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FLO.N - Q3 2023 Flowers Foods Inc Earnings Call

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OVERVIEW:

Company Summary

CORPORATE PARTICIPANTS

A. Ryals McMullian *Flowers Foods, Inc. - CEO & Chairman of Board*

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

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

CONFERENCE CALL PARTICIPANTS

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

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

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

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

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

PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the Flowers Foods Third 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.

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

Thank you, Liz, 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 call -- I'm sorry, 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 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, Chairman, CEO and President; and Steve Kinsey, our CFO. Ryals, I'll turn it over to you.

A. Ryals McMullian - *Flowers Foods, Inc. - CEO & Chairman of Board*

All right. Great. Thanks, J.T. Good morning, everybody. Appreciate you joining our third quarter call.

We're very pleased with our strong third quarter results. We generated record quarterly revenues and maintained our unit share despite inflationary pressures.

Sales benefited from strategic pricing initiatives that are designed to mitigate inflation and improve volume trends. Our leading brands continue to perform well. And we're investing in innovation and marketing to maintain that momentum. We also continue to make progress in our digital and cost savings initiatives, which are helping to improve our efficiencies.

Despite the strong results, revenues did come in a little bit less than expected due to business rationalizations that materialized sooner than we expected and a lower-than-normal amount of storm activity. It's important to note that although the timing can be unpredictable, these business exits are an integral part of our portfolio strategy as we aim to improve the profitability of our foodservice business.

We've made great progress in that regard, and we expect continued improvement moving forward. I remain extremely confident in our prospects, and I've never been more confident in our ability to grow shareholder value over time.

Before we move to questions, I also want to acknowledge that today is Veterans Day. And so we would like to express our heartfelt gratitude to all the men and women in service that have chosen to risk their lives to protect our freedoms here at home. So thank you very much for your service.

With that, Liz, we're ready to take questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question will come from the line of Bill Chappell with Truist Securities.

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

Just maybe summarizing your comments and I just want to make sure I'm looking at this right is, is it fair to say kind of you feel like the turbulence of the business post pandemic kind of bottomed out over the summer and you're -- while you're not meaningfully changed from -- in the third quarter, things are starting to at least temper back up, and the only real change was just that the exit of some of your businesses happened a little bit faster than you expected. Is that the best way to summarize kind of the quarter?

A. Ryals McMullian - *Flowers Foods, Inc. - CEO & Chairman of Board*

Yes. I think it's a great way to summarize. I mean, frankly, we're really pleased with the results in the quarter. Yes, the loss of the foodservice business that we mentioned did impact the quarter and impacted the guidance. But I mean, that was going to come anyway.

These are planned exits. This is low-margin business, highly complex business. In this particular case, actually, we're actually getting some benefit from some reduced transportation costs because this was a bit of a difficult customer to serve.

But then the strength of the underlying business is where the focus should be, at least in our minds. And in that regard, we're really pleased. I mean, you look at -- Bill, you look at mix in the quarter, actually ticked up a little bit from a branded mix standpoint. So that's good.

The volume sequentially on the branded retail side continues to improve and then, of course, the share performance on top of that. So I think the way you framed it is accurate. We're starting to see things stabilize. And I think we also mentioned even looking into the first few weeks of the fourth quarter, though it's early, we continue to see that strong unit share performance continue.

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

Great. No, that helps. And then just maybe a little bit more color on the settlement in California, not necessarily the legals, but that you're converting into an employee model. I guess I don't remember or if you've disclosed how big California is anyways, but does that alter the margins going forward? And is there a chance that other states have to go to an employee model down the road?

A. Ryals McMullian - *Flowers Foods, Inc. - CEO & Chairman of Board*

Yes. So just remember that California is a unique legal environment, unfortunately. And so we're kind of in this position due to that legal environment. So it is unique. This is not something I would extrapolate across the country.

We did have one other settlement in Maine. Now this was on a much smaller scale, but we also converted to a company-owned model in that state as well.

With regards to California, you're right, we will be -- over the next year or so, whenever the settlement comes through kind of expecting that early next year, will, in phases, convert the independent model to a company-owned model. So it does -- and Steve can speak to this a little more if you like, but it will shift some costs around a little bit.

And generally speaking, obviously, we're not providing any guidance in '24. We can put a little finer point on this probably in February. But generally speaking, it's a little bit more expensive to run the company-owned model than it is an independent distributor model.

However, there are some advantages to having -- for lack of a better word, having some control back when you think about store-level service, display execution, days of service, et cetera. We actually see a little bit of upside as well that we would expect to offset those incremental costs.

Operator

Our next question will come from the line of Steve Powers with Deutsche Bank.

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

Can you hear me?

A. Ryals McMullian - *Flowers Foods, Inc. - CEO & Chairman of Board*

Yes, Steve.

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

Okay. Great. Sorry. Operator cut out there for a second. Two questions. The first one is on the ERP program and progress there and how things have gone since the -- since that rollout started. If I'm not mistaken, '23 projected costs dropped from about $100 million at the midpoint to $75 million this quarter.

Capitalized costs from -- also dropped, and the amount embedded in adjusted EBITDA went from $26 million to $17 million quarter-over-quarter. So is that -- first of all, hopefully, those numbers are right. Tell me if they're not. But if they are, does that constitute savings that you're finding? Or is that early delays in the rollout? And how should we think about that as we look forward?

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

Yes, Steve, it's really more of a shift in cadence. Overall, the total cost of the project is still estimated in the range we've disclosed in the Q, which I think is around $350 million, $350 million or so on average. And the completion of the project is still scheduled for 2026.

So total costs remain the same, but you're right, we did shift that. Part of that was driven by the fact, if you recall, we rolled out ERP to 2 bakeries. We're trying -- we're pretty close to getting through all -- working on all the kind of the bugs, if you will, on the rollout. And we'll pick back up with other bakeries starting next year. We did have some schedule for the back half of this year, but we decided to change the cadence slightly in that regard.

And then also back to Bill's question on California, we're having to shift a few resources within IT in the business to working through the model we'll be deploying in California. So that -- we thought it was more prudent to the -- shift the cadence of ERP, given that focus. That way, hopefully, we can do both projects well.

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

Okay. Okay. That makes sense. And then the second question I had was actually on Terry Thomas' appointment as Chief Growth Officer back in August. I know Terry reports to you, Ryals, but love a little bit more perspective on what his team looks like and how he's integrated himself in his broader role or how the company has just within broader business operations. How does the Chief Growth Officer sort of interface with the rest of the business? And how does that change planning and just day-to-day execution as the company goes forward?

A. Ryals McMullian - *Flowers Foods, Inc. - CEO & Chairman of Board*

Yes. Good question. So we're really excited about this role. This was a direction that I had wanted to head eventually. And frankly, fortunately for us, the opportunity came along a little sooner than I even thought it did.

So the makeup of Terry's team essentially, he's over all the brand teams, marketing, consumer insights, innovation, revenue growth management. So really all of the growth levers that we have are in Terry's purview. And then, of course, Heeth as President and Chief Operating Officer has all the operations of the business firmly under his umbrella. And so those 2 gentlemen will obviously be working very, very closely together.

You mentioned planning processes. I don't think anything is going to change immediately, but we are working on improved processes relative to planning that I think are only going to help us just overall from a sales execution standpoint as well as a demand planning standpoint.

And then finally, of course, Terry will be working closely with me on finding new revenue streams, both organically and via M&A. He's a very accomplished executive, as you can see from his CV. And we couldn't be more thrilled to have him on board.

Operator

Our next question will come from the line of Mitchell Pinheiro with Sturdivant & Co.

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

So a couple of questions. First, why do you think the promo activity is below average? With the consumer kind of getting pressured, I think grocery and retail would be a little more interested in seeing some volumes turn positive in the category. So why do you think it's sort of down or below average? And wouldn't you anticipate down the road here in a quarter or 2 to see a little more heightened activity?

A. Ryals McMullian - *Flowers Foods, Inc. - CEO & Chairman of Board*

So Mitch, it is up a little bit. I think in the prepared remarks, we indicated that (inaudible) was up for the category, but it still remains below pre-pandemic level. So your comment about it sort of being below average certainly rings true.

The primary reason that we're seeing for that in our research is there's just not much lift to be had. The category has historically been mainly driven by base sales. But there was also historically some incrementality available via promotion.

What we're seeing now is that you're really not getting much lift when you do promote. And I've said before, I think that kind of to your point, that does somewhat indicate a pressured consumer in the extent -- to the extent that the opportunity for expandable consumption is not really there right now. Consumers are buying what they need, and that's it.

Now going forward, would I expect to see some higher promotions maybe as we look into next year? We'll have to see. It's a very tough thing to predict. I -- just looking at the overall macro environment and the consumer, I would have thought that we might have already seen a little bit more of an uptick, but we really haven't. And I think that's largely due to the fact that there's just not a lot of return available right now on promotion.

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

And then what's driving the higher stale rates that you mentioned in the -- as it related to margins?

A. Ryals McMullian - *Flowers Foods, Inc. - CEO & Chairman of Board*

Yes. So a lot of that is retailers are very keen on minimizing out of stocks due to the growth of e-commerce. And so keeping a little bit more on shelf can obviously impact your stale a bit.

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

Okay. And is that across -- is that in all categories? Or meaning, is it just in traditional loaf? Or are you seeing it broadly into the organic and other subcategories?

A. Ryals McMullian - *Flowers Foods, Inc. - CEO & Chairman of Board*

No, I would say it's more centered in traditional loaf. I mean, the stale rates for DKB and things like that are trending about where they were.

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

Okay. And then sort of final sort of bigger picture question is, your market share in bread is relatively stable, up and down a couple of basis points for over the last couple of years. And so I'm curious like what it's going to take -- I mean, at 17% share of the category or 18% share but still relatively modest, especially for being #2 player in the category. And I'm curious when it's going to take to get that from 17% to 19% to 21%.

A. Ryals McMullian - *Flowers Foods, Inc. - CEO & Chairman of Board*

Yes, it's a great question. I mean, obviously, one element that we're dealing with right now, of course, is the sort of a research as to private label while the consumer is under pressure, though I do think it's important to note that continues to moderate as we go forward. So that's one factor.

The other thing that's going to impact our growth is further penetration into underdeveloped territories. We continue to grow very nicely in the Northeast. But we -- Mitch, we also have a decent chunk of the country that we don't cover in the Upper Midwest area. So gaining access to that market at the right point in time will also be nicely accretive to overall share.

And look, we continue to innovate as well. And bringing -- we've proven that consumers will pay a premium price for differentiated items that really lean in heavily on quality and taste, right? And our innovation efforts, whether that's in our core category or now moving outside the category with snacks is focused on that. And that should also help us drive share going forward.

I'd also call out breakfast. Until we brought forth Dave's Killer Bread into the breakfast category, we virtually had no presence there. And so -- and we're experiencing some nice growth there.

Now we have -- we've got Papa Pita online out West. We're able to deliver fresher muffins to that part of the territory and are picking up some distribution that we lost due to quality issues shipping across the country. So all these things are important and ultimately add up to improved share over time.

Operator

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

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

Yes. So I guess first things first on the business exit that you mentioned. I guess I'm just a little bit confused as to why these were headwinds to full year guidance. I mean, were these not scheduled to occur until 2024? Or was this maybe more of an opportunistic cost savings decision in 2023?

A. Ryals McMullian - *Flowers Foods, Inc. - CEO & Chairman of Board*

Yes. So this one would have occurred probably either right towards the end of the year in phases or into '24. So the fact it occurred when it did accounts for the impact that it had in the third quarter and for the rest of the year.

But again, I just want to reiterate that wherever it fell, this was planned. It's a smart exit, believe me, and we'll be a lot better off for it. If you think about our portfolio strategy and what we're trying to do, just to reiterate, is to either margin up to our targets or exit this low-margin foodservice business.

And the good news is it's working. We've been able to increase the profitability of our foodservice business so -- even though we've made it smaller. And those efforts will continue.

Now if we can, through price or distribution or otherwise, get this business up to our target, then fine. We're more than happy to keep it and grow with the customers. If not, then we're also more than happy to exit and help them transition to a new supplier.

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

Got it. Makes sense. And then also, as far as the call out on the storm activity as a headwind in 3Q, so as a Floridan, I can say I'm very thankful for the limited storm activity this year.

But as far as it relates to this -- I mean, as far as it relates to the business, I guess I also typically thought of hurricane activity as more of like a demand pull forward rather than like a structural increase in demand in like any given year. I mean, like just kind of the line of thinking, right, like if you buy bread for a storm, you're probably not eating all of it in like a 1- to 3-day span. I guess am I thinking about that correctly?

A. Ryals McMullian - *Flowers Foods, Inc. - CEO & Chairman of Board*

Yes, you are. Look, it's a factor. Certainly not the factor -- obviously, storms are very hard to plan for. But just for -- in terms of year-over-year comparisons, there was a lot of -- I think there were like 13 named storms or something last year. I don't think that many made landfall.

But this year, significantly less activity than even the historical average would suggest. So it was unusual to have this little storm activity in the third quarter. But again, that's a very difficult thing to try to plan for, but it was a factor.

Operator

Our next question will come from the line of Jim Salera with Stephens.

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

Maybe as a quick follow-up to the last question on the storm activity. Is there any way you can size up the impact, I don't know if you guys had like an internal estimate based on what you might have thought? Or just to kind of give us a sense for how much of an impact that was in the quarter?

A. Ryals McMullian - *Flowers Foods, Inc. - CEO & Chairman of Board*

Yes. I mean, we can internally. It's not something that we typically disclose. I would just -- I would say that if we hadn't had the unexpected foodservice exit and if we had a more normal full amount of storm activity at least that would have affected reasonably populated areas, we would have been a lot closer to where we guided.

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

Okay. That's fair. When you talked about unit share in the prepared remarks, I don't think DKB share gain is surprising just given the strength that, that brand has. But I was a little bit surprised that Wonder gained while Nature's Own lost. If anything, I probably would have thought it would be the inverse. So can you just offer some color around the divergence between Wonder and Nature?

A. Ryals McMullian - *Flowers Foods, Inc. - CEO & Chairman of Board*

Yes. We've actually talked a little bit about this before, but I'm glad you asked so we can put a finer point on it. So the Wonder share gains are largely going to be in the sandwich, buns and rolls segment where we've actually hit some unit share highs with our focus on and execution with our Wonder Bread program, the -- you still call it another holiday in that quarter with Labor Day, our partnership with the USO, et cetera.

So that accounts for a lot of the Wonder share increase, which we're really happy to see because before we bought the Wonder brand, we didn't have a national sandwich, bun and roll brand that we can compete with across the country, right? But we do now. We've really made some nice progress there from a share standpoint.

On the Nature's Own side, as we said before, remember, the segment of the portfolio that is most susceptible to private label trade down is that traditional loaf category that Nature's Own is a big player in. While we're #1 and we have the #1 SKU and all that, which is great, it is the least differentiated piece of the portfolio and therefore, more susceptible to private label trade down. So that accounts for the drop there.

Having said that, the relative performance of Nature's Own has been quite good on a relative basis. I know it's been down and pressured. On a relative basis, we're pretty pleased with where we are, and we expect the trends to continue to improve as we kind of come out of this pressured consumer cycle.

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

Great. That's all very helpful. Maybe one more question on kind of the share dynamics. I know we will see when consumers trade channels from grocery to mass that they'll also trade down to private label as kind of a manifestation of that value-seeking behavior.

Do you anticipate -- and I know this is a little bit harder to call, but just kind of hydraulically, when the consumer comes back to grocery from mass that they'll also shift back up to branded? Or is it a slower transition, where they come back to grocery but still buy private label?

A. Ryals McMullian - *Flowers Foods, Inc. - CEO & Chairman of Board*

No, I think you're spot on. As a matter of fact, if you look at private label and grocery, so ex mass channel, private label is still losing share. And that's been a trend, I think, pretty much all year, try to remember back, but I'm pretty sure that's been the case all year. The private label trends have really been centered in the mass channel.

So to the extent that -- consumers that are still shopping in grocery are still shopping more premium, they're still shopping more differentiated, et cetera, and less private label. Those that have shifted channels to mass, you're correct, are looking more at private label. But I will also tell you that the private label share gains in mass are also coming down. I mean, they're still up, but the gains are starting to moderate.

And furthermore, our overall share in mass has been improving all year. I mean, we were down 80 bps in the first quarter, 30 in the second and only 10 in the most recent. So again, another indicator. These trends are starting to reverse themselves and get better, which is very encouraging.

Operator

We're showing no further questions in queue at this time. I'd like to turn the call back to Ryals McMullian for closing remarks.

A. Ryals McMullian - *Flowers Foods, Inc. - CEO & Chairman of Board*

All right. Thanks, Liz. Just want to thank everybody for taking time today and joining us for questions. As always, we appreciate your interest in our company, and we look forward to speaking with you in February. Take care.

Operator

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