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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the Flowers Foods Fourth Quarter and Fiscal Year 2022 Results Conference Call. (Operator Instructions) Please be advised that today's conference 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. - SVP Finance & IR*

Thank you, Tanya, 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 disclosure and reconciliations are provided in the earnings release and at the end of the slide presentation on our website.

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

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

Thanks, J.T. Good morning, everybody. Thanks for joining the fourth quarter call. I'm really proud of our accomplishments in 2022 and would, once again, like to thank our Flowers team for their hard work in making that performance possible.

Despite the challenging macroeconomic environment, we generated record sales, we advanced our innovation pipeline, and we made important progress with our digital and supply chain initiatives. And we expect to build on that progress this year in 2023. We'll be making additional investments in digital and supply chain as well as marketing support for the DKB bar launch. Although these investments, alongside continued inflationary pressures, will impact our near-term results, I'm confident by enhancing our already strong foundation, we're positioning the company for future long-term success.

So with that, Tanya, we're ready to take questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question will come from Bill Chappell of Truist.

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

Ryals, could you give us a little more color on this kind of stepped-up marketing behind the snack bars? I guess it had been growing and been in test market, had been doing well, but we didn't really have a -- kind of a quantification of how big it is or how big is it expected to be this year. And maybe you could talk about what and when is being invested behind the brand, kind of what kind of impact that's having on gross margin or on earnings specifically versus just kind of overall brand spend or marketing step-up.

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

Sure. So Bill, as you know, we're beginning the nationwide rollout as we speak. So it will ramp up as production builds up and as we gain shelf space and retailers throughout the year. So it will be a build throughout the year. And most of the support behind that is going to be marketing, support, digital spend, display execution, all those kinds of things as you really need to activate a new product. DKB is a known quantity, but obviously, this is a new space for DKB. And so we're being very intentional about the investments we put behind the introduction of the new snack line. So mostly marketing support. And again, it will be a build throughout the year.

As far as magnitude goes, we're not going to disclose that separately. But as we gain traction during the year, we can start to give you, guys, additional color on how the products are performing overall in the marketplace.

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

Got it. But I guess looking at the initial guidance, which is below kind of where we were, and granted you hadn't given guidance before, I mean, is this kind of a $0.05 headwind to earnings? Is it a $0.10 headwind to earnings? Just trying to understand how much of that versus other market dynamics going into the guidance.

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

You mean the marketing support itself for the bars, what kind of headwinds is it?

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

Correct. Correct.

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

I mean, maybe $0.02 or $0.03, probably, $0.02, $0.03.

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

Okay, now that helps.

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

Yes.

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

And then just second, looking at kind of the private label trends you talked about in your prepared remarks, I mean, is there an expectation now that pricing is kind of normalized for private label at the one mass customer, that it's stable as we move through this year? That it actually improves? You mean, in terms of branded share improves. What's kind of your outlook for share as we move over the next couple of quarters?

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

Yes. So the pricing dynamics have started -- the retail pricing dynamics, I should say, for private label and mass have started to come up some, which is a good development. I think it's too early to call the play as to what the overall private label performance will be in '23. Towards the end of last year, as we saw private label kind of build the second half of the year gaining share, it did sort of plateau at the end of the year. And sort of through our first period that we just completed this year, that same dynamic is at play. So it's kind of a to be determined. And of course, that's kind of factored into our guidance range. That's one of our watchouts for the year is how those -- yes, how is the consumer overall and how does that translate into private label performance.

The divergence between mass and grocery does continue, though. In the first period, private label was up pretty significantly, in line with what it had been the last couple of periods of last year, but it was actually down from a unit share standpoint in the grocery segment. So that's -- if that continues, that's obviously an encouraging trend in and of itself.

Operator

Our next question comes from Robert Dickerson of Jefferies.

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

I have a bunch of questions, but I'll kind of -- I'll try to keep it short. Ryals, maybe also Steve, just I'm curious, in terms of the top line guidance, the essentially 8% to 9% year-over-year, is a lot of that coming from -- it sounds like some incremental pricing in foodservice and private label. And I'm kind of just asking because, obviously, there's already been some pricing taken right on the branded side, which I would think would decelerate through the year, and volumes overall for the business were still down a little bit. So just seems a little high to me, but maybe there's also some tailwind coming from the bar rollout. So just any additional color on that would be awesome.

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

Yes. So yes, definitely a little bit of tailwind expected from the bar launch, but more impactful. Remember, Rob, we've got roughly 5 months of wraparound pricing from last year. So that maybe something you're missing there, plus we have gone back with additional pricing on top of that this year. So a lot of the top line guidance range is additional price as we continue to experience higher costs.

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

Okay. Got it. And then in terms of the gross margin, it sounds like Q1 is a tough comp. You do have some pricing. It sounds like maybe there could be some easing costs as you get through the year just in terms of the hedging strategy. Kind of how would you paraphrase the year in terms of the gross margin side? Is it like probably flattish? Maybe it's down a little bit? Maybe it's a little second half better than first half? Again, any other color would be great.

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

I mean, when you look at the full year, Rob, I think you're going to look -- you're going to see probably pretty much flattish. As we said, we're expecting some significant inflation to continue through 2023. And even with the additional pricing that Ryals just discussed, from an overall margin perspective, I would say, pretty flattish and pretty even throughout the year, with some pressure coming in Q1, obviously. Because if you go back and look, Q1 was a very strong start in the last year.

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

Okay. Perfect. That's good enough. And then lastly for me is just, Ryals, in the prepared remarks, there are a lot of discussion commentary on the spending side kind of for future benefits and then also some commentary around kind of what those benefits could mean longer term. I think the line was meaningful margin expansion potential. Obviously, you're spending to make the business stronger. And hopefully, with that strength and some mix benefits, longer term, there would be margin expansion potential.

So I'm -- I just think -- I'm just curious like if we're thinking about timing that some of that spending will continue through '23 and then assuming '24 and then maybe start to decelerate '25, '26 but still some there, if we just kind of hold, let's say, commodities cost center, everything else being equal, right, which is tough to do, but just conceptually, how do you think of kind of that flow through on the benefit? Is it -- again, this is more broad-based. Is it more like, yes, we need to really -- we're spending more, right, in '23, and then we'll still be spending in '24, but as we get through these benefits, and we would expect to see, right, that margin expansion maybe play out in year 3 or 4 or what have you. So that's all.

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

Well, first of all, I would certainly hope that this is not the new normal as far as commodities go. So hopefully, there's some, yes, relief coming as we get through this year and into next year. But no, good question, Rob. And I think you've largely got it. Obviously, investment has to come before benefit, right? And I think we've laid out that due to inflation and the consumer and other things, it's going to be a pretty challenging year for us and others in the food space. But we remain steadfast about continuing to invest in this business for the future. And so we're not slowing down. We see no reason to slow down. So we will continue to roll out the bars. We'll put marketing support behind that. We're investing in supply chain this year.

We've talked a lot about the efficiency improvements that we need in the bakeries. We think that's -- that these investments are going to unlock that as well. And then, obviously, you have the digital ERP spending. And I think that's where you'll see kind of a peak spending this year, with that beginning to moderate in the years to come. And then, of course, you have the expected benefits that we'll be rolling in as well. So investments going down and benefits coming up, all of which we think will contribute to substantial margin improvement.

Operator

And our next question will come from Ben Bienvenu of Stephens.

James Ronald Salera - *Stephens Inc., Research Division - Senior Research Associate*

It's Jim Salera on for Ben. I wanted to ask some questions around demand elasticity. I know in the prepared remarks, you guys called out a significant portion of the volume decline was due to SKU rat. Can you just give us an idea for maybe what the branded volumes would have looked like ex the cake SKU rat? I assume in the other -- the whole volume decline is probably all eliminated SKUs, but on the branded side, about like half SKU rat, half demand elasticity?

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

I don't think -- we don't have that to disclose for you today, that breakout. I mean, what I can tell you is you're right that the lion's share of the volume declines are in cake and foodservice, and a lot of that is strategic and intentional. So we pulled back on a lot of underperforming SKUs. In cake, we pulled back on a lot of underperforming business in foodservice. And we'll continue to attempt to optimize that business, if you will.

So when you think about volume declines -- and certainly, there -- yes, there has been some softness on the branded side. As we've seen this mix shift to private label, I don't think that's a surprise to anybody. But as you think about the overall business, it's most -- it's heavily weighted towards cake and foodservice.

James Ronald Salera - *Stephens Inc., Research Division - Senior Research Associate*

Okay. And then on the pricing for 2023, is that kind of evenly spread across the portfolio? Or is that more targeted on foodservice and private label? Because my thought is as the value gap at mass is narrowing, if you guys put pricing, does that kind of reopen that gap back up? Or is it still going to kind of trend to a narrower gap?

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

Yes, I think the gap should -- they should stay pretty stable throughout the year. I mean, overall, there's going to be more sort of total dollar in private label and foodservice overall, but the pricing is across the entire business, but probably a little bit more heavily weighted towards private label and foodservice. But I would expect the gaps to -- assuming -- this is us talking, depending on -- yes, the retailers can always do something different, but I would expect the gaps to maintain where they are.

James Ronald Salera - *Stephens Inc., Research Division - Senior Research Associate*

Okay. And then maybe one more question on that. From a consumer perspective, do you think once -- if they have traded down, whether it's from a high premium to just a normal branded or from normal branded to private label, do you think that there needs to be promo in the channel to get them to make the switch back up the value chain? Or as the gaps narrow, do you think they'll just kind of naturally go back to buying the more premium SKUs?

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

Yes. I mean, certainly, my hope is that it's the latter. That's just something we'll have to wait and see what happens here. So far, the competitive environment has been -- has continued to be stable, haven't seen any meaningful uptick. And I would certainly hope that any consumers that might have left a Nature's' Own or DKB to trade down, that something else will come back.

But that's also remember the reason that we're continuing with our marketing spend. We're not slashing that for the year because it's going to be a difficult year. We're continuing to invest in our brands. And when the time comes, and some of this pressure is relieved on the consumer, I think that they recognize the differentiated aspects of our top brands. And I mean I think that alone, in addition to the marketing support, will drive them back to us.

Operator

And I'm going to remove Mitchell from the platform. One moment. Our next question will come from Connor Rattigan, Consumer Edge.

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

Yes, so it sounds like you guys have a really exciting innovation pipeline coming from Dave bars and snack bites to Nature's Own Breakfast Pastries. And so clearly, the [snack indication] is totally incremental to the existing portfolio. But I guess on the breakfast pastry, in your research, do you guys see this as a substitute to your current breakfast products like bagels or English muffins? Or is this really bringing in a new customer or a new occasion?

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

Yes, we actually think it will be incremental, Connor, which is a pretty exciting prospect. Now remember, those breakfast pastries are still just in test. But the thesis is bringing something additionally differentiated. And what's interesting about these breakfast pastries is that we would intend actually to market those in the bread isle. So I see it as an incremental item to a bagel or an English muffin, something like that, that distinguishes those from the DKB bars, which, of course, are warehouse distributed, and they're in the kind of the traditional bar out.

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

Okay. That's great. That's really interesting. And then also, too, just a little bit on the bakery of the future initiative, if possible, could you guys maybe share some of the data points you're collecting or maybe some of the insights that you've claimed thus far? And maybe any cost savings initiatives [that allowed] you to pursue?

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

Yes. I mean a big one for us is scrap or waste reduction. And so having greater data insights into how the bakeries are running allows us to be smarter about how we run the lines and reduce that waste. Waste is a big cost for us. So it's not immaterial at all.

The other thing it helps us do is it helps us with preventive maintenance, understanding when breakdowns may occur so that we can plan for downtime instead of having unplanned downtime, which is costly. And then there's a whole notion of micro stops on the line. You have your normal downtime for cleaning or whatever or if you have a mechanical problem, but it's the tiny stops, the 10-, 15-, 20-, 30-second, 1-minute stops that build up day by day, week by week, month by month throughout the year that become a big expense as well. So all this data that we're able to gather is going to help us alongside of leadership capabilities and process improvements, things like that help us gain those efficiencies in the bakeries that we needed for some time now.

Operator

And our next question will come from Mitchell Pinheiro of Sturdivant.

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

Of your sales guidance, is any Papa Pita included in that?

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

Yes.

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

Okay. Have you -- I mean, I had -- so what should we assume? Is that small, but what percentage of the sales guidance comes from Papa Pita?

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

Yes, we can't break that out specifically, Mitch. I mean it's not tremendous. Remember, they were a co-manufacturer for us. So the overall top line sales impact is not that huge.

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

Okay. But it is included in there, right? So whatever incremental you expect to get out of that would be included?

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

It's in the sales guidance, yes.

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

Okay. And then of the sales guidance, what's the breakdown of volume and mix -- pricing and mix in the year?

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

I mean, it's primarily price/mix, Mitch, yes.

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

Okay. And where maybe now, after this...

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

That would (inaudible).

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

What would be the SKU rat this year? Is it the same 3%-ish of sales? Is that included in there?

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

We should see the effect of SKU rat decline as we get throughout the year. Now again, that will -- we'll continue to do SKU rat, but the volume losses that you've been seeing over the last year or so, that should start to moderate as we move through the year.

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

Okay. When I look in terms of -- you're going to try to take some pricing in foodservice and private label, but I'm looking at Slide 8 of your fourth quarter presentation. You have some of your store brands and the priority and some of your store brands tactical. What percentage of your store brands are in each of those categories? And where are you going to be taking the price?

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

We're taking price across the portfolio, Mitch. And the pricing has already been taken.

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

Okay. Okay. And is that -- I mean -- and what percentage is your store brand, the breakout between priority and tactical? Is it 50-50? Is it mostly priority? Can you describe that?

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

I'll have to get back to you. I don't have that in front of me.

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

Okay. And then another question, just sort of on interest expense, you expect it to go up this year, but most of your debt's fixed. And when I look at your cash flow, just based on the preliminary guidance, you're going to have free cash flow, so I wouldn't anticipate debt to rise. Am I wrong?

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

I mean, you'll have the financing of the Papa Pita acquisition. So you will see it rise for a moment in time until we're able to delever and pay back down. And also from a investment perspective, we're still investing in ERP this year. So although last year was the highest cash flow year, it's still pretty significant in 2023 as well.

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

Okay. And then -- and finally, so as you look at your guidance range, let's say your EBITDA guidance range, EPS, if you were down -- if you're down at the bottom, what's that saying about -- what would have caused that to be down at the very low end? Is there to be more private label pressure commodity cost spikes? What's the -- what gets you to the low end?

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

Yes, it's not really going to be on the commodity side just because of our hedging program. So we pretty much know what our costs are going to be for the year, Mitch. But I think you're spot on, it's mostly going to be the overall health of the consumer, how does this private label uptick trend play out throughout the year? What happens with the competitive environment, to an earlier question. Does it start getting -- do we start seeing much higher promotions as perhaps we move into the back of the year and some of those inflation subside, do people start trying to win consumers back with promotions. And then finally, it's our ability to execute on our savings programs. I mean, you saw in the prepared remarks, and we have additional savings of $20 million to $30 million in the plan for this year, and it's up to us to execute on that. So those are the biggest swing factors that we could see during the year that could move you higher or lower on the guidance spectrum.

And yes, then I would also note that, once again, in addition to those items, pressuring EPS this year are the investments that we're making behind the bars, behind our supply chain capabilities, additional investment in digital, yes, that's pretty much a $0.09 headwind on the digital ERP side alone this year, plus you have the additional D&A from the Papa Pita acquisition and the ERP plus program that are pressuring EPS as opposed to EBITDA.

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

That's helpful. Have you made any -- or included into your guidance would be continued growth margin improvement, I guess, in the cake business? Or is that not in your -- do you anticipate that in your guidance, I should ask.

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

Yes. I mean, every year, we're making improvements with the cake business. I mean last year, despite some of the syndicated data that you all see that doesn't pick up nearly all of our cake business, the profitability in our cake business improved substantially last year.

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

Okay. And that should continue. I mean I remember, I thought early in the year, we're still struggling a little bit. So is there incremental growth there?

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

Remember that a lot of times, Mitch, when we're talking about the cake business, some of the struggles that we focus on are the struggles at the Navy Yard specifically. And the Navy Yard is not all of the cake business, right? So significant improvements have been made at the Navy Yard. But alongside that, we've done really well with our SKU rat program, getting rid of all the unprofitable -- well, not all of them, but a lot of the unprofitable SKUs, taking pricing to improve profitability. Innovation, et cetera, has done a lot to improve the profitability overall of the cake business.

Operator

I would now like to turn the conference back to Ryals McMullian for closing remarks.

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

Okay. Thank you, Tanya, and thanks, everybody, for your interest in Flowers Foods, and we certainly look forward to speaking with you again next quarter. Everybody, take care.

Operator

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