08-Mar-2018

United Natural Foods, Inc. (UNFI)

Q2 2018 Earnings Call

CORPORATE PARTICIPANTS

Katie Turner
Partner, ICR, Inc.

Steven L. Spinner
President, Chief Executive Officer and Chairman, United Natural Foods, Inc.

Michael Paul Zechmeister
Chief Financial Officer, United Natural Foods, Inc.

Sean F. Griffin
Chief Operating Officer, United Natural Foods, Inc.

OTHER PARTICIPANTS

John Heinbockel
Analyst, Guggenheim Securities LLC

Chuck Cerankosky
Analyst, Northcoast Research Partners LLC

Karen Short
Analyst, Barclays Capital, Inc.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.

Scott A. Mushkin
Analyst, Wolfe Research LLC

Frederick Wightman
Analyst, Citigroup Global Markets, Inc.

Andrew Wolf
Analyst, Loop Capital Markets LLC

Kelly Ann Bania
Analyst, BMO Capital Markets (United States)

Shane Higgins
Analyst, Deutsche Bank Securities, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Greetings and welcome to the United Natural Foods Second Quarter 2018 Earnings Conference Call. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded. It is now my pleasure to introduce your host, Katie Turner. Thank you, Ms. Turner, you may begin.

Katie Turner

Partner, ICR, Inc.

Thank you, good afternoon, and thank you for joining us on United Natural Foods' second quarter fiscal 2018 earnings conference call. By now you should have received the earnings release issued this afternoon. The press release and the webcast of today's call are available under the Investors section of the company's website at www.unfi.com. On the call today are Steve Spinner, Chairman and CEO, Sean Griffin, Chief Operating Officer, and Mike Zechmeister, Chief Financial Officer. Before I begin, we'd like to remind everyone that comments made by management during today's call may contain forward-looking statements. These forward-looking statements assess plans, expectations, estimates, and projections that might involve significant risks and uncertainties. These risks are discussed in the company's earnings release and SEC filings. Actual results may differ materially from the results discussed in these forward-looking statements. In today's earnings release and on the call, management will also provide GAAP and non-GAAP financial measures. Explanations and reconciliations to their most directly comparable GAAP measure are located in the company's earnings release and on the investor's section of the company's website. And it's now my pleasure to turn the call over to Steve Spinner.

Steven L. Spinner

President, Chief Executive Officer and Chairman, United Natural Foods, Inc.

Thank you, Katie. Good evening, everyone. Today I'm excited to discuss our second quarter business highlights, and then Mike will review our financial results and update to our annual guidance. Following our prepared remarks, Sean, Mike and I will take your questions.

The broad-based momentum we started off the year with continued throughout our second quarter, all of our significant customer channels generated strong growth, driving record quarterly sales of $2.5 billion for the second quarter. And our rate of top-line and earnings growth accelerated sequentially from Q1 to Q2. Sales to our top customers, from number two to number 25 increased 13% for the quarter, demonstrating that demand is growing across all of our channels and customers.

Sales mix remained a headwind, and was the primary driver of lower gross margin rate compared to the prior year period. However, we are pleased with our earnings and adjusted EBITDA results. While we did leverage our expenses against our strong top-line growth, we continued to have higher labor expenses in several of our distribution centers that are capacity-constrained. We've taken steps in the quarter to mitigate these headwinds through additional capacity, expected to be online by this fall. While we expect some of the expense to continue in the near term, we believe its effect will moderate over the next several quarters. Our mission continues to be improving service levels to our customers.

It is really exciting to be finishing our second quarter 2018 and be able to say that we believe UNFI will likely achieve over $10 billion in net sales this year, representing a significant milestone for the company. We will have grown our yearly net sales over $4 billion since fiscal 2013, with a compounded – sales compounded annual growth rate of over 13%. Net of the tax reform and the Earth Origins Market impairment and restructuring, the quarter exceeded our expectations.

Several categories of products continued to grow significantly at UNFI. Single service beverage, salty snacks, spices and grains, nutritional bars, yogurt, and protein and meal replacement powders all had substantial growth. We also saw very strong growth across our wellness categories, digestive health growing 70%, vitamins growing 74%, and personal care growing 34% in the quarter when compared to the second quarter of 2017.

And as you know, UNFI's Woodstock Farms Custom Snacks is a large national provider of packaged bulk snacks, primarily as a private label co-packager to retailers across the country, and we're pleased with Woodstock's growth. For the second quarter, eCommerce sales continue to be a focus, as we extended our eCommerce solution to our fourth broadline fulfillment center. UNFI's eCommerce business is primarily comprised of delivering to brick-and-mortar eCommerce providers, unfieasyoptions.com, endless aisle fulfillment, and fulfillment to home on behalf of others, offers realizers a wide array of service options designed to satisfy the changing consumer purchase decision. The retail food industry has evolved into a three-tiered omni channel experience. In-store, eCommerce with pickup in store, and ship to home.

UNFI plays in all three tiers today with a sophisticated network of distributions and fulfillment centers. Also over the last year, we talked quite a bit about UNFI Next, our emerging supplier incubation team. Our revenue with these suppliers grows faster than UNFI's overall growth rate, with almost 200 suppliers in the program, and 10% of the suppliers graduating into our primary supplier management program. UNFI Next is differentiating for our supplier participants, and our retailers showcasing these exciting new brands.

As I mentioned at the beginning of the year, we expect continued confidence in the strength of our business and it's reflected in our increased sales and earnings guidance for fiscal 2018, which Mike will address shortly. We believe our sourcing capabilities, our acquisitions, our very strong balance sheet, and demonstrated leadership within better-for-you distribution will support our long-term growth, and enable us to achieve our strategic objectives.

As we discussed during our first quarter 2018 call, higher demand is continuing to pressure our supply chain, as we're seeing further degradation in supplier inbound fill rates. On the expense side, we did incur higher labor costs in DCs that remain capacity constrained. Service levels continued to be challenged during the quarter, supplier out-of-stocks in the second quarter of fiscal 2018 were approximately 250 basis points unfavorable, versus the same quarter in the prior year, equating to approximately $50 million in lost sales. We continued to work across supply chain teams closely with our suppliers, to ensure that we are aligned on the demand signals and improve service level going forward.

During the quarter, we did see a recovery in most of our distribution centers, as they have adjusted to new demand, and I am quite proud of their resilience and commitment to the retailers we serve every day. The good news is we've rebalanced the most constrained distribution centers and secured additional capacity.

Tight capacity brings challenges beyond warehouse operations, and extends to our gross margin as we are more restricted in our ability to forward buy into rising markets and manufacture promotion. Additionally, our inbound freight rates have increased incrementally during the quarter, driven primarily by market supply constraints. We expect that these headwinds will continue through the balance of the fiscal year, but at a more moderated rate.

I am very proud of our people. UNFI's entire organization has demonstrated their dedication through this strong period of growth. Our management and associates have worked tirelessly and around the clock to minimize service disruptions to our customers from selectors, loaders, drivers, and buyers. Based on the strength of our growth, and the performance of our team of almost 10,000 associates, we are committed to attracting and retaining the best talent. Our compensation plans must reflect the competitive nature of current market dynamics, while we continue to deliver shareholder value. Also, UNFI will be adding capacity at several critical markets throughout the next several years, and we provide more color in September. Capital expenditures as a percentage of revenue or sales guidance for fiscal 2018 continues to be within the range we previously announced.

As we continue throughout our fiscal 2018, we expect our growth to continue, driven by demand for better-for-you products, more competition at retail, and enabling differentiated solutions. Consumers are shopping many different ways today. They want variety, specific attributes, exclusive brands, private labels in brick-and-mortar retail. We play a role in each of these purchase options and have valuable merchandising, data insights, category management, to mutually pursue high-growth opportunities.

In summary, we are very pleased with our results. Our team continues to execute at a high level. Our industry has and continues to evolve quickly, and UNFI is consistently taking decisive steps to change with it. Going forward, UNFI remains well positioned to meet the needs of our customers as we grow together.

With that overview, I'll now turn the call over to Mike.

Michael Paul Zechmeister
Chief Financial Officer, United Natural Foods, Inc.

Thanks, Steve. And good evening everyone. Net sales for the second quarter of fiscal 2018 were $2.53 billion which represents growth of 10.6% or approximately $242 million over the second quarter of last year. As Steve said, this was a record for the company for quarterly net sales. As a reminder, our last acquisition occurred in Q1 of fiscal 2017. As a result, acquisitions did not have an impact on the comparability of our results in Q2 this year versus Q2 of last fiscal year.

In Q2 of this fiscal year we experienced modest inflation of approximately 34 basis points, which was relatively consistent with our inflation from the last quarter. This marks our seventh consecutive quarter of either modest deflation or nearly zero inflation, which continues to be a headwind to our net sales and EBITDA dollar growth.

Demand for our products continues to ramp up resulting in a higher level of growth than we expected. We experienced broad based growth across our significant channels during the quarter. Supernatural net sales were up 19.2% or approximately $149.7 million over last year's second quarter and represented 36.8% of total net sales compared to 34.2% in Q2 of last year. Q2 was the highest quarterly year-over-year net sales growth in the supernatural channel since Q4 of fiscal 2013, which was benefited by an extra week.

Supermarket channel net sales increased 6.4% over the second quarter last year and represented 28.8% of total net sales. The independent channel net sales grew 5.6% versus Q2 last year and landed at 24.5% of total net sales in the quarter. Our food service net sales increased 6% over Q2 last year and our eCommerce net sales increased approximately 28.9% versus the second quarter of last year.

Gross margin for the quarter came in at 14.70%, a 39 basis point decrease over last year's second quarter. This decrease was driven by a shift in customer mix where sales growth with lower margin customers outpaced growth with other customers, and an increase in inbound freight costs as a result of increased rates throughout the industry.

Our operating expenses for the second quarter were 13.11% of net sales, an increase of 4 basis points compared to the second quarter of last fiscal year. Included in the Q2 total operating expenses were an impairment and restructuring charges of $11.4 million related to the company's Earth Origins Market retail business. The Earth Origins charges were comprised of: $7.9 million of non-cash goodwill impairment; $3.3 million of non-cash long-lived asset impairment; and $0.2 million in restructuring expenses associated with the decision to close three non-core underperforming stores.

In the second half of fiscal 2018, we expect to incur an additional $2.6 million of restructuring expense related to physically exiting the three stores. Excluding these impairment and restructuring charges, adjusted operating expenses were $320.1 million or 12.66% of net sales for the second quarter of fiscal 2018, a decrease of 41 basis points as a percentage of net sales compared to Q2 of last year. This decrease in adjusted operating expenses as a percentage of net sales was primarily driven by leveraging fixed costs on increased net sales and partially offset by increased labor costs incurred to fulfill the increased demand for our products.

Fuel costs for Q2 of fiscal 2018 increased 3 basis points as a percentage of distribution net sales compared to Q2 of last year, and represented 45 basis points of distribution net sales. Our diesel fuel cost per gallon increased by approximately 14.3% compared to the second quarter of last year, which compares to the Department of Energy's national average price per gallon for diesel in Q2, which increased 17.4% or $0.44 per gallon compared to the second quarter of last year.

Our lower diesel fuel cost increase per gallon compared to the national reported average was primarily due to unfavorable fuel locks, which expired during Q2 last fiscal year. Compared to the first quarter of fiscal 2018, our diesel fuel cost per gallon were up 9% or $0.23 per gallon. For the same period, the Department of Energy's national average price per gallon for diesel was up 8.1%.

Share-based compensation expense represented 26 basis points of net sales in Q2, a 6-basis-point improvement compared to 32 basis points in the second quarter of last year. On a dollar basis, share-based compensation expense was down $0.8 million to $6.6 million compared to $7.4 million in Q2 last year.

Q2 operating income was $40.2 million, a decrease of $6.1 million from $46.3 million in Q2 last year. Excluding restructuring and impairment expenses, adjusted operating income was $51.4 million, an increase of $5.2 million or 11.2% compared to Q2 last fiscal year. Interest expense in Q2 of $4.2 million was $0.2 million lower than Q2 of last year, primarily due to less debt year-over-year and partially offset by a 97-basis-point increase in our floating interest rate exposure. At the end of Q2, we had fixed interest rates on approximately 69% of our debt, leaving approximately 31% of our debt with floating rate exposure.

For the second quarter of fiscal 2018, the company reported net income of $50.5 million, an increase of approximately $25 million over the second quarter of last year. Q2 earnings per diluted share was $0.99 compared to $0.50 in Q2 last year.

Given the new 21% corporate tax rate that went into effect on January 1 resulting from the Tax Cuts and Jobs Act tax reform, the company's anticipated fiscal 2018 blended federal statutory tax rate is expected to be approximately 27.0%. Excluding the impact of impairment and restructuring charges, the effect of this component of the tax reform on Q2 results was a benefit to net income of approximately $7.3 million or $0.14 per diluted share.

Included in net income and also result of the tax reform was a one-time non-cash benefit of $21.9 million or $0.43 per diluted share related to the preliminary re-measurement of our net deferred income tax liabilities. Including this one-time non-cash provisional tax benefit resulting from the tax reform and the restructuring impairment charges, Q2 adjusted earnings per diluted common share was $0.71, an increase of $0.21 or 42% over Q2 last year.

Adjusted EBITDA for the second quarter of fiscal 2018 was $73.3 million, an increase of 8.5% from $67.5 million in the same period last year. Adjusted EBITDA margin was 2.90% of net sales, down 5 basis points from Q2 last year. We had free cash flow of $26.6 million in the second quarter of fiscal 2018 compared to free cash flow of $90.7 million in the second quarter of last year. Total working capital at the end of Q2 was $1.1 billion, up 2.5% versus Q2 of last year compared to net sales growth of 10.6% over the same period.

Despite the solid working capital performance relative to net sales growth, the increased size of our business combined with our commitment to high service levels has led us to carry higher inventory levels than previously expected. As a result, free cash flow for fiscal 2018 is now estimated to be in the range of $120 million to $150 million, down from the previous range of $155 million to $185 million. Our capital expenditures for the second quarter were approximately $10.3 million or 0.41% of net sales, a decrease of 18 basis points from 0.59% of net sales in the second quarter of last year.

As a reminder, on October 6, 2017, we announced that our board of directors authorized a share repurchase program for up to $200 million of our common stock. In the second quarter, we repurchased approximately 403,000 shares for $15.8 million or an average cost per share of $39.21. This compares to the market average share price in Q2 of approximately $46.10. The share repurchase impact on diluted EPS in Q2 was approximately $0.01. Year-to-date, we've repurchased approximately 565,000 shares at a cost of $22.2 million or an average price of $39.36 per share.

Our strong balance sheet continues. At the end of the second quarter, our debt to adjusted EBITDA leverage, excluding operating leases, was 1.44 times down 38 basis points compared to the second quarter last year. Outstanding lender commitments under our credit facility were $882 million, excluding reserves with available liquidity of approximately $590 million including cash and cash equivalents. At the end of Q2, available liquidity under our credit facility was approximately $141 million higher than Q2 last year.

Based on UNFI's performance to-date, the impact of the tax reform act and the outlook for the remainder of fiscal 2018, the company is raising its net sales and EPS guidance which was provided on December 7, 2017.

For fiscal 2018 ending July 28, 2018, the company now estimates annual net sales to increase 8.0% to 9.5% versus fiscal 2017 and exceed $10 billion for the first time finishing in a range of approximately $10.01 billion to $10.16 billion. This compares to previous guidance of an increase of 6.2% to 7.8% over fiscal 2017 net sales. The company now estimates earnings per diluted share for fiscal 2018 to be in the range of approximately $3.27 to $3.35, an increase of approximately 28% to 31% over fiscal 2017 earnings per diluted share of $2.56 compared to the previous estimate of $2.72 to $2.80.

Adjusting for restructuring and impairment charges and the impact of one-time preliminary re-measurement of U.S. debt deferred tax liabilities resulting from the tax reform, the company estimates adjusted earnings per diluted common share for fiscal 2018 to be in the range of approximately $3.06 to $3.14, an increase of approximately 20% to 23% over fiscal 2017. The company now expects its fiscal 2018 GAAP effective tax rate to be in the range of 23.8% to 24.3% and its fiscal 2018 adjusted effective tax rate to be in the range of 33.0% to 33.3% compared to the previous guidance of 40.0% to 40.3%. Capital expenditures for fiscal 2018 are expected to remain in the range of 0.6% to 0.7% of estimated fiscal 2018 net sales.

At this point, I'll turn the call over to the operator to begin the question-and-answer session. Operator?

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now be conducting a question-and-answer session. [Operator Instructions] Our first question comes from John Heinbockel with Guggenheim Securities. Please go ahead.

John Heinbockel
Analyst, Guggenheim Securities LLC

Q

So, Steve, let me start with, what's the pipeline look like for new business wins? And do you have the capacity right now to bring that type of business on board? So, are you aggressively prospecting it, or you sort of need to wait until you have capacity?

Steven L. Spinner
President, Chief Executive Officer and Chairman, United Natural Foods, Inc.

A

No, John. Certainly, if you look at our overall growth, we're doing really well as it relates to both growth within our existing customer base, as well as there are some new wins embedded in our current run rate. We are always out looking for the right new business, and we do have some capacity constraints in some markets. We think we're addressing those. So, I would say that, generally speaking, we can be out there looking for new business. In some markets we would have to be – the timing would have to work in a way that as we'll have to wait until some capacity comes onboard. But, the other side of it is, we've got a lot of DCs in a lot of markets, and where necessary, we find a way to make it work.

John Heinbockel
Analyst, Guggenheim Securities LLC

Q

And maybe just as a follow up to that, thinking about bringing more capacity online, particularly in new facilities, so, what's the timing of that? I assume we're out to next fiscal year. And could we have a multi-year period here? Yeah. [indiscernible] (27:26) could we have a multi-year period here where annual CapEx is running kind of in the $150 million range temporarily, or not that high?

Steven L. Spinner
President, Chief Executive Officer and Chairman, United Natural Foods, Inc.

A

Yeah. I mean, look, if you look back over time, right, I think that gives you a pretty good window into the kind of lumpiness of our CapEx growth. We have capacity that we've secured that will be online in this fiscal year, and is embedded in our guidance for this fiscal year. Will there be some capacity that we have to add in 2019 and 2020? Yes. Might some of them be new buildings? Yes, but I wouldn't want to give any other color to that until we get to kind of our 2019 guidance. Mike, you want to add something?

Michael Paul Zechmeister
Chief Financial Officer, United Natural Foods, Inc.

A

Yeah. You know, John, we said long-term that we would expect our CapEx as a percent of sales to be 1%. And if you look back over the last five years, it's about 1%. Now that's comprised of fiscal 2014 and 2015 where we were adding new warehouses and we were certainly well above 1%. But that combined with the last few years, we've been well under 1%. That's how you get to that 1%. Now, going forward, as Steve said, we'll be bringing on new capacity where we need it, and so that percentage is likely to go up above 1% here in the next couple of years.

John Heinbockel
Analyst, Guggenheim Securities LLC

Q

Okay. Thank you.

Operator: Our next question comes from Chuck Cerankosky with Northcoast Research. Please go ahead.

Chuck Cerankosky
Analyst, Northcoast Research Partners LLC

Q

Good afternoon, everyone, or good evening.

Steven L. Spinner
President, Chief Executive Officer and Chairman, United Natural Foods, Inc.

A

Hi, Chuck.

Chuck Cerankosky
Analyst, Northcoast Research Partners LLC

Q

Could we talk about mix a little bit? If we look at those top customers, numbers 2 through 25, what percent of the sales do they represent? And then in looking at overall sales mix, could you talk about your effort to sell more perishables in the mix and how that was in the quarter?

Steven L. Spinner
President, Chief Executive Officer and Chairman, United Natural Foods, Inc.

A

Yeah. Well, they look for the first part of your question, I can comment on kind of fresh. Fresh is still growing nicely within the company. Obviously, with the kind of increase in growth that we've had over the last couple quarters, we've been a little bit kind of focusing our time on getting capacity and getting production in our warehouse, keeping fill rate up. So, I think, we probably took our eye off the ball a little bit on fresh. But it's still growing nicely across the country, not only in the broadline division, but in our Tony's division and our Albert's division as well. As far as the percentage of sales in customers 2 through 25?

Michael Paul Zechmeister
Chief Financial Officer, United Natural Foods, Inc.

A

Yeah, Chuck. This is Mike. If you look at our top 25 customers that represents a little over 70% of our total net sales, and we've given you what our top customer is.

Chuck Cerankosky
Analyst, Northcoast Research Partners LLC

Q

Okay. All right. Thank you.

Operator: And our next question will come from Karen Short with Barclays. Please go ahead.

Karen Short
Analyst, Barclays Capital, Inc.

Q

Hey, thanks. Just to clarify something. Obviously, your top line is unbelievably good. And you've got a little bit more leverage in the second quarter. And I mean, we all know what the problems were in the first quarter. You explained some of it or you explained most of it for the second quarter. But I guess what I was wondering is, one, are you still expecting leverage in the third and fourth quarter? Because I think you previously indicated you would. And I guess when I back into your earnings guidance, I'm looking kind of at flat operating margins in the second half. So, doesn't really show any real improvement from 2Q into 3Q or 4Q. So, I just want to make sure I'm right about that. And then I had a follow up.

Michael Paul Zechmeister
Chief Financial Officer, United Natural Foods, Inc.
A

Hey, Karen. It's Mike. There's been a variety of things going on there. One of the things we said in Q1, which I think is still true today is that, when the business ramps up like it has, it takes us a little bit of time to assimilate that extra business and normalize our cost. And we pointed last quarter to some increased costs as that business ramped up and we did this quarter as well with labor. And so, it generally takes us about four to six months to normalize on an increase, and so that comes into play a little bit here. But we certainly do expect to get some leverage benefit in the back half. And that should translate through the bottom line.

Karen Short
Analyst, Barclays Capital, Inc.
Q

Okay. And then just the second question was on actual dollars that you will get incrementally from the tax reform. Could you give that number and then maybe just give some directional commentary on what you think or how you think you'd allocate that? And it sounds like it's probably capital, but just to be clear.

Michael Paul Zechmeister
Chief Financial Officer, United Natural Foods, Inc.
A

Yeah. So, when we say dollars, there are two main components of the tax reform, as you know. There is the federal rate reduction to 21% that kicked in on January 1, and that has a real cash benefit to us given our blended rate for the year. That benefit to us in Q2, excluding the impact of Earth Origins, was about $7.3 million. If you went to the GAAP impact, the all-in impact, it's about $6.5 million. Now you might recall back to January, what I indicated that the annual impact of the change from a cash standpoint was going to be $16 million to $18 million for us. I'd say, we're still in that range.

The second component of the reform that impacts us significantly was the revaluation of our deferred tax assets and liabilities. In the quarter, that impacted us positively by $21.9 million. Now we're going to give a little bit of that back as we go. And at the end of the year, we'd expect that number to be around $20 million, but that's non-cash. And so, there are dollars associated with that.

Karen Short
Analyst, Barclays Capital, Inc.
Q

Okay. And so, in theory, the allocation for some of that will be to CapEx or is that not the right way to think about it?

Michael Paul Zechmeister
Chief Financial Officer, United Natural Foods, Inc.
A

So, yeah, I think that we're going to look at in a couple different ways, not necessarily specifically tied to tax reform. One is certainly capital. So, growth drives the need for expansions and new buildings. Two, we always look at our wage rates to make sure that we're competitive in attracting and retaining our top talent. And that's certainly something that we're looking at all the time. So, if I had to point to two places, I would say it's buildings, infrastructure, and making sure we have the right competitive wage rates, primarily in our warehouse and transportation.

Karen Short
Analyst, Barclays Capital, Inc.
Q

And do you think you have that now, or do you think there's a gap that needs to be filled?

Michael Paul Zechmeister
Chief Financial Officer, United Natural Foods, Inc.
A

[ph] You know (35:16), listen, I think we look at it regularly. The world is changing, and it's a little more competitive. Keep in mind that our kind of average pay rate is far above minimum wage. It always has been. But as minimum wage increases and unemployment goes down, we always have to assess our wage structure. But we always do it keeping shareholder value at the top of our consideration as well.

Karen Short
Analyst, Barclays Capital, Inc.
Q

Great. Thanks so much.

Michael Paul Zechmeister
Chief Financial Officer, United Natural Foods, Inc.
A

Okay.

Operator: Our next question comes from Rupesh Parikh with Oppenheimer & Co. Please go ahead.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.
Q

Good afternoon. Thanks for taking my question. And also congrats on a nice quarter.

Steven L. Spinner
President, Chief Executive Officer and Chairman, United Natural Foods, Inc.
A

Thanks, Rupesh.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.
Q

Staying on the topic of tax reform – so staying on the topic of tax reform, how should we think about the tax rate post this year?

Michael Paul Zechmeister
Chief Financial Officer, United Natural Foods, Inc.
A

I provided some insight to that back in January. We don't think any differently today than we did back then. What happens next year relative to this year is, you don't have the benefit of the one-time restatement of deferred tax assets and liabilities, but you do have a full year of the cash tax savings at the corporate rate down at 21%. So, this year, we only get seven months' worth of that lower cash tax benefit. Next year we get a full year of that. And so, we certainly said that that will be the big driver of our tax rate reduction for next year. And we've said that if you thought about us as a 40% taxpayer that you would expect 11 to 13 percentage points worth of reduction in our tax rate off of that rate in fiscal 2019 and going forward.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.

Q

Okay, great. And then just going back to your comment here on free cash flow. I understand the inventory increase just due to – I guess you guys are trying to improve the service levels. The AR balance also increased meaningfully year-over-year. So, I was just curious if there's anything there or if it's just timing.

Michael Paul Zechmeister
Chief Financial Officer, United Natural Foods, Inc.

A

Yeah. AR and AP both did increase as well. We've transitioned into our shared service center, and seen some changes there that we're getting after. But, actually, the AR and AP offset is a little bit positive to working capital.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.

Q

Okay, great. And then my last question too. So, Steve, you mentioned that you're going to be adding more capacity later this year. So, I was just curious what the nature of that capacity is? Is that in addition to your distribution centers or just trying to get a feeling for what you guys are doing [ph] about capacity (38:17)?

Steven L. Spinner
President, Chief Executive Officer and Chairman, United Natural Foods, Inc.

A

Yeah. Go ahead, Sean.

Sean F. Griffin
Chief Operating Officer, United Natural Foods, Inc.

A

Yeah. Hi, Rupesh. This is Sean. And in remainder of FY 2018, any capacity expansion will be expanding our existing footprint within our DC. So, we're not talking about new buildings. We're talking about adding more capacity and contiguous buildings with leases. That's kind of what we're doing.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.

Q

Okay, great. Thank you.

Operator: Our next question is from Scott Mushkin with Wolfe Research. Please go ahead.

Scott A. Mushkin
Analyst, Wolfe Research LLC

Q

Hey, guys. Thanks for taking my question. So, I had a housekeeping issue and maybe I'm the only one. But you actually cut out when you gave the supernatural growth, at least for me, and I was wondering was that 19.2%. Did I hear that right? I just didn't hear it.

Michael Paul Zechmeister
Chief Financial Officer, United Natural Foods, Inc.

A

Yeah, Scott. Yeah, the growth in supernatural was 19.2% over.

Scott A. Mushkin
Analyst, Wolfe Research LLC

Q

Okay, perfect. Okay. So, then my second question goes to the growth rates that you're seeing across your business besides what's going on with Whole Foods/Amazon. I mean, it's pretty significant. I'm trying to understand the underpinnings of it. I mean, if we look at some of those core customers which we know intimately, they're not growing nearly as fast. And so, I was wondering if you can talk to us about why the 13-plus-percent in the top 25 ex-Whole Foods/Amazon and how sustainable that is? I mean, the marketplace isn't growing that fast. They're not growing that fast. So, I was just wondering if you could give us a little color.

Steven L. Spinner
President, Chief Executive Officer and Chairman, United Natural Foods, Inc.

A

Yeah, Scott. I'll take that one. So, as you know, we've been working hard to, what we call, building out the store which is selling more to existing customers. And so, in the case of our supernatural, even though our reported number is 19%, and that's actually what it is. If you actually take out the new categories that we have taken on recently, the supernatural growth is actually very similar to the growth of our customers 2 through 25.

Scott A. Mushkin
Analyst, Wolfe Research LLC

Q

Okay. And then...

Steven L. Spinner
President, Chief Executive Officer and Chairman, United Natural Foods, Inc.

A

So, the second part of the question is why are they growing so rapidly at 13%. And it's a matter of, certainly, those retailers seem to be getting it right as it relates to a product differentiation, product attributes, price point, and we are taking on larger portions of those customers' overall business mix. So, it's really hard using UNFI's numbers to say exactly what's happening in the store itself, because obviously as we add SKUs or categories, that will make the number look larger.

Scott A. Mushkin
Analyst, Wolfe Research LLC

Q

So, and, Steve, are you seeing these top 25 customers actually accelerate their store growth? I mean, take Wegmans for instance, kind of can't understand what their comp is from being in the marketplace. And, obviously, nowhere near what you guys are reporting. So, are you taking obviously more share of what they're selling, and are you seeing square footage growth ramp up again with some of these guys?

Steven L. Spinner
President, Chief Executive Officer and Chairman, United Natural Foods, Inc.

A

Yeah. I mean, I obviously can't talk about any one customer individually. And so, yeah, I would tell you that across the customer base, I think it's probably a combination of a couple things that are happening in new store growth, its expansion of SKUs that we're delivering into their footprint and the stores themselves performing well.

Scott A. Mushkin
Analyst, Wolfe Research LLC

Q

And then my final question is, you're going to have put more capital in the ground, obviously, in part because of how fast your number one customers are going to probably grow. What are your protections? Obviously, you have a long-term contract there, but how else can you approach this as you commit more capital to, more or less, to them? Not only to them, but more or less to them?

Steven L. Spinner
President, Chief Executive Officer and Chairman, United Natural Foods, Inc.

A

I mean, if we're growing in customers 2 through 25 at 13%, we need the buildings. We need the capacity, regardless of what's happening at our largest customer. I think there's going to be a point in time where we'll start to think about the question that you raised, but we're a fairly long ways from there. And so, we'll kind of wait to see how the dynamics of the industry continue to change and readjust with it. We have the most built-out, intricate, complicated supply chain within our space. And we need to make sure that we can continue to provide the kinds of services that we do today in the most efficient manner. And the only way to do that is to be smart about how we build buildings, expand the buildings, lease buildings versus buy buildings. So, there's a lot of triggers that we have within our arsenal that we'll pull as we need to.

Scott A. Mushkin
Analyst, Wolfe Research LLC

Q

Great. Thanks for taking my questions. I really appreciate it.

Steven L. Spinner
President, Chief Executive Officer and Chairman, United Natural Foods, Inc.

A

Okay.

Operator: Our next question comes from Greg Badishkanian with Citi. Please go ahead.

Frederick Wightman
Analyst, Citigroup Global Markets, Inc.

Q

Hey guys, actually Fred Wightman on for Greg. You talked about elevated freight costs for a few quarters now, and I think you mentioned they also increased incrementally in the quarter. So how are you thinking about those rates for the rest of the fiscal year and going forward?

Sean F. Griffin
Chief Operating Officer, United Natural Foods, Inc.

A

Hey, Fred, it's Sean. Well, we certainly did see an uptick, a pretty significant uptick in terms of our inbound freight expenses. That will take some time to cycle through. As you know, many of our customers are cost-plus customers. We're taking the expense in this cycle, and we'll be passing that through, through the remainder of the year. We're not exactly sure where this is going to go. You know that the transportation industry is under a lot of pressure. Capacity is scarce, the labor market is difficult, and we're prepared to move forward in the back half. We think we got it covered.

Steven L. Spinner
President, Chief Executive Officer and Chairman, United Natural Foods, Inc.

A

Yeah, I'd add a couple of comments to that. On the outbound freight side, we've been able to do a lot with our loads and routes and increase our drop sizes in a way that we've been able to protect ourselves from a lot of the escalation in costs that you hear throughout the industry. So on the outside side, we've actually performed quite well.

Frederick Wightman
Analyst, Citigroup Global Markets, Inc.

Q

Okay, perfect. And then if we look at the potential steel and aluminum tariffs that are being discussed. I mean is that something that would represent an incremental headwind to leasing rates going forward, or to your costs, or is that really just not something it would impact?

Sean F. Griffin
Chief Operating Officer, United Natural Foods, Inc.

A

I don't think that we've contemplated it yet, Fred. Certainly in terms of our fleet, we would presume to have some incremental expenses there, but really couldn't characterize that.

Frederick Wightman
Analyst, Citigroup Global Markets, Inc.

Q

Great, thanks.

Operator: Our next question comes from Andrew Wolf with Loop Capital Markets. Please go ahead.

Andrew Wolf
Analyst, Loop Capital Markets LLC

Q

Hi, good afternoon and congratulations on the quarter. I wanted to ask you on the sequential improvement in the leveraging sales and getting some margin – operating margin expansion. I understand that it sounds like you're managing better against the demand surge, but look, based on internal sales growth, I mean, it accelerated. So I assume it might have kind of surprised you even this rate of acceleration given you raised your guidance of sales. So, and the other – so I wanted to ask about that and is that all of it or is just basic economics of a nice increase in drop size also driving that. And the follow-up if you're willing to go there is, could you quantify how much the excess labor to try to meet the demand surge, how much that impacted your operating margin so we can get a sense of how the business would have leveraged if you were staffed up for it?

Michael Paul Zechmeister
Chief Financial Officer, United Natural Foods, Inc.

A

Yeah, Andy, I think there's a couple of things there. First all of, we did get leverage across our fixed costs, so you're right about that. We did improve our loads and routes in a way that increased our drop sizes, which gives us a little leverage. And we did take on additional costs that were unexpected as a result of the ramp-up even further in demand for the product. So I think those things are all true. As far as labor goes, that's been the area where we've seen an increase as a result of demand on the products goes beyond just the ramp up in business. We've taken on over time we've taken on temporary labor to help us out. And that's in the range of 10 to 15 bps of a headwind to us on our EBITDA margin coming through outbacks.

Andrew Wolf
Analyst, Loop Capital Markets LLC

Q

Gotcha. Thanks and that's very helpful. And could you give us a sense also maybe not quantitatively but qualitatively of kind of the incremental profit margin or the contribution margin across the segments? I mean, I think some people have the sense that when you mix the way you mixed, it's going to hurt your operating margin. Clearly it didn't. So is it fair to say, the effects of drop size, for example, leverage across the segments and so that's part of the reason the operating margin expands despite where the growth is?

Michael Paul Zechmeister
Chief Financial Officer, United Natural Foods, Inc.

A

Yeah, when you think about margin on our business, the levers that impact margin the most are not necessarily driven by channel. They're driven by scale that the customer provides, they're driven by assortment of products and they're driven by the level of service that customer asks for. So we see a variety of different needs across different channels and segments. Those are kind of the things that affect us on a margin standpoint. Certainly as you get down to EBITDA margin, when we can leverage our fixed costs and technology and infrastructure by increasing load size, increasing drop size, that makes a big difference. So that's where a customer that has a lot of scale, we can also get a better leverage from because the chances are we've got higher drop sizes. So that's the way we think about that.

Andrew Wolf
Analyst, Loop Capital Markets LLC
Q

Okay. Got you. Great, thank you.

Operator: And our next question comes from Kelly Bania with BMO Capital Markets. Please go ahead.

Kelly Ann Bania
Analyst, BMO Capital Markets (United States)
Q

Hi, thanks for taking my question. Just wanted to clarify on the guidance raise, when you look at your adjusted EPS guidance now $3.06 to $3.14, relative to where it was last quarter, was that basically entirely due to tax? Or I guess I'm trying to understand, did your...?

Michael Paul Zechmeister
Chief Financial Officer, United Natural Foods, Inc.
A

Let me sort that out for you a little bit, Kelly. Clearly, the GAAP guidance includes all the changes, and that's the full tax reform, the two primary pieces being the restatement of deferred tax assets and liabilities, and the lower federal rate of 21% that kicked in January 1st. And then, it's the Earth Origins impairment and restructuring charges. So those are the things that are all in the GAAP number. When you drop down to adjusted, the two pieces that get pulled out are the Earth Origins impairment and restructuring charges of about $11.4 million in the quarter, and you also pull out the restatement of deferred tax assets and liabilities, which was $21.9 million in the quarter. So those are the two pieces that get pulled out to get to adjusted EPS.

So adjusted EPS has included in it, the corporate tax rate changed out to 21% that went into effect on January 1. That's the part that stays in adjusted, because that's the ongoing benefit that will continue into next year. Now clearly that benefit for us in fiscal 2018 is a benefit for seven months, as we get into fiscal 2019, it'll be a benefit for 12 months. So we'll certainly see an increase related to that part of the tax reform going into next year. Hopefully that helps.

Kelly Ann Bania
Analyst, BMO Capital Markets (United States)
Q

Yeah, no, I think that all makes sense. I was just curious, I mean, if it weren't for changing your tax rate guidance, your adjusted tax rate guidance, would you be updating guidance for earnings now?

Steven L. Spinner
President, Chief Executive Officer and Chairman, United Natural Foods, Inc.
A

We'd still be better. Yeah, we'd still be better.

Kelly Ann Bania
Analyst, BMO Capital Markets (United States)
Q

All right, I guess, can you quantify the magnitude of it? Because it seems like you would still be within the prior range, maybe at the high end? I don't know. I guess I'm just trying to understand. Clearly sales was very strong, you're raising the guidance. Just trying to understand how of that is really flowing through to operating income, or the outlook for operating income for the year?

Steven L. Spinner
President, Chief Executive Officer and Chairman, United Natural Foods, Inc.
A

Yeah, I think if you did the math off of the midpoints of where we were, and where we're at, you'd see a couple of [ph] cent (52:53) increase.

Kelly Ann Bania
Analyst, BMO Capital Markets (United States)
Q

Okay. And in terms of – there was a lot of articles over the last couple of months about one of your customers may be putting some fees on their suppliers, and just curious if, in general, if any one of your customers are doing something like that, if there's an impact for you? Or is that just a pure pass-through? Is there any opportunity for you to maybe participate in that, or it's just a pass-through?

Steven L. Spinner
President, Chief Executive Officer and Chairman, United Natural Foods, Inc.
A

Well, I'm not sure which fees you're referring to. Obviously, many, many of our customers have fees associated with slotting or manufacturer's promotions, and we frequently handle the administration of processing those fees. And we do make a little bit of money on that. But we also obviously incur some costs to do it as well. But I'm not sure I've seen anything outside of what is typical.

Sean F. Griffin
Chief Operating Officer, United Natural Foods, Inc.
A

We are not experiencing any, nor are we incurring any additional fees, any incremental fees, and have not over the last several quarters.

Kelly Ann Bania
Analyst, BMO Capital Markets (United States)
Q

Got it. And just also want to clarify and make sure I understand the comment about the freight and passing that on. I guess does that work in the form of freight surcharge? Is that how we should think about it? When did that take hold? And how do you feel about your suppliers being able to absorb a cost like that at a time like this when either they're already out of stocks or they're working capital's going up, too? So, just curious how you feel, or what you're maybe seeing already, and how they're dealing with that?

Steven L. Spinner
President, Chief Executive Officer and Chairman, United Natural Foods, Inc.
A

It for us it's a straight pass-through in our cost of goods.

Michael Paul Zechmeister
Chief Financial Officer, United Natural Foods, Inc.
A

There's just a lag here, where when the rates go up, it takes us a little bit of time to be able to work that through. So that's why we saw the headwind on our inbound in Q2, but as Sean said, we ought to be able to work through that and get it into our costs, so that it's not a headwind going forward.

Kelly Ann Bania
Analyst, BMO Capital Markets (United States)

Q

Okay. And then the last one for me, I guess, similar to last quarter, your guidance for the year implies maybe a slowdown relative to where you are. I mean, are you seeing something to that effect, or are you just trying to plan conservatively, or at what point do you plan a little bit more, so that you can try to have those labor expenses more in line with where sales are really tracking?

Steven L. Spinner
President, Chief Executive Officer and Chairman, United Natural Foods, Inc.

A

Yeah, I mean, I think we generally plan conservatively. We do lap some business in the fourth quarter of the year. But we just feel like that's a good number, and one that we're comfortable with.

Kelly Ann Bania
Analyst, BMO Capital Markets (United States)

Q

Okay. Thanks.

Operator: Our next question comes from Shane Higgins with Deutsche Bank. Please go ahead.

Shane Higgins
Analyst, Deutsche Bank Securities, Inc.

Q

Yeah, good evening, thanks for taking the questions. On your out-of-stock, they stepped up to about $50 million I think you said, during the quarter. That's about double what they were in the first quarter. Is that kind of a level that you guys anticipate in the third quarter? I mean, how are your vendors mitigating that?

Michael Paul Zechmeister
Chief Financial Officer, United Natural Foods, Inc.

A

Well, I'm not sure which number you're referring to, but the first quarter and the second quarter were actually relatively similar in terms of the total supplier, the rate issues. But still, when you look year-over-year, $50 million in lost sales is a pretty significant number. Now, fortunately, suppliers are aligned with – everybody's interests are aligned. They want to have the product. So, it's either a capacity issue within the supplier. It's – they can't keep up with the demand, but ultimately, I think they will.

Sean F. Griffin
Chief Operating Officer, United Natural Foods, Inc.

A

Yeah, these cycles generally correct. It has certainly been a circumstance here presently where it's taking longer than we had expected, but we think that we can get through it towards the back half of 2018 and then we'll see some improvement.

Michael Paul Zechmeister
Chief Financial Officer, United Natural Foods, Inc.

A

Yeah, by the way we just saw [ph] where (57:43) you were referring to. Because in the first quarter it was 250 basis points and this quarter it was 250 basis points. I'm not sure where the difference between $25 million and $50 million came from, but it's probably closer to $50 million. But we just need to check it out.

Shane Higgins
Analyst, Deutsche Bank Securities, Inc.

Q

Okay. No, I appreciate that and then a question on the free cash flow guide. You guys did lower that by about $35 million, but I just want to make it clear: you guys do expect a $16 million to $18 million cash tax benefit from tax reform. Is that correct? And then, if so, that $50 million delta between your old guidance and the new guidance. Is that all working capital?

Steven L. Spinner
President, Chief Executive Officer and Chairman, United Natural Foods, Inc.

A

Yeah, I think that's – you're thinking about it the right way. We certainly had – actually, the working capital performance is up 2.5% versus sales growth of 10.6%, it wasn't bad. But we are seeing an increase in inventory along with the increased size of our business and the need to protect our service levels.

Shane Higgins
Analyst, Deutsche Bank Securities, Inc.

Q

Okay. I'm just trying to understand. Just thinking out into next year, if you might be able to drive some incremental free cash flow by maybe bringing down working capital or if that might be an opportunity?

Michael Paul Zechmeister
Chief Financial Officer, United Natural Foods, Inc.

A

Yeah, we're continuously working on opportunities to improve our working capital. We've made some pretty good progress over the years. But with the unexpected increase in demand, we've got, as Steve said, one of our top priorities is to preserve high service levels for our customers and sometimes that means taking on a little bit of extra inventory to make sure we can get through the demand.

Shane Higgins
Analyst, Deutsche Bank Securities, Inc.

Q

Got it. And then just a last question for me is, obviously, you guys talked about how capacity constrained you are and some of the challenges there. Do you guys have any opportunities to rationalize any less profitable business to possibly free up some capacity?

Michael Paul Zechmeister
Chief Financial Officer, United Natural Foods, Inc.

A

Well, let me make one point of clarification. We're only capacity limited in a few of our markets. We are not capacity limited across the country. And so you raise a great question and that is something that we look at all the time. But we're focused on building out the store. We're focusing on selling more to existing customers, and you need the infrastructure and the capacity to do that, but I want to make sure that we don't characterize our network as being at capacity. We have several markets that are at capacity. We're addressing those. There's plenty of capacity throughout the balance of the network.

Shane Higgins
Analyst, Deutsche Bank Securities, Inc.

Q

Got it. Thanks for taking my questions.

Operator: This concludes our question and answer session. I would like to turn the floor back to management for any closing remarks.

Steven L. Spinner

President, Chief Executive Officer and Chairman, United Natural Foods, Inc.

Thanks for joining us on this exciting quarter. Have a terrific night.

Operator: The conference is now concluded. Thank you for attending today's presentation and you may now disconnect your lines.