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FLO.N - Q3 2020 Flowers Foods Inc Earnings Call (Pre-Recorded)

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CORPORATE PARTICIPANTS

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

PRESENTATION

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

Hello, everyone. This is J.T. Rieck, SVP of Finance and Investor Relations for Flowers Foods. As a reminder, Flowers Foods released its third quarter results on November 5, 2020. You can find the release and related slide presentation in the Investors section of our website. Our 10-Q was also filed and can be found on the SEC website.

This quarter, we have made a change to our usual earnings format. Instead of hosting a live earnings call and webcast that includes both prepared remarks and a Q&A session, we are now posting recorded remarks from our CEO and CFO, along with the release of our earnings. After our earnings release, we will host a live Q&A session. For the third quarter of 2020, this call will be held on Friday, November 6, at 8:30 a.m. Eastern. The details are posted in the Investors section of flowersfoods.com. We hope this new format gives analysts and investors more flexibility and more time to prepare for the live Q&A session.

Before we get started, keep in mind that the information presented here may include 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. Providing remarks today are Ryals McMullian, President and CEO; and Steve Kinsey, our CFO.

Ryals, I'll turn it over to you.

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

Thanks, J.T., and thanks, everybody, for their interest in Flowers. We're very pleased with our results in the third quarter, which remain strong and reflect the continued trend of elevated in-home meeting that began at the onset of the pandemic. This has been a very challenging year on a lot of fronts. Our everyday lives and work have been impacted in ways we never could have imagined, but throughout, our Flowers team members have demonstrated their unwavering commitment to serve our markets. I'm grateful for their perseverance. I'm humbled by their dedication, particularly from our front-line workers. They have shown tremendous courage and a devotion to ensuring that our consumers have the products they need, and we are committed to doing everything in our power to provide a healthy and safe work environment for them.

Our performance this quarter is a reflection of our 4 strategic priorities: developing our team, focusing on our brands, prioritizing margins and pursuing smart M&A. Executing on each of these priorities is how we intend to deliver on our long-term goals to grow sales 1% to 2%, EBITDA 4% to 6% and EPS of 7% to 9%. We continue to develop our team to ensure that we have the proper capabilities to achieve our goals. On previous calls, we've discussed our work to optimize our portfolio and supply chain, and we've restructured our organization to meet those objectives.

During the third quarter, we hired a new Chief Supply Chain Officer and a Chief Procurement Officer, who are advancing our expertise in each of those areas. Our brand focus is progressing as well. New product introductions such as DKB buns and extensions of our Nature's Own Perfectly Crafted line are delivering excellent early returns.

We've made further progress in standing up our new innovation capabilities, and we are developing plans to deliver more distinctive and differentiated items that meet our consumers' changing needs and building upon our foundational consumer research, we're developing a road map for profitable growth that's intended to optimize our resource allocation. As part of this work, we've segmented our portfolio into 4 distinct roles, ranging from high-growth brands to business with limited profitability. Segmenting our portfolio, this way establishes clear roles for the brands and products within our portfolio, which is designed to drive more targeted decision-making around our brand investments to deliver the highest return.

I do want to emphasize that while some of our private label and foodservice business does underperform from a margin standpoint, each continues to play an important supporting role in the portfolio. Our intention is to improve their performance, working collaboratively with our customers. We believe this can be accomplished with price, certainly in some cases, but that's not the only way. As strategic partners to our customers, we're working to find ways to improve profitability on our side of the table as well. That can include more efficient distribution, manufacturing, different formulation, packaging and other options. While there will likely be cases where we're unable to find a mutually acceptable solution to achieving the levels of profitability we require, our intention at the outset is to continue serving our customers in a way that is beneficial to both parties.

With regard to the portfolio and supply chain optimization work we launched at the end of last year, we expect to deliver at least $20 million of savings from those efforts in 2020. These savings are coming from a number of different initiatives, including procurement, overhead streamlining, network optimization and bakery operations improvement. Now as a reminder, we were originally projecting those savings to be between $10 million and $20 million this year. So I am happy to report that we're ahead of our prior expectations. We also expect to realize additional benefits from this work as we move into 2021.

Another area of focus for improving margins relates to information technology. As many of you know, we operate in an SAP environment, and we'll need to update to a more robust platform, S/4HANA over the next few years as SAP winds down support of our current platform. We installed SAP over 20 years ago, and many improvements have been made since then. The upgrade is expected to improve data management and efficiencies while automating many of our processes.

But rather than approaching this as a purely an IT project, back in August, we launched a digital strategy initiative that's designed to transform how we operate our business. Our 3 primary goals with this new strategic initiative are: one, to enable more agility in our business model, empowering the organization by fundamentally redesigning core business processes and our ways of working; two, embed digital capabilities where it matters and transform the way we engage with our consumers, our customers and our employees; and three, modernize and simplify our application and configuration landscape to remove existing roadblocks and support our new ways of working with the new ERP system becoming a key enabler of our business strategies. We're currently in the process of completing the initial planning and road mapping work, but much remains ahead of us as we move into 2021, and we expect to provide you an update on our fourth quarter call in February.

The current environment and the resulting mix shift to branded retail products are also clearly driving margin improvement. As I've discussed on earlier calls, we began our portfolio strategy work before the onset of COVID, and we're already moving toward a more brand-centric focus. But the mix shift that we've experienced this year has demonstrated the value of our strategy and has helped accelerate our adoption of it. Though total volumes have been down in 2020, our profitability has improved markedly as we're now seeing the true power of focusing on our brands. So as we're working to capitalize on the opportunities before us, we also recognize that we're operating from a position of strength with our portfolio of top brands like Nature's Own, Dave's Killer bread, Canyon Bakehouse and Wonder. We expect that focus to allow us to retain many of our new consumers, even as the demand environment begins to moderate.

Regarding M&A, we remain proactive in the deal space, but we are maintaining our long-established disciplined approach. M&A has always been and will continue to be an important part of our growth story. Our criteria for M&A candidates are those that can enhance our branded portfolio, extend our geographic presence, our strong cultural fit and bring enhanced capabilities to our company. We believe our strong balance sheet gives us the flexibility to pursue a wide range of deals. And when the right deal comes along that meets these criteria, we will be ready.

Now I'll turn it over to Steve to review the details of the quarter and update our guidance for 2020. And then I'll come back on the back end to discuss the current business environment. Steve?

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

Thank you, Ryals, and hello, everyone. I'd like to echo your comments and express my sincere thanks to our incredible team, whose efforts during this difficult time have been outstanding. Again, thank you.

Now turning to the quarterly results. Our results continue to be strongly influenced by COVID-19, so its impact is diminishing slightly. Total sales in the quarter rose 2.4%, a decrease compared to our second quarter growth rate of 5.1%. Price/mix drove 8.1% of the sales increase, with the main factor being the shift in mix to branded retail items due primarily to consumers eating more meals at home. Volumes reduced overall sales by 5.7%, with particular weakness in-store branded and foodservice and other nonretail channels.

Looking at sales by channel, directionally results followed the same pattern as in the second quarter, though at a more moderate level. Branded retail sales increased $71.2 million or 12.2%. Our leading brands continue to drive company performance, with particular strength from Nature's Own, Dave's Killer Bread and Wonder. As Ryals mentioned, new products such as DKB bunds and extensions of our Nature's Own Perfectly Crafted line were significant contributors. Store branded retail sales decreased $14.4 million or 9.5% with weakness across the board as consumers shifted to branded products. Foodservice and other nonretail sales decreased by $33.7 million or 14.7%. Lower volumes due to the impact of the COVID-19 pandemic drove most of the decline. We saw these declines across most categories of our nonretail business, particularly food service, schools and other institutions. In the quarter, gross margin, excluding depreciation and amortization, increased 240 basis points as the mix shifted to higher-margin branded retail products. Partially offsetting that benefit was $1.9 million related to start-up cost incurred with the conversion of our Lindsborg, Virginia facility to an organic bakery.

SD&A increased 160 basis points in the third quarter. Excluding the items affecting comparability detailed in the press release, adjusted SD&A expenses increased 50 basis points as a percentage of sales. A shift in product mix drove more sales through our DSD network, resulting in higher independent distributor fees. Workforce-related costs increased primarily due to higher employee incentive costs due to our improved financial performance. GAAP diluted EPS in the quarter was $0.21 per share. Excluding the items affecting comparability detailed in the release, which are largely restructuring costs related to employee and lease terminations and impairments driven by our strategic initiatives, adjusted EPS in the quarter was $0.29 per share, up $0.07 compared to the prior year quarter.

Turning now to our balance sheet, liquidity and cash flow. Year-to-date cash flow from operating activities increased $86.3 to $364.4 million compared to the year ago period. Capital expenditures were $68.3 million, and dividends paid were $124.9 million. Our financial position remains strong. At the end of the quarter, net debt to trailing 12-month adjusted EBITDA stood at approximately 1.4x, down from 2x at 2019 year-end. At quarter end, we had approximately $326 million in cash and cash equivalents, and had $478 million of remaining availability on our credit facilities.

Now turning to our outlook for the remainder of 2020. With only one quarter remaining in the year, we are raising our 2020 guidance. We are now forecasting sales growth in the range of 5.5% to 6% and increasing our earnings guidance range, which is $1.23 to $1.28, up from prior guidance of $1.15 to $1.25. As a reminder, 2020 includes an extra week, which is expected to contribute approximately 1.5% to our annual sales growth.

As we've moved into Q4, the operating environment has remained relatively consistent with what we experienced in the third quarter. Some of the factors, however, we considered when adjusting guidance were higher incentive compensation, an uncertain holiday season that favors dinner rolls over Love Bread and changes in our scrap and still rates, which have been favorable year-to-date. In a moment, Ryals will share more color on the factors we considered when looking out into 2021.

We expect continued strong free cash flow generation and our capital allocation priorities and philosophy remain consistent with our focus on maximizing return on invested capital and growing shareholder value. For 2020, we are targeting capital expenditures in the range of $85 million to $95 million, which includes approximately $19 million related to converting our Lindsborg bakery to organic production.

Thank you. And now I'll turn it back to Ryals. Ryals?

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

Thank you, Steve. So the environment does remain favorable for our branded business. Demand is moderating somewhat from the peak levels of the first quarter that we saw, but our strong brands and operational execution continue to drive attractive share gains and margin improvement. In contrast to the strong branded retail sales, foodservice results remain pressured, as many customer locations operate with capacity restrictions and reduced demand. Nobody knows how long this environment will last, but our aim is to maximize our current performance, while at the same time preparing for the time when demand normalizes. If nothing else, we believe the current environment validates our portfolio strategy to drive margin improvement as we shift our focus to our branded retail products.

I spoke earlier about our road map for continued profitable growth and how we expect it to drive our results going forward. The process of segmenting our portfolio instills renewed and increased discipline and focus. We're fortunate to operate in a business that generates ample free cash flow. In order to drive meaningful shareholder returns, we've got to focus our resources on areas offering the most attractive risk-adjusted returns.

Our portfolio strategy, together with our recent organizational restructuring will help to optimize these allocation decisions. Going forward, capital will be allocated to areas throughout the company to further enhance our market-leading products and improve efficiencies to drive margin growth over time. A perfect example of this is the conversion of our Lindsborg bakery to organic production, which we began back in March. And I'm happy to report that since early October, the bakery has been up and running and producing great quality DKB products for the market. This additional production is intended to help us improve our days of service, our quality in the critical Northeast markets and provide some needed relief to our other bakeries currently serving that market. DKB is still growing at a rapid clip, with 2020 retail sales now expected to exceed $800 million. And Lindsborg is a powerful example of our strategy to reorient production to the highest margin and highest growth in the portfolio segments.

As part of our effort to prioritize margin and manage cost, we're also allocating capital to improve returns at our underperforming Navy Yard bakery. Recall that as part of our organizational restructuring, we named David Roach, President of Cake Operations, with the sole objective of improving performance at the Navy Yard. In this particular case, our primary goal is not to drive growth in the near term, but rather to improve operations. We've automated our production lines, upgraded the management team and improved efficiencies. Now, our work is far from complete, but I am pleased to report that we're beginning to see the green shoots of improvement after a rather protracted period of underperformance. And I expect those trend lines to continue to improve as we move into 2021. As I've mentioned before, getting that bakery up to its operational potential represents a material profitability improvement to the company as a whole.

Finally, I recognize that at this point in the calendar, much of the investment community has focused its attention on 2021 and beyond. We're working to formulate our plans for next year, taking into consideration the anomaly that 2020 has been and bringing our best insights to bear in an effort to forecast what the demand environment will look like next year. There are a multitude of factors to consider, as I'm sure you can appreciate, including those that we can't control, such as the macroeconomic outlook, commodity prices, 1 fewer week in the next fiscal year, the political landscape and, of course, the trajectory of the COVID situation. But there are also factors that are within our control, including new product introductions and investments in talent, marketing, digital, as I mentioned earlier, and innovation. These investments, which are essential to achieving our long-term growth targets and increasing shareholder value will begin to accelerate in 2021.

Speaking of long-term targets. As we outlined during our Investor Day in August, we remain committed to generating performance, in line with those targets in fiscal 2022 with 2019 as the base year. We'll provide more detail about our expectations for 2021 when we announce our fourth quarter earnings in February. Currently, we're seeing continued strong branded retail performance, combined with weakness in store brand products and foodservice. While certainly off-peak, branded retail remains elevated, well above pre-COVID levels. The real question, as we move into 2021 is how long these trends will last and what the trajectory of normalization will be. However, no matter what the operating environment is, we believe we have the right strategies in place to thrive in any environment. We've got a portfolio of top brands, and we're focused on allocating resources behind them. I can promise you that our talented and dedicated team is working hard to affect positive change and optimize our performance. We're focused on what we can control, even as we plan for a post-COVID environment, consider how the world may look 2 to 3 years down the road and strive to develop strategies that we believe will best position our company for future success. By continuing to execute against our 4 strategic priorities, we believe we can meet or exceed our long-term financial goals.

So I'd like to thank you for your time this morning. This concludes our prepared remarks. I invite you to listen to our live question-and-answer webcast, which will begin at 8:30 a.m. Eastern on Friday, November 6, and will be available for replay on the Investors section of flowersfoods.com. Thank you for your time.