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FLO.N - Q3 2020 Flowers Foods Inc Earnings Call

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OVERVIEW:

Co. reported 3Q20 YoverY total sales growth of 2.4% and GAAP diluted EPS of \$0.21. Expects FY20 sales growth to be 5.5-6.0% and adjusted diluted EPS to be \$1.23-1.28.

CORPORATE PARTICIPANTS

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

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

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

CONFERENCE CALL PARTICIPANTS

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

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

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

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

PRESENTATION

Operator

Thank you for standing by, and welcome to the Flowers Foods' third quarter question-and-answer session conference call.

I would now like to hand the conference over to J. T. Rieck, Senior Vice President, Finance and Investor Relations. Thank you. Please go ahead, sir.

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

Thank you, operator, and good morning. I hope everyone had the opportunity to review our earnings release and presentation and also listen to our prepared remarks, all of which are available on our Investor Relations website. Following the conclusion of 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 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. And with that, Deborah, can we begin the Q&A?

QUESTIONS AND ANSWERS

Operator

(technical difficulty)

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

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

Operator

Can you hear me now?

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

Yes.

Operator

Okay. I'm sorry. (Operator Instructions) And your first question comes from Bill Chappell with Truist Securities.

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

I guess, can you talk a little bit more about just what you're doing or what you're seeing on the price/mix in terms of the move of consumers more to branded? And I'm trying to understand, I guess, first, from a manufacturing standpoint, I mean, are you starting to change your mix? Where you're actually making less private label and making more branded just to reduce kind of sales?

And then, at the same point, is this really all just brand migration? Or is there any pricing in it?

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

Yes. So to start with the manufacturing concept, Bill, I mean, as you know, we have pretty flexible manufacturing facilities. So the same plant that makes brand oftentimes makes private label, too.

So it's very easy for us to ship, along with the consumer dynamics from private label to brand. But to layer on top of that, if you think about the Lynchburg bakery is probably a great example of moving up the mix chain or up the margin chain, depending on how you want to look at it, towards our higher-margin products and adding production capacity to serve the market that way.

From a pricing standpoint, not too much. We haven't seen too much pure pricing this year, but the promotional environment is certainly well beneath historical levels. So average base prices are, I guess, are up some. We have seen that start to tick back up a little bit more recently, but still well off the historical levels.

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

Got it. And I guess, just when I'm trying to understand the migration of the brands, I mean, there's one benefit from going from private label to Wonder. There's another one going up to Dave's Killer Bread. I mean, which is the bigger driver? Or is it kind of all of the above?

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

Yes, I mean, it's kind of in totality. You're right in what you say. I mean the DKB margins and the Nature's Own margins, together, would be higher than Wonder and some of the other brands.

But any shift out of that lower-margin business to higher-margin business in totality helps the bottom line. But DKB, obviously, is a tremendous growth driver. Canyon has been a big growth driver this year, and both those carry, yes, very high margins.

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

Got it. And then looking to next year, I realized you're not giving a guidance, but 2 questions. One, what kind of impact on your business is the fact that 70% of U.S. school children are going to school at home or virtually or hybrid? And that, that might change and, hopefully, for a lot of us, sometime in 2021? Does that -- is it a positive or a negative impact?

And then the same thing, I think, Steve, you had mentioned there was a variable comp component, which understandably everyone is having a good year. What kind of switch does that turn into a tailwind as you kind of reset that to normal numbers for next year?

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

Yes. Sure, Bill. Let me take the school children piece, and I'll pass it to Steve for the incentive comp. Yes, I mean, there are sort of puts and takes to the kids being at home, right? I mean we sort of missed the back-to-school bump that we normally get in the fall, with all the kids staying home or having gone and getting pulled back.

But then, again, on the other side of the equation, you have elevated in-home eating if the children are home all day, which is really what we saw at the outset of this, right? I mean everybody is sitting right at home, kids at home, parents at home, so you get that increase in at-home eating.

So there's a little bit of a balance in puts and takes there. It's a little hard to separate them and quantify them. But yes, I guess, at the end of the day, I know there's probably going to be a lot of questions about '21 this morning, so I might as well go ahead and make a few comments around that now.

Obviously, as you might -- as I'm sure you can appreciate it, it's pretty tough to plan for next year, just given the outsized year that 2020 has been. But there's 2 ways you can think about it. You can sit here and try to guess what the demand environment is going to be in 2021 and beyond, or you can sit here and figure out what strategies do you need to put in place to drive that demand environment.

And that's what we're trying to do, through our portfolio strategy, through the brand support that we continue to increase and bring to bear to grow our brands. So you can either take what you're given, or control which you can control and try to drive that brand environment with good innovation, great quality and brand support. So that's kind of how we're approaching next year.

Steve, do you want to address the incentive comp?

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

Sure. Obviously, Bill, you're right. As you look at the year and you can see through the comments and the financials that -- and the fact we've raised guidance and brought up the lower end as the year progressed, that it has been an outperformance compared to where we thought coming into the year. So obviously, that's flowing through the P&L this year.

As we plan for next year, and we set targets and goals, we get specifics around incentive comp. But we do expect things to normalize somewhat because, obviously, we'll set our goals in line with what we think expectations are. And while there will be a bit of a tailwind from this year, we expect the incentive comp to be somewhat more normal going into 2021.

Operator

Your next question comes from Brian Holland of D.A. Davidson.

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

Congrats on the continued strong results. I just wanted to ask, first, about 4Q. You cleared what was, at least, in my model, a pretty high bar that I set for you in Q3. Then if I look at the guidance revision, the low end is above what my model implies for Q4.

Now certainly, it's possible that I'm just doing something like in my model that's different here for Q4. But assuming that there's no real issue there, I'll ask the question. Anything incrementally stronger building into year-end? Because it does feel like a pretty marked improvement in guidance.

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

Yes. I'll let Steve comment here as well. But nothing specific I would call out. I mean we -- as I said earlier, we continue to see pretty good trends from a branded retail standpoint. I mean you see that data as well, still pretty elevated.

And we don't -- as far as we can see, we don't see that dropping off substantially. The headwinds in Q4 are always the holidays for us, which is a very strong roll season, which is not a huge part of our portfolio. So it kind of depends on how the holidays go to.

But on the upper end of the range, we're seeing continued elevated branded retail as we have been seeing. It's sort of, in recent weeks, kind of plateaued and been pretty steady kind of week over week. So if we continue to see that, and we feel good about the upper end, obviously, the lower end of it would reflect some relatively meaningful drop-off in the branded retail mix.

Steve, any other commentary you want to make?

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

Not specifically, I mean, I think Ryals covered the majority of it. But just to remind folks, Q4 is typically our toughest quarter as you look at the year and as things progress. And Ryals did call out the fact -- and we did call that in the release as well, the prerecorded conference, there's -- actually, there's 3 holidays in the fourth quarter this year, even with the extra week.

And typically, that business was roll business, and our strength is more on the loaf side. So we are taking a little cautionary look kind of around the holidays. But as Ryals said, if this branded mix continues this -- it's performed well, things should shape up rather nicely for the quarter.

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

Yes. And I should just clarify, I mean, I do have the extra week in. But I'm looking for mid-single digits in the branded retail segment in Q4. You are clearly outperforming that in the scanner data we can see thus far. So right, anyway, just to clarify that on my end.

Two dynamics that seem to be rearing its head, based on some other food companies that we have reporting this earnings season, that have weighed on you in the past. One, we're hearing about tight labor markets and costs related to that.

And then also, we have freight. Labor seems like that's a particularly acute issue for you guys, given the manual intensive manufacturing. And then on the freight side, 2017, 2018, you guys actually had a lag impact, as I recall, kind of given the way you go about that.

But just curious, obviously, any comments on the labor side? How we should be thinking about that going forward? And then on the freight side, just thinking about how you manage what we saw in 2017 into 2018, and how that impacted you. And maybe what changes did you make that might allow you to mitigate those factors in 2021, if this continues?

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

Sure. Thanks, Brian. I'll take the labor market piece, and maybe let Steve address the transportation side of it.

Yes, look, the labor markets continue to be a bit of a challenge, depending on where you are. It's not acute everywhere, but we certainly have some areas where we continue to struggle a bit, just kind of keeping people, keeping turnover down. Then you have the overlay of COVID. So you have folks calling out for one reason or another, and it does present some challenges in the plants.

In fact, despite our excellent results, we still have a lot of opportunity in our plants. Our efficiencies are down a bit, even from last year. That may seem counterintuitive with the results that we've had. But you've got the volume drop-off, plus you have higher scrap rates and things like that, that are directly attributable to the stability of your labor force. So a lot of effort to try to bed that down, and particularly where it has been most acute, because there's some meaningful improvements that we can make there.

I think beyond that, we've talked about before really working on our overall work environment, making sure that our pay scales, obviously, are competitive. That's one element. But also working on things like scheduling. Because we find, as many other companies have found, that there's a huge quality of life component at play today that's oftentimes equally or more important than the compensation.

So working on our scheduling to give more clarity to, particularly our frontline employees, on when they will have time off, trying to ensure that they have consecutive days off, where possible, which is a significant departure from the norm in our industry. Those types of things really do make a difference. So we continue to work on that as well.

Steve, on freight?

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

Sure. Bill, so we benefited somewhat this year from the fact that our mix is more DSD driven. So as you recall, that's -- we term it as a closed-loop system. We actually have 3 to 4 primary carriers for our DSD products that are delivered to our DCs. So those contracts are usually negotiated on a 12-, 24-month cycle.

So we're not in the true market buying so much freight as we do typically on our warehouse business. So we have seen some benefit for that. So if this mix continues into 2021, we would expect some of that to continue until we begin to lap some of it late in Q1.

Also, I would say, as Ryals alluded to, on the labor side and being more efficient, I think we've gotten more efficient from a production standpoint. And our runs, we have better transportation run efficiency as well because we're sending fuller trucks to these DCs versus sending half loads. So that's impacted us as well.

And again, that's a mix -- that's mix driven. So if that continues through 2021, I would expect to continue to see somewhat stable transportation going into next year as well. And then, obviously, fuel costs will impact that as well. And so I would say those are probably the 3 or 4 factors that really influence transportation for us.

Operator

Our next question comes from Mitch Pinheiro, Sturdivant & Co.

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

So just looking at current trends, I mean, how has foodservice been ramping for you? If you could break that out sort of QSR and casual?

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

Sure. The QSR business, I think we mentioned this on the last quarter, so it's kind of a continuation of the trend. The foodservices -- the fast food, excuse me, QSR business has been a bit quicker to recover just by its nature, drive-throughs, that sort of thing. Yes, Chick-fil-As, the ones I see, the lines are double wrapped around the store. So they're doing pretty well.

The sit-down, fast-casual-type stuff is still lagging. It, Mitch, hits off the bottom, but still well down. You can see that in the nonretail numbers that we put out, down roughly 14.5% or so. But off the lows that we saw early in the year.

So slow recovery there. I think it's going to be a long time. That's my personal opinion. And you kind of have to factor into that, well, what happens with COVID. If you have another surge, it's really going to get hurt. You're seeing that start to happen in Europe with new lockdowns.

And does that migrate its way over here as we move into the flu season? We'll have to see. So it's trying to come back, but it is slow. And I think it will be protracted.

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

And is that -- so is it off the bottom, like in the third quarter? As you -- as we're here in the fourth quarter, is it just sort of stabilized? Is that what you're saying?

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

Yes. If you -- in the second quarter, nonretail for us was down 15.8%. And in the third quarter, it was down 14.7%. So better, but not by a whole lot.

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

Okay. And then as you're looking into '21, just broadly speaking, in broad terms, what type of cost savings, supply chain savings, you all -- part of that \$20 million that you had this year. I mean are we talking about the same type of level of cost savings next year? Or does it drop off? Any color around that?

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

For obvious reasons, I'd rather stop short of actually quantifying it. But it is a continuation of many of the same initiatives we had in place this year. So it will be largely first half weighted, until we lap it in the second half, Mitch. But it's across those same categories, right?

The overhead streamlining that we did, procurement, depot consolidation, all the things that we've talked about. That is not to say that we're not working on additional incremental things, but that's -- some of those are still in the planning stages. But it will be meaningful. But it will also be mostly first half weighted.

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

Okay. And then just a couple more. So has the current environment affected your ability to gain new distribution or new -- getting new products on the shelf in your newer territories? Have you ever -- are there -- is this -- has this been good for you? Has this been neutral? Any color around that.

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

It really hasn't. I mean we continued to introduce new products, the DKB buns, the perfectly crafted line extensions that we talked about in the prepared remarks. All that's happened in the midst of all this.

And we're not the only ones. I mean our competitors have put new products forth. We've gained new shelf space during this period. Mitch, no really meaningful geographic expansion during this. But by the same token, we weren't trying to.

We're really focused, as we've talked about before, on places like the Northeast, where we're still relatively low share. So we're there, but really trying to gain deeper penetration by gaining incremental shelf space and putting forth our brand support, those types of things.

So from that standpoint, it really hasn't -- Steve, unless I'm missing something, it really hasn't impacted us negatively.

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

And then just last question on Tasty Baking. So...

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

Mitch, let me cut you off there, because I do want to add one more thing to your question. As I sit here thinking about it, I do think, in some ways, that the COVID circumstance has been a positive relative to new product introductions.

Because what we have seen in the mix shift is somewhat of a shift away from traditional loaf to buns and rolls and to breakfast items, right? And so as we've introduced new items in those categories, from that standpoint, it's actually been a positive rather than a neutral.

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

Okay. Got you. I just wanted one more question about Tastykake, Tasty Baking. So where are we right now here in the fourth quarter with Tasty Baking? Is it -- are we -- are the operations sort of optimized where you want them to be? Is this something that we're going to see slowly build into the first half of next year?

And we're Tastykake's sales up? Or can you talk about up, down in the third quarter?

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

I'll answer your question bluntly, to start, and then provide some color. We are not where we want to be. Period.

We are making improvements. I'm extremely pleased with the job that David Roach is doing. As you know, he's one of our more seasoned operational executives. He's doing a great job up there with a very difficult task.

We have installed new automation. Most of that is complete. We have made some management upgrades. We have even brought in some outside help to improve our operational processes. We've been through union contract negotiation, and that is all settled down now.

So things are getting better, Mitch. I think that you're -- I forget the exact phrasing you used, but I think it's spot on, that I expect to see slow, steady progress as we move through next year. But if we're successful, I believe that, that slow steady progress will culminate in a meaningful improvement for the company next year.

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

Okay. Tasty Baking?

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

Oh, yes, by the way, Tasty was flat for the quarter, but let me point something out there. The operational inefficiencies that we've been experiencing at Navy Yard has impacted their top line, too. Because we've had to cut -- because of those inefficiencies and scrap, it's -- we've had to cut product, which obviously impacts your top line. So making these improvements will not only help the bottom line, but it will improve the top line as well.

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

Okay. And one more thing. I just -- I do like the new conference call format. So I appreciate you doing that.

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

Good. Thanks. Sure.

Operator

Your next question comes from Ryan Bell of Consumer Edge Research.

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

Is there any way you could provide some detail about the direction of store brands, given the nonretail parts of your business throughout the quarter? Kind of talking about where they were to start the quarter? And where they came at the end, just to see where the momentum is being pushed?

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

So the intra-quarter trajectory of private label, is that what you're asking?

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

Yes. For the private label, and then also the nonretail portion of the business. I know that's still down and improved a little bit, but it's harder to get the magnitude of sort of the month-to-month to figure out where that might be going.

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

I'm with you, Ryan. I don't have that in front of me. I have the totals, which you already have from the release. We can look into that and come back to you, though. I want to say it was fairly steady for the quarter, but let me check that.

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

Okay. And then when we're talking a little bit more about private label at the industry level, we've been seeing that down pretty significantly in scanner. Would you be able to share some of your perspective about the drivers of the industry decline?

Obviously, producers, such as yourself, have the ability to favor branded over store brand. That's for the margin advantage and other reasons. But is there any commentary you could have about that on the industry level?

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

Yes. I've talked a little bit about this before, but it's a kind of a key question, right? I think it all started at the outset of the pandemic, because you had this massive shift to brand because of capacity constraints, right? So everybody was pumping out as much branded product as they could in a limited SKU assortment.

But now as we've maybe found something akin to a new normal, now what's driving it? Well, I think e-commerce is one. It's -- the brands are a bit more prominent on the e-commerce platform. And obviously, that's playing a much larger role today. I think it's -- time spent in in-store is a lot shorter now, number of trips are shorter.

People don't want to spend a lot of time wandering around the grocery store. So they go for what they want. And in this particular case, brand delivers more of what they want than perhaps the private label does. There's more differentiation there. There's more innovation there, some of which we're happy to have brought to the category. So yes, I think those are probably the primary drivers.

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

Okay. And that kind of seems like as you're looking out to 2021, that private label probably is not going to be picking up quite as much, given what you're talking about overall?

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

Yes, I mean, I would certainly think so. I mean if we do our job correctly, and we bring a compelling brand proposition to the consumer, then naturally hope that should lead them to stay with our branded products. If you think about a deeper recessionary environment and stimulus money running out and that sort of thing, yes, you could see some trade down.

But the good news for us is that we play across a variety of different price points. So you've got your super premiums up in the Dave's and Canyon areas. You've got the premium on Nature's Own. And you've got a little bit more value in the Wonder area.

So we're kind of able to address all those price points with the brands that we have, which we believe provides us some insulation, should you encounter a recession. And if you think back to '08, '09, the last one we had, we fared pretty well through that environment, as we have through prior recessions.

Operator

Thank you, gentlemen. Do you have any closing remarks?

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

No, not except to thank everybody for their time and for your interest in the company. I certainly hope you like the new format. We certainly like it better, able to dedicate a little more time to your questions. So we appreciate you joining the call this morning.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.

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