THOMSON REUTERS

EDITED TRANSCRIPT

Q3 2019 Sportsmans Warehouse Holdings Inc Earnings Call

EVENT DATE/TIME: DECEMBER 04, 2019 / 9:30PM GMT

CORPORATE PARTICIPANTS

Jon Barker *Sportsman's Warehouse Holdings, Inc. - President, CEO & Director*
Robert K. Julian *Sportsman's Warehouse Holdings, Inc. - Secretary & CFO*

CONFERENCE CALL PARTICIPANTS

Peter Jacob Keith *Piper Jaffray Companies, Research Division - Principal and Senior Research Analyst*
Peter Sloan Benedict *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*
Rachel Schacter *ICR, LLC - SVP*

PRESENTATION

Operator

Greetings, and welcome to the Sportsman's Warehouse Third Quarter 2019 Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded.

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

Rachel Schacter ***ICR, LLC - SVP***

Thank you. With me on the call is Jon Barker, Chief Executive Officer; and Robert Julian, 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 includes 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 a number of risks and uncertainties including those described under the caption Risk Factors in the company's 10-K for the year ended February 2, 2019, 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 SEC today, which is also available on the Investor Relations section of our website at investors.sportsmanswarehouse.com.

Now I'd like to turn the call over to Jon Barker, Chief Executive Officer of Sportsman's Warehouse.

Jon Barker ***Sportsman's Warehouse Holdings, Inc. - President, CEO & Director***

Thank you, Rachel. Good afternoon, everyone, and thank you for joining us today. I'll begin by reviewing the highlights of our third quarter performance and then discuss our strategic initiatives that are driving market share gains as well as thoughts on the remainder of the fiscal year. Robert 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 very pleased with our third quarter results, which were at the high end of our guidance on the top and bottom line, excluding the 8 recently acquired stores that were not included in our original outlook.

For the quarter, net sales increased 8.7% to $242.5 million driven by a 4.8% comp increase and 11 new stores, including 8 new stores acquired at the end of Q3. These 8 new stores were rebranded and grand opened as Sportsman's Warehouse locations in the last 2 weeks of Q3. The 8 stores saw a nice grand opening sales lift, which also contributed to our noncomp sales growth for the quarter.

Comparable sales increased 4.8%, which came in ahead of our expectations, partially due to an 80 basis point lift from generator sales in California driven by devastating wildfires and related power outages. Our thoughts are with everyone impacted, and we are grateful to the many first responders and our store associates who helped with the recovery efforts.

Continued strong performance across our mature stores and e-commerce platform were also notable comp drivers in the quarter. Gross margins were approximately flat with prior year period, including a modest benefit from sell-through of lower-cost inventory included as part of the acquisition of the 8 stores.

Operating expenses were impacted by 130 basis points of deleverage, largely attributed to preopening and transaction expenses associated with the 8 locations acquired. This resulted in adjusted diluted earnings per share of $0.25 for Q3 inclusive of a $1.05 headwind from the 8 acquired stores.

Our strong Q3 results and industry outperformance are a testament to the team's disciplined execution of our growth strategies combined with our unique positioning within a consolidating industry. Our focus and commitment to innovation across our business to drive customer acquisition and engagement is further differentiating us and the outdoor sporting goods industry and helping to strengthen our competitive positioning.

I will now highlight a few of these strategies and the progress we've made against them in the third quarter.

Beginning with our omnichannel strategy, which includes our stores and e-commerce platform, we continue to grow our store base and capitalize on the white space opportunity we see for our flexible store formats. As you're aware, during the quarter, we announced and closed on the acquisition of 8 new stores for a total purchase price of approximately $29 million. This was an opportunistic acquisition that allowed us to expand our store footprint in both existing and new markets, where we didn't already have a brick-and-mortar presence, such as New York and Pennsylvania. These markets were appealing given the well-established customer foundation in each of these respective markets.

The 8 stores were converted to Sportsman's Warehouse stores and officially opened on October 19 with grand openings at each on October 25 and 26. The grand opening celebrations were a great way to showcase our products and interact with new customers in each respective community.

In terms of unit economics, the 8 acquired stores are an average of approximately 50,000 square feet, which is larger than the average Sportsman's Warehouse store. We expect them to generate double-digit four-wall EBITDA margins and at least 20% ROIC consistent with the traditional Sportsman's Warehouse store hurdle rates. While these stores are still new, we are pleased with our performance thus far.

Following a period of investment in our omnichannel capabilities, technology and debt reduction over the past 2 years, we are excited to return to a more typical store growth pattern. With the acquired stores, we've expanded our store base by 11 stores or 13.6% square foot in fiscal 2019 to date, which is up from 5 stores or 3.9% square foot in fiscal 2018.

We have one additional store planned in the fourth quarter. This new store will be our first store launch under a new brand, legacy shooting center. This new brand concept will allow us to test a small retail store as well as an indoor archery and firearms range, appealing to a broad spectrum of shooting sports participants. The legacy shooting center will be in the same physical structure as our new corporate office in West Jordan, Utah.

Touching briefly on our e-commerce performance. We continue to be very pleased with the traction we've seen from our new website, sportsmans.com, as well as improved digital capabilities, including BOPUS, which increased over 80% in the quarter versus prior year. In addition, we are moving from a test to rollout phase for ship from store to home with 20 stores now utilizing this capability to improve transit time to our customers, reduced transportation expense and increased leverage on our inventory. We will continue to grow and enhance these features and keep you updated on additional progress.

Next, customer acquisition and engagement. We saw strong growth in our loyalty program in Q3. We now have over 2 million members, driving approximately 50% of our revenue. As an extension of our loyalty program, during the quarter, we launched our new Sportsman's Warehouse Explorewards Visa Card through a partnership with Alliance Data. This program provides greater access to credit for our customers and best-in-class benefits, including the ability to earn 5 points for every $1 spent in a Sportsman's Warehouse store or online at sportsmans.com.

Turning to merchandising. During the third quarter, we continue to expand our exclusive product offering, including a new hunting rifle package developed and launched with the support of key brands and a well-known influencer. The reception of this rifle by our customers has exceeded expectation, providing a right to win with proving our right to win within exclusive products.

As mentioned in Q2, the assortment expansion initiatives in our Killik, Marquee outerwear brand, and focus on camouflage for the fall season supported an increase in apparel sales, which Robert will discuss in his section.

Shifting gears to our Q3 comp performance and the composition of our third quarter comparable sales results. In addition to the 80 basis point generator lift I mentioned earlier in my remarks, firearms and ammunition sales increased 4.9% in Q3 2019. Firearm units across the company again increased over prior year. This performance continues to be a reflection of our dominant positioning within the firearms industry, leveraging our extensive offering and value-added services, including FFL partnerships and used firearms. These differentiators and our best-in-class shopping in-store and online at sportsmans.com are driving customer acquisition and engagement. For the third quarter, firearm units increased 3.9% driven by growth across a broad spectrum of firearms products.

In summary, we had a very strong third quarter and exceeded the midpoint of our guidance on both the top and bottom line. We are very pleased with the momentum of the core Sportsman's business as we continue to make progress on all of our growth initiatives. The underlying strength of our core business, combined with successful completion of the 8 new store acquisitions, further strengthens our competitive positioning, and we remain focused on building on our share gains moving forward.

As you saw in our press release, we are increasing our full year guidance, which Robert will discuss in more detail. We feel very good about our long-term positioning, but there are large competitors currently deemphasizing the hunting and shooting categories, creating short-term sales headwinds, which are reflected in our guidance. These changes in the competitive landscape are causing near-term sales pressure as these retailers sell-through inventory. However, given our growing brand and expanding reach through e-commerce and retail expansion, we are uniquely positioned to capitalize long term on the market share opportunities.

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

Robert K. Julian ***Sportsman's Warehouse Holdings, Inc. - Secretary & CFO***

Thank you, Jon. I'll begin my remarks with a review of our third quarter results and then discuss our outlook for Q4 and full year 2019. Most of the financial figures discussed on today's call are reported on a U.S. GAAP basis. In the instances where we report non-GAAP financial measures, we have reconciled the non-GAAP measures to the corresponding GAAP measures in our earnings press release, which we issued earlier today.

Also, please note that both our reported and projected results include the impact of 8 new stores that were open for business for the final 2 weeks of Q3 2019.

Third quarter 2019 net sales were $242.5 million compared to $223.1 million in the third quarter of fiscal year 2018, an increase of $19.4 million or 8.7%.

Same-store sales increased 4.8%, which was above the high end of our previously guided range of 1.5% to 4.5% growth. We saw same-store sales growth in every one of our product categories in Q3 2019. The fishing department had the highest growth rate at 9.0% led by rods and reels, terminal tackle and lures. The clothing category grew 8.3% compared to prior year led by men's hunting apparel, men's fishing apparel and men's sportswear. The camping department also showed strong growth at 6.8% led by generator sales, which was significantly impacted by the California fires and associated power outages. Firearms and ammunition sales grew 4.9% in the quarter versus prior year.

We ended the quarter with 103 stores operating in 27 states. Total square footage growth was 13.6% compared to the third quarter of fiscal year 2018. Q3 2019 gross profit was $84.2 million compared to $77.6 million in the third quarter of fiscal year 2018, an increase of $6.6 million or 8.5%.

Gross margin was relatively flat at 34.7% versus 34.8% in the prior year period. Gross margin in Q3 2019 included a lift of approximately 10 basis points due to the discount we received on the purchase of inventory when we acquired the 8 new stores.

SG&A expense of $68.3 million for Q3 2019 was an increase of $8.3 million or 13.8% compared to the third quarter of fiscal year 2018. This includes $1.9 million of preopening expenses and transaction costs related to the 8 new stores that opened at the end of the quarter.

We incurred additional payroll expense of $4.0 million primarily due to minimum wage and benefit increases plus new store growth. Rent expense increased approximately $0.7 million primarily due to new store openings. Other operating expense increased approximately $1.6 million primarily due to incremental marketing expenses and software support fees.

As a percentage of net sales, SG&A increased approximately 130 basis points from 26.9% to 28.2%. This includes an 80 basis point increase for preopening expenses and transaction costs related to the opening of the 8 new stores.

Income from operations was $15.9 million or -- in Q3 2019 compared to $17.5 million in the third quarter of fiscal year 2018. Q3 adjusted income from operations was $16.3 million.

Interest expense in Q3 2019 was $2.1 million compared to $2.6 million in Q3 of the prior year, a reduction of $0.5 million. This improvement is the result of lower total borrowings primarily attributable to our inventory reduction efforts.

We recorded income tax expense of $3.3 million in Q3 2019 compared to $2.5 million last year.

Net income for the quarter was $10.5 million or $0.24 per share based on a weighted average share count of $43.2 million as compared to net income of $12.4 million or $0.29 per share based on a weighted average share count of $42.9 million last year.

Adjusted net income was $10.8 million or $0.25 per diluted share based on a diluted weighted average share count of $43.6 million in the third quarter of 2019 compared to adjusted net income of $11.1 million or $0.26 per diluted share based on a diluted weighted average share count of $43.1 million in the third quarter of last year.

Adjusted EBITDA for third quarter 2019 was $23.2 million compared to $22.6 million in the prior year period.

Turning now to the balance sheet. Q3 2019 ending inventory was $338 million as compared to $369 million at the end of third quarter of last year, a reduction of $31 million. Our Q3 ending inventory balance includes approximately $20 million of inventory related to the acquisition of the 8 new stores. On a per-store basis, inventory was down 18.2% compared to last year.

We had $13.4 million of capital expenditures during the third quarter of 2019 compared to $6.3 million in the prior year period, an increase of $7.1 million. This increase includes $5.3 million of furniture, fixtures and equipment acquired with the 8 new stores. The remaining increase is primarily associated with the build-out of our new corporate headquarters, for which, we expect to enter into a sale-leaseback arrangement by fiscal year-end.

Q3 year-to-date 2019 operating cash flow was positive $57.9 million versus negative $14.4 million for Q3 year-to-date 2018. This $72.3 million improvement in operating cash flow year-over-year is primarily due to tight working capital management of both inventory and payables.

Our liquidity remains strong as we ended the quarter with $131 million in outstanding borrowings and approximately $79 million of availability under revolving credit facility. The outstanding balance on our revolving credit line is $51 million lower at the end of Q3 2019 compared to the same period last year, even while utilizing this facility to fund the acquisition of the 8 new stores during the quarter.

The outstanding balance on our long-term debt was $30 million at the end of Q3 2019 compared to $38 million in the same period last year, a reduction of $8 million.

Turning now to our outlook for Q4 and fiscal year 2019. As you saw in our press release, we are revising our full year guidance to reflect our Q3 top line results, which came in at the high end of our guided range, the opening of 8 new stores, which occurred at the end of Q3 and the impact of the short-term competitive environment that Jon referenced earlier. We now expect net sales in fiscal year 2019 of $891 million to $901 million. In same-store sales growth in the range of flat to positive 1.0% compared to fiscal year 2018. We project 2019 adjusted earnings per diluted share of $0.55 to $0.61 on approximately 43.5 million diluted weighted average common shares outstanding.

Our outlook for the fourth quarter of 2019 is as follows: net sales in the range of $263 million to $273 million. Same-store sales growth of minus 1.5% to positive 1.5% compared to Q4 of fiscal year 2018. Adjusted net income in the range of $12.6 million to $15.3 million. Adjusted diluted earnings per share of $0.29 to $0.35 on approximately 43.5 million diluted weighted average common shares outstanding.

We expect net capital expenditures of approximately $22 million to $25 million in fiscal year 2019 with approximately $34 million to $38 million in gross capital expenditures, offset by $12 million to $13 million in landlord incentives and sale-leaseback transactions.

With that, I will now turn the call back over to the operator for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Peter Keith with Piper Jaffray.

Peter Jacob Keith ***Piper Jaffray Companies, Research Division - Principal and Senior Research Analyst***

Congrats on the nice results. I guess it seems like you gave us some quantification for the impact of the field and stream acquisition in Q3, which was about -- I'm taking that $1.9 million of expenses. But I'm looking more towards Q4, where you're calling for a little bit of comp in sales pressure, but some pretty healthy EPS. It looks like there's a pretty solid inflection in margin performance. So could you help us understand the impact of the field and stream stores on the model in Q4, if there is a big swing factor with better gross margins or better sales?

Jon Barker ***Sportsman's Warehouse Holdings, Inc. - President, CEO & Director***

Peter, it's Jon. Good to talk to you. There's 2 things influencing the margin outlook in Q4. One is the inventory purchased with the 8 acquired stores, we were able to purchase that at a discount to normal rates.

The other thing that is critical to understand, as we entered into Q4 holiday season of this year, we were better prepared than we've ever been on our marketing and our promotional cadence. And we've stayed true to that and kept our margins very solid. Some of that came from first cost of goods and rebate negotiations, some will stay with just a really clear marketing strategy. And we expect to stay with that marketing strategy and stay rigorous on our margins and our profit to the remainder of the quarter. So those 2 things combined are driving the optimism in our margin outlook for Q4.

Peter Jacob Keith ***Piper Jaffray Companies, Research Division - Principal and Senior Research Analyst***

Very helpful. And I guess on the -- as a follow-up on that field and stream discounted inventory, will you largely be sold through a majority of that by the end of Q4? Or should we expect some carryover into 2020 as well?

Robert K. Julian ***Sportsman's Warehouse Holdings, Inc. - Secretary & CFO***

Peter, the carryover to 2020 -- the fiscal 2020 will be minimal.

Peter Jacob Keith ***Piper Jaffray Companies, Research Division - Principal and Senior Research Analyst***

Yes. Okay. And then pivoting to a different topic on the competitive landscape. So we know Walmart has had a pretty high-profile announcement about deemphasizing the ammo category. Are you seeing some discounting of ammunition in the channel? And maybe furthermore, I know you have stores that are right next to Walmart. Are you seeing any sales benefits at this point from perhaps some market share gains?

Jon Barker ***Sportsman's Warehouse Holdings, Inc. - President, CEO & Director***

Yes. So Peter, good question. As you know, there's 3 major retailers that are assessing or have clearly communicated their desire to limit hunting and shooting sports. As you mentioned, Walmart is exiting categories around handgun ammunition and MSR/AR platform ammunition. We saw, in mid-November, the pricing start to get more aggressive from those stores. We are now seeing a situation where it appears that they are dwindled through that inventory at a price point that's very, very promotional. And our understanding is that the new receipts into Walmart have stopped. So over the next few weeks, we expect to see that ammunition be sold through. That's creating some, I'll call it, near-term pressure on ammunition pricing in that commodity class, which we are not chasing. We are staying with our everyday low pricing in our traditional promotional cadence. The exciting thing for us as we look forward to 2020, every one of our stores has at least one Walmart within 20 miles. The average distance is 8 miles, and in some cases, probably about a dozen of them, we actually share a parking lot more than a couple of hundred yards. So while near term, it is creating some pressure on the sales for that category, long term as they exit those categories, which we expect are somewhere between $250 million and $300 million nation-wide, there is a nice market opportunity for us to go after. We've -- as you can imagine, we've known for some time what's happening on that -- on their side of business through their press releases and our work with vendors. And we have already started to reforecast our inventory purchases to ensure that we maintain our in-stock positions and our margin positions in 2020.

Peter Jacob Keith ***Piper Jaffray Companies, Research Division - Principal and Senior Research Analyst***

Okay. That's very helpful and interesting. Maybe one last question for me. Jon, you had mentioned that the credit card launched, I think it was in October. The benefits that are presented on the website look quite attractive from a points perspective and interest rate financing. So curious on what the initial reaction is, maybe it's a little early, but as the card starting to resonate with consumers at this point.

Jon Barker ***Sportsman's Warehouse Holdings, Inc. - President, CEO & Director***

Yes. I can give you some color -- at this point, we're not prepared to give any data points. But what I can tell you, Peter, is the combination of the Visa card and the in-store credit has created an acceptance rate for our consumers that we've never seen before with our prior partners on the credit card so -- or in-store. So as you know, Alliance Data as the Visa card, the consumer is unable to qualify for the Visa card, we have an in-store Sportsman's Warehouse credit option throughout that's backed by Alliance Data. What I can tell you the response rate from the consumers and the acceptance rate is significantly better than we've experienced with our prior card that we had in the past and really right on track with our expectations as presented through Alliance Data. So we'll talk a little bit more about that at the end of -- at the next earnings call. I believe we launched that card right around the first week of October. So we only have a few weeks in, but we're really pleased with the progress.

Operator

(Operator Instructions) Your next question comes from the line of Peter Benedict with Baird.

Peter Sloan Benedict ***Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst***

I apologize if I missed this, I was some time away. But do you have -- can you give us a sense for what the field and stream revenue impact is in the fourth quarter plan? And then as we think about the 4Q EBIT margins, it seems like implied up maybe 75 basis points or so year-over-year. How is the gross margin look within that? And then just are you able to tease out kind of what the contribution is from field and stream?

Robert K. Julian ***Sportsman's Warehouse Holdings, Inc. - Secretary & CFO***

So Peter, this is Robert. A couple of comments. In Q3, we have -- this is part of our filings, we have disclosed that the field and stream stores contributed about $3.8 million of revenue in Q3. So we beat Q3 revenue by about $7.5 million versus the midpoint of our guidance. Let's say, half of it was the field and stream stores. Half of it was exceeding same-store sales growth at certainly higher than midpoint and even higher than the top end of our range. We are not disclosing how much the field and stream stores are projected to impact Q4. We do not want to get in the habit of reporting specifically the growth of any new store opening. The same way that we haven't provided specific sales numbers for Lansing or Fort Wayne and so on. Although there probably is some math that you can do to triangulate. We did effectively reduce our same-store sales growth outlook for Q4. And more or less, we're sort of projecting the baseline business to be flat to our outlook the last time we gave guidance. So you could probably triangulate something in there that the overall increase is probably due to some new stores, but we haven't provided more guidance than that specifically.

As it relates to gross margin, it is true that the discounted inventory that we received in this transaction has given a lift to margin in Q3. Over that 2-week time period, it had about a 10 basis point impact. I would say that the projected impact in Q4 is roughly 80 basis points or so. And so if you look at our gross margins, that is the lift that you would see in Q4 relative to that discounted inventory, which we expect to be sold out of -- primarily sold out of by the end of the quarter and as Jon said, probably will not impact our view of Q1 margins.

Peter Sloan Benedict ***Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst***

Got it.

Robert K. Julian ***Sportsman's Warehouse Holdings, Inc. - Secretary & CFO***

Hopefully, that answered your question.

Peter Sloan Benedict ***Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst***

Yes. No, no, that's great. That's excellent. I just maybe -- I mean there was -- you did a great job there kind of framing kind of the Walmart dynamic. Can you -- I mean is there a similar color? You can just at least frame how you are seeing kind of the other players who are stepping back, maybe the timing and the cadence of maybe when those headwinds might fall off.

Jon Barker ***Sportsman's Warehouse Holdings, Inc. - President, CEO & Director***

Peter, you cut out a little bit there. But I think your question was, the other retailers are deemphasizing, when that will happen, is that accurate? Is that your question?

Peter Sloan Benedict ***Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst***

Yes. Just any color around what they're doing and then when you see those processes being behind us.

Jon Barker ***Sportsman's Warehouse Holdings, Inc. - President, CEO & Director***

I can tell you, looking at the promotional activity that's happening by the 2 other retailers that we're referencing, there's a significant effort to reduce inventory, which I can only assume as part of a change in strategy in those categories. We do know that 1 of those 2 retailers has announced that they will close somewhere between 20 and up to 35 of their stores because it does not fit their strategic assortment goals. We know that there's other folks that are deemphasizing, and we are seeing that in their promotional materials and their marketing. We expect -- or we assume that a lot of that will flow through during Q4. They're taking advantage of the sales cycle and the traffic to move through this excess inventory. So that's part of our reflection of Q4 guidance is what we're seeing real-time from those retailers, and we expect them to be more normalized going into Q1 of 2020.

Peter Sloan Benedict ***Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst***

Okay. And then I guess my last question would just be around the recent background checks. There's always volatility in those. But more recently, we saw some, I think, maybe the one from last month were down a bit, but -- so your latest view maybe on a trend within background checks in the industry overall from that standpoint.

Robert K. Julian ***Sportsman's Warehouse Holdings, Inc. - Secretary & CFO***

Yes, Peter, I think -- again, sorry for the phone connection. I'm not sure if that's you or me. But I think your question is around the kind of cadence of mix checks. I believe November adjusted mix was up 2.1%. I can tell you that if you look state by state, there was some significant changes this year state by state. Specifically in the state of Washington, there was legislation passed at the beginning of November 2018 that was then enacted in mid-2019. If you look at the adjusted mix data, the state of Washington on adjusted mix in November was down 43% in firearm units background checks. So we've seen some pretty significant volatility in November, depending on which state you look at. We've seen some other states that are up in the double-digit range. Our business continued to be solid. We were pleased with our same-store unit expansion in Q3. And I can tell you, we're very pleased with the performance we saw over the key shopping holiday that we just went through.

Operator

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

Jon Barker ***Sportsman's Warehouse Holdings, Inc. - President, CEO & Director***

I want to thank everyone for their time today. A special thanks to all of our hardworking team members who contributed to our successful third quarter and are working diligently to serve our customers during this holiday season. Thank you, again, for your time.

Operator

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