07-Dec-2017

United Natural Foods, Inc. (UNFI)

Q1 2018 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Greetings, and welcome to the United Natural Foods Incorporated First Quarter 2018 Earnings Conference Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Katie Turner for opening remarks.

Katie Turner

Managing Director, ICR LLC

Thank you. Good afternoon, and thank you for joining us on UNFI's First Quarter Fiscal 2018 Earnings Conference Call. By now, you should have received a copy of the earnings release issued this afternoon. This press release and 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 we begin, we would 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 addition, in today's earnings release and during the call, management will provide GAAP and non-GAAP financial measures. These non-GAAP financial measures include EBITDA, EBITDA margin, free cash flow and leverage. A complete reconciliation and explanation of these data changes and reconciliation to the most directly comparable GAAP measures is located on the Investors section of the company's website.

And I'd now like 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 first quarter business highlights, and then Mike will review our financial results and annual guidance. Finally, Sean, Mike, and I will take your questions once we finished our prepared remarks.

We're out of the gate in our first quarter of fiscal year 2018 with very strong top line growth, which we will expect to continue throughout our fiscal year. All of our significant customer channels saw a broad-based growth with our broadline business shipping over a 100 million units and leading UNFI to record quarterly sales of $2.4 billion in the first quarter.

We are very encouraged by what we see is increasing and broad-based demand for the capabilities and solutions UNFI provides to our very diverse customer base. We expect this business momentum to continue for the balance of the year as reflected in our increased sales and earnings guidance for fiscal 2018, which Mike will address shortly.

We believe we are uniquely positioned and in the nexus of robust industry activity and interest in better-for-you food products and services, across brick-and-mortar retail, eCommerce, food service, and international relationships, wherever the demand is, we believe UNFI is the preferred solution.

As the aforementioned momentum came on quite quickly, our ability to respond and execute at a high service and low-cost manner was challenged during the quarter. Typically, our operational teams would plan and prepare several months in advance for the kind of ramp-up we saw in Q1, in this case, we adjusted in real-time. We did incur a higher than normal overtime and outside storage expenses leading to overall lower productivity levels and higher expense ratios.

I would really like to salute UNFI's management and associate teams who work tirelessly and around the clock, including dealing with two hurricanes to minimize service disruptions to our customers from selectors, loaders and drivers and buyers, our staff demonstrated that how they could rise to meet the challenge.

As we move into our second quarter, we are continuing to see record sales and shipping unit volume and have made the appropriate staffing and facility adjustments. Additionally, associated with the unexpected demand, our inbound fill rates from our supplier partners was and continues to be a challenge. Suppliers out of stocks in the first quarter of fiscal year 2018 versus the same quarter in the prior year were almost 250 basis points unfavorable, equating to approximately $25 million in additional lost sales. Our supply chain teams are working closely with suppliers to make sure we are aligned on the demand signals and improve service level going forward.

We also delivered solid product profit improvement versus the prior year period with earnings diluted share of $0.60 for the first quarter, particularly in light of the inventory, operational and other expense associated with meeting our customer needs, against unplanned demand. 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 and private label and in brick-and-mortar retail. We play a role in all and add valuable merchandising, data insights, category management to mutually pursue high growth opportunities.

Under the leadership of Kirsten Hogan, our new VP of Wellness & eCommerce, we are focused on realizing the opportunities from our investments and technology and infrastructure necessary to fuel growth. For the first quarter, eCommerce sales were up more than 30% and we see many opportunities ahead. We believe our distribution network and deep assortment of brands and products offer our customers an endless aisle of opportunity in our customer relationships.

I would like to reiterate our 2018 key strategic goals, all of which we focused on during the first quarter and these goals are the pillars that support our Building Out the Store strategy. First, to win new customers and expand our relationships with existing customers; second, expand deli, meat and cheese categories into our broadline distribution network; third, optimize our gross margin; fourth, to grow our eCommerce space; and finally with our exceptionally strong balance sheet maintain a robust M&A pipeline. We believe success in this strategy drives value for all our key constituents.

In summary, we've accomplished an incredible amount across our organization in a very short period of time. As our industry has and continues to evolve, our leadership team has consistently taken decisive steps to change with it, so that UNFI remains well positioned to meet the needs of our customers as we grow together. Consumer demand for the products we sell remain robust and we have a strong pipeline of exciting opportunities ahead. We believe our sourcing capabilities, our recent 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.

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

Michael Paul Zechmeister

Chief Financial Officer, Treasurer & Senior VP, United Natural Foods, Inc.

Thanks, Steve and good evening, everybody.

Net sales for the first quarter of fiscal 2018 increased 7.9% versus Q1 of last year or approximately $179 million to $2.46 billion. This was the company record for quarterly net sales, which resulted from broad-based growth across our significant channels.

As a reminder, our acquisition of Haddon House closed on May 13th of 2016 approximately two weeks into Q4 of fiscal 2016 and the Gourmet Guru acquisition closed on August 10th of 2016 less than two weeks into Q1 of fiscal 2017. And as a result of the acquisition timing of Haddon House and Gourmet Guru, they did not have a meaningful impact on the comparability of our results in Q1 of this fiscal year versus Q1 of last fiscal year.

In Q1 of this fiscal year, we experienced modest inflation of approximately 19 basis points, which was relatively consistent with our inflation from the last quarter. And this marks the sixth consecutive quarter of either modest deflation or 0% inflation, which continues to be a headwind to our net sales and EBITDA dollar growth. From a channel perspective, supernatural net sales were up approximately $106.6 million or 14.3% over last year's first quarter and represented 34.7% of total net sales compared to 32.8% in Q1 last year. As Steve mentioned, demand for our products ramped up quickly and resulted in higher level of growth than we expected in Q1.

Supermarket channel net sales increased 4.7% in Q1 versus Q1 last year and landed at 28.6% of total company net sales. Independent channel net sales grew 6.6% in Q1 versus Q1 last year and represented 26.0% of total net sales in the quarter. Our food service net sales increased 1.2% over the first quarter last year. Our eCommerce net sales increased 32.1% versus first quarter last year, representing our strongest quarter of year-over-year net sales growth since Q3 of fiscal 2016.

Gross margin for the quarter came in at 14.94%, a 38 basis point decrease over last year's first quarter. The decrease was primarily due to a shift in customer mix where sales growth with our lower margin customers outpaced growth with other customers and that was partially offset by an increase in fuel surcharge.

Our operating expenses in the first quarter were 12.70% of net sales, a 28 basis point reduction compared to the first quarter of last fiscal year. The year-over-year decrease was primarily driven by leveraging fixed costs on our increased net sales. This decrease was partially offset by increased costs incurred to fulfill the unexpected demand for our products, including overtime labor, outside storage, and transportation costs. We also experienced an increase in our healthcare costs in Q1 versus Q1 last year.

Fuel cost for Q1 of fiscal 2018 increased 1 basis point as a percent of distribution net sales compared to the first quarter of fiscal 2017 and represented 44 basis points of distribution net sales. Our diesel fuel costs per gallon increased approximately 7.2% compared to the first quarter of last year, which compares to the Department of Energy's national average price per gallon for diesel in Q1, which increased 13.5% or $0.33 a gallon compared to the first quarter of last year. Our lower diesel fuel cost per gallon compared to the national reported average was primarily due to unfavorable fuel locks in fiscal 2017, which expired in Q2 of that year. Compared to the fourth quarter of fiscal 2017, our diesel fuel costs per gallon were up 11.4% or $0.26 a gallon. For the same period, the Department of Energy's national average price per gallon for diesel was up 8.0%.

Share-based compensation expense represented 30 basis points of net sales in Q1 compared to 29 basis points in the first quarter of last year. On a dollar basis, share-based compensation expense was up $0.6 million to $7.3 million compared to $6.7 million in Q1 last year. Q1 operating income was $55.1 million, an increase of $1.8 million from $53.3 million in Q1 last year.

Interest expense in Q1 of $3.7 million was $0.9 million lower than Q1 of last year due to less debt year-over-year and partially offset by an 81 basis point increase in our floating rate exposure. At the end of Q1, we had fixed interest rates on approximately 79% of our debt leaving approximately 21% of our debt with a floating rate exposure. For the first quarter of fiscal 2018, the company reported net income of $30.5 million, an increase of approximately $1.3 million over Q1 of last year. Q1 earnings per diluted share was $0.60 compared to $0.58 in Q1 of last year.

During the first quarter of fiscal 2018 the company adopted Accounting Standards Update 2016-09, Improvement to Employee Share-Based Payment Accounting. This new accounting standard negatively impacted the company's effective tax rate in the quarter by $0.9 million or a slightly less than $0.02 headwind to our earnings per diluted share in the quarter. Recorded as a discrete item, the impact of this adoption on the rest of the year is expected to be minimal, as the vast majority of our stock awards vest in Q1.

EBITDA for the first quarter was $77.5 million, an increase of 4.0% from $74.6 million in Q1 last year and EBITDA margin was 3.16% of net sales, down 11 basis points from Q1 of last year. Total working capital at the end of Q1 was $1.0 billion, up 0.2% versus Q1 of last year, compared to net sales growth of 7.9% over the same period. Our capital expenditures for the first quarter were approximately $5.3 million or 0.21% of net sales, a decrease from 0.40% of net sales in the first quarter of last year.

As a reminder, on October 6, we announced that our board of directors authorized share repurchase program for up to $200 million of our common stock. In the first quarter, we repurchased approximately 162,000 shares for $6.4 million or an average cost per share of $39.79. This represents a significant discount to our closing share price today.

Due to the timing of the shares we repurchased during the first quarter, the impact on diluted EPS in the quarter was not meaningful. We had a negative free cash flow of $77.3 million in the first quarter fiscal 2018 compared to a negative free cash flow of $16.5 million in the first quarter of last year. Q1 is typically our lowest quarter of free cash flow driven by our increase in inventory in preparation for holiday demand. The impact this year was exaggerated by the unexpected increase in demand.

Our balance sheet continues to be strong. At the end of the first quarter, our debt-to-EBITDA leverage excluding operating leases was 1.42 times, which was down 57 basis points compared to the first quarter of last year. At the end of Q1, the company's debt-to-EBITDA leverage was a full turn lower than our long-term expectations. Outstanding lender commitments under our credit facility were $883 million, excluding reserves with available liquidity of approximately $585 million, including cash and cash equivalents. At the end of Q1, our available liquidity was approximately $149 million higher than Q1 last year.

Based on UNFI's performance to-date and the outlook for the remainder of fiscal 2018, the company is increasing its net sales and EPS guidance, which was previously provided on September 13th of 2017.

For fiscal 2018 ending July 28, 2018, we now estimate net sales growth at 6.2% to 7.8% over fiscal 2017 net sales or in the range of approximately $9.84 billion to $10.00 billion, compared to the previous estimate of $9.63 billion to $9.81 billion or growth of 3.5% to 5.8% over fiscal 2017 net sales.

We now estimate our earnings per diluted share for fiscal 2018 to be in the range of approximately $2.72 to $2.80, an increase of approximately 6.3% to 9.4% over fiscal 2017 earnings per diluted share of $2.56. This represents a $0.04 increase at the midpoint compared to the previous guidance of $2.67 to $2.77 per diluted share.

We are reducing our expectations for the fiscal 2018 tax rate to be in the range of 40.0% to 40.3% compared to previous guidance of 40.3% to 40.7%. This does not include any impact from tax reform under consideration in U.S. Congress. Capital expenditures as a percent of net sales remains unchanged at 0.6% to 0.7% of sales, as well as our estimated range of free cash flow at $155 million to $185 million.

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: At this time, we will be conducting a question-and-answer session. [Operator Instructions] Our first question is from Rupesh Parikh, Oppenheimer & Company. Please proceed with your question.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.

Q

Thanks for taking my question and congrats on a nice quarter.

Michael Paul Zechmeister
Chief Financial Officer, Treasurer & Senior VP, United Natural Foods, Inc.

A

Thanks, Rupesh.

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

A

Thanks, Rupesh.

Rupesh Parikh
Analyst, Oppenheimer & Co., Inc.

Q

So maybe to start out, I guess looking at the overall environment, we've clearly seen trends pick up at really all the natural, organic publicly traded players at this point. So just curious from your vantage point, what do you think is driving that pickup and how are you thinking about the sustainability?

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

A

Yeah, I mean, that's really the question of the day, isn't it? And I think, we've spent a lot of time thinking about that and we think the products are more desirable. We think that the retail price environment has become more competitive. And what that's doing I think is closing the gap, the price gap between healthy and better-for-you and conventional, which is bringing more traffic into the stores. We've had long periods of a very limited inflation. And so, UNFI is the clear beneficiary in the short-term and we believe in the long-term as evidenced by the revision to our guidance.

So the other interesting comment is, when you look at our growth overall, Mike talked about kind of the disclosure around supernatural. But if you look at our other top 24 customers, they also grew at 10%. And so, we're seeing lift across most of our customer channels, which is great news for us. So I think that's our view of what's happening.

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

And again, I'm not sure if you guys actually have the data, but any sense of in terms of whether natural, organic growth rates have increased across the industry?

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

Yeah, I mean, it's premature for that and we would probably get access to the data in probably the next quarter, two quarters or so, because it takes a long time to aggregate it. But my guess is that we're going to see nice pick up there.

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

Okay, great. And then one more quick question. You commented on the increased SG&A expenses, this really is the greater unexpected demand. Is there any way to quantify that – I guess quantify what the – I guess the expense lift was during the quarter or impact on EPS?

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

We typically don't give that kind of disclosure. I mean, I can tell you anecdotally, when you get the kind of dramatic increase that we had in demand, we are so focused on service. In other words, making sure that our customers have access to the products that we kind of close our eyes to the fact that we're going to have to spend a lot of money in order to do it, whether it'd be moving product around the country, using less efficient lanes to move the freight. And whenever you get that kind of increase, it's just something that we have to do and we certainly have that in this quarter.

Michael Paul Zechmeister
Chief Financial Officer, Treasurer & Senior VP, United Natural Foods, Inc. A

Yeah Rupesh, I would add to Steve's comments that when the demand picks up unexpectedly, that's when we get put in a position where we're going to spend a little more on overtime, outside storage and transportation and the like. But once we've got a sense for that over a longer period of time, then we certainly can handle that expense and it doesn't present itself as a headwind. Now, we would expect that certainly by the back half of this year, we would be able to absorb this kind of demand flow without additional expense over our normal run rate.

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

Okay, great. Thank you.

Michael Paul Zechmeister
Chief Financial Officer, Treasurer & Senior VP, United Natural Foods, Inc.

A

Thank you.

Operator: Our next question is from John Heinbockel, Guggenheim Securities. Please proceed with your question.

John Heinbockel
Analyst, Guggenheim Securities LLC

Q

So, Steve, just following up on that then. I guess, you have not yet been able to work the overtime and outside storage cost back down to a more normal level, that will still take a few more months?

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

A

Yeah, absolutely, we'll probably see that continue until after the holidays.

Michael Paul Zechmeister
Chief Financial Officer, Treasurer & Senior VP, United Natural Foods, Inc.

A

Yeah. I would say, early Q3.

John Heinbockel
Analyst, Guggenheim Securities LLC

Q

Okay. And we've all talked about the issue of capacity utilization, the fact that you had a low dip there. Are you seeing – putting aside these one-time costs, are you seeing a benefit and do you think you'll see a benefit as we get into the back half of the year from higher utilization or is that demand coming in the right places?

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

A

Yeah. Hey, John, this is Sean. First of all, as it relates to capacity and utilization, we certainly have had discussions in FY 2017 in this regard. So, we did not obviously as discussed planned for the revenue ramp up from a timing perspective or the size of the ramp up related to our present capacity model. So we're evaluating that here as we go. And we may make some changes to the model, we'll see – we'll see how that goes. But in terms of expense and leverage in the distribution centers, we do expect in the back half of the year to begin to see the type of leverage off of our DC expense ratios that we historically would get with an increase in the top line. So, we feel good about where we can go from here.

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

A

Now I would just – yeah, it's important to note that, we did not revise our CapEx for this year, we're still comfortable with that. And once we get through the back half of the year and we'll start looking at fiscal 2019 and 2020, we'll give consideration to where we need to do some additions or new construction, but we're comfortable with the CapEx guidance we provided for 2018.

John Heinbockel
Analyst, Guggenheim Securities LLC

Q

All right. And then lastly, where are we pipeline-wise on M&A and new customer wins? And do you think the whole – Amazon, Whole Foods dynamic, did that kind of freeze things in terms of people making changes or no?

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

A

No, not at all. Our pipeline for new customers is strong, our pipeline for M&A is strong. And as I said previously, we swallowed four acquisitions within 18 months, it took a lot of work and heavy lifting, a lot of people within the company did a lot – spent a lot of time integrating them and we're really satisfied with where we ended. And so, we're really ready to get back on to the M&A trail, we've got a balance sheet to support it. And so, I look forward to both the customer and the M&A pipeline delivering some nice results throughout fiscal 2018.

John Heinbockel
Analyst, Guggenheim Securities LLC

Q

Okay. Thank you.

Operator: Our next question is from Andrew Wolf of Loop Capital Markets. Please proceed with your question.

Andrew Wolf
Analyst, Loop Capital Markets LLC

Q

Yeah. Thank you. On the vendor shortages, is there any commonality there like, was it more from in grocery versus the specialty perishable side of things?

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

A

Andy, this is Sean. I would say that actually the demand was so sudden that it affected a great many categories. Keep in mind, it's generally specialty suppliers that we're talking about. So, we expect that to moderate. We expect that suppliers and manufacturers will sort of get their legs under them to meet this demand towards the Q2-Q3 timeframe. And important to note is, [Technical Difficulty] (28:15). And so, in our case, the majority of buyers are doing less than $30 million a year in total. So, when you [indiscernible] (28:29) smaller supplier to a great deal of increased demand, they don't have the ingredients, they don't have the co-packers to produce it. And the vast majority of our suppliers do a just heroic job in trying to get the inventory to us that we need. There were some suppliers that had significant out-of-stocks during the quarter in the holiday season. But they have the same issue that we did and that is a lot of increased demand really quickly they just couldn't produce it fast enough.

Andrew Wolf
Analyst, Loop Capital Markets LLC

Q

Okay. Good, thank you. But there's enough ingredients out there that if the pipeline stays as strong as it is, eventually they should be able to meet demand or at least close the gap.

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

A

Without a doubt.

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

A

We agree.

Andrew Wolf
Analyst, Loop Capital Markets LLC

Q

Okay. Now, on your sales beat, was that mainly from just more sales with existing customers or was there a reasonable cohort of new customer business sales, so help that.

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

A

I think it was a little bit of both.

Andrew Wolf
Analyst, Loop Capital Markets LLC

Q

Okay.

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

A

Yeah. And I would tell you that we're on target as it relates to shipping the new customers that we previously discussed.

Andrew Wolf
Analyst, Loop Capital Markets LLC

Q

Okay, great. And then just the last thing is a quick kind of follow-up on the expense side, you called out healthcare costs. I assume that's not related necessarily to the surge in demand in the other costs. But nevertheless is that something that is manageable or is that just one of these – is it the randomness of healthcare or is it a trend that you're going to have of healthcare costs for the year?

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

A

We instituted a really, really terrific wellness program across the company about four years, five years ago and made significant improvements to that plan every year to have a healthier workforce and an educated workforce about how to acquire healthcare. And so, if you look at our healthcare costs over the last couple of years, they were really, really strong and we're just – in the quarter in particular, we just had a handful of claims that brought our healthcare costs way higher than we thought they were going to be. Whether it continues or not, I don't know, I'm hopeful that it doesn't. But in this particular quarter, they were significant.

Andrew Wolf
Analyst, Loop Capital Markets LLC

Q

Got you. And then any of these excess costs that you have – I understand you don't want to necessarily want to quantify them it precisely. But nevertheless, were any of them impacting the gross margin rate or did any of that flow through cost of goods sold or did it all impact operating expenses?

Michael Paul Zechmeister
Chief Financial Officer, Treasurer & Senior VP, United Natural Foods, Inc.

A

Well, when we talked about the increased overtime, outside storage, transportation expense, medical expense, none of that was in gross margin. When you think about fuel costs, we have a geography difference that needs to be noted, which is when we have increased fuel costs which we've had, we have a surcharge and the surcharge enhances gross margin, but then we pay for the extra fuel costs in our operating expense. And so, we get an increased gross margin, but then it comes back to us and nets out neutral at net income.

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

A

One other comment I would make and then Andy we'll probably going to take another call. But if you look back at our fiscal 2017, we did a great job managing our gross margin. And when you can properly plan for the inventory, you have a much greater capacity to manage the gross margin on the inbound associated with that inventory. When you're scrambling to catch up and you're doing everything in your power to get inventory into the buildings, you're spending less time managing the gross margin than you should be. And so, that's just something that we have to get back to once we get some stability in our overall growth number.

Andrew Wolf
Analyst, Loop Capital Markets LLC

Q

Yeah. Okay. That's what I was getting at inbound freight. Thanks. Well, great problem to have. Thanks.

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

A

Thank you.

Operator: Our next question comes from Chuck Cerankosky, Northcoast Research. Please proceed with your question.

Chuck Cerankosky
Analyst, Northcoast Research Partners LLC

Q

Good evening, everyone. Great quarter.

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

A

Thanks, Chuck.

Chuck Cerankosky
Analyst, Northcoast Research Partners LLC

Q

In looking at inflations still flattish – or flat with the previous quarter, are you seeing the rate of inflation perhaps looking better for you, and I'm getting at opportunities for United to earn some inside margin?

Michael Paul Zechmeister
Chief Financial Officer, Treasurer & Senior VP, United Natural Foods, Inc.

A

Yeah, Chuck, we really enjoy inflation and we haven't seen it now for a year-and-a-half, but there is a very modest trend within those six quarters that it is a little bit higher now than it was, as you recall we had some quarters of deflation in there too. So it's gotten a little bit better. But our 10-year average inflation rate is a little over 2.5% and that includes these past six quarters where we didn't have it. So no guarantees of where it's going in the future, but as if it were to head back to the historical average, that would certainly be a tailwind for us in net sales and EBITDA dollars.

Chuck Cerankosky
Analyst, Northcoast Research Partners LLC

Q

But you're not seeing it yet?

Michael Paul Zechmeister
Chief Financial Officer, Treasurer & Senior VP, United Natural Foods, Inc.

A

No.

Chuck Cerankosky
Analyst, Northcoast Research Partners LLC

Q

And then back quickly on the vendors. So it's going to take them at least another quarter to sort of catch up with the demand just because of their size?

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

A

Yeah, I mean it's improving here early Q2, but we expect it's going to take another couple of periods. Yes.

Chuck Cerankosky
Analyst, Northcoast Research Partners LLC

Q

And then finally on the sales growth you saw in the quarter, how did that sort of pace over the three months of the quarter? Was it uniform or accelerating through the quarter?

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

A

I mean, we've started to see some acceleration at the back end of the fourth quarter 2017. We weren't exactly sure where the acceleration was coming from. We were very happy to see it. We really didn't know whether it was going to be sustained. But we've seen a continual ramp since then.

Chuck Cerankosky
Analyst, Northcoast Research Partners LLC

Q

All right. Thank you.

Operator: Our next question is from Shane Higgins, Deutsche Bank. Please proceed with your question.

Shane Higgins
Analyst, Deutsche Bank Securities, Inc.

Q

Yes. Thanks for taking the questions. So you guys said that – looks like eCommerce had a nice ramp up during the quarter. Any color as to what was driving that and how that impacted the overall margins?

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

A

We don't give any disclosure on the margin. I can tell you that eCommerce is a very big focus for us, both in terms of the technology that we used to deploy an eCommerce solution as well as the rate of sales growth in all. I don't know about all, but most of our eCommerce providers whether it would be brick-and-mortar eCommerce or web-based eCommerce, we saw really, really strong growth across all of them. That's an area that's a very important strategic objective for us. We're doing a lot of work on the technology side. We're really focused on having an endless aisle for our retailers, so we can go directly to them or to their consumers to offer really extensive lines of all the products that we curate so well.

Shane Higgins
Analyst, Deutsche Bank Securities, Inc.

Q

And do you guys have the capacity to continue to handle that level of growth that kind of 30% plus year-over-year growth?

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

A

Yeah, I mean, fortunately, we've deployed eCommerce into, I guess four of our DCs through the...

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

A

That's correct.

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

A

Four of our DCs now. And so, I think we're well poised to continue to see that kind of growth for some period of time. And we now have that volume segregated into four different distribution centers as opposed to just in one.

Shane Higgins
Analyst, Deutsche Bank Securities, Inc.

Q

Okay. Great. And then just last one for me on the hurricanes. Was that a net benefit or was that fairly neutral to sales and to earnings during the quarter?

Michael Paul Zechmeister
Chief Financial Officer, Treasurer & Senior VP, United Natural Foods, Inc.

A

Yeah, we think of that as a net headwind to earnings. We definitely experienced some disruption and some of the expense associated with that disruption. We'll make a claim under insurance and get back some of that. But because of our deductible and other things there were certainly some expenses in the quarter, and not a net benefit.

Shane Higgins
Analyst, Deutsche Bank Securities, Inc.

Q

Okay. But it wasn't that material, I mean you guys didn't call it out?

Michael Paul Zechmeister
Chief Financial Officer, Treasurer & Senior VP, United Natural Foods, Inc.

A

Right.

Shane Higgins
Analyst, Deutsche Bank Securities, Inc.

Q

Okay, great. That's it for me. Thanks.

Operator: Our next question is from Ben Bienvenu, with Stephens Incorporated. Please proceed with your question.

Benjamin Bienvenu
Analyst, Stephens, Inc.

Q

Yeah thanks. Good evening. Thanks for taking my question. You called out in the last quarter competitive pricing as a pressure on gross margin, but not in this quarter. Would it be inaccurate to infer that competition is lessened sequentially? Any color you can offer there would be appreciated.

Michael Paul Zechmeister
Chief Financial Officer, Treasurer & Senior VP, United Natural Foods, Inc.

A

Yeah, Ben, we've called out competitive pricing pressure for quite a while many quarters, I can't tell you how many exactly, but it's been quite a few. And so that came out this quarter, your observation is accurate. And I think we were trying to point to the biggest drivers of our gross margin in our margin overall. And at this point, we just didn't feel like that made the list as one of the notable call-outs.

Benjamin Bienvenu
Analyst, Stephens, Inc.

Q

Fair enough. And the strong growth in supernatural is impressive, that was obviously a contributing factor to the mix shift and result in lower margin pressure from lower margin customers. I would think of the incorrect to assume that if this growth persists and the mix shift persists, this wouldn't preclude you from leveraging operating margins – or said another way, would you leverage the operating margins ex some of the ramp to fulfill the demand?

Michael Paul Zechmeister
Chief Financial Officer, Treasurer & Senior VP, United Natural Foods, Inc.

A

Yeah, I think you are going down the right path.

Benjamin Bienvenu
Analyst, Stephens, Inc.

Q

Okay. Great. And then just one last quick one. The $200 million share repurchase, you guys have a lot of free cash, not a lot of leverage. That's not a signal that M&A isn't particularly imminent, or is it more just a, you want to get this program in place, put capital to work now, and then you could have the flexibility to turn that off when a deal heats up?

Michael Paul Zechmeister
Chief Financial Officer, Treasurer & Senior VP, United Natural Foods, Inc.

A

Yeah. Yeah, Ben, we wanted to have share repurchase as a tool in our toolbox for capital structure management. To the extent that we have investments in capacity or in M&A that provide greater returns and we do believe we've got a pipeline for those, then we prefer to use our balance sheet strength to return value to shareholders through investment. But to the extent that we didn't have that teed up, then we believe that opportunistic share repurchase at the right price is a way to help ourselves out. And so in the quarter, you saw we made some share repurchase at under $40 a share and we feel pretty good about that today.

Benjamin Bienvenu
Analyst, Stephens, Inc.

Q

Okay, great. Best of luck.

Michael Paul Zechmeister
Chief Financial Officer, Treasurer & Senior VP, United Natural Foods, Inc.

A

Thanks.

Operator: Our next question is from Chris Mandeville, Jefferies. Please proceed with your question.

Christopher Mandeville
Analyst, Jefferies LLC

Q

Hey, good afternoon guys. Mike, I apologize my connection was quite poor earlier on the call. But just in terms of order of magnitude, what were the primary drivers to the gross margin erosion aside from just the actual mix shift to the lower margin customer?

Michael Paul Zechmeister
Chief Financial Officer, Treasurer & Senior VP, United Natural Foods, Inc.

A

Yeah. As I've said, we only called out one and that was the customer mix shift. You heard Steve comment a little bit more about that, we certainly saw our disclosure in supernatural a 14% growth there. But if you looked at our top 25 customers or a top 24 customers excluding our number one customer that growth rate was 10% also. So you can surmise from that, that we had real good growth there. But from a margin standpoint that was a headwind on gross margins.

Christopher Mandeville
Analyst, Jefferies LLC

Q

Okay. And any color in terms of the benefit from the actual fuel margins and maybe anything regarding FX?

Michael Paul Zechmeister
Chief Financial Officer, Treasurer & Senior VP, United Natural Foods, Inc.

A

Yeah. We didn't call out those specifically. I can tell you that the fuel was in the neighborhood of 8 basis points to 10 basis points on the gross margin from a tailwind standpoint, but then we give that back in the operating expense. From an FX standpoint you're talking about the same level roughly from translation and transaction.

Christopher Mandeville
Analyst, Jefferies LLC

Q

Okay. Very helpful. And then, I apologize, but I'm still a little bit confused by the true surprise in the sales ramp at the back end of the quarter. Can you just give us a little bit more context around what caught you off guard?

Michael Paul Zechmeister
Chief Financial Officer, Treasurer & Senior VP, United Natural Foods, Inc.

A

Yeah. I mean, obviously, we finished out our fiscal 2017. We budgeted for fiscal 2018 based upon what we knew in fiscal 2017. And then towards the end of our fourth quarter, we started to see the sales starting to ramp up. Yeah, we really weren't sure whether it was going to be a sustained ramp. And as we got into the first couple of weeks and months in fiscal 2018, not only was it sustained, but it continued to grow. And so, as you might imagine, in a distribution center, if you budgeted for example a 5% volume growth and in a very short period of time that 5% budget turns into 15% actual. We're just not prepared with the inventory with the labor, with the workforce. And so it puts a tremendous amount of stress on the organization in order to ensure that we have a high level of service. And so that's really what we're talking about.

Yeah. And just to add a couple more comments there. If you look at our core growth, so you look at the growth ex-acquisition impact, ex-inflation, we've seen our core growth increasing quarter-by-quarter for the last four or five quarters. And so, we've enjoyed that increase. As we set the guidance for this year at 3.8% to 5.8%, this year, we didn't have the impact of acquisitions as a tailwind, so we felt like that captured that core growth that we had seen previously. Now obviously we delivered a 7.9% without inflation and without the benefit of acquisitions. So that just kind of in numbers shows you the rapid increase from expectation that we saw just on core growth.

Christopher Mandeville
Analyst, Jefferies LLC

Q

Okay. And then just on the sales increase or the outsized movement in the quarter itself with the lower-margin customer. Was that simply a factor of them driving more volume with what you've historically been servicing them with? Or is that somewhat of a result of you may be expanding and providing them with a greater SKU set?

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

A

I think generally speaking, it's a former rather than later, it's just higher traffic into the stores. It's the effect of new customers coming on board. It's expansion of existing contracts, some category expansion inside. But I think generally speaking, it's just a general lift, an improvement at the stores that we service.

Christopher Mandeville
Analyst, Jefferies LLC

Q

Yeah.

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

A

And they're expanding at a higher velocity than the rest of the customer base.

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

A

Yeah. There is a lot of consumer excitement out there and the kind of products that we sell. And I think the attention in the space has really picked up and that's translated into higher volumes.

Christopher Mandeville
Analyst, Jefferies LLC

Q

Okay. And then the last one for me here, just on the buyback itself of $6 million in the quarter. Had it not been for the incremental demand on working capital, would that have been greater in the quarter? I'm just kind of curious as to why it was so small relative to the $200 million you have available?

Michael Paul Zechmeister
Chief Financial Officer, Treasurer & Senior VP, United Natural Foods, Inc.

A

Well, if you look at it, the approval of the program didn't start till October. So, we didn't have the benefit of a full quarter to be out there and then – yeah, and that's probably the primary reason.

Christopher Mandeville
Analyst, Jefferies LLC

Q

All right. Thanks, guys.

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

A

Thank you.

Operator: Our next question is from Vincent Sinisi, Morgan Stanley. Please proceed with your question.

Vincent J. Sinisi
Analyst, Morgan Stanley & Co. LLC

Q

So just wanted to just once again go back to the sales dynamics and kind of the balance with the margin here. So totally get it that the mix shift in the customers had the obviously nice effect on volume, reverse on the margin. But maybe is it fair to say that, as you mentioned the competitive commentary coming out, is it kind of like status quo on the competitive front? And the top 24 customers, 25 customers that had that 10% growth or greater, is it fair to say that the smaller ones had similar growth, I guess kind of the heart of that question is, are you seeing a difference in growth rates between your larger versus smaller customers, just trying to get a sense for kind of where the industry dynamics may have changed or not?

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

A

Yeah, I mean I think, that's a pretty good observation that the larger customers are growing faster than the smaller. But we still had over 6% growth in our independents, which was a really respectable quarter. But I think directionally, we certainly believe that the larger customers are growing faster.

Michael Paul Zechmeister
Chief Financial Officer, Treasurer & Senior VP, United Natural Foods, Inc.

A

Yeah. And I think that's a good point that Steve is making that the growth with our largest customers did not come at the expense of our other customers. And the fact that independents grew at 6.6%, that's a stronger growth rate than the quarter before. And it's testament to the popularity of the products across all of our most significant channels.

Vincent J. Sinisi
Analyst, Morgan Stanley & Co. LLC

Q

Okay. All right. Thank you. And just a fast follow-up, just to make sure that we understand when you had mentioned earlier on with some of the – with the ramp in sales, some of the outside storage expenses, was that more of a case – and maybe varied by geography, but was it more of a case that the timing just didn't allow for it to normally come to the DCs as you would have planned if you had more kind of advanced planning or was it more of a case where in some areas you just did not have the capacity physically, how should we kind of think about that?

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

Yeah. It certainly is geography, certain distribution centers had challenges versus others that continue to have some upside capacity. But the long and the short of it as we've sort of described a couple of times is that typically to digest and execute against the volume ramp up that we saw in Q1, we would have several months to prepare. And if that included adding expansion into a distribution center or contiguous space in the distribution center, we certainly would have done that. In this instance, we were not afforded that planning and prep opportunity, so we kind of did the best we could. And that irons out and levels out and from an execution perspective, we'll gain better leverage as the year goes by.

Vincent J. Sinisi
Analyst, Morgan Stanley & Co. LLC
Q

Got it. Okay, very helpful. Thanks very much. Good luck.

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

Sure. Thank you.

Operator: Our next question is from Scott Mushkin, Wolfe Research. Please proceed with your question.

Scott A. Mushkin
Analyst, Wolfe Research LLC
Q

Hey, guys. Thanks for taking my questions. Hopefully you can hear me, I'm on a cell and I apologize for that. But one clarification, the top 24 [indiscernible] (49:50) independents, are none of the top 24 clients in the independents bucket, I thought there were some, maybe I'm mistaken there?

Michael Paul Zechmeister
Chief Financial Officer, Treasurer & Senior VP, United Natural Foods, Inc.
A

If you're talking about true independents, singular customers, they are not reflected in the top 24 obviously, but in the top 24 are some...

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

Significant customers that are aggregated as a single entity that are national in scope and have significant scale.

Michael Paul Zechmeister
Chief Financial Officer, Treasurer & Senior VP, United Natural Foods, Inc.
A

Customers that we would consider are natural multi-unit operator.

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

Yeah.

Scott A. Mushkin
Analyst, Wolfe Research LLC
Q

But they're not in that independent bucket you guys give us?

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

A

No, they're not.

Scott A. Mushkin
Analyst, Wolfe Research LLC

Q

Okay.

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

A

Is that true? That's not true. Some of them are in the independent channel.

Scott A. Mushkin
Analyst, Wolfe Research LLC

Q

Okay. I just wanted to make sure – I thought so, and I just wanted to make sure. The second question I had is kind of [indiscernible] (50:56), I mean Amazon buys Whole Foods, Amazon – [indiscernible] (51:00) cut price, volumes goes through the roof, they've been cutting price again and there's been some out-of-stock issues there. And I don't think you're really at fault, I think it's just the volumes gone through the roof. So if they continue to do that, I mean, how well are you guys prepared to deal with this. It's a great problem to have, but it's a problem we're seeing in more stores and again they're being very aggressive going by our research. So how [indiscernible] (51:27) do deal with it? And is it possible you might have to pull forward some of your CapEx spend, or other things to deal with this, because my expectation would be if they continue to operate this way, this challenge is likely to persist?

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

A

Yeah. I mean listen we obviously wouldn't comment on any one customer or channel. We've had periods in our history where we see volume ramping either as a result of a new customer or inflation. And so, we're used to having some lumpy growth in our history and we know how to deal with it. And so regardless of the costs, our goal is to provide the finest level of service across our entire customer base and we have the most built-out distribution network, we have the most sophisticated supply chain network throughout North America. We know how to buy the product, we know how to move it around the country and we know how to deliver a very high level of service and that's really our function, that's what we do. And when we get bumps like the one that we're in or challenges as a result of a hurricane, we get a little bit of a short-term pain in our neck. But we know how to deal with it. We've got an incredible workforce that is very focused on execution and we'll work our way through it like we always do.

Scott A. Mushkin
Analyst, Wolfe Research LLC

Q

Okay. And then my last question – thanks for that, Steve. My last question is regarding the tax cuts, the potential of the tax cuts to the Home Depot Analyst Day yesterday and question came up, what do you expect your vendors to do to get their cuts and they kind of said, well we expect them to reduce their pricing and share. And so can you maybe walk us through how you guys are thinking about the tax cuts vis-à-vis, maybe some of your big retail partners and how that may play out? That would be wonderful and thank you for taking my questions.

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

A

Yeah. Thanks, Scott. I can't speak for what the tax reform may do to customers or suppliers, but I'll tell you how we're thinking about it. And, just as a disclaimer, until the contemplated tax reform is signed into law, we can't provide any assurances on the impact to UNFI. But that said, we're evaluating all aspects of the tax reform that had been made public and we see the potential for significant reductions to our effective tax rate as a result and that would certainly lead to a meaningful increase to net income, free cash flow and EPS.

Now, if you assume for example that the 20% corporate tax rate does happen, then we would expect to see $25 million to $35 million cash benefit and an additional book tax benefit that would be $25 million or more as well. Now, the timing of the impact is certainly subject to when the bill gets signed and when the various changes go into effect and what if any changes occur in the state tax rates, where we do business as well. But overall, we see as quite a bit of a positive. Now, again not able to comment on what might happen with suppliers or customers in terms of the impact that it has on now.

Operator: Our next question is from Chris Prykull, Goldman Sachs. Please proceed with your question.

Christopher Prykull
Analyst, Goldman Sachs & Co. LLC

Q

Hey, guys, thanks for taking the questions. Just a few follow-ups on the sales growth. Are there specific categories that you saw large increases? And given the cadence that you described, is it fair to assume the strength has, a, continued into the second quarter and you're probably running above where you reported for the first quarter? And then just an accounting question, are any online sales done by your supernatural customer reflected in that line item or is that reflected in the eCommerce number you report?

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

A

Well, so the last question is all of our eCommerce sales are reflected in eCommerce, because our sales are calculated by the channel in which we handle the distribution not the customer. Number two, I mean, on the category side, I would respond that we generally do not speak and communicate in terms of the category growth, but the channel growth. And looking at it, I would say it's broad-based. I think there was a third in there, Chris, I just don't remember what it is.

Christopher Prykull
Analyst, Goldman Sachs & Co. LLC

Q

Yeah. I was just trying to gather from the cadence of sales growth that you described sort of from 4Q to today. Is it fair to assume that that strength I guess has continued into the second quarter and probably you're running above what you just printed for the first quarter?

Michael Paul Zechmeister
Chief Financial Officer, Treasurer & Senior VP, United Natural Foods, Inc.

A

Yes. So obviously we don't give quarterly guidance. We just revised our guidance upward for the year and so that's a number that we're comfortable disclosing.

Christopher Prykull
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Makes sense. And then just one last one on CapEx. What does the scenario look like where your CapEx needs to go back up and would it be closer to sort of that 1% of revenue number or would you have to go higher?

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

Yeah. Chris, what we've said is that our long-term guidance on CapEx is 1% of sales. Now what you've seen here over the past few years is certainly lighter than that, but that's because we haven't put on new warehouses or expansions onto existing warehouses. If you go back in our history and you look at the years where we opened new warehouses, you see that that CapEx as a percent of sales pops up. So, as we contemplate capacity expansion, and again we've affirmed our guidance for this year, so we don't see that happening in this year. But as we go forward, if we have to put the CapEx in, it's likely to go above that historical average.

Christopher Prykull
Analyst, Goldman Sachs & Co. LLC
Q

Great. Thanks for taking the questions and good luck over the holidays.

Michael Paul Zechmeister
Chief Financial Officer, Treasurer & Senior VP, United Natural Foods, Inc.
A

Thank you.

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

Thank you.

Operator: Ladies and gentlemen, we have reached the end of the question-answer-session. And I would like to turn the call back to Steve Spinner for closing remarks.

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

Yeah. Thanks everybody for joining us this evening. I know there's a couple of people that were in the queue that we didn't get to, we just ran out of time. And we're happy to have one-on-one conversations with you. Have a safe and healthy holiday season and we'll talk to you next year.

Operator: This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation.