Sportsman's Warehouse Holdings, Inc.

Third Quarter 2017 Earnings Conference Call

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CORPORATE PARTICIPANTS

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Kevan Talbot, *Chief Financial Officer and Secretary*

CONFERENCE CALL PARTICIPANTS

Kieran McGrath, *Credit Suisse*

Andrew Burns, *D.A. Davidson*

Patrick McKeever, *MKM Partners*

Ronald Bookbinder, *IFS Securities*

PRESENTATION

Operator:

Greetings and welcome to the Sportsman's Warehouse Third Quarter 2017 Earnings Conference Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. If anyone should require Operator assistance during the conference, please press star, zero on your telephone keypad. As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Rachel Schacter of ICR.

Rachel Schacter:

Thank you. Good afternoon everyone. With me on the call is John Schaefer, 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 under the caption Risk Factors in the Company's 10-K for the year ended January 28, 2017 and the Company's other filings made with the SEC.

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, 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 third quarter and then discuss our progress on our key priorities 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.

Our third quarter results were largely in line with our expectations as we again navigated a difficult operating environment. Though modestly fell short of our expectations, in part due to the timing shift for one new store from Q3 to Q4, comparable store sales were in line with our expectations. Our comp performance reflects the continued softness in firearms, and to a greater extent ammunition as we anniversaried difficult comparisons from the election run-up last year. This sales performance, combined with gross margin expansion, drove EPS in line with the low end of our guided range. We managed inventory well and paid down debt during the quarter, ending with a net debt to Adjusted EBITDA ratio of 2.78 times, a sequential decrease of 0.28 from the end of the second quarter.

Turning to our results, total sales grew 0.4% to $218.1 million for the third quarter. Same-store sales declined 7% versus the prior year, driven by continued softness in firearm demand which declined 12.4% for the quarter and even more pronounced weakness in ammunition demand which was down 19.4% for the quarter.

Drilling down further on the composition of same-store sales, the weakness in firearms was reflected in the NICS data which showed still slow firearm demand for the third quarter as a result of the difficult comparisons in the prior year due to the election run-up. For the quarter NICS demand in the in which we operate decreased 15.2% while our firearm unit sales decreased only 3.4%. Our overall comp decline of 7% was again driven by our hunting and shoot department. If we exclude our hunting and shooting department, our other departments were up 0.2% on a same-store sales basis for the third quarter. As we've consistently said in the past, despite the short-term volatility in firearm demand, the long-term underlying demand trend in the hunting and shooting category remains strong compared to historical levels fueled by increased participation rates in outdoor shooting sports for more women and children, and also increased firearms sales in the use category versus protection purchases.

For the third quarter, our non-MSR rifle and shotgun sales increased 6.6% on a same store sales basis versus the third quarter of the prior year. We believe this reflects the more consistent trends within this area of firearms.

In terms of ammunition, the 19.4% decline we experienced in Q3 we believe in large part reflects customers' reluctance to purchase ammunition at full price, which has risen rather dramatically over the past seven years. When we ran periodic promotions in the ammunition category, both as part of our normal promotional calendar and as incremental tests, we saw good results. We believe this is a structural pricing issue and we have been working with our vendor partners to determine the most appropriate long-term course of action to bring ammunition sales back into historical alignment with firearm demand. We have seen movement in this area from our vendors in Q3 which we believe will translate into better pricing for the consumer beginning in early 2018.

The new store competition cohort within our store base also negatively affected comps in the third quarter by 90 basis points, given the impact of competitive openings on two additional stores during the quarter.

As a reminder, this is the segment of stores within same store sales that are negatively affected by new competition in a particular market until approximately the 18 months mark, at which point the impact begins to diminish. These two new openings are the only stores we expect to be impacted by new competition in Fiscal Year 2017, resulting an approximate 100 basis point headwind for the year, down from five stores in Fiscal Year 2016 or 170 basis headwind that we experienced in Fiscal Year 2016.

Our oil and gas market stores provided a 36 basis point tailwind to our comp in Q3, representing a continued sequential improvement from the 13 basis point tailwind in the second quarter. We expect continued improvement for the remainder of the year as we anniversary easier comparisons in these markets.

Turning to our category sales performance, while the hunting and shooting segment of our business saw continued weakness in Q3, we are encouraged by the strength we saw in other categories. We continue to be pleased with our footwear and clothing categories which are our highest margin categories. For the quarter, footwear increased 1% on a same-store basis and clothing decreased 1.1% on a same-store basis given we lapped a difficult comparison of a 5.2% increase in the prior year period. However, on a two-year stacked basis, clothing increased by 4.1%. Our fishing category increased 4.3% on a same-store basis, now that the water flows have returned to normal levels and the run-off issue is behind us. We are also pleased with our camping category performance in the third quarter. That increased 0.2% despite being impacted by the wild fires in the west, particularly in Northern California.

We are continuing to capitalize on the market share opportunity available to us as the industry is rationalizing with in the outdoor sporting good niche. We are uniquely positioned within the space given our convenient and relevant stores that provide a differentiated in-store shopping experience through an unparalleled breadth of brand name products, every day low pricing and knowledgeable customer service. Also, our flexible store format provides us the opportunity to reach customers in smaller markets that are often more difficult to enter for other players.

From an online perspective, we believe we are well positioned against the online only competitors given our many moats around the business. We know that our customers use our site as a research tool ahead of purchasing, especially within the hard goods categories, which ultimately drives traffic in-store give the nature of our product and our customers' desire to see the product, and also the requirement for an in-person background check to complete any firearms transaction. This background process excludes approximately 30% of our revenue from being sold online given restrictions around firearms and ammunition. Also, many of our heavier hard goods products can require costly shipping, or oftentimes, these purchases have a more immediate use so the customer needs it right away. In addition, our everyday low pricing is competitive if not better than online only players.

So, given the industry rationalization we're seeing, especially in the Midwest, we continue to see significant opportunity to build on our market share gains through both our physical store presence and our ability to attract more online customers with buy online/pick up in store, and we saw continued momentum in our online business in Q3.

In terms of our strategic priorities, we are pleased with the progress we continue to make against these key priorities that are centered on three major objectives. One, driving same-store sales through activities such as our loyalty program and private label that are designed to increase traffic, average ticket and conversion in all areas of our business. Number two, elevating our omnichannel experience through both store growth and an increased pace of ecommerce development. Three, paying down our term debt and reducing our leverage to our longer term goal of under 2 times.

Touching briefly on our loyalty program, we ended the quarter with approximately 1.5 million loyalty members, up 30% from approximately 1.1 million loyalty members last year. Revenue from our loyalty member transactions now accounts for approximately 45% of total sales and our personalized and targeted marketing strategies aimed at our loyalty member customer base are proving to be effective.

On the store front, with the opening of 12 stores to date, we have now completed our 12 planned openings for 2017. Looking ahead to Fiscal 2018, as previously announced, we have moderated our new store plans and will be opening five stores next year, the low end of the five to nine planned 2018 store openings we had previously discussed. With this prudent moderation, we plan to allocate more free cash flow to debt paydown in Fiscal 2018.

Turning to our ecommerce business, we are very pleased with the traction we are gaining in our small but growing ecommerce segment which grew to $2.7 million from $2.2 million in prior year period, an increase of 21.9%. Our online gun assortment is now approaching 7,500 firearms. This continues to drive traffic to our site and to our special order firearms which remained approximately 50% of our guns sold online and picked up in store in the third quarter. We remain on track to have one of the largest online firearm offerings of all online players by year end, further deepening the moat around our business. Jon Barker, our President and COO, continues to elevate our omnichannel offering and capabilities. He has been focused on assortment expansion across multiple categories, improved data analytics and enhanced mobile capabilities to help drive sustainable top line growth.

As discussed previously, we also believe there's an opportunity to create potential incremental revenue streams through our ecommerce site. While it is still early, we are collaborating with our vendors and ecommerce developers to expand our product offering as well as our customers' online experience. We are working towards building a bigger offering of everyday low-price product that is relevant to our customer, drives increased attachment rates and spurs in-store visits.

So, overall, while the softness in the firearm and ammunition category continued into the third quarter, we saw increases in our footwear, fishing and camping categories. Importantly, we expanded gross margins in four of our six categories, delivering EPS within our guidance range, albeit at the low end. We ended the quarter with inventory down 8.7% on a per store basis and reduced debt by approximately $24 million during the quarter. We are encouraged by the progress we continue to make against our key priorities and remain focused on continued execution and delivering sustainable long-term growth.

In terms of the remainder of the fiscal year, we are modifying our expectations for Q4. While the difficult firearm comparisons that we anniversaried through the first three quarters of Fiscal Year 2017 will be behind us, we are seeing a heightened promotional environment and we'll discuss our guidance in more detail.

Before turning the call over to Kevan I want to thank all of our team members for their tireless dedication to serving our customers. 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 third quarter results and then discuss our outlook for the remainder of Fiscal Year 2017. 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.

Net sales for the quarter increased 0.4% to $218.1 million from $217.2 million in the third quarter of last year with a same-store sales decrease of 7%. As John mentioned, sales came in lower than expected, partially due to the delay in the opening of our Pueblo, Colorado store which shifted from Q3 into Q4. We opened three stores during the quarter and ended the quarter with 86 stores in 22 states or a square footage growth of 1.8% from the end of the third quarter of Fiscal Year 2016. The store openings in the third quarter were: Spokane Valley, Washington; Stockton, California, and Visalia, California. The last of our 12 store openings for this fiscal year opened subsequent to the end of our quarter on November 9 in Pueblo, Colorado.

For Fiscal Year 2018 we are planning to open five stores total or approximately 3% square footage growth. With this morning's announcement of a location in Anderson, South Carolina, we have now announced three of the five locations that we intend to open in Fiscal Year 2018. This future site in Anderson, South Carolina joins the previously announced locations in Sheridan, Wyoming and Walla Walla, Washington. We will announce the remaining two locations as the lease agreements and permits are finalized in the new few months.

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 third quarter, excluding the four stores in our comp base that were subject to new competitive openings, our same-store sales decreased 6.1% compared to the third quarter of last year. Our 50 base stores saw same-store sales decreases of 6.4% in the third quarter. In addition, our 21 new stores saw a same-store sales decrease of 5.1% in the third quarter compared to the corresponding period of the prior year. Finally, our four stores that were subject to new competitive openings experienced a same-store sales decrease of 16.7%.

As John mentioned, our competitive headwinds were approximately 90 basis points during the quarter, representing a 90 basis point improvement from the 180 basis point headwind in the third quarter of last year.

Gross profit increased 3.6% to $77 million compared to $74.3 million in the third quarter of Fiscal Year 2016. During the third quarter of Fiscal Year 2017, gross profit as a percentage of net sales increased 110 basis points to 35.3% from 34.2% in the prior-year period due to product margin expansion as well as mix shift away from firearms and ammunition towards higher margin products.

SG&A increased 6.9% to $57.4 million for the third quarter of Fiscal Year 2017 from $53.7 million in the third quarter of Fiscal Year 2016. As a percentage of net sales, SG&A expenses in the quarter increased approximately 160 basis points to 26.3% from 24.7% due to a combination of the higher wages due to increases in state minimum wages as well as the impact of the fixed costs deleveraging.

Income from operations for the quarter was $19.5 million as compared to $20.5 million in the third quarter of Fiscal Year 2016. Our net interest expense in the third quarter of 2017 was $3.5 million compared to $3.4 million in the third quarter of 2016. We recorded an income tax expense of $6.2 million for the 13 weeks ended, October 28, 2017 compared to $6.6 million in the corresponding period of Fiscal Year 2016.

Net income for the quarter was $9.8 million or $0.23 per diluted share based on a diluted weighted average share count of 42.6 million as compared to $10.5 million or $0.25 per share based on a diluted weighted average share count of 42.6 million shares last year. Adjusted EBITDA for the third quarter decreased to $25.1 million compared to $26.1 million in the prior-year period.

Turning to our balance sheet, as of October 28, 2017 ending inventory was $318.3 million as compared with $304 million as of the end of the prior-year period. On a per store basis, inventory decreased by 8.7%. This continued reduction in inventory is consistent with the execution of our inventory strategies that have adjusted to the current levels of demand for our products. This reduction in inventory led to the generation of approximately $7.5 million in positive cash flows from operations for the 39 weeks ended October 28, 2017, compared to cash flows used in operations of approximately $15.1 million for the 39 weeks ended October 29, 2016, an improvement of approximately $22.6 million year-over-year.

Our liquidity remains strong as we ended the quarter with $78.5 million in outstanding borrowings on our $150 million credit facility. During the third quarter, we paid down approximately $23.3 million on our senior secured revolving credit facility.

We incurred approximately $7.4 million in capital expenditures during the third quarter.

Turning to our outlook, as we look toward the remainder of Fiscal Year 2017, we are considering the following items in our guidance. For the fourth quarter, as John mentioned, we expect the promotional environment to remain heightened and also anticipate ammunition to continue to be a headwind. Therefore, we expect to see pressure on our sales and gross margin.

We anticipate the negative impact from new competitive stores to our same-store sales to be consistent with the third quarter. For the full-year, we still anticipate the impact of new competition to be approximately 100 basis points down from the 170 basis point headwind in Fiscal Year 2016.

We expect the modest tailwind we experienced in Q3 from our stores in the oil and gas markets to continue into the fourth quarter. As we've said in the past, our full-year guidance includes $1.5 million to $2 million in SG&A due to state minimum wage increases that is impacting 56 of our stores.

Taking these factors into account, our outlook for the fourth quarter is as follows. Revenue in the range of $240 million to $245 million; a same-store sales decline in the range of down 4% to down 6% compared to the fourth quarter of last year; and diluted earnings per share of $0.26 to $0.29 on a weighted average of approximately 42.6 million estimated common shares outstanding.

For Fiscal Year 2017 we expect revenue of $807 million to $812 million, which includes $9 million to $11 million of revenue from the 53rd week. On a 52-week basis we expect a same-store sales decline in the range of down 6% to down 7% compared to Fiscal Year 2016. Our Fiscal Year 2017 expectations for adjusted earnings per diluted share are $0.56 to $0.59 on a weighted average of approximately 42.6 million estimated common shares outstanding. Our earnings per share guidance includes approximately $0.01 from the 53rd week in Fiscal Year 2017.

As it relates to capital expenditures, we expect to incur approximately $40 million to $43 million in total capital expenditures in Fiscal Year 2017 or net capital expenditures of $20 million to $23 million inclusive of approximately $20 million in deemed sale-leaseback transactions and landlord incentives that we expect to receive for the year.

Our Fiscal Year 2017 capital expenditure expectations includes the 12 stores in our 2017 class of stores as well as some of the construction costs related to the five new stores which we expect to open in 2018.

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

Operator:

At this time, we will 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 the question queue. You may press star, two if you 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 of Credit Suisse. Please proceed with your question.

Kieran McGrath:

Good afternoon guys. This is Kieran McGrath on for Seth. Just two quick questions from me. Firstly, on the firearms category, are you seeing any evidence that demand has started to stabilize as we anniversary the election? Then, related to that, can you speak on the inventory type levels you're seeing in the channel? The second question is just on the weather. What kind of weather have you baked into your guidance here for Q4? Any color there would be appreciated. Thank you, guys.

John Schaefer:

I think we're starting to see the ending of the last peak in MSR increased demand and we're going to start seeing in 2018 I think a more normal level of MSR demand. I think that's one of the reasons that while the hunting category is down, the use firearms, the hunting firearms and the shotguns on a unit basis were actually up over 6% from us.

The handguns I think are also going to continue to be down and I think that's probably going to go into 2018 a little longer because, again, those are for concealed carry and for protection and I think we're going to see a moderation in the protection purchases as we go through 2018. Now luckily, where we have our stores, we're skewed away towards the use category so I don't think the impact will be as severe for us as it may be for others.

As it relates to inventory in the channel, I think the inventory is working its way through. It's taken a little longer than we had thought. A number of the mom and pops early in the year we thought would be putting firearms on sale and getting rid of them by the end of the first quarter or second quarter, that's continued through the third quarter, and I think there's also the consolidation of the business with the undergoing out of business in the Bass and Cabela's combination, there's going to be some movement from a promotional standpoint to reduce inventory in the channel through that mechanism as well.

I don't know that we are predicting anything in terms of weather to be impacting the fourth quarter. Everything we've heard is it's going to be a pretty normal weather pattern for Q4 so we haven't really built anything from a weather standpoint into our guidance.

Kieran McGrath:

Thanks. I appreciate that.

Operator:

Our next question comes from Andrew Burns, D.A. Davidson and Company. Please proceed with your question.

Andrew Burns:

Good afternoon. Just a question on the promotional activity that you're expecting in the fourth quarter. Looking at the past two holiday seasons there was certainly a heightened promotional environment. You fared fairly well given your everyday low pricing strategy, so could you highlight a little bit more about what part of this season's promotional activity is seemingly a little more impactful than perhaps past seasons.

John Schaefer:

I think the types of products that are being promoted this year, especially by a major competitor of ours are a little different than last year, and I think that's probably due to trying to clear out some inventory, so I think that's something that we have to acknowledge and deal with. Usually the promotions on the key product categories are usually pretty consistent across the channel, but I think there's some unusual things, one time things going on this quarter as it relates to inventory rationalization from a couple of our major competitors that we have to be aware of and have to be ready to address.

Andrew Burns:

Okay, thanks. Then as you look at the hunt category into next year, it sounds like ammunition is likely to remain a headwind. Use-driven gun purchases seemed to have turned the corner but handguns and probably like the MSRs continue weakness. Is it fair to think that we should think about the hunt category remaining under pressure even as we move past this whole anniversary impact in early next year?

Kevan Talbot:

Andrew, with respect to how things play out next year, we'll provide more color on our year-end call. As we sit here today, certainly there are some headwinds and some factors that you've enumerated there that we are watching very closely. As to exactly how it turns remains to be seen.

With respect to the performance of the hunt category, it performed very strong for us in the third quarter. We are, as John mentioned, concerned about the heightened promotions going into the fourth quarter, which obviously will impact those categories as well. So, we will continue to monitor the situation closely and provide a little bit more color based upon what we're seeing through the fourth quarter and our look into all of 2018 on our year-end call.

Andrew Burns:

Okay, thanks.

Operator:

As a reminder, we are now 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 the question queue. You may press star, two if you 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 next question comes from Patrick McKeever, MKM Partners. Please proceed with your question.

Patrick McKeever:

Okay, thanks very much. Just a question on the acceleration in online sales and what drove that. Was that primarily in firearms that are purchased online and then picked up in store, or have you done things in other categories as well to drive that? What are you thinking as we move into next year in terms of how the site and the offering evolve?

Then my second question is just on the Bass Cabela's merger. Do you have any clearer sense as to what might happen there as it relates to potential store closures or the pace of new store openings? Those sorts of things.

John Schaefer:

Let me answer the second question first because it's very short. We don't know anything more than I think anybody else knows. Any sources we have are basically maintaining status quo, almost as if it's still two separate companies, so I don't know that we know anything more definitive than anyone else would know at this point.

Kevan Talbot:

Patrick, with respect to your first question, just as a matter of policy, our online firearms, because the transactions are consummated in the stores, any online firearm transactions, that revenue gets reported as retail revenue, not as online revenue. The consumer has to come into our retail locations to complete the background checks and consummate that transaction so all of that revenue is there.

That being said, we did see an increase in our online firearms that helped us with respect to our same-store sales. The increase that we're seeing there is in all departments. All departments were up. We have made some changes with respect to partners that we have used, with respect to PPC, other online strategies that are there, and we're starting to realize the benefits there.

Again, it's a small number but we have seen an increase in the assortment. We've seen an increase in the benefits coming from our service providers and that is resulting in increased online revenue that we saw this past quarter.

Patrick McKeever:

Then just a question on the cadence of firearms sales last year post the election. Can you just remind us of how the months shook out in the fourth quarter for your firearms business?

Kevan Talbot:

I don't have the monthly mix data in front of me. We don't disclose our own monthly data, we simply disclose that on a quarterly basis. However, our data tracks fairly closely with the NICS data. So, I don't have that in front of me but I would refer you back to the NICS data from last year. If I recall, the NICS data was strong in November and then it fell off in December and January.

Patrick McKeever:

Right. Okay. I have that data. Thank you, Kevan. Appreciate it.

Operator:

Our next question comes from Ronald Bookbinder at IFS Securities. Please proceed with your question.

Ronald Bookbinder:

Good afternoon and thank you for taking my question. I was wondering on the gross margin expansion, how many basis points came from this shift away from firearms and how many basis points might have come from increased IMU or increased private label?

Kevan Talbot:

Absolutely, Ron. My estimates as I analyze that data is approximately 52 basis points of our 110 basis points came from a product mix shift. That is down from the 75 basis points that we experienced in the second quarter. The remaining 58 basis points came from increased product margins. As John called out in his remarks, four of our six departments saw increases; the other two were just slight decreases. We're starting to realize the benefits of some of the opportunistic buys that we have referenced to. Our inventory position being where it is allows us to take advantage of deals that come our way from the vendor community, and we're starting to realize some of those benefits as we sell through some of that product. So, we're very pleased with our margin position through the third quarter.

Ronald Bookbinder:

Great. Thank you very much.

Operator:

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

John Schaefer:

Great. Well, I appreciate everybody being on the call today, and have a great rest of your day. Thanks very much.

Operator:

This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation and have a great day.