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United Natural Foods, Inc. (UNFI)

Q3 2018 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to the United Natural Foods' Third Quarter Fiscal Year 2018 Earnings Results Conference Call. All participants will be in listen-only mode. [Operator Instructions] And please note that this event is being recorded.

I would now like to turn the conference over to Faten Freiha, Director of Investor Relations and Corporate Strategy. Please go ahead.

Faten Freiha

Director-Investor Relations & Corporate Strategy, United Natural Foods, Inc.

Thank you, Will. Good evening, everyone. Thank you for joining us on UNFI's third 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 the webcast of today's call are available under the Investors section of the company's website at www.unfi.com.

Joining me for today's call are Steve Spinner, our Chairman and Chief Executive Officer; Sean Griffin, our Chief Operating Officer; Mike Zechmeister, our Chief Financial Officer; and Chris Testa, President of the Atlantic Region. Steve and Mike will provide a business update and speak about our performance from the quarter and outlook for fiscal year. We'll take your questions after management's prepared remarks conclude.

Before we begin, I'd like to remind everyone that comments made by management during today's call may contain forward-looking statements. These forward-looking statements include 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.

And lastly, I'd like to point out that during today's call, management will refer to certain non-GAAP financial measures. Reconciliations to the most comparable GAAP financial measures are included in the schedules on our press release and on the Investors section of the company's website under Events & Presentations.

I'll now turn the call over to Steve.

Steven L. Spinner

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

Thank you, Faten. Good evening, everyone, and thank you for joining our call today. I'm excited to discuss our results for the third quarter, which were underscored by strong top line and bottom line growth while we continued to progress against our strategic growth objective to build out our product and service offerings through our build-out store initiatives.

Before discussing our results, I would like to talk about recent changes in our management team, including the appointment of Jill Sutton as General Counsel, Corporate Secretary and Chief Compliance Officer and Sean Griffin's previously announced retirement and succession plan. Joe Traficanti has served as our General Counsel and Chief Compliance Officer for nine years and will be retiring. Joe was UNFI's first General Counsel. He built our internal legal department and organized it to serve all UNFI constituents in all legal matters. I would like to thank Joe for his outstanding commitment and dedication to UNFI over the years and wish him well in his retirement.

I'm pleased to welcome Jill Sutton to UNFI. Jill joined our team in mid-May as the General Counsel, Corporate Secretary and Chief Compliance Officer. She is a highly accomplished executive and her background, experience and values match well with the UNFI. Jill brings a valuable blend of expertise to UNFI, including her experience as an active member of the executive team and General Counsel of a food and beverage company with significant distribution operations. I'm looking forward to partnering with Jill to continue to drive UNFI's mission and execute on our strategic plan.

Sean Griffin and I have worked together for many years throughout our careers and over the years, Sean has demonstrated incredible leadership, accountability, integrity and performance. Sean has been an important team member as our business has almost doubled in size over the last five years. He has developed a very strong team as reflected in new roles for internal candidates who were all part of our robust succession planning process.

And speaking for everyone at UNFI, I cannot thank him enough for his service and wish him the very best as he begins to wind down and enjoy retirement. Sean will retire from his current role as COO on August 1 and from the company on October 1 and then, remain engaged with us as a strategic advisor. Sean's responsibilities will be assigned amongst three very strong internal UNFI leaders, Chris Testa, who is currently serving as President of our Atlantic Region, will take over as President of UNFI.

Previous to Chris' role as President of the Atlantic Region, he ran our Blue Marble Brands group. Eric Dorne, Chief Administrative and Information Officer will be assuming responsibility for several of our business units and Paul Green will become UNFI's Chief Supply Chain Officer. Eric Dorne is a proven leader who has led information technology, UNFI Canada, risk management and other important UNFI divisions. Paul Green has served as Senior Vice President, National Operations, and as President of UNFI's Pacific Region. Eric and Paul have delivered incredible value to UNFI over the last five years and are well-positioned to continue our drive forward.

Chris Testa is here with us on the call today and he will be participating in the Q&A session and I'm going to ask Chris to briefly introduce himself. Chris?

Christopher P. Testa

President-Atlantic Region, United Natural Foods, Inc.

Thanks, Steve. It's great to be on the call this evening. I've been with UNFI for almost nine years in various capacities and currently serve as the President, Atlantic Region, as Steve noted. Following Sean's retirement, I'll assume the role of President, UNFI, and oversee the company's broadline distribution business in the U.S., Select Nutrition in eCommerce as well as the national enterprise sales and service teams.

In addition, I'll continue to oversee the brand and communications group. I look forward to my new role as UNFI continues to adapt and grow with this dramatically changing environment. I've had a chance to meet some of you and over the next year, you'll see me at conferences and investor meetings as I settle into the new position.

Steven L. Spinner

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

Thanks, Chris. So, let's turn to our results for the third fiscal quarter. We achieved record sales of $2.6 billion, which represents approximately 12% growth compared to the prior year. We continue to see strong top line growth across all customer channels. These results demonstrate that demand for better-for-you products and for UNFI services continues to be strong. It's important to note that we are maintaining this growth which does not include benefit from acquisitions, despite low inflationary environment.

This quarter, our gross margin of 15.4% was positively impacted by a change in our estimate, which Mike will provide more details on during his remarks. The decline in our gross margin from the prior year was primarily driven by customer mix and an increase in inbound freight expense. We expect a headwind from inbound freight expense to continue throughout the next couple of quarters.

From a total operating expenses standpoint, although we continue to have higher labor expenses, including increased overtime in several of our distribution centers due to high growth over the prior year, we weren't able to offset these increased costs by leveraging our fixed cost base. Year-to-date, on an adjusted basis, growth in our bottom line outpaced top line growth.

As we discussed in the past, higher demand is pressuring our supply chain as we continue to see degradation in supplier inbound fill rates. Supplier out-of-stocks in the third quarter of fiscal 2018 were approximately 150 basis points unfavorable versus the same quarter in the prior year. We continue to be dedicated to working with our suppliers and to enhance alignment on demand signals. We are focused on improving service level to our customers, which is why you're seeing the increased level of inventory in terms of volume, but we continue to be disciplined, maintaining and when possible lowering inventory days on hand.

Looking forward to the remainder of fiscal 2018, we expect our growth to continue, driven by demand for better-for-you products. We've raised our guidance on the top line as well as the bottom line to reflect this improved outlook. Capital expenditures as a percentage of net sales guidance for fiscal 2018 continues to be within the range we've previously announced.

So, now, let's turn to the macro environment and discuss our strategic initiatives. While our industry continues to grow and we continue to outpace its growth, the environment remains challenging. The retail industry is constantly evolving and is experiencing consolidation and price pressure. Consumers are demanding more, shopping in various ways and continuously changing their habits. They want variety, specific ingredient attributes, exclusive brands, fresh products, private label, brick-and-mortar retail and eCommerce options, among other things. We play a role in each of these purchase options and have valuable merchandising data insights and category management to pursue high-growth opportunities.

That being said, UNFI has considerable runway in channels seeing the highest growth in better-for-you products such as conventional and mass grocery. With this as a backdrop, going forward, we will focus on our building out the store strategy and increasing our exposure to fresh categories of products and increasing our market share with existing customers and new customers.

Importantly, we remain committed to supporting our independent customers in this competitive environment. Field Day, our private label which was specifically developed a few years ago for the independent channel, continues to grow significantly and remains one of the top brands in the natural channel. Also, our skilled sales and service force of almost 1,000 associates works hard every day so they can make a difference for their retailers and customers.

We remain focused on growing our eCommerce business, and for background, UNFI's eCommerce business consists of delivering to eCommerce and secondary eCommerce providers, delivering to consumers on behalf of brick-and-mortar locations looking for endless aisle fulfillment and to alternative channels that want our unique assortment through our Honest Green Easy Options website.

And during the third quarter, we activated eCommerce fulfillment from our Midwest facility located in Racine, Wisconsin. UNFI now provides eCommerce solutions from five facilities, three being grocery warehouses, which give us the capability to meet the delivery turnaround expectations of eCommerce customers. In addition, our unfieasyoptions.com B2B platform, which I mentioned earlier, has seen double-digit growth, thanks to the development of curated assortments and increased traffic to the site overall.

I'd like to share with you a few statistics that reflect the scale that we have achieved throughout our network. UNFI associates select more than 450 million cases on an annual basis, conduct over 1 million deliveries on close to 200,000 routes. With this high growth, we are gaining scale, and over time, we expect to continue to leverage the scale by enhancing our customer experience and bottom line.

I am very proud of our people. UNFI associates and our management team have continuously demonstrated their dedication throughout this period of strong growth and have worked tirelessly to provide exceptional service in our dynamically changing retail environment. Their work is exceptional.

In summary, we're very pleased with our performance. We delivered strong top and bottom line results, underscoring the strength of our market position as we continue to win amid continuous change. UNFI is an important connector between manufacturers, brick-and-mortar retailers as well as eCommerce customers. We believe that our strong balance sheet and demonstrated leadership will support our long-term growth and positions us well to achieve our strategic objectives and 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.

Thank you, Steve. Good evening, everyone, and thank you for joining our call this evening. I will speak to our third quarter performance, provide some year-to-date highlights and then cover our updated outlook for fiscal 2018.

As Steve noted, we had record net sales for the third quarter of $2.65 billion, reflecting growth of 11.8% or approximately $279 million year-over-year. In Q3, we continued to experience modest inflation of approximately 23 basis points, which was slightly lower than last quarter's inflation of 34 basis points. This marks the eighth consecutive quarter of either modest deflation or near-zero inflation, which continues to be a headwind to our net sales and EBITDA dollar growth compared to our 10-year average inflation of approximately 2.3%.

Despite the lack of meaningful inflation, we continue to see strong demand for our products, which is translating into greater-than-expected net sales growth across our customer channels. Supernatural net sales in Q3 were up 24.3% over Q3 last year and represented 37.5% of total net sales compared to 33.7% in Q3 last year. Supernatural growth is driven by the growth of our supernatural customer and the success of our build out the store strategy, which is driving growth in new categories, most notably, health, beauty and supplements. Q3 marked the highest quarterly year-over-year net sales growth in the supernatural channel since Q2 of fiscal 2011.

Supermarket channel net sales increased 3.7% over the third quarter of last year and represented 27.1% of total company net sales. Independent channel net sales grew 6.1% versus the third quarter last year and landed at 25.1% of total net sales in the quarter. Our food service net sales increased 4.6% over Q3 last year and our eCommerce net sales increased approximately 23% versus the third quarter last year.

Let's turn to gross margin. Gross margin results for the quarter included the positive impact of a change in accounting estimate of $20.9 million, associated with our accrual for inventory purchases. A change in accounting estimate arises when new information allows for improved estimation. Our change in estimate was initiated based on an analysis of historical data and performance following the growth of the accrual for inventory purchases, which resulted from higher-than-expected business growth and the centralization of our shared services operations. Substantially, all of this change in estimate is related to inventory purchases from the current fiscal year.

Let me provide some additional background on this change in estimate. When we receive purchase inventory prior to receiving a supplier invoice, we accrue a liability associated with this received but not invoiced inventory. This accrual is common practice in U.S.-based companies that sell products. Due to our large volume of orders and SKUs and pricing and quantity differences that can exist, at times, only a portion of this accrual for inventory purchases is matched to a vendor invoice.

Historically, we would leave these unresolved or partially matched amounts when the amounts were substantially matched or when they aged past 12 months and we determine the liability was no longer probably. In Q3 of this fiscal year, following analysis and review of our accrual for inventory purchases, we determined that we could reasonably estimate the outcome of partially matched vendor invoices following receipt rather than waiting for up to 12 months. As a result, gross margin for the quarter came in at 15.41%, a 5 basis point decrease over last year's third quarter.

For the year-to-date period, gross margin decreased 27 basis points to 15.02% compared to 15.29% in the prior year comparable period. This decrease was driven by a shift in customer mix, where sales growth with lower margin customers outpaced growth with other customers, coupled with an increase in inbound freight costs and partially offset by the impact of the change in estimate for the accrual of inventory purchases described earlier.

Our adjusted operating expenses for the third quarter, excluding restructuring charges, were 12.30% of net sales, a decrease of 25 basis points compared to adjusted operating expenses for the third quarter of last fiscal year. The year-over-year decrease was driven by leveraging fixed costs and partially offset by increased overtime and temporary labor costs, associated with higher-than-expected demand for our products.

Fuel costs for Q3 of fiscal 2018 increased 5 basis points as a percent of distribution net sales compared to the third quarter of fiscal 2017 and represented 47 basis points of distribution net sales. Our diesel fuel costs per gallon increased by approximately 19.3% compared to the third quarter last year, which compares to the Department of Energy's national average price per gallon for diesel in Q3, which increased 18.5% or $0.48 per gallon compared to the third quarter of last year. Compared to the second quarter of fiscal 2018, our diesel fuel costs per gallon went up 3.9% or $0.11 per gallon. For the same period, the Department of Energy's national average price per gallon for diesel was up 3.3%.

Share-based compensation expense represented 30 basis points of net sales in Q3 compared to 20 basis points in the third quarter of last year. On a dollar basis, share-based compensation expense was up $3.2 million to $7.9 million compared to $4.7 million in Q3 last year. This increase was driven by an increase in performance-based compensation expense related to our long-term incentive plan.

Q3 operating income, excluding restructuring charges, was $82.3 million, reflecting an increase of $13.4 million or 19.5% from the same period last year. From a year-to-date standpoint, adjusted operating income increased 12.1% to $188.9 million compared to adjusted operating income of $168.5 million in the prior fiscal year period.

This increase outpaced the 10.1% year-to-date increase in our net sales.

Adjusted EBITDA for the third quarter was $104 million, an increase of $13.7 million compared to Q3 last year. Adjusted EBITDA margin was 3.93% of net sales, up 12 basis points from Q3 last year. For the year-to-date period, adjusted EBITDA was $254.8 million, an increase of 9.6% compared to the same period last fiscal year. For the year-to-date period, adjusted EBITDA margin was 3.34% of net sales, off 1 basis point versus the same period last year.

Interest expense in Q3 of $4.5 million was $0.2 million higher than Q3 of last year, primarily due to a 61 basis point increase in our floating interest rate exposure and partially offset by less debt year-over-year. At the end of Q3, we had fixed interest rates on approximately 66% of our debt, leaving 34% of our debt with floating interest rate exposure.

For the third quarter of fiscal 2018, net income was $51.9 million, an increase of approximately $15.3 million over Q3 last year. Q3 benefited from a 6 percentage point reduction in our corporate tax rate versus Q3 last year, primarily due to tax reform. Q3 GAAP EPS was $1.02 per fully diluted share compared to $0.72 in Q3 last year. Third quarter adjusted EPS was $1.04 per fully diluted share, an increase of $0.27 or 35.1% compared to adjusted EPS for third quarter of fiscal 2017.

Total working capital at the end of Q3 was $1.16 billion, up 18% versus Q3 of last year compared to net sales growth of 11.8% over the same period. This increase in working capital was driven primarily by increased inventory levels resulting from customer demand and our commitment to high service levels. Our capital expenditures for the third quarter were approximately $14.1 million or 0.53% of net sales, a decrease from 0.73% of net sales in the third quarter of last year.

We had negative free cash flow of $34.2 million in the third quarter of fiscal 2018 compared to positive free cash flow of $48.9 million in the third quarter of last year. The negative Q3 free cash flow was primarily driven by the increase in inventory. And as a result, we now expect at the end of fiscal year with positive free cash flow of between $10 million and $30 million.

Our balance sheet continues to be strong. At the end of third quarter, our debt to adjusted EBITDA leverage, excluding operating leases, was 1.48 times, which was down 3 basis points compared to Q3 last year. Outstanding lender commitments under our credit facility were $887 million, excluding reserves, with available liquidity at quarter-end of approximately $550 million, including cash and cash equivalents. At the end of Q3, our available liquidity under our credit facility was approximately $528.5 million.

Based on performance to-date and our outlook for the remainder of fiscal 2018, we are updating our fiscal 2018 guidance, which was provided on March 8 of 2018. For fiscal 2018, we expect annual net sales to increase 10.3% to 10.8% year-over-year compared to our previous guidance of 8.0% to 8.5%. We expect GAAP EPS for fiscal 2018 to be in the range of $3.39 to $3.44 compared to the previous estimate of $3.27 to $3.35.

Adjusting for restructuring and impairment charges and the impact of one-time preliminary remeasurement of U.S. deferred tax liabilities resulting from the tax reform, the company's estimates adjusted EPS for fiscal 2018 to be in the range of approximately $3.18 to $3.23 compared to our previous guidance of $3.06 to $3.14.

Capital expenditures for fiscal 2018 are expected to remain in the range of 0.6% to 0.7% of estimated fiscal 2018 net sales. As a reminder, on our fourth quarter call, we will provide fiscal 2019 guidance as well as updated long-term guidance. Also, please note that fiscal 2019 results will include a 53rd week compared to the 52 weeks in fiscal 2018.

In closing, we are pleased with the top line momentum on our business and the year-to-date bottom line results. We remain focused on working through the challenges that come with this growth and driving additional operational efficiencies.

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 begin the question-and-answer session. [Operator Instructions] And our first questioner today will be Chuck Cerankosky with Northcoast Research. Please go ahead.

Chuck Cerankosky
Analyst, Northcoast Research Partners LLC
Q

Good afternoon, everyone.

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

Hey, Chuck.

Chuck Cerankosky
Analyst, Northcoast Research Partners LLC
Q

Mike, I want to make sure I understand this inventory adjustment. That reflects something that took place over the first nine months of the year, but only hit the most recent quarter?

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

Yeah. As I mentioned, Chuck, the change in estimate that we recorded in Q3 was substantially all related to purchase orders in the fiscal year.

Chuck Cerankosky
Analyst, Northcoast Research Partners LLC
Q

Okay. But if you take that $20 million and remove it from the operating income, you get a decrease in operating income. Is that the right way to look at it?

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

Well, Chuck, as I mentioned in my comments, this change in estimate is an improvement in how we were estimating the liability for accrued inventory purchases. So, to adjust it would be to kind of ignore the accuracy or the improvement in the estimate of $20.9 million or in other words to place value on a liability that doesn't exist.

Chuck Cerankosky
Analyst, Northcoast Research Partners LLC

Q

Okay. And then, looking at the conventional supermarket channel, that was up 3.7%. If you look at conventional supermarket customers who do not do their own distribution, is the growth to those types of retailers stronger?

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

A

We typically wouldn't split that out. I think what you're asking is, is the growth to supermarkets that have captive distribution different than the growth of supermarkets that don't? Is that your question?

Chuck Cerankosky
Analyst, Northcoast Research Partners LLC

Q

Yes.

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

A

Yeah. We would typically not split that out.

Chuck Cerankosky
Analyst, Northcoast Research Partners LLC

Q

All right. Thank you.

Operator: And our next questioner will be Eric Larson with Buckingham Research Group. Please go ahead.

Eric J. Larson
Analyst, The Buckingham Research Group, Inc.

Q

Yeah. Good afternoon, everybody. Couple questions. First of all, when I look at CapEx, could you help us – you have a few facilities that are running really tight on capacity, et cetera, and we're expecting that CapEx rate to go up. Is that a fiscal 2019 event or are you expecting some of that incremental CapEx to start this year?

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

A

Well, we haven't provided guidance for 2019 and we've essentially given you guidance for the full year in the current year. So, there's not a material change to our CapEx guidance for fiscal 2018. And as far as what CapEx is going to look like in 2019, I think we're just going have to wait a little while before we get into the specifics of that.

But, Mike, you want to add some more color?

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

A

Yeah. Eric, if you look at our long-term CapEx guidance that we provided last fall, we said long term, you should think about us as 1.0% of net sales. When you look at our actual CapEx performance over the last three years, you see a number that looks like 0.6% of net sales.

However, if you looked at our last five years, you're back right on 1.0% of net sales because, four and five years ago, as you recall, we were adding some capacity. So, as I mentioned, we'll provide you our fiscal 2019 guidance in our next call. And we'll provide some update on long-term guidance, but I think you can think about us over the long term in that range. And as we go into a period of CapEx investment, you can expect us to be a little higher than that 1.0% number that we provided.

Eric J. Larson
Analyst, The Buckingham Research Group, Inc.

Q

Okay. Thanks. And then, just one more question, so that – I'll ask one more then hand it over. But obviously, you saw massive acceleration in your supernatural growth in the quarter. How is the best way for us to look at this going forward from a modeling perspective? And obviously, pricing, as you did – there's very little inflation in the industry. So, that's all real volume or real organic growth. So, Steve, how is the best way to look at how we should sort of model and review the supernatural category for you?

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

A

Yeah. I mean, that's a hard one for me to answer. I mean, obviously, we stay very focused on this whole building out the store strategy in selling more categories of products to existing customers, whether it be supernatural or any other customer that we service. And I think in this particular quarter, we had some nice success there in supernatural that we've talked about over the last couple of quarters. But I don't think I would want to put ourselves in a position to give any specific color about any one customer other than to say we are just really focused on selling more categories of products to existing customers throughout the network.

Eric J. Larson
Analyst, The Buckingham Research Group, Inc.

Q

Okay. Good. Thank you.

Operator: And our next questioner today will be Andrew Wolf with Loop Capital Markets. Please go ahead.

Andrew Wolf
Analyst, Loop Capital Markets LLC

Q

Sure. Thanks. Just on the guidance in relation to the inventory change and the earnings impact, so for the fourth quarter, I just want to confirm my math, looks like at the midpoint of the implied EPS guidance about high teens growth, about 18% and about mid-single-digits EBITDA growth. So, I just want to make sure that that comports with – that I did my math right as I just whizzed through it kind of on the road.

And also, the follow-on to that is, if it's right, I just want to know if there's accounting change that impacted the third quarter materially, does that [ph] – in your ability (34:16) to estimate the vendor partial payments or the partial billings, did that impact the fourth quarter materially such that those year-over-year numbers are also kind of changed, year-on-year both numbers?

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

A

Yeah. The change in estimate that we recorded in Q3, as I mentioned, was related – it was substantially all in the – related to POs in the fiscal year, but wouldn't be related to any POs that are yet to come, so none in Q4 or going forward. One of the ways to think about this in an unrelated industry would be an example of gift cards. And if you think about when gift cards first came out, companies had to record a liability and weren't sure what percent would be redeemed or how long they should carry that liability before they relieved it. But over time, they gained experience about how quickly the gift cards got redeemed and how many got redeemed. And as a result, they changed their estimate and their liability for gift cards over time.

And I think about our change in estimate on our accrual for inventory purchases very similarly. We used to wait a year to relieve that liability, and through data and analysis and really a benefit from bringing our shared-service operation centrally, we're able to analyze and look at the information in a way that gives us more insight to the actual performance.

And so, we've changed that methodology now and when we get a three-way match, we know from our experience that there won't be another – there won't be a liability associated with that PO going forward, and so we relieve it shortly after that three-way match. So, instead of waiting a year, we're doing it more quickly. And that's really the essence of it. So, again, going forward, if a PO were to qualify in that way, it would be treated the same way in the new estimation process that we have.

Andrew Wolf
Analyst, Loop Capital Markets LLC

Q

Okay, I got that. So, was this cumulative adjustment for the first nine months or the first three quarters? Kind of if you just divided it by three, would you be able to get what the impact was per quarter if you wanted to – or is it more lumpy than that?

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

A

Yeah, what I mentioned there, Andy, was it substantially all related to purchase orders in the fiscal year and we can use our guidance to indicate where we land.

Andrew Wolf
Analyst, Loop Capital Markets LLC

Q

Oh, that relates to the fiscal year? The entire fiscal year? I'm sorry.

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

A

The guidance is for the fiscal year and, of course, you have our year-to-date results for the first nine months.

Andrew Wolf
Analyst, Loop Capital Markets LLC

Q

Yeah, but I'm talking about the $20-plus million adjustment, that was for the first nine months. Right?

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

A

Yeah. It relates substantially all to POs from this fiscal year.

Andrew Wolf
Analyst, Loop Capital Markets LLC

Q

Yeah. Thank you. Was this change contemplated in the last updated guidance?

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

A

Yeah. Our updated guidance reflects our best estimate of where we'll finish the year this year.

Andrew Wolf
Analyst, Loop Capital Markets LLC

Q

Now, when you issued the previous guidance a few months ago, was this part of that? Even though you may not have shared it with us, was that part of your guidance?

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

A

We just did the change in estimate here in Q3. So, the impact of it was in our Q3 results.

Andrew Wolf
Analyst, Loop Capital Markets LLC

Q

Thank you. And lastly on the same topic, given it's a big number, did you decide to share any of that benefit, even if it's an accounting benefit to some extent, a large extent, did you decide to invest any of that or give any of that to your customers to grow market share or for any other reason?

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

A

The change in estimate is related to the liability. So, an accrual for the inventory purchases. So, the entry that was made to book it is a non-cash entry and really just recognition of a liability [ph] that are a (38:37) reduction.

Andrew Wolf
Analyst, Loop Capital Markets LLC

Q

So, even though it flows through your income statement, you didn't – you decide – it didn't change your business practices. So, did I hear that right?

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

A

Right. No.

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

A

Thanks, Andy.

Operator: And our next questioner today will be John Heinbockel with Guggenheim. Please go ahead.

John Heinbockel
Analyst, Guggenheim Securities LLC

Q

So, where are we in the build-out of new capacity? I know you've added some, but there's more to go. And maybe, in particular, where do we stand on automating more facilities to get greater labor efficiency?

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

Yeah. John, this is Sean. Good afternoon.

John Heinbockel
Analyst, Guggenheim Securities LLC
Q

Good afternoon.

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

We have several expansion projects that are underway pointed, from a capacity perspective, at distribution centers that have had some aggravation as it relates to outside storage and other capacity constraints and, of course, that's in our guidance for 2018. We have not communicated 2019's plan as it relates to CapEx, although we're doing a lot of development today as it relates to where we're going to go and to what extent.

As it relates to automation, along with the development approach to what we're taking for 2019 and beyond, automation is certainly part of that, particularly automation as it relates to our each pick velocity products.

John Heinbockel
Analyst, Guggenheim Securities LLC
Q

Okay. And then, maybe as a follow-up, the idea was we would sort of get past some of this inefficiency, right, in demand in the second half of the year. Where did you come out in the third quarter relative to where you thought you would be in terms of ameliorating some of that pressure? And it sounds and looks from your guidance that the fourth quarter would be better still versus the third quarter with regard to that pressure, is that right?

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

Well, you just keep in mind, so UNFI's network is substantial. We have 33 distribution centers in the U.S. and Canada. So, when we're talking about distribution centers that are capacity-challenged that are impacted by labor and then, of course, through the P&L, we do not get the leverage that we'd anticipate, this is contained through a handful of distribution centers, albeit they are the high-volume DCs. So, we have not been able to get the leverage that typically we would get, but across the network, when we think about 33 DCs, we're talking about a handful of DCs that I would refer to as let's say suboptimal.

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

Yeah. John, also I think I mentioned in my prepared remarks that we did get nice expense leverage in the quarter on a consolidated basis.

John Heinbockel
Analyst, Guggenheim Securities LLC
Q

Okay. So, you're talking about overhead primarily.

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

Yes.

John Heinbockel
Analyst, Guggenheim Securities LLC

Q

All right. That will get better do you think as we – and I guess that's implied in your guidance getting better into the fourth quarter?

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

A

Yeah, I mean, I think as we think about the fourth quarter and into 2019 and 2020, I mean we have to be more efficient. We've talked about that before.

John Heinbockel
Analyst, Guggenheim Securities LLC

Q

Yeah. Okay. Thank you.

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

A

Thanks, John.

Operator: And our next questioner today will be Rupesh Parikh with Oppenheimer. Please go ahead.

Erica Eiler
Analyst, Oppenheimer & Co., Inc.

Q

Good afternoon, guys. This is actually Erica Eiler on for Rupesh. Thanks for taking our questions. So, I wanted to touch on cash flows here. So, it looks like AR and inventory were both quite high. You touched on the inventory piece. Maybe you can talk a little about what's driving the higher AR. Has there been a change in terms or is there something else driving this? And then, what are the opportunities to improve working capital from here?

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

A

Yeah. Erica, thanks for the question. We have got some initiatives in place now on AR to improve performance there. We should see improved results going forward here in particular by the end of the fiscal year. And I would expect across our working capital that we'll see improvement in our results going forward. And it's primarily because we've had a lot of unexpected growth in our business this year. And as I mentioned, the centralization of our shared services operation is allowing us to change process, improve process and focus better going forward.

Erica Eiler
Analyst, Oppenheimer & Co., Inc.

Q

Okay. Great. And then, just on the inflation, deflation front, it seems still muted there. Maybe you can just update us on your expectations for the balance of the year. And then, additionally, are you starting to see more increases start to come through from your supplier community?

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

A

We've been talking about our hope for higher inflation for a long time now and unfortunately, we haven't seen any material kind of inflection point. And we haven't seen the rate of inflation increase. And so, our expectation, it's probably going to hover plus or minus somewhere where it is today.

Erica Eiler
Analyst, Oppenheimer & Co., Inc.

Q

Okay. Great. Thanks so much.

Operator: And the next questioner today will be Chris Mandeville with Jefferies. Please go ahead.

Aaron Eisenberg
Analyst, Jefferies LLC

Q

Hey, guys. This is actually Aaron Eisenberg on for Chris. Thanks for taking my questions.

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

A

Sure.

Aaron Eisenberg
Analyst, Jefferies LLC

Q

So, just starting with the guidance, so you raised EPS by around $0.10 at the midpoint. If I look at your benefit, my math is certainly more than $0.10. So, just trying to square things on the guide there or am I missing something here?

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

A

Yeah. I'm not sure how you're breaking it down. At the midpoint, our sales guidance is up in the neighborhood of $165 million to $170 million and EPS is up as you said $0.105 at the midpoint. And so, I'm not sure beyond that what your question is.

Aaron Eisenberg
Analyst, Jefferies LLC

Q

No. So, if I strip out the $20.9 million benefit that you've got this quarter...

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

A

Yeah. So, to take out that is to assign value to a liability that no longer exists. We've improved our ability to estimate that accrual for inventory purchases in a way that are now system performance historical results supported.

Aaron Eisenberg
Analyst, Jefferies LLC

Q

Understood. Okay. And then, I guess on the free cash flow front and more specifically on the working capital side of things, with the reorg creating now a new head of supply chain, is there any color you can provide there on what you're expecting from inefficiencies and a cost savings standpoint?

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

Yeah. This is Sean. Just as it relates to – let me address this in the context of inventory, because I think that's kind of what you're thinking about with respect to supply chain role, et cetera. And just consider that service to our customers is a primary objective for the company. And when we have inbound service level fill rates from suppliers, we feel like there are steps that we need to take by intent as it results to inventory levels in order to assure that we can service our customers.

And so, clearly, in Q3, we had a negative impact as it relates to this strategy. And we don't see in the quarter ahead of us necessarily that inbound service will improve. Although it did not necessarily get worse versus Q2, we would expect more of the same.

Aaron Eisenberg
Analyst, Jefferies LLC
Q

Okay. That's helpful. Thank you. And then, lastly, you mentioned pressures from freight. Have you been able to begin passing on some of the recent freight pressures and kind of how do you feel ending the year on this issue?

And then, separately, how are you handling your own drivers these days? I think on the last call maybe you referenced looking at wages, but did you and do you feel the need to bump their pay at all or provide some additional incentives?

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

Yeah. Good question. On the first part of the question as it relates to the inbound, think of it as a cycle in that as expense increases and the percentage of tons that UNFI manages and controls if you will, we do a review process of freight lanes by supplier. We have a commitment to our customers to provide notification of any increases related to this inbound freight expense, the products landed into our inventory and then we only recognize that benefit if you will when we sell through the inventory.

So, it's quite a lengthy cycle. We are underway. We expect some benefit in Q4, but really we're going to need to get into and through Q1. As Steve suggested, it takes a couple of quarters in order to get, let's say, back to par.

Aaron Eisenberg
Analyst, Jefferies LLC
Q

All right. Great. Thanks, guys. Best of luck going forward.

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

Thank you.

Operator: And our next questioner today will be Karen Short with Barclays. Please go ahead.

Karen Short
Analyst, Barclays Capital, Inc.
Q

Hi. I just wanted to ask a little differently in terms of your guidance and in terms of this quarter. So, I'm just trying to understand like philosophically, this was a one-time benefit. And so, to the extent that you are kind of slightly raising your guidance without this one-time benefit, you're meaningfully lowering your guidance. So, I guess I'm trying to understand how you kind of get your head around including this as a part of ongoing results as opposed to calling it out separately? That's my first question.

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

A

Yeah. So, the change in estimate that we recorded in the third quarter is – there's a timing element related there. And what we've talked about is that we used to wait a year to clear these balances that we no longer believe we owed. And the change in estimate was to say we don't need to wait a year and that we can do that immediately and we got there based on analysis of our performance and the history there.

And we can look at the purchase orders that the change in estimate related to. And they're substantially all in this fiscal year, but certainly, because we're talking about purchase orders that would have had a three-way match against them, they're not purchase orders that have occurred yet into the future.

So, as we move forward and we have thousands of purchase orders at any given time, those ones that are partially matched and have a remaining balance associated with them, in our experience, we believe, those are right away or shortly after the three-way match now. And so, that is a practice that we will continue to do as long as it continues to be supported by performance of our – and history in our practice. And so, that is something that will be applied to those instances going forward.

Karen Short
Analyst, Barclays Capital, Inc.

Q

But as we look at gross margins this quarter, excluding this one-time benefit, your gross margins were down 84 basis points. So, the question is, as we look to the fourth quarter and we look into fiscal 2019, how are we supposed to think about the trajectory of your gross margins? Because it doesn't seem like necessarily the pressures that you're experiencing in this quarter are going go away in near term, because we're [indiscernible] (51:16)...

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

A

But that's why...

Karen Short
Analyst, Barclays Capital, Inc.

Q

...excluding the benefit.

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

A

Yeah. As I mentioned, the change in estimate is related to purchase orders or substantially all within the fiscal year, which gives you a sense for its impact throughout the year.

Karen Short
Analyst, Barclays Capital, Inc.

Q

Okay. But, again, how are we supposed to think about gross margins going forward when we back out this? Even if we break it into a third, a third, a third, how are we supposed to think about the trajectory of gross margins going forward given that there was still meaningful degradation this quarter when we back out this benefit?

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

A

Yeah. We still have a headwind on our gross margin related to the fact that our fastest growing customers are our largest customers. We still have some headwind on our gross margin related to inbound freight, which, as we've talked about, will dissipate over the next couple of quarters and become part of our cost basis. And as a cost-plus provider, that's a benefit on an ongoing basis.

And so, I think that's the way you kind of think about the results that we've had year-to-date and then as information about how we'll move forward. But the gross margin that you see reflected in our year-to-date number is the appropriate gross margin. That is our current run rate. So, it's not appropriate – we don't feel it's appropriate that you would back it out.

Karen Short
Analyst, Barclays Capital, Inc.

Q

Okay. That's helpful. And then, I just – one question I wanted to ask was in terms of the supernatural contract, has anything changed contractually with that other than mix shift in terms of payment terms or anything along those lines?

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

A

No. Absolutely not.

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

A

No, nothing has changed.

Karen Short
Analyst, Barclays Capital, Inc.

Q

Okay. Thank you.

Operator: And our next questioner today will be Edward Kelly with Wells Fargo. Please go ahead.

Edward J. Kelly
Analyst, Wells Fargo Securities LLC

Q

Hi, guys. So, I don't want to beat a dead horse here on the accrual, but I'm going to go back anyway. As we think about – I think what you're trying to say, right, is that basically you were under-earning because of the accounting methodology around the liability. And I guess the adjustment probability relates to the inventory that you have on hand at this point. Is that all? That's fair, right? That's what you're trying to say here?

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

A

Go ahead, yeah.

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

When we have pricing or quantity discrepancies on our purchase orders and we have a partial match, what remains is a part of the balance which is then accrued. And what we have discovered is that part of the balance does not need to remain around for 12 months before it's relieved. We can actually relieve it immediately because it's actually not owed. And so, it's really a timing issue here. It's a better reflection of our liability. And so, its translation into our earnings is one that we feel better about the estimates, more accurate.

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

And I would say that – I would try to explain in a way that says, I wouldn't be comfortable saying we were under-earning. We just didn't look at the estimate using the latest data and processes that we now have. And so, with the reflection of the estimate and the process change, our earnings now reflect the appropriate run rate, both in terms of EBITDA, gross margin, et cetera.

Edward J. Kelly
Analyst, Wells Fargo Securities LLC
Q

Okay. And as it relates to that, you're not restating, right? So, as we think about...

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

Absolutely not.

Edward J. Kelly
Analyst, Wells Fargo Securities LLC
Q

Right. So, as we think about Q4, do you continue to get some benefit from a gross margin standpoint because of the comparison to last year in all this?

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

Perhaps.

Edward J. Kelly
Analyst, Wells Fargo Securities LLC
Q

And would that benefit – I guess, is it possible to quantify how big that benefit is going be over the next few quarters to like gross margin rate?

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

Well, again, we haven't given guidance for next year yet. We've revised our guidance for the current year. And like I said a minute ago, I think if you think about the current run rate in the nine months through the period ending third quarter, that's the appropriate way that you should look at our gross margin and our EBITDA.

Edward J. Kelly
Analyst, Wells Fargo Securities LLC
Q

Okay. And then, I do just want to go back to what Karen was trying to ask. If we look at your guidance, your guidance went up by about $0.105. You did not previously contemplate what's about a $0.27 benefit from the accrual change, which basically suggests that guidance went down by about $0.17. And I'm just trying to figure out, as we all are, I think, what drives that. Is that the shortfall in Q3? And is that related to the underlying gross margin? Just some color there I think would be helpful for us.

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

A

Right. So, I think what you suggested is $0.27 in Q3. Is that what you're asking?

Edward J. Kelly
Analyst, Wells Fargo Securities LLC

Q

Well, $20.9 million in incremental EBIT wasn't contemplated in the guidance when you gave it last quarter, right? That's about $0.27. You've raised $0.105. So, it implies about a $0.17 shortfall and I'm just kind of curious as to what's driving that.

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

A

Yeah. I'm not sure that we see it that way. We see it more as a timing issue than it is anything else.

Edward J. Kelly
Analyst, Wells Fargo Securities LLC

Q

Well, I know that, but when you gave guidance last quarter of $3.06 to $3.14, $20.9 million wasn't in that guidance, right?

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

A

Well, yeah. I'm not sure we look at it that way. And I think that the color that we provided in our script is the color. Again, we think about it in terms of the estimate that we've provided in our Q3 results are reflective of a number that you should think about in terms of our run rate in the nine months that have ended through the end of our third quarter. We think that that's a good rate in terms of how we look at our business going forward, because that change in estimate reflects the appropriate gross margin and earnings that we've talked about.

Edward J. Kelly
Analyst, Wells Fargo Securities LLC

Q

Okay. I got it. Thank you.

Operator: And our last questioner for today will be Scott Mushkin with Wolfe Research. Please go ahead.

Scott A. Mushkin
Analyst, Wolfe Research LLC

Q

Hey, guys. Thanks for taking my questions. And before I get going, congratulations, Sean, on retirement and, Chris, congratulations to you on your new role.

Christopher P. Testa
President-Atlantic Region, United Natural Foods, Inc.
A

Thanks, Scott.

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

Thanks, Scott.

Scott A. Mushkin
Analyst, Wolfe Research LLC
Q

You're welcome. So, I think we kind of get this accounting thing and wanted to actually ask something a little bit different. As we move forward, and we talked about capacity constraints, you're obviously seeing substantial growth out of the supernatural channel, how should we think about your willingness to invest in your distribution? Obviously, there, you're going to need to make some substantial investments if the growth continues at this rate. So, how should we think about your willingness to do that and how should we think about the cash flow implications of that as we think of next year and the year after?

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

Yeah. So, look, as a distributor, we need the capacity to satisfy the growth. And so fortunately, we have a very disciplined model that looks at return on invested capital, internal rate of return and a variety of other factors that would move us towards making a capital investment or not.

Now, we have, as we've talked about in the last couple quarters, a lot of customers that are growing really quickly. We made reference to our customers 2 through 25 having double-digit sales growth. That still continues. And so, there are certainly markets where we're going to need to add capacity to grow with the customers within those markets. And we'll apply that same level of discipline in the decision-making process that we always have. And if we can't get over the hurdle, as it relates to inventory or economic conditions or the macro environment or the customers that are growing the fastest or the slowest in that particular market, then we'll make those decisions when we need to.

But I think the way that Mike articulated kind of our historic CapEx to free cash is a good way to look at it both in terms of the last three years and the last five years. And if you modeled it out using that data, you'd probably get to a pretty good point.

Scott A. Mushkin
Analyst, Wolfe Research LLC
Q

And so, just a quick follow-up question. [ph] As we (01:01:05) look at the largest part of your business, which is growing very, very rapidly, likely to eclipse 40-plus-percent, we've seen you guys move to extend out the key contract in that bucket. Is that something you're going to need, given the amount of capital that likely will need to be deployed to keep that relationship at its optimal? Is that something you guys would like to do?

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

Yeah. I don't know. We would never get into talking about any individual customer. We still have a long time to go on that contract. As you know, it goes out to 2025. So that's something that we'll start thinking about maybe five years before the end of the agreement itself. In the meantime, we've got lots to do. Lots of growth, lots of good things happening within the company and those are the things that we'll focus on.

Scott A. Mushkin
Analyst, Wolfe Research LLC

Q

Okay, guys. Thanks very much.

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

A

Thanks.

Operator: And this will conclude...

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

A

Thanks, everybody.

Operator: Sorry, about that. I was going to say this will conclude our question-and-answer session. I would like to turn the conference back over to management for closing remarks.

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

Thanks, everybody, for joining us this evening and have a terrific summer.

Operator: And the conference has now concluded. Thank you for attending today's presentation. You may now disconnect your lines.