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FLO.N - Q1 2023 Flowers Foods Inc Earnings Call

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**Robert Frederick Dickerson** *Jefferies LLC, Research Division - MD & Senior Research Analyst*

**Stephen John Lengel** *Truist Securities, Inc., Research Division - Research Analyst*

**Stephen Robert R. Powers** *Deutsche Bank AG, Research Division - Research Analyst*

## PRESENTATION

### Operator

Good day, and thank you for standing by. Welcome to the Flowers Foods First Quarter 2023 Results Conference Call. Please be advised that today's event is being recorded.

I would now like to hand the conference over to your speaker today, J.T. Rieck, Executive Vice President of Finance and Investor Relations. Please go ahead.

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### **J. T. Rieck** - *Flowers Foods, Inc. - Executive VP of Finance & IR*

Thank you, Shannon. And good morning. I hope everyone had the opportunity to review our earnings release, listen to our prepared remarks and view the slide presentation that were all posted yesterday evening on our Investor Relations website.

After today's Q&A session, we will also post an audio replay of this call. Please note that in this Q&A session, we may make forward-looking statements about the company's performance. Although we believe these statements to be reasonable, they are subject to risks and uncertainties that could cause actual results to differ materially. In addition to what you hear in these remarks, important factors relating to Flowers Food's business are fully detailed in our SEC filings.

We also provide non-GAAP financial measures for which disclosure and reconciliations are provided in the earnings release and at the end of the slide presentation on our website.

Joining me today are Ryals McMullian, President and CEO; and Steve Kinsey, our CFO. Ryals, I'll turn it over to you.

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

Okay. Thanks, J.T. Good morning, everybody. Thanks for joining the call. Our results this quarter reflect the strength of our leading brands and the dedication of our Flowers team. And I do want to thank them for their hard work. It was instrumental in helping us drive record quarterly sales. We did face difficult year-over-year comparisons in the quarter due to a strong impact from the Omicron surge early last year and by some storm activity during the same time period.

to enhance our competitive position. Some of these initiatives may impact near-term results, but they are crucial for enabling our growth plans. I'm excited about our prospects, and I've really never been more confident in our ability to grow shareholder value over time.

So with that, Shannon, we are ready to take questions.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Our first question comes from the line of Steve Powers with Deutsche Bank.

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### Stephen Robert R. Powers - Deutsche Bank AG, Research Division - Research Analyst

I guess picking up on those opening comments, just how much of the sort of temporary transitory nature of the headwinds that you're seeing? Do you expect to improve within this year? I guess that wasn't clear from your prepared remarks last night. In other words, are you assuming that things get better? Is it temporary within the year? Or is it temporary over a longer period of time?

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

Yes. Steve, I appreciate the question. Look, we are likely being a little bit conservative with the guidance, just given the soft start to the year. We felt it just most prudent to do that at this time. However, what we did see towards the end of the quarter was some pretty meaningful improvement. And by that, I mean, our branded retail units turned flat to positive in several of the last weeks of the quarter.

And at the same time, private label share gains really started to come down. When we started off the year, I think in the first period of the year, we saw private label gain the most unit share that we've seen during this whole trade down situation. Gained 120 basis points. By the end of the quarter, it was 50%. So we are starting to see that come down. It is still a tale of 2 channels in the sense that we're not seeing the same dynamics in grocery that we're seeing in mass. Most of the private label activity has been concentrated in mass. So that's a continuation of what we've talked about in prior quarters.

So as to exactly when it's going to happen, that's a little bit difficult to predict. But I do have at least some hope at this point that things already look like they're beginning to get better. But for the time being, we've decided to be conservative.

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### Stephen Robert R. Powers - Deutsche Bank AG, Research Division - Research Analyst

Okay. So I guess that's -- so the soft start you called out in the year, I guess, I mean, it's evident in the data. And I guess what I'm trying to reconcile is it seems like that would have been evident also to you when you guided in early February. Things are getting better towards the end of the quarter. So what got worse? Is my question...

**Stephen Robert R. Powers** - *Deutsche Bank AG, Research Division - Research Analyst*

Okay. And I'll pass that in a second. But just one more question, if I could. Just you called out the temporary imbalance between capacity and production as a result of the softer start. I guess just can you elaborate a little bit on that in terms of what the implications are from a financial perspective? And then just the time line you expect some resolution through the supply chain optimization work.

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

Yes, sure. I mean we're not going to quantify it. But I want to make it clear, too, that the imbalance is -- was certainly a factor in the quarter. It is definitely not the factor. The factor is the consumer and the softness in the category. So I just want to be very clear about that. But we're trying to be transparent with you guys and give you as complete of a picture as we can as to what's going on good, better and different with the company.

And when we talk about our portfolio strategy, and we've talked about not really so much the SKU rationalization, that's kind of a common ongoing thing, but more of the business exits where we have elected to exit certain lines of business that were marginally profitable and really didn't have a chance to ever really meet our profitability thresholds through pricing or efficiencies or whatever. Those types of exits are what I'm referring to. And typically, those pieces of business do contribute at least a little bit of something to the business, right?

So you're going to have a little bit, you're going to have a little bit of stranded cost when you add into those pieces of business. Now over time, as we -- and we've talked a lot about network optimization over time, that's where that comes into play. And once again, you've seen us do this. You've seen us -- we exited the Phoenix bakery recently, but we've also converted facilities to organic production, all brand, that type of thing. That's what we'll take care of that. In addition to branded growth over time, we'll take care of that imbalance.

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**Operator**

Our next question comes from the line of Bill Chappell with Truist Securities.

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**Stephen John Lengel** - *Truist Securities, Inc., Research Division - Research Analyst*

This is Stephen Lengel on for Bill Chappell. Can you guys give us some more color regarding the price gap dynamics along and other pricing round? How have the mass retailers reacted to additional pricing? Is it kind of fair to assume that maybe the gaps have started to widen and you might need some time to touch up. Any color there would be super helpful.

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

Yes. So if you recall, last year, when we implemented pricing, they're what -- the gaps between brand and private label did widen. Some retailers were holding their retail prices down. And I believe it was late in the year or early this year, the gap started to narrow as the private label retailers came back. We have recently taken some additional branded pricing that goes into effect this month.

So there could be a much smaller increase in the gap because our branded price increases, this round were quite a bit smaller than what we've done in the last few rounds. So that could widen the gap temporarily at least for a while, but it's too early to say because the pricing just went in, so we haven't seen the data yet.

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

Yes. No, we're still really excited about it. So we're in about 6,000 stores now. So call it, roughly halfway to where we want to be by the end of the year. And as far as us entering the retailers that we expect it to, we're largely on track there. As far as the performance goes, where the bars have been in the market the longest, we're doing really, really well. Where we're newer, it's a little bit lower, but yes, you expect that.

We had -- just in -- one retailer, in particular, we had a few executional issues just on the front end. We're getting all that taken care of. So those numbers are already starting to track better. So all in all, we're in a really good position and super excited about where we're headed with the bars.

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**Operator**

Our next question comes from the line of Robert Dickerson with Jefferies LLC.

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**Robert Frederick Dickerson** - *Jefferies LLC, Research Division - MD & Senior Research Analyst*

Great. A couple of questions. I guess kind of first question is just with respect to that incremental pricing that's coming through, I know that was already discussed previously. Just kind of where you're seeing share trends as you're entering -- or sorry, as you're exiting the quarter, is there a scenario that plays out such that maybe you do need to promote a little bit more?

Because I know, Ryals you've said historically, right? It's not very -- a very heavily promoted category but at the same time, at some point, volume growth should matter. So I'm just kind of curious how you think about that right now?

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

Yes, absolutely. So Rob, the branded pricing just went in. So we're not really -- we can't really see any impacts from that just yet. I will tell you, we promoted a little bit more in the quarter. It wasn't terribly significant, but we did tick up a little bit as far as our activity went to your direct point.

I know that particularly with -- if you think about elasticities with our business, set the category softness aside for a second, we're still performing very, very well against our elasticity model. So it hasn't -- we're outperforming virtually everything. Now when you look at something like Tastykake, for example, where we don't have a stronger brand. We've had more elasticities there and have had to promote a little bit more from that standpoint, but that probably wouldn't be a surprise to anybody.

But overall, we've seen -- once again, we've seen some pockets of competitive activity from our competitors in the category and our promotional level did tick up just a little bit in the category. But as of yet, Rob, I wouldn't call out anything terribly meaningful. I think we're going to continue, to your point, continue to watch the volume trends. Once again, they did start to get better, and we actually saw unit increases towards the end of the quarter. So that gives me a little bit of confidence.

I just don't have enough of a trend line yet. Because it happened right at the end of the quarter to call it a long-term trend just yet. So once again, that's why we're a little bit conservative with the guidance.

while at the same time, grains deflated.

So I would assume at some point, that does become a benefit, but I don't know if you're being conservative because maybe you need to kind of reinvest some of that back in. So lot in there, but just trying to kind of gauge as to how the year could play out, right, in terms of gross margin?

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

I mean the reality is, overall, we expect inflation throughout the whole year. I mean, the first half is definitely our toughest comp because we had pretty favorable hedges coming into the year last year. And then obviously, the inflationary environment around we really begin to ramp until kind of early first half and we would have been covered for most of that period last year.

So looking to the kind of the full year and thinking about cadence, obviously, the first half is the top back half. Like I said, we still expect inflation. A lot of it is driven by other buckets other than Flower across the input bucket. Sugar is up. Gluten is up pretty significantly, and we use quite a bit of gluten because of -- typically because of protein quality within the wheat. We're also seeing yeast is up, honey, several other smaller or minor ingredients up. So while we do expect better and easier -- better comps in the back half, we are expecting an inflationary environment throughout the whole year.

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**Robert Frederick Dickerson** - *Jefferies LLC, Research Division - MD & Senior Research Analyst*

Okay. Got it. Fair enough. That's helpful. And then, look, I know you're not -- it's not really your style, so to speak, to kind of speak to the next quarter, right, a quarterly guide, but I'm kind of curious, maybe kind of in more general terms, we saw this EBITDA step down in Q1. Is there any way you can frame it? So we kind of understand a little bit of the cadence as we get through the year, like we'll probably again see more of a step down in Q2 relative to what we would expect in the back half?

Just thinking about kind of the midpoint of the updated guide.

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

Obviously, I mean, you're right, we don't give quarterly guidance. So when you think about the annual guidance that we've given from an EBITDA perspective, again, we do think complicate easier in the back half. Overall, from a kind of cadence perspective, hopefully, as Ryals said, too, we're seeing improvement across markets coming out of the first quarter. So not speaking specifically to any quarter, I think we should come in kind of in line with some of the comments you've made and expectations.

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**Operator**

Our next question comes from the line of Mitchell Pinheiro with Sturdivant & Company.

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

So why do you think the environment is transitory and not -- and I don't know what transitory means, like is it quarter, 2 quarters versus transitory, it's shorter than that. But the environment looks pressured and looks pressured for longer, at least in our view. So why do you see it as transitory?

And the reason I believe that is because eventually, we're going to come out of this inflationary cycle. Presumably, at some point, you have a recovering consumer. And when you think about our business in particular and the trade down to private label, I firmly believe that the premiumization of the category is a long-term trend. I do believe that people will come back to differentiation. I do believe that people will come back to our top brands. That's why I believe that it's temporary now is that 2 months? Is it 6 months? Is it 9 months is a year? I don't know that. But I do believe it will come back, and I think we'll be well positioned to take advantage of it when it does.

Once again, we're keeping up our brand investments, we're keeping up our market activity. We're investing in the business. We're investing in our team. So we wouldn't be doing that if we believe that this is a permanent circumstance.

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

You also -- you talked about taking specific steps in the short term to mitigate some of these pressures. And I heard you said that you did step up promotion a little bit in the quarter, at the end of the quarter. What else are you doing in the short term here?

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

Well, obviously, cost savings activities. I think we said in the prepared remarks, we're on track for our \$20 million to \$30 million for this year. All the investments that we're making in the bakeries from a digital standpoint, bakery in the future, in particular, which I'm excited to say, is really starting to show some nice returns. It took in a while to gain some momentum. But once we got through the first period or so of this year, it's really starting to come on strong. And that's going to be particularly meaningful this summer during the height of the summer bun season because we did not operate well last year.

Though our financial results were good last year, we really struggled in the bakeries last year. So that is going to be a good comp for us coming up this year. You may also recall, we had some of the packaging issues in the second quarter last year that we'll be comping as well. We don't have those issues this year. We're in great shape from a supply chain standpoint. So all of those factors together help to mitigate not only inflation, but just kind of the overall macro environment that we're facing today.

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**Operator**

Our next question comes from the line of Connor Rattigan with Consumer Edge.

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**Connor Rattigan** - *Consumer Edge Research, LLC - Research Analyst*

So it seems like you guys are doing really well in grocery. The pressure really is just coming from the mass channel. And so I guess I'm trying to better understand the dynamics here. So I mean I suppose we can assume the more budget-conscious shopper is more likely to both trade down and be a channel and from brand to private label.

But I guess if we think about the consumer's decision to make either jump, I guess, have you simply see the consumer jump right from, say, I think on low growth rate to private label and mass? Or has this been sort of a gradual waning? And I guess also those -- for those consumers that have already made the jump, how should we sort of think about bringing them back into the branded fold?

couple of reasons.

One, there's been a channel shift. So people across, frankly across the income spectrum, quite interestingly, including higher income, shoppers are looking for bargains given the environment that we face. So there has been a bit of that channel shift in the mass, in the club, in the dollar stores and away from grocery. So that does play into it. However, for those shoppers that are still in grocery, our performance has been really good. I mean we were up in the unit share in grocery, and we were up across the board in every category -- we are flat or up across every category -- subcategory rather.

So it is an interesting dynamic. But I think to your point about how do you bring them back to brands if they trade down to private label, I think you've got to keep them front and center. We've got to be spot on with our display execution. We have to put our marketing dollars in the right places, whether that's digital or TV or whatever to keep these brands in front of people.

And then I think it's also still about innovation. We're not slowing down our innovation just because of the environment we're facing. I think it's more important than ever now. And so whether that's in our core category in terms of our keto low or our Hawaiian these new items that we're putting out or whether it's outside of our core category in terms of the bars, keeping these brands front and center for consumers is more important than ever today.

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**Connor Rattigan** - *Consumer Edge Research, LLC - Research Analyst*

That was great, Ryals. Really helpful. And then also just a quick follow-up, too. So on Canyon, I think in the prepared remarks, you guys commented that the track data was kind of skewed just given the sort of mix shift in club channel? And yes, I think you guys quantified about 80 bps of share losses, but flat unit sales. I guess, how are share trends looking when accounting for the club channel mix shift?

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

So the ultimate question is -- what Connor. Sorry.

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**Connor Rattigan** - *Consumer Edge Research, LLC - Research Analyst*

I just kind of want to get a sense for how share trends were looking for Canyon when accounting for that club channel mix shift? Because I think in track channels, you guys had -- share was down about 80 bps, but I assume it will be better in the club -- when you account for the club channel that is.

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

It is. It is. Yes. So our internal data, we're still up. We've got every confidence in Can. It's proven to be one of the most inelastic brands that we have, which I guess makes sense given some of the dietary issues with folks and gluten allergies. But yes, we're still really excited about Canyon. It's doing quite well. And frankly, from an innovation standpoint, we're really excited as well. Obviously, we started with DKB from an innovation standpoint just because it's a bigger category. But I think that we've got some really nice opportunities to innovate both inside and outside the core with Canyon as well.



Can you just follow up on the Canyon dynamic there a little bit. I believe in the prepared remarks, you mentioned some dislocation just as you're doing some SKU rat and some product availability. Should we think about the Canyon as you kind of have a limited amount of Canyon product. You shifted distribution towards club. And as the production capacity kind of comes back online in moving forward, do you have a chance to refill the SKUs in the track channels? Or should we think of those as grown...

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

No, no. When we -- it's a good news, bad news situation, right, because we are a little bit strained with Canyon, but restrained because it's grown so much. So once we get our capacity situation resolve, which we're obviously actively working on, we expect to refill in that space.

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**James Ronald Salera** - *Stephens Inc., Research Division - Analyst*

And then maybe more broadly, just across the branded portfolio, you talked about kind of the [private gap] narrowing. Obviously, consumers strained right now. But as things hopefully ease as the year progresses, do you think that the consumer will just kind of gradually come back to branded? Or are you going to need to have some additional push to pull that consumer back into the branded portfolio if they've shifted towards private label?

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

Yes, that's a really good question. And it's -- I'll answer it in 2 parts. Frankly, it depends on what brand you're talking about. If you're talking about a brand like DKB, it has tremendous consumer pull right? So there -- you don't have to do as much to draw people back to days because they want to come back to it naturally because it is so differentiated and high quality.

Frankly, when you're talking about a brand like Nature's Own, yes, you're probably going to need a little bit more push there, hence the marketing investment. That's why we're not stopping that. And we're not waiting for the consumer to get healthy before we start that market until we want to keep it front and center now so that they want to come back to us. So I do think it depends on which brand you're talking about. Some will take a little bit more pushing than others will, if that makes sense.

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**James Ronald Salera** - *Stephens Inc., Research Division - Analyst*

Yes, yes, absolutely. Should we think about from kind of the levers that you guys have to pull to bring them back? Is it more traditional marketing, kind of just making the consumer more aware or kind of highlighting the positives of the brand? Or is it promotion getting them to come back with an initial lower price point and then hoping that with the inertia, as you pull the promotion, they kind of stay in the branded portfolio.

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

Well, we certainly hope it's not in the latter, right? I mean but sometimes you have to pull that lever. But I go back to execution as well. Display execution in our category, off-shelf display execution is so important in our category. And sometimes that does come with a promotion to bring people back to the brand, but we've got to be best-in-class in that regard. If we can do that, and I believe we can when the consumer is ready, I think we're well positioned to win. So it's really -- you've got a toolbox of things, right? You've got marking, you've got some, hopefully, limited promotions.

**James Ronald Salera** - *Stephens Inc., Research Division - Analyst*

Got it. And then maybe if I could sneak in one more question. Just looking at DKB bar launch, I know we still got a lot of opportunity to ramp that. The kind of initial results that you guys are seeing, are there existing DKB buyers that are just expanding their buy rate and taking it into new categories? Or do you see incremental buyers that maybe aren't a DKB bread buyer that will buy the bar and then obviously they hope that you kind of cross-pollinate into the traditional brand category.

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

Yes, it's both. It's both. It's -- this is why the opportunity for DKB is so -- is so interesting and so fun to think about going forward. I've talked about the household penetration for DKB many times in the past, and it's actually still quite low. As a matter of fact, I was actually speaking with recently retired Chief Marketing Officer from a major CPG company that had never heard of DKB before.

And this is a person that's in the business of marketing. So -- it just goes to show you that as well as that brand is done, we still have a tremendous runway ahead of us, both in the -- with the core items and with the new consumers. So to answer your question, it's both. There are people that are discovering bars that may not even know that the bread exists and vice versa. And we're also doing some things from a shopper marketing standpoint to cross-pollinate that and encourage it more.

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**Operator**

I'm showing no further questions at this time. I'd like to hand the call back over to Ryals McMullian for closing remarks.

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

Okay. I want to thank everybody for taking time today and joining us for questions. Thank you very much for your interest in our company. And as always, we look forward to speaking with you again next quarter. Take care.

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**Operator**

This concludes today's conference call. Thank you for participating. You may now disconnect.

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