VIAVID

communications simplified.

Sportsman's Warehouse Holdings, Inc.

Second Quarter 2016 Earnings Conference Call

August 18, 2016

CORPORATE PARTICIPANTS

Rachel Schacter, *Investor Relations, ICR, Inc.*

John Schaefer, *President, Chief Executive Officer and Director*

Kevan Talbot, *Chief Financial Officer and Secretary*

CONFERENCE CALL PARTICIPANTS

Seth Sigman, *Credit Suisse*

Stephen Tanal, *Goldman Sachs*

Peter Benedict, *Robert W. Baird*

Daniel Hofkin, *William Blair*

Peter Keith, *Piper Jaffray*

Patrick McKeever, *MKM Partners*

PRESENTATION

Operator:

Good afternoon, ladies and gentlemen. This is Sportsman's Warehouse Second Quarter Earnings Conference Call. Today's conference call is being recorded. All lines are currently in listen-only mode.

I would now like to turn the conference over to Ms. Rachel Schacter of ICR.

Rachel Schacter:

Thank you. Good afternoon, everyone. With me on the call is John Schaefer, President and Chief Executive Officer; and Kevan Talbot, Chief Financial Officer.

Before we get started, I would like to remind you of the Company's Safe Harbor language. The statements we make today will contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, which include statements regarding our expectations about our future results of operations, demand for our products and growth of our industry. Actual future results may differ materially from those suggested in such statements due to a number of risks and uncertainties, including those described in the Company's most recent 10-K filed with the SEC on March 24, 2016.

We will also disclose non-GAAP financial measures during today's call. Definitions of such non-GAAP measures as well as reconciliations to the most directly comparable GAAP financial measures are provided as supplemental financial information in our press release, included as Exhibit 99.1 to the Form 8-K we furnished to the SEC today, which is also available on the Investor Relations section of our website at investors.sportsmanswarehouse.com.

Now, I would like to turn the call over to John Schaefer, President and Chief Executive Officer of Sportsman's Warehouse.

John Schaefer:

Thank you, Rachel. Good afternoon everyone and thank you for joining us today. I will begin by reviewing the highlights of our second quarter performance and then discuss our progress on our strategic initiatives and thoughts on the remainder of the fiscal year. Kevan will then go over our financial results in more detail and review our outlook, after which we will open up the call to your questions.

We are pleased with our second quarter results which came in above our guidance on both sales and earnings per share. We believe the unique characteristics of our business model and our disciplined execution allowed us to navigate the headwinds in the second quarter that affected soft goods in the broader retail market.

As we have demonstrated in the past, we met each of our financial performance objectives. We again focused on maintaining and, where possible, enhancing gross margin, which has allowed us to continue to meet our ROIC objectives and earnings guidance. Despite the continued deep discounting in many categories by some of our competitors at both the national and local level, we were able to maintain our normal promotional calendar driven by our continuous efforts on the right product in the right place at the right time and our everyday low price merchandising strategy.

Additionally, despite our pricing and promotional discipline in this environment of increased discounting, we were able to not just grow our same-store sales, but it is noteworthy that the largest increase in same-store sales came from those stores where we faced mature competition. This further illustrates the differentiating attributes of the Sportsman's Warehouse experience offering and value proposition that continue to resonate with our customers.

With the increased demand for firearms, especially in the states in which we operate, NICS data strengthened and we were able to outperform this increase in NICS data increasing our share in 19 of the 20 states in which we operate despite new competition in six markets in these states. Our new stores continued to outperform our expectations with all of these stores being either our standard format or smaller format models in metropolitan service areas that are, for the most part, very difficult for our larger national competitors to enter or in markets where our national competitors have historically chosen to avoid.

Our results across the markets in which we operate continue to demonstrate that we are able to coexist with our national competitors in those markets where we compete as a neighborhood alternative and also that we are continuing to take share from the mom-and-pop retailers across markets, large and small. We opened three stores in the second quarter and are on pace with our plan to open 11 stores this fiscal year, which represents 17% store growth, reflecting our continued focus on growing the Company while also meeting our twin objectives of delivering a 20% ROIC on new stores and generating free cash flow to pay down debt.

Net sales for the second quarter increased 13.7% to $189.8 million. Same-store sales increased 2.9% versus the prior-year period. As we've discussed many times, the effect of new competition impacts same-store sales until approximately the 18-month mark. As expected, in the second quarter, this impact from competition was 210 basis points.

We are very pleased with the performance of our stores facing new competition, especially when considering the significant increase in promotions among some of our competitors in the quarter. Based on announced competitive openings, we are now at a point where this impact will begin to diminish over the next few quarters, both as a result of fewer new competitive openings, as well as many stores that face new competition, reaching that 18-month mark where the competitive impact starts to fade.

Looking more closely at our store sales performance for the quarter. Firearm unit sales were up 30.8% versus the second quarter of last year and versus the NICS data for our states being up 24.6%. Ammunition sales were also up over the prior year. Our assumption of a three to four month lag in ammunition growth following firearms growth, that we discussed previously, appears to again be relevant.

We are very pleased with the overall growth in firearms and ammunition and we believe we are the best positioned brand in our niche to continue to capture market share in the category. Our sales performance in the firearm and ammunition categories and ancillary businesses as well as the growth in our non-hunting categories all point to continued share gains and traction in markets of all sizes as either complementary alternatives to major competitors in larger markets or at the expense of mom-and-pops and the direct channel in smaller markets.

From a comp composition standpoint, conversion and average order size continued to increase. Once again, as we moved through the quarter, it became evident that our customers were focusing their dollars on the use categories within hunting, camping and fishing versus the ancillary categories in these same areas and the clothing, footwear and electronics categories. However, we are pleased that we continue to see sequential improvement in our clothing and footwear categories as we continue to improve our product offering, merchandising presentation and inventory position and we saw this sequential improvement despite the significant promotional activity in these categories from some of our competitors.

Now on to profitability. Gross profit increased 14.1% with corresponding gross margin as a percentage of sales increasing 20 basis points versus the same period last year despite the higher mix of lower margin product lines. On an individual department and item basis, we continue to see steady to slightly increasing gross margins as we continue to maintain our discipline on promotions, while achieving our objective of being the everyday low price leader in our categories.

We are especially pleased with our private label performance as one of our main product offerings in the good category of the good, better, best offering strategy. While private label is still a very small portion of our business at 3.4% of our net sales during the second quarter, we increased private label sales by 25% quarter-over-quarter. This increase as well as the higher gross margin that comes with these sales has us very confident that we are on the right track with this strategy.

Adjusted operating income for the quarter was $16.7 million, a 30.4% improvement over the prior year, driven by our top line performance, which was accompanied by gross margin strength and continued discipline with expense management. We are accomplishing our dual objectives of both investing in our future while ensuring we are operating as efficiently as possible on a day-to-day basis. Earnings per share was $0.20, which was above our guidance and an improvement over the adjusted earnings per share of $0.14 in the prior-year period.

We believe our results continue to demonstrate that our customer base enjoys shopping in our stores, given our unique environment as well as our convenience as a neighborhood store in larger markets or our big-box appeal in smaller communities where we provide a greater assortment than the mom-and-pop competition. We also believe that we have an advantage versus online-only options by providing outdoor enthusiasts with the touch and feel of product that they may not have been exposed to in a store setting before. Our pricing is similar too and, in many cases, better than the prices that can be found online and as we have noted before, many key product lines are not available or very difficult to purchase via the direct channel.

Looking ahead, we remain focused on our strategic growth initiatives and key priorities. Let me discuss a few, including the progress we made in the second quarter.

Number one, we remain focused on the significant store growth opportunity we see in existing and new markets that we expect will support an anticipated unit growth rate of greater than 10% annually for the next few years.

With the opening of stores in Juneau, Alaska, Prescott, Arizona and Roseburg, Oregon in the second quarter and stores in Las Cruces, New Mexico, and Gillette, Wyoming already opened so far in the third quarter, we have now opened eight stores in fiscal year 2016. Rock Springs, Wyoming, Avondale, Arizona, and Fairfield, California will be opened in the third quarter and will complete our previously-announced 11 store openings for this fiscal year.

In addition, today, we have announced the first four stores for our 2017 class. These store locations are in Cedar City, Utah, Moses Lake, Washington, Wilmington, North Carolina, and Morgantown, West Virginia. Of note, Gillette, Wyoming, Rock Springs, Wyoming, Cedar City, Utah and Moses Lake, Washington will all be our smaller format stores. Our operating discipline and prudent use of cash have continued to allow us to self fund our store growth while also reducing our leverage. We expect to continue our pace of new store openings into fiscal year 2017 and beyond.

Number two, we have seen consistent performance out of our 45,000 square foot boxes and executed a successful fixturing strategy grounded in analytics around SKU productivity and customer preferences among other things that has enabled our success in standard format or 30,000 square foot stores. As I discussed in previous quarters, our smaller format or 15,000 square foot stores in Klamath Falls, Oregon, and Heber City, Utah are performing as we expected and that has given us the confidence to continue to pursue this unique strategy going forward as evidenced by the three smaller format stores in 2016 and the additional announced two smaller format stores so far for 2017.

Number three, we continue to focus on maximizing the potential of our loyalty program, which continues to post strong gains. We now have over one million members, an increase of greater than 55% over the prior year and the transactions from our loyalty members continue to increase, representing more than 40% of our net sales in the second quarter.

Number four, while we are still a very small percentage of revenue, we continue to invest in our e-commerce with a focus on increasing our digital presence to build our brand awareness and drive customer interaction. Traffic on our website increased greater than 30% in the second quarter versus the prior-year period as we continue to improve all aspects of our site. As we have noted before, driving traffic to our site is a key component of our e-commerce strategy as we know customers use our site for product knowledge and availability as much as they do for pricing information.

So in summary, we are pleased that we delivered Q2 results above our expectations and are encouraged by the progress we continue to make against all of our strategic growth priorities as well as the consistent performance of the vast majority of our store locations in what remains a choppy retail environment. As we look toward the remainder of 2016, as I mentioned earlier, we expect the impact of competitive openings to begin to decline.

In addition, our use categories of hunting, fishing and camping have continued to see positive momentum in the past few months, which we feel very good about and indicates that our customers are continuing to take advantage of the activities available to them in the outdoors. We continue to see demand and excess supply in a few key camping categories that have made good progress with our key vendors in these categories to ensure supply will meet demand as we approach the all-important fall season. In addition, while we expect the recent surge in firearms to moderate in Q3, we do continue to see demand exceeding supply in certain key firearm configurations.

Before I end, I want to thank all of our team members for their hard work and commitment to Sportsman's Warehouse that has driven our success to-date and will enable us to continue to build on our track record of consistently delivering against our operational and financial goals.

With that, I'll turn the call over to Kevan to discuss our financials.

Kevan Talbot:

Thanks John. Good afternoon everyone. I'll begin my remarks with a review of our second quarter results and then discuss our outlook for the remainder of our fiscal year 2016. My comments today will focus on adjusted results. We have provided these results as well as an explanation of each line item and a reconciliation to GAAP net income and earnings per share in our earnings press release which was issued earlier today.

We are pleased with our second quarter 2016 results. Net sales increased 13.7% to $189.8 million from $166.9 million in the second quarter of last year, with a 15% increase in stores and a same-store sales increase of 2.9%. Our second quarter revenue was above our previously issued second quarter guidance driven by increased demand for firearms and ammunition.

We continue to be excited about our opportunity to grow our store base in both new and existing markets. During the second quarter, we opened three of our announced 11 planned store locations for our 2016 class of stores, bringing us to a total of six openings through the end of the second quarter. Since then, we have opened two stores in the third quarter to-date, with an additional three stores scheduled to open later this quarter. By the end of fiscal year 2016, we will operate 75 stores in 20 states.

We remain committed to growing our store base and capitalizing on the significant white-space opportunity we see available to us. We are excited about the first four stores in our 2017 class of stores, which we announced this afternoon. As John mentioned, these stores are in the following locations, Cedar City, Utah, Moses Lake, Washington, Morgantown, West Virginia ,and Wilmington, North Carolina. Work on our 2017 class of stores is well underway and we expect to announce additional 2017 store locations in the near future.

Turning to our same-store sales by each of our three store groupings, which are one, base stores, two, new stores or acquired stores that have been in the comp base for two years or less, and three, stores that were subject to competitive openings, which we define as a new competitive entrant into a market within the past 18 months. In the second quarter, excluding the eight stores in our comp base that were subject to new competitive openings, our same-store sales increased 5% compared to the second quarter of last year.

Our 39 base stores saw same-store sales increases of 4.6% in the second quarter. In addition, our 12 new stores saw same-store sales increase of 7.4% in the second quarter compared to the corresponding period of the prior year. Finally, our eight stores that were subject to new competitive openings experienced a same-store sales decrease of 8.3% in the second quarter of this year.

Gross profit increased 14.1% in the quarter to $66.2 million compared to $58 million in the second quarter of fiscal year 2015. During the second quarter of fiscal year 2016, gross profit as a percentage of net sales increased 20 basis points to 34.9% from 34.7% in the corresponding period from last year. This gross margin increase was due to lower freight costs and increased vendor incentives that were offset by a decrease in our product gross margin as a result of a sales mix shift to lower margin products, primarily firearms and ammunition.

SG&A expenses, excluding the reversal of a $4 million litigation accrual in the second quarter of last year, were $49.5 million in the second quarter of this fiscal year compared to $45.2 million in the corresponding quarter of last year. Excluding the reversal, SG&A expenses, as a percentage of net sales in the quarter, decreased to 26.1% from 27.1% in the corresponding fiscal quarter of 2015, primarily due to our ability to leverage our fixed payroll, rent and other operating expenses with the increase in sales.

Income from operations for the quarter increased to $16.7 million from adjusted income from operations of $12.8 million in the second quarter of fiscal year 2015. Our net interest expense in the second quarter of 2016 was $3.1 million compared to $3.4 million of interest expense in the second quarter of 2015. We recorded an income tax expense of $5.2 million for the 13 weeks ended July 30, 2016, compared to $5.1 million for the corresponding period of fiscal year 2015. Net income for the quarter was $8.3 million or $0.20 per share based on diluted weighted average share count of 42.5 million as compared to adjusted net income of $5.7 million or $0.14 per share based on a diluted weighted average share count of 42.3 million shares last year.

Adjusted EBITDA for the second quarter increased 28.5% to $22.3 million compared to Adjusted EBITDA of $17.3 million in the prior-year period. As of July 30, 2016, the end of our second fiscal quarter, ending inventory was $265.7 million as compared to $235.4 million as of the end of the second quarter of fiscal year 2015. On a per store basis, inventory decreased by 1.6%. During the second quarter of fiscal year 2016, we incurred approximately $15.4 million in capital expenditures.

Turning to our outlook. As John mentioned, we continue to expect the competitive headwinds to moderate in the second half of the year and remain encouraged by the positive trends that we have seen in the use categories of hunting and shooting and fishing, which we anticipate will continue. This momentum is balanced somewhat by our expectation that this Q2 strength in firearms will moderate in the back half of the year.

Taking these factors into account, our outlook for the third quarter includes five new store openings, revenue to be in the range of $212 million to $217 million, same-store sales increase in the range of 2% to 4% compared to the third quarter last year and earnings per diluted share of $0.23 to $0.26 on a weighted average of approximately 42.6 million estimated common shares outstanding.

For fiscal year 2016, we expect revenue of $780 million to $790 million, same-store sales in the range of flat to up 2% compared to fiscal year 2015 and adjusted earnings per diluted share of $0.70 to $0.76 on a weighted average of approximately 42.5 million estimated common shares outstanding. We continue to expect operating margins to be relatively flat year-over-year as we begin to invest in personnel and resources to allow for continued growth in 2017 and beyond.

We ended the quarter with $66.1 million in outstanding borrowings and $44.9 million in borrowing availability under our credit facility. As it relates to capital expenditures, we still anticipate incurring approximately $35 million to $40 million in capital expenditures in fiscal year 2016, which includes the 11 stores in our 2016 class of stores as well as work on our 2017 new stores.

With that, I'll now turn the call back over to the Operator to open up the call for questions.

Operator:

Thank you. At this time, we'll be conducting a question-and-answer session. If you would like to ask a question, please press star, one on your telephone keypad. A confirmation tone will indicate your line is in question queue. You may press star, two if would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys. One moment please while we poll for questions.

Our first question comes from Seth Sigman from Credit Suisse.

Seth Sigman:

Thanks guys. Good afternoon. Nice quarter.

John Schaefer:

Hi. Thanks.

Seth Sigman:

So as you think about how the quarter played out, clearly you performed better than you expected. I guess, what surprised you? You pointed to strength in firearms, but also improvements in camping and other categories. I think, you even mentioned a sequential improvement in apparel. So just wondering if you can elaborate on some of those trends?

John Schaefer:

Sure. I think we all saw the improvement in firearms sales in the back half of the quarter and you could see it in the NICS data. Our camping continues to show strong demand. We actually had a couple of categories where we ran out of product a little early which I mentioned and we've had very good discussions with our vendors to make sure that we have adequate supply for the hunting season in the fourth quarter.

So I think we are pretty pleased with the pickup in camping based both on part of it's weather that's getting better, but we also had a pretty tough compare in that category because we were pretty strong in the second quarter last year in camping as well. It just continues to be an area of the store that people are understanding that we're very good at and we have the product they want and they continue to come in and shop for that product.

The clothing is a couple of things. One is, we're not getting the inventory in the right position, where last year we kind of ran out and didn't have anything to liquidate in the first couple of quarters this year. So our inventory position, I think, on a go forward basis is much better, plus we're getting a lot of good traction with some of our private label products, especially in the Camel area which I think bodes well for not only the upcoming hunting season but into the next year and beyond because our private label in that good category is really starting to show customers that we have a high quality product that's very reasonably priced, which I think bodes well going forward.

So that was probably the area that I was most pleasantly surprised about was just the—while it's still a little bit negative, it was still the sequential improvement in clothing, I think, was a real win one for us in the second quarter.

Seth Sigman:

Okay. Then John, you noted that you have observed some deep discounting across the industry at some of your competitors. What do you think is actually driving that? Then your gross margins being up in the quarter, how are you able to navigate that from a merchandise margin perspective?

John Schaefer:

We've continued to maintain our promotional calendar and our strategy has always been to be the everyday low-price and I think as we've talked before when competitors both national and local begin to put items on sale, they come toward our pricing and we've just been able to manage our business such that we don't have to do that. I think, probably, it's certainly appeared there were some promotions going on to drive traffic within stores by certain competitors, both national and local and I think that's why the discounting went on. But when you start comparing the quality of the product and price versus price, we're still right there with them without having to discount and I think that's the real key for us. Frankly, what it does is it gets more people understanding that we truly are the everyday low price leader when we have pricing as good or better than promoted pricing without having to promote.

Seth Sigman:

Okay. Thanks a lot. Nice quarter.

John Schaefer:

Thank you.

Operator:

Your next question comes from Stephen Tanal from Goldman Sachs.

Stephen Tanal:

Hey, good afternoon guys. Thanks for taking the questions.

John Schaefer:

Hi Steve.

Stephen Tanal:

Hi. So just one thing on apparel, just following up on some of the comments there. It sounds like you guys are pretty lean at this moment. You're probably already buying for the hunting season and I guess you're going to get a nice, good, fresh assortment there. What are you seeing from the vendors? Is there a lot of newness out there? Is there a product that you're excited about? How you are looking at that?

John Schaefer:

There's not a lot of newness out there. I think, from our standpoint, we have a better read on the women and kids category than I think we had last year. All the stuff has been bought. I think, we've talked before about we overbought in 2014 so we underbought in 2015. I think we have the right amount coming in.

In terms of newness, there really isn't a lot of great stuff coming online. That doesn't mean it's not going to look new in our store as we add color ways (phon) and things. The newness I think that we're getting and maybe one of the reasons we're getting some traction is, I think, our private label Camel patterns are a little bit unique and are gaining some traction and that I think is the thing I'm most pleased about with our apparel going forward.

Stephen Tanal:

Awesome. That's helpful. Then you talked a little bit about your competitors and some of the promotions that are out there. I know some of what we've heard is really sort of permanent price reductions or at least that's the message. Is that what are you're seeing? Is there any ongoing impact from any of this stuff? Or do you feel like it was more kind of cut through the quarter?

John Schaefer:

I don't know if the pricing is permanent. If it is, we're still priced very competitively with it as shown by our performance. So I don't know that I can really comment on whether it's a permanent or a temporary. It certainly seems they've been going on for quite a while now. I mean if you'll recall the stuff started going on at the end of the third quarter of last year and we thought it was going to subside in the first half of this year and it really kind of never did. So maybe in fact it is permanent. But to me and I think to our customers it reinforces the fact that we are indeed the everyday low price leader in all categories and I think that serves to help us.

Stephen Tanal:

Awesome. Then just lastly for me. It sounds like there is still a little bit of cautiousness or conservatism, however you want to think about it in the back half outlook on the consumer, maybe still buying closer to need. I know oil markets were part of that outlook. Is there anything you see in there? I know you cycled some probably easier compares on that front. Any color there would be helpful. Thanks.

John Schaefer:

Well, I think, as it relates to the oil markets where we're going to start getting better comps is in the third quarter where it really started to hit hard last year. We didn't see a whole lot of that in the second quarter. Firearms are moderating. They're moderating back to what we would consider a normal level. The unknown is how fast is the hunting season going to grow and it's an unknown every year. So (inaudible) a little bit conservative as we go into the all-important hunting season, which is two weeks from now to really six weeks from now.

Weather will play a determination in terms of whether people are buying the heavier Camel and the higher price point gear if the weather turns bad. So there's always that little bit of unknown to deal with. So I don't know that we're being any more conservative than we ever have been. I think we're just basically saying, listen, we had certain expectations for the third and fourth quarter when we began the year and I don't know that there's anything that we've seen in our crystal ball that would tell us that those expectations should be different.

Stephen Tanal:

Awesome. Thanks a lot.

Operator:

Thank you. Our next question comes from Peter Benedict from Robert W. Baird.

Peter Benedict:

Yes. Hi guys. Thanks for taking the question. A couple here. First just on the third quarter outlook with respect to gross margin. Obviously, the margins have been very good. It would seem that maybe that's implied to have gross margins down. Is that right? Is that just because of the mix of firearms that you're expecting in 3Q?

Kevan Talbot:

Mix definitely is playing a role in that outlook. You are correct with your assessment there. It's flat to down slightly in the third quarter. Part of that has to do with the fact that the mix shift really is the biggest piece there. Soft goods plays a little bit into it but not much. But really, it's driven by the mix.

Peter Benedict:

Okay. Thanks, Kevan. Then the Eastern expansion, North Carolina, West Virginia, how are you thinking about that? Just can you take us through the thought process and why now and which? Should we be expecting even more markets in 2017 as the new markets get announced?

John Schaefer:

I think we've talked before that we see a big opportunity and a lot of similarities both starting on that I-10 corridor through the South of Louisiana, Mississippi, Alabama, Georgia and then up the Atlantic Seaboard. It's just really a matter of us—I mean we spent—I mean it's going almost three years looking at places in these areas. We've had some success with Slidell and Southaven and we like the area.

People are receptive to what we're bringing to the table and now it's a matter of just finding the right locations and getting the right doors opened. So as I think we've said before, it's been a strategy of ours and I think you're seeing kind of the first indication of that strategy coming to fruition.

Peter Benedict:

Okay, that makes sense. Last question, just back to the firearms. The complexion of the buyer, is that still kind of an existing owner who is just kind of adding to their assortment? Or are you seeing some new buyers come in? Just what's the trend in average ticket that you're seeing, John, in terms of the firearm sales? Thanks so much.

John Schaefer:

Well, we're seeing, if you look at all the surges and many surges over the last few years, there have been five or six of them. We've done a lot of analysis to try to figure out if there's any similarities between them and what it means both in terms of how long, how big the peak will be, how long it will last, if there will be a valley or if it will moderate, what the percentage of new people coming in versus existing buyers and I think the thing that we found with this most recent surge is it's placed somewhere in between the election of 2012, Sandy Hook where we had about 20% of the sales were new customers and the San Bernardino in January which was virtually all existing customers. It's not all existing customers like San Bernardino, but it's not 20% like the election and Sandy Hook. It's somewhere kind of in between. I wish I could be more definitive to that, but we're still kind of in that process and its moderating, but its moderating back to normal levels, so it's really kind to tough to tell.

Peter Benedict:

Well, that makes sense. Then anything on the average price or the average ring you're getting off the firearm sales?

Kevan Talbot:

As John mentioned, our average ticket went up clearly with firearms and our hunting and shooting category being 50% of our business that's driven by firearms that's there. So yes, with respect to that, we are seeing an increase in our average ticket as a result of the increase in firearms.

Peter Benedict:

Okay. Thanks guys.

Operator:

Thank you. Our next question comes from Daniel Hofkin from William Blair.

Daniel Hofkin:

Good afternoon. Nice results. Just to follow up a little bit on the third quarter guidance, just with the 2% to 4% comp expectation. I heard your comments about gross margin and mix. Is there anything from an SG&A standpoint or anything else that kind of keeps in check your earnings guidance for the quarter on a year-over-year basis? Then just one or two follow-ups.

Kevan Talbot:

As we've provided guidance for the year, all along we've spoken to an investment in personnel and resources in the back half of the year. We remain committed to that investment. So what you're seeing now is an increase in those personnel in that as we anticipate bringing on some additional people and some resources, particularly in the third and the fourth quarter here of the year.

So from an operating margin perspective, we're going to be relatively flat there. With respect to that, we've had some good gains here in the first half of the year, but we've planned all along and we've spoken to those investments and we intend to continue to prepare for our growth and be properly prepared for the future, which we feel like we're doing.

Daniel Hofkin:

Okay, great. Then just in terms of back to the inventory question. You've talked at times about sort of some increased inventory planning and allocation opportunities with some systems. Can you just update us on where that stands?

Kevan Talbot:

Yes. We've talken—spoken in the past—terrible English there. My apologies. We've spoken in the past with respect to trying to do a better job of planning. We clearly, through a knee-jerk reaction of our overbuy in 2014, underbought in 2015, we've made some tweaks within our systems to help us better in our planning and forecasting so that we can dial in those amounts that we need to buy a little bit better.

We feel like we've accomplished those changes within our systems. It was no major system overhauls. Just better utilization of the existing systems. Maybe a few additional reports here or there that's given us the information and given us comfort that we feel like we're going to be right-sized on our soft goods inventory in particular here going into the fall.

Daniel Hofkin:

Okay. Then lastly just to clarify, in terms of the firearms. You're already seeing some moderation back to normal growth trends. That's not just your expectation going forward?

Kevan Talbot:

That is correct.

Daniel Hofkin:

Okay, great. Thanks very much.

Operator:

Thank you. Our next question comes from Peter Keith from Piper Jaffray.

Peter Keith:

Hi. Thanks guys. Good quarter. I was wondering on the new store performance where I guess your stores that are in years two and three, the gap of outperformance ticked up. It was the best we've seen in over a year. I guess was there some dynamic that's beginning to emerge on that maturity curve that may be sustainable here?

Kevan Talbot:

As I drilled down into that detail and looking specifically at that phenomenon, two of our oil stores that were in the new store tailwind grouping in the first quarter, they hit their two-year mark and rolled out. So the oil stores, as we've addressed, has been significantly impacted there and may have been weighing down that new store tailwind performance.

Those two stores rolled out in the second quarter and so they're no longer in that store grouping. The gap between the base stores and the new store tailwind is getting closer to where our expectations are with respect to on a go-forward basis. It really primarily was a unique phenomenon. I think there's 12 stores in our new store tailwind and two of the 12 were oil stores.

Peter Keith:

Okay, that's helpful. I think each quarter you've given the drag from oil markets. I apologize if I missed it, but would you be able to give that to me?

Kevan Talbot:

Yes. It was approximately the same as it was last quarter. We're hoping for a little bit better of a sequential improvement as far as the drag goes but it was just a little bit higher than it was in the first quarter. The first quarter was about 90 basis points. We were up a little bit over 1% this quarter. Sequentially, the oil stores actually saw a lower decline than the other stores. So they improved, but they just didn't improve as much as our base stores did given the less disposable income and the consumers in those markets.

Peter Keith:

Okay. Great. One last one for me here. It still might be a couple of months early, Kevan. But on the overtime rule change, I'm wondering if you guys have come to any conclusions on how you may make adjustments or what, if any, impact there would be on expenses once that kicks in in December?

Kevan Talbot:

We've made some assessments. We've made some plans. We're doing some testing. Once we know the result of this testing, we'll be able to speak further with respect to specific guidance there to what, if any, changes are going to occur with respect to our cost structure. So as of today, we don't have any definitive answers to give there other than we're testing some changes and once we see the results of this we'll be able to speak better towards those changes that occurred later in the fourth quarter.

Peter Keith:

Okay. Sounds good. Thank you very much.

Operator:

Thank you. Our next question comes from Patrick McKeever from MKM Partners.

Patrick McKeever:

Thanks very much. Just a couple of questions. First on just the unit growth outlook, the 10% longer term. As you open more of the smaller stores, the 15,000 square foot stores, does that change your thoughts around unit growth? Are you thinking more square footage growth with that new format in place and doing well? Then the second question is just on, if I recall correctly, the shotgun business was soft in the third quarter of last year with waterfowl hunting, I think, affected by the dry conditions in many of your markets. So just an update on where things stand with the lakes and the outlook for that particular business in the third quarter.

John Schaefer:

Sure. I'll answer the weather question first. The spring had some nice rains. A lot of the fisheries opened. The summer has been a little dryer than we had hoped. It's been a little warmer than we had hoped. The 90-day outlook is both drier and warmer in the Western United States and into Alaska. That said, I think the overall condition for those types of hunts is better this year than it was last year. I wouldn't categorize it as great. I would simply categorize it as better than it was. I don't know that we have a whole lot more that you can really add to that.

On your first question about the unit growth. I think we want 10% unit growth. I think we look at opportunities in 30s and 50s. To the extent we have to have 12% or 13% unit growth to get 10% square footage growth, we can certainly manage that. Whether we choose to do that or not I think is going to be based on the locations, the timing of the openings, other various considerations.

But we're very close to the point where we're going to start talking about square footage growth with a 10% square footage objective as opposed to unit growth once we probably in another year as we get enough of the 30,000 and 15,000 square foot stores on a pace where we know what the percentage of new stores are going to be; 30 percentage of new stores are going to be 15% going forward. So we're kind of playing it a little bit both ways as we sit here right now. It's not going to bother me if you talk about 10% square footage growth any more than it bothers me if you talk about 10% or 11% unit growth.

Patrick McKeever:

Okay. Then just on, I guess this quarter has been asked in different ways. But on the guidance, the flat to up 2% for the year, that's unchanged from before, but the second quarter was better than expected. The third quarter outlook I think is a little bit above where most of us are modeling. So that implies a softer fourth quarter. Is that largely conservatism around the strong firearm sales that you had in last year's fourth quarter and some of the pulling forward of demand into that quarter that you talked about?

John Schaefer:

My perspective is that we're sticking to our guns in the third and fourth quarter. As I look at our guidance, we've brought up the lower end of our guidance because we're more comfortable moving to the middle the higher end of that. There's still that uncertain retail environment going on. We still have the big seasons of hunting and the holiday season in front of us. In the fourth quarter, as you know, had that San Bernardino surge, which we haven't modeled in any surge for a presidential election or any type of event, if you will, in that nature. So I don't think we're necessarily saying we're more conservative around Q4. I think we're basically saying we're comfortable with the year and here's how we see Q3 coming out as we sit here in August.

Patrick McKeever:

Okay. Thanks very much.

Operator:

Thank you. At this time, we have no further questions. I will turn the call back over to Management for closing remarks.

John Schaefer:

Well, I appreciate everybody on the call today. Thanks for listening and for your questions and we'll talk to you again. Thanks.

Operator:

Thank you. This does conclude today's teleconference. You may disconnect your lines at this time. Thank you for your participation.