategy informs the brands and segments that we target. By pivoting capacity to our most powerful brands, we maximize our revenues and margin expansion potential.

A good example of this is what we're doing with our network optimization work in Lynchburg, Virginia. Historically, Lynchburg was producing a fairly standard portfolio of products. However, with the substantial growth of Dave's Killer Bread in the area, we needed additional capacity, especially in the Mid-Atlantic and Northeast. Rather than build an entirely new bakery, we are in the process of converting Lynchburg to an organic facility that will meet the demand, but also reduce transportation costs. That flexibility of our bakery network allows us to shift production of the items formerly baked at Lynchburg to nearby sister bakeries, thereby improving their capacity utilization.

Another part of our optimization process is network consolidation. An example of the consolidation work we've been doing is reducing the number of depots. The graphic details our production and distribution process, as goods are produced at our bakeries, transported to our depots and then moved by our independent distributor partners to retailers and other customers. One example of how we are working to remove excess capacity in this network is by consolidating depots, which often comes with the added benefit of reduced transportation models. Our portfolio optimization work will enhance this process as we narrow our product focus and potentially free up additional network capacity.

One particular benefit of our portfolio and supply chain work is an improvement in sales. Through a process which includes better ordering and SKU rationalization, we have lowered cost and increased realized capacity. By reducing the amount of production that turns into sales, we have freed up enough capacity that amounts to adding 1 new bakery. Each of our bakeries has a certain product mix of branded retail, store brands and foodservice production. As we increase the production of branded retail products baked in our facilities, as we did in our Lynchburg example, we can be more selective about the type and quality of other business we accept.

Not only are we reducing the percentage of store brand and foodservice products that we make, but that process allows us to negotiate better pricing and terms on the business we decide to keep. The end result is a higher mix of branded retail products and a more profitable mix of store brand and foodservice business, which we expect to help us meet our updated sales and EBITDA growth targets.

With that, I'll turn it back over to Ryals.

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Director*

Thank you, Brad. So building on Brad's discussion, we're going to turn it over to Debo Mukherjee now, who's going to give you some more detail on our marketing and innovation efforts. Debo?

Debo Mukherjee - *Flowers Foods, Inc. - CMO*

Good morning, everyone. Ryals, thank you so much. As Brad mentioned, we look at our growth underpinnings in 2 clear buckets: one is brand relevance and the other one being brand presence. I'll focus on brand relevance. And my partner, Mark Courtney, will take you through the brand presence component.

So what are we talking about when we talk about brand relevance? It starts with having a category that's vibrant, and I'll take you through some dynamics there. But within that vibrant category, we need to make sure that our brands relate to our consumers and that they are relevant in their promise as well as in their vision. I'll take you through how we develop that. And not only how do we develop it, but the fact that we center it on consumer insights. And our core principle here being honoring the consumer in all their facets, their stated and unstated needs in terms of deriving not only our brand promise, but also our innovation, as Ryals mentioned a bit earlier.

And last but not least, we need to take continued look at consumers' evolving behaviors and habits. And the COVID-related e-commerce digitization has certainly spawned a new activity set for us as well. So why don't we get started?

We are going to take a look at the bread category. The bread category is one of the most vibrant categories in the entire grocery store, certainly among the largest. So it's at $24 billion and continuing to grow. What you may or may not realize is that 98% of households, American households, so that's roughly 128 million to 130 million households, purchase bread. And what's interesting about that is that they buy bread every 12 days. So you're talking about a very large category, very dynamic, reaches a lot of households and pantries and is purchased with a great frequency.

Now astoundingly, among that, we also realized that this category is deeply brand-centric, in the sense that the share of brands relative to private label continues to grow. So consumers are demonstrating a propensity to choose brands with a differentiated proposition. Alongside with that, we also see the pricing power that's resident within this category, meaning that as folks are paying more per loaf for choosing a brand with a differentiated product benefit allows each one of us to create a profitable growth environment. So that gives you the underpinnings for why the bread category is so relevant to us, so important to us, and having that reach and frequency is powerful.

Now why should that matter? It matters when we make our brands relevant in that context. So why don't we go to the next slide and talk about creating brand relevance?

When we think of the -- of a funnel, and at the top end of the funnel being the 128 million households that I referred to are roughly 98% of the U.S. household -- 98% of U.S. households, it is to them that we want to make our brands very relevant. We want to make sure our brand promise as well as our positioning matters to them in a manner that they find acceptable, in a manner in which they accept that messaging and brand promise, and therefore use it towards making their decisions. So referring to the widest part of the funnel, 128 million households, as I mentioned, we then want to generate awareness.

The awareness creation is perhaps the biggest unlock towards the value creation. And within awareness, there are 2 elements that I would point your attention to. One is aided, meaning that they're prompted. Have you ever heard of Nature's Own? But more powerfully, it's the unaided that we really want to seize on. So this is a consumer having the top-of-mind awareness for Nature's Own or Dave's Killer Bread or Wonder when they're approaching the bread shelf, when they're getting ready to make that shopping occasion. So that is what we really want to seize and that's your unlock. From there, if we have promised our brand and positioned it well, the consumer may be prompted to try us. And that starts the second part of that leg, which is the penetration component, the first purchase.

And again, if the brand promise holds up, as well as the product delivery from a texture, quality, taste and all of these other attributes, then ideally, we've created a brand loyalist who will come back and repeat. And that's the promised land, if you would, from the open-end of the funnel, down to the most narrow end. And this is how we're looking to create brand relevance. But how do we understand what it is that the consumer is looking for? So let's go to the next slide.

We start with understanding what consumers are facing on an everyday basis: their stated needs, their gaps, their opportunities. But we also seek to understand the emotional benefits and the gaps thereof. What are they looking to convey? What remains unmet? What says -- what remains unsaid? We accumulate all that information to then develop our brand architecture. And the brand architecture effectively means to who does the brand mean what? And why? And within that, we construct, how will the brand be spoken about? What is its promise? What is its tonality? Is it going to be a friend? From there, we ladder our brand strategies, what are its products is going to be, where are we going to advertise, how are we going to raise awareness with consumers, all those aspects and that further ladders to the ultimate gestalt, which is consumer messaging.

Now as you see here in the middle, we know that moms seek to make everyone in their homes happy with her offerings and her foods. We also know that she's got a keen eye towards health. So for those moms that want to balance both happy and healthy, we bring you Nature's Own. And that's our tagline there. You notice that it has not only our functional attributes, but also our emotional promise of happiness.

Similarly, with Wonder, we don't talk about white bread necessarily in the payoff for the brand promise. What we talk about is moms wanting to inspire imagination in their children. So inspiring child-like wonder, thus being the tagline. So now we have this information, but how do we get to it. So let's go to the next slide.

We look at our consumers, and as most brands do, we look at it from a segmentation of geo demographics, socioeconomics. Well, we went a step further. We really took to understand their lifestyles. How do they behave? What propels them? And then we look to understand the emotional motivations as well. So in this particular example in the matrix on the right-hand side, we identify people who -- that I think we can all relate to, a person who's a busy budgeter. She's got an active lifestyle. She has to run her household on a particular budget. But within that intersection, we also realized that she has a craving or a desire to convey love, comfort or even bonding to her family.

And how does she express that? We all realize that we have a love for fresh products. And freshness and cooking something fresh or offering something fresh to our families is a way of conveying our love and caring to them, and a mom is no different in this particular intersection. When we discovered this particular insight, we then translated that to our unique selling proposition for Nature's Own, which is from scratch to shelf in 48 hours. And therefore, Nature's Own gets well positioned in conveying that comfort and love that a mom wishes to express, all the while also having the rational attributes of being healthy and having no preservatives, colors or flavors in addressing that consumer's needs.

Now as Ryals mentioned earlier, we are also doing a great deal of innovation work, and our innovation work is consumer-centric. Now if you look at the other intersection points within this chart, and there are others like it, we seek to find not only areas where our brands can grow into, to address certain needs. Or in some cases, they're virgin-white spaces that deserve to be exploited a bit further through some -- from some additional analyses. So this becomes a basic fabric, a weave, if you would, of identifying growth opportunities that lie within this core bread category and one that we find so powerful. So let's go to the next slide.

As I said earlier, the unlock, the greatest unlock for our growth upside is driving awareness. And while prompted awareness is certainly helpful, which is aided, the more powerful statistic here and the one that I'd love for you to key in on is the unaided. So unaided awareness for Nature's Own is only 15%. However, aided awareness is over 70%. A way to interpret that then is that 15% of the households could rattle off Nature's Own without even being prompted, right? So of the 128 million people, it stands to reason that if I can raise my unaided awareness, it would convert to a greater degree of sales. And that is my first step of unlock. If you recall back to the funnel analogy that I mentioned earlier, this is where the first unlock starts.

Now how do we convey our messaging to our consumers? Well, we are very dynamic in how we deliver that messaging to our consumers through using a myriad of mediums. And you see that a bit to the right, and that's largely to demonstrate to you that we're staying nimble as and when the consumer's modus changes, how they receive the information changes, we're flexible and reaching out to them and creating meaningful points of impressions during that time period. So with that, let's go to the next slide.

The second piece of that unlock, so traveling down on the funnel again, is that once we've identified what the awareness is and hopefully gotten to that point, then there are 3 particular levers that we really want to focus on. One is household penetration. So household penetration, if you recall, is the component of our household buying the loaf of bread once and then ideally going to repeat. So household penetration. Household consumption in terms of how quickly they're consuming it. And then the third, as I mentioned, the lowest part of the funnel, loyalty. So let's speak to that.

We know that the American household, 98% of them have bread. So they purchase bread. And yet when you look at Nature's Own, only about 30% of those households buy Nature's Own. Stands to reason that if I increase the number of households buying Nature's Own, it would be incremental to our business.

Now if you look on the right-hand side, the top right, you'll notice that bread is purchased every 12 days, but Nature's Own is only purchased about every 30 days. I have an opportunity, therefore, to help drive incremental consumption of Nature's Own once it's in the pantry, by offering perhaps more usage ideas addressing different dayparts. And that also helps help spawn innovation ideas as well from how to tackle the Nature's Own franchise with that consumer base.

Last but not least, it's a loyalty. Holding onto that valuable consumer once you've converted them, once they've tried your product. And to it, the desired behavior, obviously, is to make sure that the consumer doesn't get swayed by other competitive offers or pricing or other endeavors when they approach the shelf the next time. So holding onto them and retention is powerful.

To shed light in terms of how this could work for us, I point you to the Southern region of the United States where Nature's Own has been particularly well established. While on a national basis, we have about 33% household penetration, in the South, where we've been established, we have over 52% household penetration. Right there, you see almost 20 percentage points of upside that exists. And if we can translate that on, on a national basis, I hope it gives you a sense for our growth underpinnings. With that, let's go to the next slide.

We realize that with COVID, consumers' behaviors have changed rather substantially. What was otherwise lacking in terms of an uptake for edibles, in terms of consumers buying edibles on e-commerce, that has dramatically switched. Today, about 13% of bread is purchased via e-commerce.

Now what does it take to win in-e commerce? Very simply, it's 2 aspects: it's awareness and optimization of the search. So you notice how key the word awareness is again. And if we continue to drive our focus and making sure that we're targeting the consumer in a manner that they wish to be spoken to, awareness continues to be the key unlock towards value creation or growth. So with that, let's go to the next slide.

What I should touch on from the prior slide is that under Ryals's leadership, we are now setting up a digitization competency within our organization. And while disparate pieces of work are being put together towards it, we feel very confident about being able to bring that to life very shortly.

So I've talked to you about the funnel analogy, if you would, from the upper end down -- going down to the bottom. The key through all of this is not only selecting right consumer, but also retaining that consumer. So what I'd love to play a clip for you here is a video that's taken off our 30-second ad for Nature's Own, but sculpted towards a 6-second demonstration that we use in social or other forms of digital media. So with that, let's roll the clip, please.

(presentation)

Then notice the tagline there, it says goodness in our nature. And look at the articulation of some of those messages over on the right-hand side. We told you about the scratch to shelf in about 48 hours, and how powerful that is with the consumer. We also spoke to the fact that goodness is in our nature, is -- as part of our product benefits. All of that ladders to the higher order messaging in terms of how Nature's Own can be relevant to our consumers.

So with that, let me turn it back to Ryals.

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Director*

Thanks, Debo. A lot of exciting efforts underway in both marketing and innovation. Hopefully, that read through with Debo's presentation.

So now we're going to move to Mark Courtney, our Chief Brand Officer. And he's going to talk to you about our portfolio and growth strategies. Mark?

H. Mark Courtney - *Flowers Foods, Inc. - Chief Brand Officer*

Thank you, Ryals, and good morning. Today, I'll highlight our portfolio strategy and how we will use it to profitably grow our business by expanding our brand presence in underdeveloped markets, underdeveloped segments and by staying closely aligned with our retail partners.

The fresh packaged bread category has certainly seen a sales lift since the pandemic began. This channel-shifting from foodservice to retail has been significant, fueling category growth of 14%. I'm pleased to say that we have outpaced category growth by 420 basis points and introduced our brands to 3.5 million additional households in just this last quarter. Our challenge now is to drive engagement with these consumers by increasing our brand presence, wherever and however they shop.

To that end, we have clarified the roles for each of our brands and businesses, that we can now leverage to drive branded growth and meaningful margin expansion. Our portfolio includes some of the strongest brands in the category, that collectively appeal to a very broad percentage of the population. It includes strong regional brands that allow us to win locally. And our national brand portfolio is comprised of the Who's Who of mainstream bread brands. Starting with Wonder, which gives consumers an opportunity to trade up from store brand and into the most iconic bread brand. And Nature's Own, the #1 loaf bread in the United States, which offers premium products at mainstream prices.

And our super premium entries, Dave's Killer Bread has been driving category growth for the last 5 years with the best bread in the universe. And our newest entry, Canyon Bakehouse, has quickly become the #1 gluten-free bread by giving consumers a reason to love bread again. We've developed growth maps for our brand portfolio to drive optimal revenue and margin growth and serve as a guide for resource investments in prioritization. We've aligned our growth maps and brand strategies with our network optimization plans to ensure that we have the right capacity for the right products in the right markets, and with minimal capital investment.

We have also sunsetted 2 brands this year and streamlined our assortment, deleting some 20% of our products. We will continue to leverage the portfolio to delight our consumers of every demographic, while driving sales and margin expansion for our retail partners, our independent distributors and our shareholders.

One of our key growth opportunities is clearly to drive growth in underdeveloped markets. Keep in mind that we have a 17.5% share nationally. But when you look at this map, you can see that our growth opportunities vary widely by market. You can see where our strengths are and how much headroom we have for growth. And while we have a 30 share in the IRI South market, we have only begun to scratch the surface in high population markets like the Northeast and the Midwest, and we're just beginning to hit our stride on the West Coast. We're taking a focused approach to targeting markets that offer the greatest opportunity for profitable growth, and investing appropriately to drive brand presence with customers and consumers in high-potential markets.

We have a great opportunity to grow our business in close and adjacent segments. In the markets we serve, we are the clear leader in loaf bread, with over a 30 share. As you can see, loaf is the biggest segment in the category, almost an $8 billion segment. And loaf has 2 primary use occasions, lunch and breakfast, core sandwiches for lunch, where our brands over-index; and also is toast for breakfast, where we are fairly indexed. We believe we have significant headroom to build our business in non-loaf segments by introducing products for the breakfast and dinner meal occasions that uniquely deliver on our brands' promises. Let me give you an example, getting back to breakfast.

Our Dave's Killer Bread consumers, we call them breadheads, are quite vocal. They love our bread. They love our second chances program, and they have encouraged us to offer them killer nutrition and killer taste and texture in other types of bread. So we listen to them. And in just 3 years, we have built our Dave's Killer Bread, bagels and English muffins to over $100 million business and seen our share increased 420 basis points.

Just this year, we made a strong push in the dinner meal occasion, specifically with sandwich buns. Now it's true that we've sold buns for many years, but our growth has been limited by 2 factors. First, much of our bun capacity has been dedicated to nonbranded buns. And secondly, our branded bun strategy has been fragmented, with most of our sales efforts behind our regional brands. Our portfolio strategy addresses both of these issues, as we have defined and communicated that our first priority for line capacity is branded retail, and our mainstream bun priority is Wonder. We're leveraging the power of the Wonder brand and have rallied our team's efforts behind this iconic brand.

We've also launched innovation in our premium and super premium brands, Nature's Own perfectly crafted brioche buns were introduced this year. Dave's Killer buns have been introduced. And for the gluten-free consumer, we have launched Canyon Bakehouse Burger buns. I'm pleased to say that early results for the entire bun segment in our branded business is up 29%, and our share has improved 80 basis points in the second quarter in this $3.5 billion segment.

Finally, I want to speak to the marketplace and our retail partners. Our retailers are doing a great job of serving the most rapidly changing environment most of us have ever seen. They're dealing with consumer behavioral changes that are happening at blinding speed, such as the accelerated adoption of the e-commerce platform, home delivery. And in many cases, they've transformed their business into a hybrid retail store and a fulfillment center. They're also dealing with workforce-related issues from the pandemic, as well as an uncertain economy and an uncertain future. I'm pleased to say that though we're far from perfect, our team is generally recognized as a leader in serving the market in times of crisis. Our retailers know they can depend on us, not only to serve them well and help them stay in stock for their customers, but because we have a portfolio of brands that their customers demand.

Our brands are important to consumers, as you can see from this chart. Nature's Own, Dave's Killer Bread and Canyon Bakehouse have the highest loyalty, the highest share of wallet in our category. And because our brands are important to consumers, they are important to retailers. Our brands command a premium price, driving higher category sales and profits for our retailers. We will continue to work strategically with our retail partners as they continue to evolve and serve the changing consumer in this important category.

Thank you. And back to you, Ryals.

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Director*

Thanks, Mark. I hope you can see, our marketing efforts, our innovation efforts and our portfolio strategies going forward are really the backbone of everything that we're going to be doing going forward. And hopefully, it read through, and you can see why we're so excited about it.

M&A, turning our attention to M&A. I'd like to introduce Mark Gerrish. Mark is the new Vice President of Corporate Development and runs all of our M&A now, taking over my old job. And trust me, it's an upgrade. So Mark, why don't you take us through?

Mark Gerrish

All right. Thank you, Ryals. Good morning, everyone. I'm excited to be here. I'm going to spend the next few minutes talking about our corporate development program.

Earlier, Debo discussed how we use consumer insights to leverage opportunities for our core business. Equally important to the future of Flowers is taking that same information and using it for M&A. We have growth ambitions through M&A. We are positioned for this growth, and we will take a structured approach, partnering with our newly formed innovation team to identify opportunities, both in our core and within grain-based adjacencies.

As Ryals discussed earlier, M&A is 1 of our 4 strategic priorities that will enable long-term growth. With a strong balance sheet, free cash flows, we are poised to invest for this growth. But we're not just standing here telling you that we have cash and capacity. We have the experience, we have the capabilities and we have the commitment, coupled with a long history of delivering on M&A.

As you can see by the chart on the screen, our 2 recent deals, Dave's Killer Bread and Canyon Bakehouse, have produced incredible profitable growth. And even more importantly, and that, that slide doesn't show, is these brands have a long runway, and we expect many years of continued growth from these brands.

A structured M&A approach is critical to ensuring Flowers' long-term success. Again, we have the track record of M&A, and we will continue that success by developing a clearly defined, repeatable process with a clear set of acquisition criteria. We view -- here at Flowers, we view M&A as a capability. This is not a one-off project focused on a discrete target. We are developing a capability to provide a steady stream of potential growth drivers. Demonstrating on that commitment, I was hired in September 2019 as a dedicated resource. I sit within our Corporate Strategy Department to ensure a tight link between strategy, strategic intent and M&A.

Enabled by our defined strategic M&A criteria, we will look to identify, assess, prioritize and maybe most importantly, look to cultivate relationships with potential partners. Our structured approach extends beyond the screening and acquisition phase to cover integration. As we know, integration is a key component of acquisitions, and we've not overlooked that. We're developing dedicated resource by aligning internal functions -- areas throughout our company. Ryals spoke earlier about our commitment on what we call Smart M&A. Smart M&A to me -- to us means following a disciplined process, informed by our strategic goals, and innovation platform goals. We will seek to develop new brands and products, both in-house and through investments. We're looking at opportunities not only solidify our core, but also look in new adjacencies.

Within the core, we are identifying areas for infrastructure and distribution growth in underdeveloped locations. Basically, we're looking to expand in areas where we know our brands have a right to win with not only the retailer, but with the consumer.

Within adjacencies, we're looking to gain exposure to growing underdeveloped segments with innovative brands and our capabilities. My partnership with our corporate strategy team, our brand team, our newly formed innovation team and our R&D team will inform these target areas. From an operating perspective, our operating model for adjacencies will vary by deal. But similar to Dave's Killer Bread, we expect to leave a significant portion of the acquired company in place while driving significant growth.

For example, after we acquired Dave's Killer Bread, manufacturing, marketing, sales, stayed in place. We really left the heart of the company in place, and we drove growth not only through our industry expertise, but also through innovation, as we talked about earlier, adding buns and breakfast items to fuel growth.

In the same way that we are flexible with the types of targets that we're exploring, we are also considering various transaction structures. We remain open to alternative deal structures, such as joint ventures, minority investments, strategic partnerships. We know that this dedicated, disciplined yet flexible approach will enable long-term success. We will deliver on our core strategy priority of Smart M&A. I thank you for your time. I look forward to sharing our progress and results.

And with that, I'll turn it back over to Ryals.

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Director*

Great. Thank you, Mark. As we've said many times on this call and prior calls, M&A has always played a vital part of our growth story. And it's going to continue to do so in the future. It might look a little bit different. You heard from that, that we're really trying to open the aperture, not only just for the types of companies that we're interested in, but with regard to the types of deal structures that we're interested in going forward, willing to make smaller minority investments to help fuel innovation from an outside perspective.

So we've talked a lot about supply chain optimization. We've talked about our portfolio strategy. We've talked about our marketing and innovation efforts. And now I'd like to call on our Chief Financial Officer, Steve Kinsey, who's going to tie it all together for us and talk about our financial progress and the long-term algorithm. Steve?

R. Steve Kinsey - *Flowers Foods, Inc. - CFO & CAO*

Thank you, Ryals, and good morning, everyone. While -- I need to admit, while I'm very excited about the fact we have the technology that we can all be together today virtually, I'm definitely looking forward to the day that we have the ability to meet again in person. So hopefully, that day comes soon.

Today, I plan to cover several key topics. First, our business is performing well. Based on our first half performance and our back half outlook, we have a positive view on 2020. Second, the business continues to generate strong free cash flow. And our capital allocation policies are aligned with supporting the priorities you've heard about today. And finally, I will provide you some color to our updated long-term targets and our road map to reaching them.

Turning to the second quarter results. As Ryals stated, we released earnings late yesterday and filed our 10-Q with the SEC as well. You can see from that release, we had another strong quarter with great performance, from both the sales and margin perspective. Results were driven overall by solid brand performance. We continue to experience elevated in-home eating, which bodes well for our brands. The top line grew 5.1%, with adjusted EBITDA growth of 21.4%. Adjusted EBITDA margins expanded 170 basis points to 12.5% of sales. Adjusted earnings per share grew 32% to $0.33 per share, a record second quarter for adjusted EPS.

I'd like to also highlight briefly a few items excluded from the adjusted results, that were driven primarily by our continued focus on brands and overall optimization work. First, we did have 2 significant impairment charges: a $4.6 million charge relating to surplus property and equipment we are in the process of selling, and a $4.6 million charge due to the discontinuance of the Alpine Valley Brand. This brand, as you know, has been somewhat challenged by the overall performance of Dave's Killer Bread. So we shifted our priorities and resources to our strongest organic bread, DKB. This allows us to use both our sales force and organic production capabilities to drive continued growth in this important segment of the category.

Second, as Ryals mentioned, in July we announced an organizational restructuring. Associated with this, we recognized a charge of $1.5 million related to employee termination benefits, and we also anticipate in the third quarter, recognizing an additional $7 million charge related to the employee termination benefits as well.

Now turning to guidance. Based on the strong business performance year-to-date, we've increased our full year guidance. We now expect sales to increase 4% to 5% and adjusted EPS to be in the range of $1.15 to $1.25. This range is wider than we typically provide at this time of the year. And that's because there are several key considerations that can influence our results in the back half. Overall, food at home consumption continues to remain elevated to the prior year. However, given that consumers are starting to cope and move about, we are closely monitoring the impact on our mix. While there are some indication consumers are comfortable with carryout or even on-site dining, in-home consumption is still elevated. As you are aware, coronavirus infections are on the rise again.

So we will continue to watch the impact this has on consumer behavior as well. If trends reverse and we begin to see a sustained decrease in overall cases, we anticipate that consumers resume something close to their normal lives. We would then expect a percentage of our non-branded business to increase, impacting mix somewhat. The uncertainty around the pace of this reversion is the main reason for the wider guidance range at this point. Back-to-school and return to work time lines are key determinants of when our sales mix begins to shift, but their trajectory is very unclear at this point. While there are a range of scenarios, we remain confident our business will continue to perform well over the balance of the year.

We continue to see strong, consistent cash generation from the business. In fact, year-to-date operating cash flow is up approximately 32%. The cash flow has not only supported a growing dividend, but also generated discretionary free cash flow that we've invested strategically to expand in new markets and growing product segments like organic and gluten-free breads.

With the stream of cash flow, we've been consistent with our capital allocation decisions, which are guided by a set of balanced principles that have served us well. First, we'll direct capital expenditures to support our core business growth; for example, the investments we made to produce DKB in the Northeast. For 2020, we are targeting capital expenditures in the range of $85 million to $95 million. Second, we'll manage our debt levels so that we can maintain our investment-grade credit rating and conservative financial position. Third, we review -- we view the dividend as a key component of total shareholder returns. We are committed to maintaining a strong dividend. As you heard from Mark, we aim to proactively identify acquisitions in the grain-based food space to add faster-growing brands to our portfolio. And then finally, we'll consider making opportunistic share repurchases with excess cash.

Our ample free cash flow has allowed us to maintain a strong balance sheet. We're very committed, as I said, to our investment-grade credit rating, and we have a track record of quickly delevering in the years following each of our recent acquisitions.

Over the past decade, and as Ryals stated earlier, we have demonstrated the ability to grow Flowers' business through both organic growth and acquisitions, delivering solid mid-single-digit top line growth over the long term. We're also pleased that we translated the growth of our business into enhanced shareholder value, achieving low-digit -- low double-digit total shareholder return over the past 10 years.

Today, you heard Ryals and team members detail our strategic priorities, and we hope you have a better understanding of the steps we are taking to deliver on our targets. To start, by focusing on our leading brands and shifting our mix to more profitable products, we aim to deliver sales growth of 1% to 2%. This level of top line growth, primarily driven by growth of our higher-margin branded products, is expected to deliver adjusted EBITDA growth of 4% to 6%. Key to this will be our supply chain optimization work, and as noted by Brad, is an important component of our overall strategy.

And finally, our 7% to 9% adjusted EBITDA growth goal recognizes that in addition to EBITDA growth driving the bottom line, there are significant opportunities within the grain-based foods arena where we can add value and improve the growth potential of our portfolio.

Now it's important to point out that we do not view our long-term targets as annual guidance, but as guideposts to better understand what we consider normalized annual results over a multiyear time frame. Obviously, we're in a unique environment right now that is providing strong performance in the current year, well above our long-term targets. On average, over time we think our business can generate those results, but results in any 1 year may differ. Looking ahead, we thought it would be useful to provide a little more color around how we see execution against our targets over the next few years. Clearly, our 2020 guidance implies growth in excess of our long-term targets.

Not only are we benefiting from greater-than-normal demand, but we also have a 53rd week, which is expected to bolster sales by approximately 1% to 2% and adjusted EPS by $0.01 to $0.02 per share. Keep in mind, fiscal 2021 does not -- does have 1 less week and potentially some demand reversion as the pandemic effect recedes, which will be a headwind we'll need to overcome in order to achieve the growth algorithm in fiscal 2021. We do expect the environment to somewhat normalize by 2022 and to deliver on our long-term targets. And as I hope you've heard today, we're executing against a set of clear strategic priorities, and the team is very committed to achieving our goals.

Now I'll turn it back to Ryals. Thank you.

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Director*

Great. Thank you, Steve. Before we wrap up, I want to highlight the strength and longevity of Flowers as a company. We've been in business for over 100 years now. And in fact, the original Thomasville Bakery that sits just right down the street from where we are now is still in operation, and is really a great illustration of why we think Flowers is such a good long-term investment. Over the years, if we've done anything, we've certainly cultivated a tremendously important asset, and that's a passionate team that's committed to delivering shareholder value.

Another key attribute, it's the emotional connection of our core products. It's fresh bread. It's a nutritious staple. It's a foundation of many, many everyday meals and frankly, very economical on a per slice basis. It's unique among staple foods. Consumers have their individual preferences across a wide variety of tastes and textures, and we play across a wide variety of those same tastes and textures. This provides innovative brands like the ones that we have; the opportunity to connect powerfully with consumers, as you heard from Debo this morning. And it's that consumer loyalty in the end that builds valuable brands over time.

Third, as evidenced by the Thomasville Bakery, there are significant competitive advantages to leading operators like Flowers. The combination of really strong brands and the logistical scale that we have, provided by our network of many bakeries across the country, supports the consistent cash flows that Steve spoke to and also offers very attractive returns on capital.

Finally, we have an opportunity to grow through product adjacencies, innovation and with smart acquisitions, as you heard from Mark, and Mark, and Debo. And with our new organizational structure in place, our vision has never been clearer. I'm really excited about the opportunity to truly unleash the power of our brands and bring our customers and consumers more new and exciting products for years to come.

So in summary, I certainly believe in what we're doing. And hopefully, today's presentation has made you a believer as well. So thank you for joining. And I think now we will open it up for questions.

QUESTIONS AND ANSWERS

J. T. Rieck - *Flowers Foods, Inc. - Treasurer and VP of IR & Financial Analysis*

Very good. Let's begin the Q&A session.

(Operator Instructions)

Our first question is from Bill Chappell with Truist Securities. Bill, are you on the line?

William Bates Chappell - *Truist Securities, Inc., Research Division - MD*

Yes, can you hear me?

J. T. Rieck - *Flowers Foods, Inc. - Treasurer and VP of IR & Financial Analysis*

Yes.

William Bates Chappell - *Truist Securities, Inc., Research Division - MD*

Fantastic. A few quick questions. I guess -- well, not quick. But first, Ryals, just help us understand on the long-term growth of kind of 1% to 2%. What are you expecting out of the category? And when I say that, I mean, can you do that? What are you expecting beyond Dave's Killer Bread and Canyon and kind of the specialty side for the core business to grow? And do you need pricing to do this? Or is this all really volume-driven?

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Director*

Yes. It's a great question. Bill, as you know, I mean, the category overall, let's take COVID out for a minute. The category overall has been pretty flat over the last several years. But we have been able to achieve above-category growth, both with our -- obviously, the acquisitions have helped, but also with some of our core products. And that's why I'm so focused in on innovation because that's really going to be key to bring those new and differentiated items to the consumer to help continue to drive that above-category growth.

As far as pricing, what we've assumed as we built our models and released the guidance, is that we will take pricing when we can to offset inflationary headwinds. And then you also heard about the ability to grow in the additional geographies as well. We still have pretty low market share in some very important areas of the country like the Northeast. We've talked about our 30 share in the South, which is great. A little tougher to grow that outside of innovation, right? But if you think about the Northeast, where we only have an 8 share and we're really just getting started up there, you can see the potential future opportunity.

William Bates Chappell - *Truist Securities, Inc., Research Division - MD*

And I guess a follow-on to that, I mean, what are you expecting for -- from your largest competitor? Because, I mean, part of the issue as we look to like Project Centennial, and the benefits never really fell to the bottom line, was because your competitor remained and -- or the competitive environment remained fairly aggressive on promotions and pricing and stuff like that. And so it was -- we were unable to see that kind of those benefits. So are you expecting from here forward, a more rational environment?

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Director*

I think it's hard to say. I mean we all know the promotional environment has been way down for a lot of food companies during this situation, just due to the high demand. So I would expect as things normalize that maybe that comes back some, but Bill, I can't control what competitors do. I can control what we do and how we react and how we run our business. And we're confident over time that, pulling all the levers that we've discussed today, that we can grow the top line at that rate, understanding that embedded underneath that top line growth rate is some anticipated pullback on lower-margin business.

William Bates Chappell - *Truist Securities, Inc., Research Division - MD*

Got it. And just 2 more for me. Since you were part of the -- I think you spearheaded the Project Centennial move. Why are a lot of these changes happening today? Why weren't they part of Project Centennial or done 4, 5 years ago?

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Director*

Yes. I think I've talked about this before. It's another good question. First of all, the supply chain piece was always planned. When we started Centennial, really started executing against it back in 2017, we were more focused on the SD&A line there, understanding we would get to the supply chain piece over time.

One of the -- looking back, one of the faults with Centennial overall is, honestly, we probably tried to do too much at once. So you lost focus in a couple of areas, whereas now, coming back around making some of the organizational tweaks after we sat with that and learned from it some. And hopefully, it came across today being much more focused around our portfolio strategy, supply chain optimization strategies, marketing investments and innovation. Hopefully, that read through today. So it's -- we're trying to be targeted in the areas that we think will have the most impact on the business.

William Bates Chappell - *Truist Securities, Inc., Research Division - MD*

Got it. And last one, just any more color on what you mean by grain-based acquisitions? I mean, in terms of your willingness to look at, it seems like a broader scope. Does that include snacks? Does that include cookies and crackers? Does that include pasta? I can go up with other grain-based type products like, off the top of my head. What does that mean?

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Director*

Well, largely, what we said, it's a -- when you look at it -- when you open up the lens, so to speak, and you look at the industry from a wider perspective than just fresh slice bread, you obviously have a much larger sample set of opportunities. It's -- honestly, Bill, it's a little bit of a tough question to answer just because I don't want to give away too much. But suffice it to say that we're looking beyond fresh bread.

J. T. Rieck - *Flowers Foods, Inc. - Treasurer and VP of IR & Financial Analysis*

Our second question is from Ryan with Consumer Edge. Ryan, are there?

Ryan Blaze Bell - *Consumer Edge Research, LLC - Research Analyst*

As you have increased frequency and household penetration over recent periods due to COVID, could you dial in a bit on your efforts to retain increased households? And can you also speak a bit more about the specific niches within bread and baked goods that you want to target for innovations and future M&A?

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Director*

Yes. And I'll probably have Debo come up and weigh in on this as well. But yes, we have reached a lot more households. And of course, the key to that opportunity is retaining those households going forward. So let me let Debo give you some details on some of the specific things that we're doing going forward, even as this thing begins to die down, to retain those new consumers.

Debo Mukherjee - *Flowers Foods, Inc. - CMO*

Great question on your part. The consumers' habits are certainly changing, and they're situational. The objective that we have is that before those habits became -- become behaviors, we need to understand what the consumer practices are going to be, what they're turning to for their sources of information and make sure that we're relevant and present in those environments. So we're studying the consumers' behavior pretty hard and looking at their -- the impressions that they're creating and what websites they're going to; for example, where are they turning to for some of their recipe ideas and usage ideas. And we're seizing on those as part of our media mix, and we're staying very nimble in that regard. I hope that answers your question.

Ryan Blaze Bell - *Consumer Edge Research, LLC - Research Analyst*

Yes. That was pretty helpful. And then with the niches within bread and baked goods in general, that you potentially want to target for innovations and future M&A. Would you be able to provide any more details on that?

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Director*

Yes. I mean, look, we've -- I think we've already demonstrated some of the things that we've done, particularly in the gluten-free category. I mean it's -- look, it's a much smaller category, but despite calls for its demise for the last 10 years, it just continues to grow, whether for dietary reasons or out of absolute necessity. And so we've been able to build on that. We've introduced the breakfast items. As you heard Mark Courtney talked about a little bit earlier under Dave's Killer Bread, which -- I mean, we've tried countless things in the breakfast segment over the years with a variety of brands, but the Dave's breakfast items have really taken off for us.

We're still small relative to some of the competition. But the trajectory is certainly really good. And look, there's a -- it was sort of similar to the question Bill asked because we've talked about innovation, both organically, inside of Flowers and outsourcing some of that innovation. And we'll be looking at some of these smaller players.

Now right now, in the situation that we're in now, we've all been reading about how big brands are winning again, and is that here to stay? And probably to some extent it is. I hope it is, because we have some big brands. But I also think that over time, when things settle down, I think people will continue to look for smaller brands, for truly innovative, differentiated items, and we need to be a part of that.

Ryan Blaze Bell - *Consumer Edge Research, LLC - Research Analyst*

That's helpful. And with your efforts to improve the profitability of the portfolio, what should we expect regarding SKU rationalizations? Maybe describe the general depth of SKU rationalization potential. And how much low-hanging fruit there might be there in terms of the mix of profitability between your most profitable SKUs and your least profitable SKUs?

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Director*

Yes. And I'll probably ask Brad to weigh in a little bit on this, too. I mean we've -- SKU rationalization is really a continual effort. I mean you heard Mark Courtney earlier talk about the SKU rat we did, the some 20% of products that we deleted. So over time, you take pieces of the portfolio that aren't doing as well or are creating too much complexity in the network, and you take them out. And honestly, that's one of the challenges with innovation, really, is you got to be careful that you don't end up just putting out a bunch of SKUs, but the ones that don't do well, you end up not taking them off.

So it's a bit more of a continual process, in my view. But the idea, the central thesis behind all this is to shift our mix. I mean, we've seen it in the current results. We've seen what it's done from a margin improvement standpoint, which has only served to steel our resolve, because we were already working on this pre-COVID, but this situation, albeit an extreme example, has really proved out the thesis. Branded business is way up, and yet we still have pretty significant declines in foodservice and private label, and yet the margins are up significantly. So you can really start to see what the potential is there.

When I talk about a potential low no-margin exits over time, that will be methodical. That will be structured. It's not all going to happen at once, because pretty much everything contributes something. And so as we grow the branded business over time, if we can't get the lower-margin business to an acceptable margin threshold -- I'd rather do that -- but if we can't, then we'll pull back on that and rationalize that capacity. Brad, anything you want to add?

Bradley K. Alexander - *Flowers Foods, Inc. - COO*

Yes, just to -- I would say the biggest change probably for us is, we've got a more structured approach to SKU rationalization now. And what we realized and we knew, but we've accelerated is, the amount of reducing the complexity in the bakeries, reducing changeovers has really meant a lot of free production time for our plant. So we are doing SKU rationalization. We're looking at everything about twice a year now. So more will come, but we've done a lot already, and it's proving benefits for us.

J. T. Rieck - *Flowers Foods, Inc. - Treasurer and VP of IR & Financial Analysis*

Our next question will come from Brian Holland, and -- Brian Holland from D.A. Davidson.

Brian Patrick Holland - *D.A. Davidson & Co., Research Division - Senior VP & Senior Research Analyst*

Can you hear me?

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Director*

Yes, loud and clear.

Brian Patrick Holland - *D.A. Davidson & Co., Research Division - Senior VP & Senior Research Analyst*

Great. Thank you so much. Maybe if we start just kind of on the second quarter results. Just kind of curious, given the backdrop of COVID-19, how grilling season sort of played out? Obviously, we could see how the results were quite strong overall. But just curious how grilling season evolved versus your expectation. And then kind of applying any of those learnings, how should we think about playing out over the rest of the summer, both with respect to consumer behavior and your promotional stance?

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Director*

We -- honestly, we had a great grilling season despite everything going on. I mean, going into it, we were all a little unsure about how it would go, with people having to social distance. But at the same time, I guess, they were stuck at home. So I went to Home Depot not too long ago. They didn't have any grills left. So clearly, people are still doing that. But we had a great season. Mark Courtney talked a little bit about this. We had great success with Wonder over the holidays. And as you all know, the sandwich bun and roll segment is very important, and yet it's one that we've underperformed in for a few years now. So it was great to see that trajectory for the summer.

Brian, going forward, I wish I was smarter than everybody else, but I'm not. I really don't know. My best prognostication is that we'll continue to see some level of elevated in-home eating even as we move into the school cycle and the fall. Because I just don't -- I don't know how anxious people are going to be en masse to go back into restaurants. I think the foodservice side of things is a pretty, pretty long road to recovery. It -- some of the drive-thru, QSR stuff may do a little bit better because you don't have to go in. But because of that, I think there will continue to be a bit more elevated in-home eating. How long that lasts is anybody's guess.

I think it's largely dependent on, when schools go back, do they stay in? What happens in late fall when flu season comes back around? How long does this last before a vaccine is available? So a bit of uncertainty there. You can see a little bit of that uncertainty, as Steve talked about, reflected in the guidance. I know it's kind of a wide range for halfway through the year, but that's the reason for it. But so far, so good. I mean, even just the few weeks we're into the third quarter, certainly off the peak, but we're still seeing good retail sales.

Brian Patrick Holland - *D.A. Davidson & Co., Research Division - Senior VP & Senior Research Analyst*

I appreciate the color and certainly agree with your view re at-home consumption. If we could switch back to the long term now. I think you spent a bit of time talking about some of the components. And Bill, you addressed with those question, some of the things that maybe didn't come along as you expected originally with Centennial, and maybe why some of these targets, therefore, are pushbacks. So I won't dwell too much on that.

But just kind of curious, you spent a lot of time talking about the brand importance. And I think that's something you've talked about for the last few years. If we think about this category historically, the largest branded players have also been very relevant as -- with respect to producing private-label products, which have been important to retailers. And I think intuitively, the thought was, private-label production is kind of the point of entry into maybe preferred shelf space, et cetera. Clearly, branded share is growing in packaged bread over the past several years and continues to do so. But it still seems like private label should be important.

So I guess what I'm curious is, how do you balance these 2 components going forward? Is private label less important to the retailers in this category than maybe it was 5 years ago? And then also, with respect to price points, et cetera, keeping private label at price points that retailers want, but you have more premiumized products. So the price gaps are wider, which in theory creates an issue, although the data would suggest that, that hasn't gotten in the way. So I apologize that's a vast question with a lot of parts, but really just want to get into the importance of private label, how you manage the 2 as you continue to increase your focus on branded products.

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Director*

Absolutely. And I'll let Brad comment as well. He's so close to it. But yes, look, private label has always been an important part of the business. I mean for -- it's still important to the retailer, to answer that question. And frankly, it's important to us, too, because when you have some excess capacity, it helps us, because we're able to cover some overhead by making it for our retailers. And I consider our retailers strategic partners. And that's why it will continue to be important to us.

Having said that, we do have some elements of our portfolio that just don't carry enough margin for whatever reason, because of the method of distribution that's required, or pricing or whatever. And Brian, at the end of the day, we're not in business to generate a sales dollar. We're in business to make money for our shareholders. And so we're approaching it as much more of a strategic partnership for our retailers, but I also think that the retailers are responding to the consumer. Certainly, there's a place for private label. We play across, as we've talked about today, a lot of different price points from private label to Wonder to regional brands to Nature's Own to Dave's and Canyon.

So kind of all across the spectrum. And there are consumers that want items in each of those areas. So we've got to be there for the consumers, just like the retailers have to be there for consumers. Brad, any additional color you want to add?

Bradley K. Alexander - *Flowers Foods, Inc. - COO*

The only thing I would add is, I think the branded companies have done a good job of differentiating their brands and coming up with new innovation. And that's, I think, got a big interest in the consumer. So -- and it varies, like Ryals said, customer by customer on what their strategy is with private label. And we have to be in sync with what they want and decide if we want to play with them or not in private label, so.

J. T. Rieck - *Flowers Foods, Inc. - Treasurer and VP of IR & Financial Analysis*

Very good. Well, let's move to our next question from Matt Fishbein with Jefferies. Matt, are you on the line? Matt, you might be on mute.

THOMSON REUTERS

Matthew Jacob Fishbein - *Jefferies LLC, Research Division - Equity Associate*

Sorry about that, didn't know I had to click there. It's Matt on for Rob Dickerson. Just one question for me. First of all, great presentation. Definitely the best webinar setup, I think, we've probably ever seen. So thank you for that.

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Director*

Wow. Thank you.

Matthew Jacob Fishbein - *Jefferies LLC, Research Division - Equity Associate*

Well, I wanted to follow-up on 1 of Bill's questions regarding Project Centennial and the supply chain optimization plan. Totally appreciate that the top line growth is clearly a big driver. It sounds like the biggest driver of fixed cost leverage increase and the go-forward margin expansion potential of the business. But in addition to the increased focus that you have now, what are the key differences between the list of levers, call it, identified to drive supply chain optimization over the last few years in the Centennial plan, versus the levers in the current plan today? And maybe as a follow-up to that, what is the magnitude of the supply chain optimizations improvement to margins, relative to that top line growth that you need? And has that changed versus the Centennial plan?

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Director*

Yes, sure. Great question, Matt. Thanks. First of all, as I mentioned a little bit earlier, the first phase of Centennial, if you will, was focused much more on the SD&A line. And we've made a lot of progress there. We always knew that we would move to Phase 2, which focuses much more on supply chain.

Now having said that, in some way, shape or form we've always done this. The company has always moved capacity to where the people are, where it can be the most profitable to optimize our transportation miles, that kind of thing. What I would say is all of the supply chain optimization efforts now are being done under the halo of the portfolio strategy. The portfolio strategy really drives everything underneath it, right? So you heard me say, we want to make sure that we've got the right plan assets and the right locations supporting the right products. So that means as we shift our mix to branded retail, that we can either repurpose capacity -- Brian talked about the Lynchburg bakery that will come online in the fall, producing DKB. I mean, essentially, that was a sort of a mainline, white bread bakery before. And now it's moving up to Dave's Killer Bread in the premium segment.

We had done the same thing with the Tuscaloosa, Alabama bakery. We'll continue to do things like that as we need capacity and great brands like Dave's keep growing. So it's important to note that it's really part of the overall portfolio strategy comes right underneath it. As far as magnitude goes, without being too specific, they're both critical, right? I mean you've got to have the right brand strategy to drive growth, but you better have the right cost base, too. And you better have the right network to support that growth, not too big, not too small, just right, but flexible enough to move up as you grow. Hopefully, that helps a little bit.

J. T. Rieck - *Flowers Foods, Inc. - Treasurer and VP of IR & Financial Analysis*

We'll go to our next question with Faiza Alwy with Deutsche Bank. Faiza, are you there?

Faiza Alwy - *Deutsche Bank AG, Research Division - Research Analyst*

Yes. Can you hear me?

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Director*

Yes.

Faiza Alwy - *Deutsche Bank AG, Research Division - Research Analyst*

Okay. Great. So I wanted to talk a little bit more about the expansion markets and the focus there. I know you've talked about that historically. But it seems like there's more of a focus now than before. And I was wondering if you're doing something different and if you're devoting maybe more investments to those markets, and what that entails?

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Director*

Yes, yes and yes. But I will turn that to Brad and let him give you more color.

Bradley K. Alexander - *Flowers Foods, Inc. - COO*

Thanks, Ryals. We are. The nice thing is we're starting to gain some traction. We've only been in New York about 5 or 6 years, and we started with a 0, and we now have a 8 to 9 share. So once you get some momentum going, it is easier to grow in those areas. But we are excited. We are putting additional efforts in those markets. We're putting additional marketing prowess in that market. We are focused on it. We've got good targets. The nice thing is, we've had strong single and low double-digit growth in those newer markets, and we want to continue that and push that along even more.

J. T. Rieck - *Flowers Foods, Inc. - Treasurer and VP of IR & Financial Analysis*

Very good. And we now have -- we will now go to Mitch Pinheiro with Sturdivant. Mitch, are you there? You might be on mute.

Mitchell Brad Pinheiro - *Sturdivant & Co., Inc., Research Division - Research Analyst*

I got you, yes. You there?

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Director*

Yes.

Mitchell Brad Pinheiro - *Sturdivant & Co., Inc., Research Division - Research Analyst*

So first question, just is on snack cake. Why -- obviously, it's a priority here to get it back to a more optimal level. But I don't understand, I mean, is this -- snack cake always seems to be an issue. And not -- long before Tastykake's an issue, Hostess has been an issue. It's not a great category or at least it doesn't seem to be. Why not just divest it? Why struggle through trying to make Tastykake and Mrs. Freshly's and everything else work?

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Director*

Mitch, I've said many times. First of all, cake has been a part of our company for a very, very long time in one form or another. But it has been tough. I mean, you're right. I mean -- and for us, we've got a brand that's not 1 of the top ones outside of the core Philly market. But we do have some really great products, some great quality products. That's why I keep saying that the first 3 priorities for our cake business is operational improvement, operational improvement and operational improvement.

Because we've got a tremendous opportunity if we can get the Navy Yard bakery back to where it needs to be, back to operational excellence, the incremental profit opportunity is quite large. It's also great support for our routes. The independent distributors like having cake on their trucks. And frankly, Tastykake is a big brand. We've got to fix operational pieces first, but we think that Tasty has got good potential down the road, too. I don't really mean to deemphasize it. It's just really first things first. And I might ask if Mark Courtney maybe wants to talk a little bit more about Tastykake as well.

H. Mark Courtney - *Flowers Foods, Inc. - Chief Brand Officer*

Yes, Ryals. Mitch, the only other thing that I would add is, as you well know, Tastykake is extremely strong in the mid-Atlantic area, where our shares are high 30s, 40. So in our portfolio strategy, it falls under the strong regional brands for that reason. We do sell it nationally. But in contrast to the Mid-Atlantic region, where we have dedicated cake routes that are really focused on selling cake every day, the balance of our cake in the rest of the country is sold on our combination routes. And it does provide incremental sales opportunities, profit opportunities for our distributors and serve a very tactical role from that respect.

Mitchell Brad Pinheiro - *Sturdivant & Co., Inc., Research Division - Research Analyst*

And just look, actually, also in the second quarter, I mean, how was -- I know you don't break it out by brand, but how was the Snack Cake business in the quarter?

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Director*

Tastykake had a good -- they had a good quarter. They did very well.

Mitchell Brad Pinheiro - *Sturdivant & Co., Inc., Research Division - Research Analyst*

Okay. When you look beyond, I think at some point -- hopefully, at some point, we get beyond this COVID issue. And things get back to normal, maybe it's in 5 years. But when you go 5 years from now, aren't we still going to be in the same spot in terms of, we'll be more foodservice sales, which is a lower margin. I'm not sure about private label, that might stay where it is. But aren't we going to start to see -- won't we have a little bit of a negative mix as COVID disappears? Or how should we think about that?

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Director*

Yes. No, it's -- I get what you're saying, Mitch. In a way, yes, because if you think -- if we're unable to grow branded retail and foodservice and private label comes back up, obviously, you have that shift there. But if we can keep growing our branded retail business at a faster rate than the foodservice and private label business grows, and of course, there's 2 ways to do that, you can not take business or you can take business down in those less attractive areas, then we should still continue to see the positive mix that we're looking for. I need to emphasize, I mean, we like the foodservice business, frankly.

We don't like all of it, but we like a lot of it. We have some really good foodservice business that we would like to stay in. The idea here, though, is, again, just like the question related to private label, we want to be in strategic partnerships with our customers. And we're -- as I said before, we're in business to make money. And so we need a framework with which to do so. If we can work with a particular customer that may be underperforming on pricing or method of distribution, doesn't all have to be priced. It might be method of distribution, for example, or formulation or things like that, where we can improve our cost structure to an acceptable margin. I don't mind keeping some foodservice business on, because it does provide us a lot of overhead coverage as we continue to grow the branded side of the business.

Mitchell Brad Pinheiro - *Sturdivant & Co., Inc., Research Division - Research Analyst*

Okay. And then last, just on -- you talked about M&A deal structure. I mean, what would it take? Why would you have an unusual or modified deal structure in an acquisition? I mean, are we talking about a large acquisition that would require that? Are we just talking, just trying to get in the door in a very small company and willing to take a minority, some sort of minority stake. Can you talk about that a little bit?

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Director*

Yes, sure. A great question. I'd say, mostly on the smaller end of things, right, almost from a venture capital type standpoint, not really formally that, but that's the general idea. Probably less so on the large acquisition side, although Mitch, you remember as well as anybody, the Keebler transaction that we did back in the late '90s, which started off as a minority investment. So certainly not ruling that out, but most likely on the smaller end of things.

J. T. Rieck - *Flowers Foods, Inc. - Treasurer and VP of IR & Financial Analysis*

Very good. That concludes our Q&A session and our investor update. Thank you for your interest in our company, and we look forward to sharing our third quarter results in November. Be well, and goodbye.