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FLO.N - Q2 2021 Flowers Foods Inc Earnings Call

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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the Flowers Foods Second Quarter 2021 Results Call. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions)

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

J. T. Rieck - *Flowers Foods, Inc. - SVP Finance & IR*

Thank you, operator, 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 Foods business are fully detailed in our SEC filings. We also provide non-GAAP financial measures for which disclosures 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.

Operator, we're ready to start the Q&A, please.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We have our first question from the line of Bill Chappell from Truist Securities.

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

Just one of the things we've heard from several or multiple food companies over the past 1 month, 1.5 months is that there's been a meaningful, for whatever reason, trade up from private label to branded. Thought is stimulus checks or other issues, though no one can quite figure it out. And clearly, that had some impact or continues to have some positive impact on your business.

So I guess the question is do you see this as a sustainable shift. Or do you think that people will move back towards private label, which could put margin pressure as we move into the back half of this year or into next year?

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

Yes. Good question, Bill. In our category with private label being historically so overdeveloped, we were actually seeing these private label declines even prior to the pandemic. And I think we've mentioned that on a couple of prior calls.

We've actually done a fair bit of research, consumer insights research into why that trend is continuing and almost accelerating, really. And it really comes down to -- in our category, there's a distinct lack of differentiation in private label. It's basic white and wheat bread and buns, whereas in the category, Flowers has participated in this. Obviously, you have a lot of differentiation with the new perfectly crafted brioche rolls with things like Dave's Killer Bread and Canyon. And that's driven a bit of a premiumization process up to branded from private label.

As to whether it's sustainable or not, I actually think it is. And that's why we're making all the investments we're making behind our brands, the marketing support, et cetera. If you get into a recessionary situation, you could see some move back to value. But even in the last recession that we saw in sort of '08, '09, we didn't see that much of a move back to private label even then.

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

But I guess, did you see a step change in this current quarter? Or is it just more of a continuation of the trend?

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

It's really more a continuation of the trend. Private label just continues to fall and branded retail continues to hold up very, very well.

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

Great. And then just on the cost front, same thing. I heard a lot of your peers talk about -- especially more on freight and incremental costs, you seem to be able to raise EPS guidance for the full year. It seems like it's less of an impact. Is that largely due just to the way your supply chain distribution works? Or is there something else that's helping you offset these costs?

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

Yes. Partially, that's -- and Steve can jump in here, too. But yes, that's partially the DSD but that works a bit more of a closed loop system. So we're not as exposed to the long-haul freight.

And then the other thing I would say is with our hedging strategy being 4 to 7 months out, sometimes a little bit longer, that gives us good visibility in advance of what our costs are going to be. And we can be proactive about mitigating those costs. Steve, anything you'd add to that?

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

No. I mean, I think, as we said earlier, Bill, in the year, we had pretty good visibility into our overall cost structure for this year. Obviously, the inflation in the back half is a little heavier, but we think we've taken the right steps to mitigate most of that. And as Ryals said, on transportation, we're not immune to the increases. But we feel like for 2021, our contracts have protected us the best they can.

Operator

Our next question is from the line of Mitch Pinheiro from Sturdivant & Co.

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

Just following up on Bill's question regarding private label. Is the retailers' view of their private label offerings changing as well, I mean, in terms of shelf space allocation? Are they looking to premiumize private label to a greater extent, trying just to keep private label? Or is that really not one of their strategies and they're willing to let the market go where it goes and will reallocate shelf space? Could you give us any -- some color on that?

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

Yes. I mean we've had some isolated discussions about that but nothing broadly in the market. We're not hearing much about wanting to premiumize private label or anything like that to this point.

Probably the one exception for us, the one area of private label that continues to do well is Canyon's private label gluten-free. That's probably the one call-out in private label that's actually showing some growth in our portfolio.

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

And -- but also as part of your discussion, are they looking to reduce shelf space to private label? I mean clearly, the dollar value and the gross margin contribution of the brands versus private label would suggest, I would think, more allocation to the branded shelf space. But is that happening at all or...

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

Again, I would say that it has happened to some extent, but we haven't seen any broad, sort of market-wide moves to take shelf space out. But there have been some isolated customers where that's been reduced.

And you also have the labor situation that's kind of happening to everybody that limits -- somewhat limits the ability to provide all the SKUs. So I mean throughout this pandemic and this whole labor situation, we've had to, in some cases, limit some of our SKUs. And so that's had some effect on the shelf space allocation. But as far as the overall private label allocation, there's been no meaningful change, really.

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

Is there -- are there any pricing changes with private labels? Is it a volume decline? Or is there pricing going up? Or can you talk about that a little bit?

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

Yes. I mean we have taken some pricing over the last several years in private label, yes.

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

Okay. In terms of your -- part of the whole strategy or some of the benefit Flowers gets is from gaining share in lower penetrated, newer markets, newer for Flowers, that is. And anything you could call out geographically, strengths or weaknesses among your territories?

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

Yes. I mean we've been calling out the Northeast for the last several quarters as a focus market for us. We continue to make investments up there. And the good news is we're seeing share gains there.

We had a good quarter in the Northeast. We continue to gain share on the West Coast, another really strong market for us. Obviously, we're super strong in the South. I mean, Mitch, as you know, the big whole -- or opportunity for us is that whole upper Midwest quadrant.

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

Okay. And then just a couple more. In terms of -- what's happening with snack cake and Tastykake in particular? Any -- are you making progress on your profitability?

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

Yes. Yes. Thanks for asking. Really good progress at Navy Yard. Again, I'll say we're not -- we're still not where we want to be, but the trajectory is really good. The team has done a great job up there. Our automation investments are paying off. Scrap rates are coming down.

Labor in the cake markets -- in the cake plants, rather, continues to be a bit of a challenge. It's just the nature of the cake bakeries with more people in there. But overall, we've been able to manage through it really well.

We've also done some things on the commercial side, Mitch, from a price promotion standpoint to make us more competitive there. So all signs pointing in the right direction. In fact, relative to our internal goals, we're actually ahead of plan there.

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

Okay. And then I guess final question is when you look longer term and you look at your margin profile, I think you mentioned in the -- I think, either in this quarter -- well, mix is certainly a powerful help for you. You have productivity and you have your whole network optimization to support further margin improvement.

But I mean how -- it just seems that the branded versus the nonbranded mix is still going to be the most important part of the change. And I'm curious as to, a, if you agree with that; and b, what you're doing -- what specifically you're doing to create the positive mix going forward?

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

No, absolutely. And I agree with you. I mean the whole notion of shifting more of our mix to branded retail is the most powerful tool we have to improve our overall margin profile. But all the other things you mentioned, whether it's network optimization, whether it's our marketing investments, whether it's our digital transformation are all intended to support that mix shift to branded retail.

So it all rolls up to the same strategy of, over time, shifting more of our mix to brands, both the brands we have today and, hopefully, the brands will have tomorrow with future M&A.

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

Okay. And then just actually one more similar question, speaking of M&A, is that can you talk, a, about your pipeline or maybe the environment in M&A right now?

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

Yes. Sure. Really no change from last quarter. I mean it's -- deal activity continues to pick up. We're looking at quite a few things right now, which is a welcome change from last year, when it really kind of dried up.

So we're happy with the pipeline. And Mitch, it's nice to be in the position that we're in, that we've got the balance sheet to act when the timing is right.

Operator

Our next question is from Ryan Bell with Consumer Edge Research.

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

So just touching maybe a little bit more on the inflationary environment and the impacts of the rising costs. Can you talk about maybe your ability to take pricing as we get into the end of the year in 2022?

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

Yes. I mean obviously, we're not going to talk about 2022 today. We're not prepared at this point to give guidance. Although it is on our mind given the inflationary environment we're in. We've seen pretty substantial runs like most other companies. Regardless of which industry or segment you're operating in, we're all experiencing pretty tremendous inflation.

What I would say for 2021, and I think we talked about it in our prepared comments, in the back half, we're pretty confident in our overall structure and also confident in the measures we've taken to mitigate the inflation, the way we have, whether that was pricing. I think you'll see promotional efficiency, which we saw in Q2.

A lot of our projects are on track with regard to efficiencies and kind of productivity. And we expect, really, to use kind of the same tools going into 2022. But beyond that, no, I can't really comment about it beyond this year.

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

Ryan, one thing that I would add to it, and we mentioned this a bit in our prepared remarks, is if you think back to the last inflationary period -- significant inflationary period that we saw, sort of the '07, '08 period, we were a much different company back then. Our market share was a lot lower. We really only had one sort of quasi-national brand in Nature's Own.

And then you fast forward to today and we've got roughly an 18% share. We've got Nature's Own, expanded Nature's Own. Now with Perfectly Crafted as well. We've got Dave's. We've got Canyon. We've got Wonder. And so the brand portfolio, if you will, is quite a bit stronger than it was, which also gives us greater confidence that we can pull that lever to the extent necessary to help mitigate any rises in costs.

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

Okay. That's helpful. And then could you talk about how you're thinking of the back-to-school season in terms of your guidance and what you're assuming about the season? And sort of what would change potentially to your base case given some of the variability that we'd see with the Delta variant and back-to-school and other types of getting back to normal?

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

Yes. Our perspective on that has changed markedly since the first of the year, when we first issued guidance. And then with the vaccine rollout, we were kind of planning for what that was going to look like and how that was going to affect the market dynamics.

And now here, we find ourselves right at the beginning of back-to-school season. We've got this Delta variant that's surging significantly across the country. So our perspective has changed as the dynamics out there have changed.

And obviously, it's hard to say. We had originally expected that the back-to-school season would give us a really good indication of what the new normal might look like in a more steady state going forward. I think the rise of the Delta variant has brought that somewhat in the question and they pushed that time line out a bit now. And obviously, in our results through Q2 and even the beginning of Q3, we're continuing to see very strong branded retail performance in line with what we've been seeing for the first part of the year.

So it's going to be a little bit of a wait-and-see. I would have thought that back-to-school would have -- and people starting to return to office would have given us a better indication. But I think that's gotten pushed out a little bit now.

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

That's helpful. And would you be able to provide maybe a little bit more detail about some of the shifts in your CapEx guidance this year? I know you took it down a little bit, and you said that it was largely due to delays from the pandemic. Is the expectation for that just to shift out to next year?

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

Yes. I mean the majority of that will just roll into 2022. I mean the reality is there's no one -- I would say, one specific or large project that was impacted. It's kind of across the whole -- just some delay in timing and getting equipment in for some of the projects.

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

And then just the last one for me. How would you feel just about the general longer-term impacts of incremental at-home demand? I mean I think that it's pretty evident at this point that there's going to be incremental work from home relative to 2019. So could you potentially share some of your thoughts about the expense or the potential for this to impact your business over the next few years?

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

Yes. I'd be happy to. Frankly, Ryan, I'm quite optimistic about it. I mean I think there's been a fundamental shift in several things, some good and some not so good.

The good parts are I think that the future of work is going to be a lot different. We hear at Flowers are going to be doing it differently, permanently. And many other companies, as you read, are doing the same thing. And I think that shift or that change in mindset really only benefits our business.

With more people eating at home, more sandwiches consumed, whatever it might be, I think we're very well positioned. Coupled with that, our commitment to innovation and continuing to bring new and exciting offerings to the consumer. That's going to continue to be really important for us to drive future growth. So I'm frankly really optimistic.

On the negative side, the labor situation continues to be difficult, as we read across every industry, whether it's service, manufacturing or otherwise. It's a difficult situation. It's tough to attract and retain people right now.

So far, we've done a really good job of managing through it. It has not been easy. But we've been able to continue to serve the market effectively throughout this period, but it is a challenge. And we're having to relook at how we view labor in the bakeries. And we'll probably have to make both some short-term and long-term changes to how we approach that because I think it's more than just extended unemployment benefits. I think there's been a systemic change of how work is viewed in this country.

Operator

Our next question is from the line of Ben Bienvenu with Stephens.

Benjamin Shelton Bienvenu - *Stephens Inc., Research Division - MD & Analyst*

Ryals, I want to follow up on that, on the compensation side of things. You talked about your reviewing compensation. I'm wondering where you are today in that process. What's considered in your guidance with respect to compensation and benefits for the balance of the year, in fiscal '21?

And then you talked about a combination of short and long term. It sounds like you're being holistic with how you approach this and more surgical. Can you talk about your mindset and kind of what you're seeing today relative to normal and how you feel about your ability to kind of ameliorate those dynamics?

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

Sure. I mean for '21, I wouldn't worry about it too much from a wage standpoint because for one thing, I think it's more than just wages that are the issue. Now certainly, we'll look at that. We do periodically look at that anyway to make sure that in each of our markets, that our bakeries are competitive.

But again, the whole dynamics change. What you used to look at as your peer set in manufacturing has changed. We used to look at other food companies or warehouses. Well, now you're competing against Amazon. You're competing against Tesla. And with all the government payments coming in, you're competing with the government, too. So it makes it pretty difficult.

So you're right, we're taking a holistic look because I don't believe it's only about compensation. It could be to some extent, and we want to remain competitive. But I think the quality of life factors are even more important. And what I mean by that is the bakers can be hot. They can be unpleasant the summertime. What can we do to improve the overall working environment inside the bakeries? We're looking at different uniforms. We're looking at different cooling systems, et cetera, those types of things.

But one of the biggest issues for us, I've mentioned this before, is scheduling in the bakeries. Working in a bakery is a tough job. And we're running the bakeries really hard, particularly right now with the labor shortage. And we've had increases in overtime and things because our folks are working really hard. And that's not a situation that you want to sustain for too long.

So what can we do from a scheduling standpoint to give more consecutive days off, more predictive -- or predictable, rather, schedule so that people can plan their child care or doctor visits or whatever it might be in daily life that they need to do? So we're looking at a myriad number of things to help mitigate this. And I'm glad that we are because, Ben, I don't think that this is a temporary situation.

Benjamin Shelton Bienvenu - *Stephens Inc., Research Division - MD & Analyst*

Yes. Okay. Makes sense. And then you noted promotional efficiency contributed to better price mix. Can you talk about what's happening there? Is it that this kind of return to normal or new normal dynamic around consumer behavior is sustaining volumes better than you thought? Is it initiatives that you have in place? Maybe just help us understand what's going on there and kind of the glide path associated with that? How repeatable is that dynamic?

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

Yes. Sure. I'll let -- I'll start and Steve can chip in if he has something else. But the overall promotional environment has been pretty steady for a while now. And it's really -- in our category, I would call it at least 5-year lows, and that's been pretty steady. And with the demand for branded retail products, I don't see that changing anytime soon.

We also internally do a much better job with our TPM system than we did historically at managing our promotions and only pursuing those that have a high return associated with them. And so both the -- kind of the macro environment is supporting this, but also our internal efforts at being more efficient with our promotions is helping. Steve, anything you'd add?

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

No. I mean I think Ryals' point about systems really can't be emphasized enough. I mean in the last couple of years, we've worked really hard on implementing some new technology and it gives us great visibility. And like we talked about in Q1, promotional activity has pulled back quite a bit. So it's really about net getting price. A lot of our inflation comes in the back half. So that's where -- when more true pricing would show up, I would say. So we've been really pleased kind of with the promotional environment and the levels we've seen, and it's been a big part of the margin equation.

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

Yes. And Ben, the only thing I would add to it is we did implement a price increase right at the beginning of Q3. And while it's early days, we've been really pleased with how volume has held up with that price increase. So that's encouraging, certainly.

Operator

There are no further questions at this time. Mr. Ryals McMullian, please continue.

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

Okay. Well, thank you very much, everybody, for your interest in the company, and we look forward to speaking with you again next quarter. Take care, everybody.

Operator

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

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