Sportsman's Warehouse Holdings, Inc.

Second Quarter 2017 Earnings Conference Call

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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*

Peter Benedict, *Robert W. Baird*

Andrew Burns, *D.A. Davidson*

PRESENTATION

Operator:

Greetings and welcome to the Sportsman's Warehouse Second 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 with 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 second quarter 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.

Looking at our second quarter performance. Our top line results were in line with our expectations given the anticipated continued softness in firearm demand as we anniversaried difficult comparisons from the Orlando tragedy in June of 2016. Our better than expected bottom line results were driven by stronger gross margins resulting primarily from product mix shift from low margin hunting and shooting sales to higher margin clothing, footwear, and camping sales.

For the quarter, net sales grew 0.9% to $191.5 million and same-store sales decreased 9% with fully diluted earnings per share of $0.15. The same-store sales decline of 9% versus the prior year reflects a combination of the following two factors. First, the NICS data, which continued to show slow firearm demand for the second quarter, especially in June and July as a result of the difficult comparisons in the prior year due to the tragic Orlando shooting.

Our overall comp decline of 9% was again mostly driven by our hunting and shooting department, which contributed eight of the nine-point comp decline. That said, the July 2017 adjusted NICS data was still the third largest July on record and on a two-year stacks basis, the adjusted NICS data was up approximately 11.2% for the states in which we operate in the second quarter.

The two-year stack increase in our firearms sales during the second quarter was 28%. Despite a short-term decrease in firearm demand, the long-term underlying demand in the hunting and shooting category remains strong compared to historical levels and continues to be driven by increased participation rates in outdoor shooting sports for more women and children and also as a result of increased firearm sales in the use category versus protection purchases. In addition, the 12.8% year-over-year increase in our non-MSR rifle and shotgun unit sales in the second quarter is a testament to the more consistent trends within this area of firearms.

The second factor is the new store competition cohort within our store base. This is the segment of stores with same-store sales that are negatively affected by new competition in a particular market until approximately the 18-month mark at which point the impact begins to diminish.

This competitive headwind was 70 basis points in the second quarter. We continue to expect only two stores will be impacted by new competition in fiscal year 2017, resulting in a 100 basis point headwind, down from five stores in fiscal year 2016, or a 170 basis point headwind that we experienced in fiscal year 2016.

For the past several quarters, we have talked about a comp headwind from our oil and gas market stores. However, we are pleased that in the second quarter, we saw a 13 basis point tailwind from these stores. Though modest, it represents a continued sequential improvement from the 27 basis point headwind in the first quarter. We are monitoring these stores closely and expect continued improvement for the remainder of the year as we anniversary easier comparisons.

Turning to our category sales performance for the quarter. Our clothing and footwear categories continued to perform well and increased 5.9% and 2%, respectively, on a same-store basis during the second quarter due to the improvement in our inventory position in both categories compared to the prior year.

We saw sequential improvement in our fishing category in the second quarter compared to the softer category performance in the first quarter due to melted snowpack and flooded rivers in the West. The runoff was less of an issue in Q2 as water flows returned to normal levels and subsequently our fishing category decreased only 0.2% on a same-store basis. We now believe the runoff issues are behind us.

Turning to profitability. Gross margin increased 90 basis points for the quarter from the same period of the prior year primarily due to a favorable product mix shift to our higher margin products. Four of our six major departments saw gross margin increases this quarter versus the same quarter last year including our hunting department.

Operating income for the quarter was $14.2 million compared to operating income of $16.7 million in the prior-year period. Net income was $6.6 million or $0.15 per diluted share compared to net income of $8.3 million or $0.20 per diluted share in the prior-year period.

As you are well aware, the industry continues to consolidate within the outdoor sporting goods niche, which provides us the opportunity to continue to capture market share. We believe our unique positioning within the industry affords us the ability to do so, given our differentiated in-store shopping experience that provides our customers with an extensive offering of brand name products, everyday low pricing, and knowledgeable customer service.

Our convenience factor also continues to make our stores particularly appealing to our customers given the ease of shopping. We also continue to believe we are well-positioned against the online-only players given our many moats around the business.

Many customers use our site as a research tool, especially within the hard good categories, which ultimately drives traffic in-store given the customers' desire to see the product and also the requirement for an in-person background check to complete any firearms transaction.

As we said before, approximately 30% of our revenue has some element of online restriction to it. In addition, the hard goods nature of our major categories can be costly to ship or oftentimes is a purchase with more of an immediate use. For example, a customer needs fishing lures or other bait the morning before going fishing that day.

Also our everyday low pricing is often the same if not better in online-only players. So with the closing of a number of competitors, especially in the Midwest, we 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 free in-store pickup.

Turning to our strategic initiatives. We are pleased with the progress we continue to make against our growth initiatives and on looking ahead we see three major objectives that will be the main focus of our strategic priorities. First, we will continue to drive same-store sales through activities designed to increase traffic, average ticket, and conversion. Second, we will continue to elevate our omni-channel experience through both store growth and an increased pace of e-commerce development. And third, we will continue to pay down our term debt and reduce our leverage to our longer-term goal of under two times.

To that end, we are focused on the following initiatives to drive same-store sales. First, our loyalty program which again showed strong gains in the second quarter. As of the end of the second quarter, we had approximately 1.4 million members, an increase of approximately 33% over the prior-year period and transactions from our loyalty members continue to grow, representing approximately 43% of our net sales in the second quarter. We have also seen early success from more personalized and effective marketing strategies targeted to our loyalty member customer base, which we will continue to utilize going forward.

Second, private-label, we continue to be pleased with our private-label performance that represented 3.5% of our net sales or a 5% increase from the second quarter of last year. Our private-label product not only offers our customers better quality at better value, but also carries a higher gross margin as we—and we will continue to build these products in certain categories going forward.

And third, customer service. Our high quality customer service continues to differentiate us from the competition and we will continue to invest in our in-store associate training programs to maintain our high level of service.

In terms of elevating our omni-channel experience on the store front, we continue to see significant whitespace opportunity and the potential for at least 300 stores nationally. With the opening of 10 stores to-date, we have almost completed the 12 stores that we have announced for fiscal year 2017. These 12 stores total approximately 350,000 square feet or approximately 11% square footage growth year-over-year.

As announced on our first quarter call, for fiscal year 2018, we have moderated our store opening plans and expect to open between five and nine stores in fiscal year 2018 or a 3% to 7% square footage growth year-over-year. This prudent moderation will also allow us to allocate more free cash flow to debt paydown in fiscal year 2018.

Turning now to our e-commerce platform. E-commerce though still a small segment for us grew to $2 million in the second quarter from $1.9 million in the prior-year period, an increase of 6.9%. We are pleased with the traffic to our site with a positive response to our online gun assortment of 6,700 firearms and to our special makeup firearms, which increased to approximately 50% of our guns sold online and picked up in-store in the second quarter.

We expect to have one of the largest online firearms offerings of all online-players by year-end. Since Jon Barker has been on board as President and COO, he has been focused on elevating the omni-channel offering through assortment expansion across multiple categories, improved data analytics, and enhanced mobile capabilities to help drive sustainable top line growth. We will keep you updated on the progress of these initiatives.

With our brand focus and our moat, we are working with our vendors and e-commerce developers on creating potential incremental revenue streams by expanding our product offering online in an effort to keep our customers captive once on our website, which ultimately drives traffic in-store given the nature of our products.

We have two advantages that make this possible. First, our customers have shown that they like to compare brands before making a final purchase decision. With our map pricing, once the customer is on our site, there is no price advantage to buying the branded product either at the vendor site or other websites. Second and more important, our customers come to our site with specific needs in mind, which is primarily the case for firearms.

With the need to finalize a firearm purchase in-store and our ability to create an endless aisle for all our other vendor categories, it is simply easier for our customers to shop these products on our site and pick them up in-store with their firearm than it is to click out of our site and on to either the vendor site or other online-only sites. The opportunity to create potential incremental revenue streams will be a focus of our strategic objectives going forward.

So overall, the softness in the firearm and ammunition category continued into the second quarter. We navigated the business through a challenging environment, allowing us to achieve our top line guidance, and exceed our bottom line expectations. We are encouraged by the progress we continued to make against our stated growth strategies in the second quarter. And looking ahead, we continue to execute on key priorities as we focus on delivering long-term sustainable growth.

For the remainder of the year, we continue to expect softness in firearm demand until we anniversary the pre-election run up that caused increased demand in our firearm and ammunition categories in the prior year and are maintaining a conservative approach for the third quarter.

Before I end, I want to thank all of our team members for the great job that they do day-in and day-out. It is their commitment and dedication to Sportsman's Warehouse that continues to drive our success.

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 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 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 0.9% to $191.5 million from $189.8 million in the second quarter of last year with a same-store sales decrease of 9%. We opened four stores during the second quarter and ended the quarter with 83 stores in 22 states or a square footage growth of 12.2% from the end of the second quarter of fiscal year 2016. The four store openings in the second quarter were: Yuma, Arizona; Henderson, Nevada; Everett, Washington and Eureka, California.

Subsequent to the end of the second quarter, we have opened two additional locations, one in Spokane Valley, Washington and one in Stockton, California that opened this morning leaving us with only two additional stores to complete our 2017 planned store openings. We anticipate that these two stores will open during the third quarter.

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 five stores in our comp base that were subject to new competitive openings, our same-store sales decreased 8.3% compared to the second quarter of last year. Our 47 base stores saw same-store sales decreases of 8.9% in the second quarter. In addition, our 16 new stores saw a same-store sales decrease of 5.3% in the second quarter compared to the corresponding period of the prior year. Finally, our five stores that were subject to new competitive openings experienced a same-store sales decrease of 16.5%.

As John mentioned, our competitive headwinds were approximately 70 basis points during the quarter, representing a 100 basis point improvement from the second quarter of last year. Gross profit increased 3.7% to $68.6 million compared to $66.2 million in the second quarter of fiscal year 2016. During the second quarter of fiscal year 2017, gross profit as a percentage of net sales increased 90 basis points to 35.8% from 34.9% in the prior-year period, primarily due to a sales mix shift towards higher margin products.

SG&A increased 9.8% to $54.4 million for the second quarter of fiscal year 2017 from $49.5 million in the second quarter of fiscal year 2016. As a percentage of net sales, SG&A expenses in the quarter increased approximately 230 basis points to 28.4% from 26.1% due to the reduced leverage of fixed cost due to lower sales volumes.

Income from operations for the quarter was $14.2 million as compared to $16.7 million in the second quarter of fiscal year 2016. Our net interest expense in the second quarter of 2017 increased to $3.4 million compared to $3.1 million of interest expense in the second quarter of 2016. We recorded an income tax expense of $4.2 million for the 13 weeks ended July 29, 2017 compared to $5.2 million in the corresponding period of fiscal year 2016.

Net income for the quarter was $6.6 million or $0.15 per diluted share based on a diluted weighted average share count of 42.6 million as compared to $8.3 million or $0.20 per share based on a diluted weighted average share count of 42.5 million shares last year. Adjusted EBITDA for the second quarter decreased to $20.4 million compared to $22.3 million in the prior-year period.

Turning to our balance sheet. As of July 29, 2017 ending inventory was $302.2 million as compared to $265.7 million as of the end of the prior-year period. On a per store basis, inventory decreased by 4.1%. We remain pleased with the quality and quantity of our inventory position as we enter the third quarter of fiscal year 2017.

During the second quarter, we exercised the $15 million accordion feature and increased the borrowing capacity on our line of credit to $150 million. As part of this amendment to our line of credit, we also extended the maturity date and decreased the interest rate by 25 basis points and lowered certain fees on our line of credit as described in our 8-K previously filed with the SEC on July 24, 2017.

Our liquidity remains strong as we ended the quarter with $101.7 million in outstanding borrowings on our $150 million credit facility. During the second quarter, we incurred approximately $18.7 million in capital expenditures.

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 third quarter, we expect some improved demand in firearms relative to the second quarter. However, we expect the firearm demand will remain soft as we anniversary the run-up from the 2016 election last year.

We anticipate the negative impact from new competitive stores to our same-store sales to increase in the third quarter as we expect two stores to be impacted by new competition. However, 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 Q2 from our stores in the oil and gas markets to continue in the second half of the year. As we 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.

Lastly, as a reminder, fiscal year 2017 is a 53-week year. We estimate that the extra week will add $10 million to $12 million in revenue, which will result in approximately $0.01 in earnings per share for the year.

Taking these factors into account, our outlook for the third quarter is as follows. Revenue in the range of $220 million to $225 million; a same-store sales decline in the range of down 6% to down 8% compared to the third quarter of last year; and diluted earnings per share of $0.23 to $0.26 on a weighted average of approximately 42.8 million estimated common shares outstanding.

For the full fiscal year, as mentioned, we are on plan to open 12 new stores with square footage growth of approximately 350,000 square feet or an increase of approximately 11% over the prior year. We expect revenue of $825 million to $835 million, which includes $10 million to $12 million of revenue from the 53rd week. On a 52-week basis, we expect a same-store sales decline in the range of down 5% to down 6% compared to fiscal year 2016.

Our fiscal year 2017 expectations for adjusted earnings per share are $0.60 to $0.66 on a weighted average of approximately 42.8 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 $34 million to $38 million in total capital expenditures in fiscal year 2017 or net capital expenditures of $18 million to $22 million inclusive of $16 million to $18 million in deemed sale-leaseback transactions and landlord incentives that we expect to receive this year.

Our fiscal year 2017 capital expenditure expectations includes the 12 stores in our 2017 class of stores as well as work on our 2018 class of stores that will begin at the end of this fiscal year.

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'd 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 is from Seth Sigman of Credit Suisse. Please proceed with your question.

Seth Sigman:

Thanks a lot. Good afternoon, guys. So my question is around the third quarter guidance, you're guiding to a slight improvement here. It would seem that the second quarter ended perhaps on the weakest note just given the NICS data. I guess the question is, have you seen any sort of improvement in August that gives you confidence that that you're on this path to improvement even if just modest? Thanks.

Kevan Talbot:

Seth, as we look at the guidance, we look at the entire period. So we are aware of the trends. Obviously as they have tailed into August we don't speak specifically to specific months, but we're comfortable with that guidance based upon what we have seen in the trends and based upon the activities from last years in the things that we expect to see going forward.

Seth Sigman:

Okay. And then gross margin, obviously very well managed in the quarter despite a lot of competitors talking about promotional activity. Can you maybe help us quantify how much of the improvement was mix versus rate moving up within individual categories? And then just bigger picture, given the gross margin gains, how do you think about perhaps reinvesting some of those gains into price to accelerate market share gains? Thanks.

Kevan Talbot:

I'll take the first stab at it. With respect to your first question, approximately 75 basis point of the 90 basis points increase was due to a mix shift. As you look at our product sales mix, approximately 4% our sales as a percentage—our hunting category as a percentage of sales decreased by 4% this year versus last year. That 4% was shifted to all higher margin categories and by my calculations that's approximately 75 basis points there. So we are benefiting from a gross margin perspective, absolutely, with respect to that.

John Schaefer:

Seth, I think taking margin in terms of pricing promotion and playing this race to the bottom that some others appear to be accepting is not in our DNA. If you look at the facts, the facts are pretty clear. Mix has gone up 11% on a two-year stack basis. Our unit sales have gone up 28%. We are in the use category strongly not in the protection category.

And to cut price on firearms to try to stimulate artificial growth in a period of time that both is not a high purchase time of year and it's just before a high purchase time of year in the September/October timeframe with hunting simply doesn't make sense. We're not—if people don't want to buy, they're not going to buy.

That said on the ammunition side, I've talked for a number of months on how we believe that the promotional type target shooting, loads on the ammunition side are overpriced. The vendors, we have consistently said need to lower their price on those high volume categories, whether it would be the 5.56 or the 2.23 or things like that. They have yet to do so, which is actually quite shocking to me.

And I think if we do any promotions, it may be in the ammunition side because it is clear that while changes in firearms are usually matched after a period of time by changes in ammunition, that change has not occurred yet and it's simply because the customer is saying the price is too high. So we may get back some margin on the ammunition side, but I see absolutely no reason to give it back on the firearm side.

Seth Sigman:

Okay. Thanks for that. Nice job, navigating a tough environment.

Operator:

Our next question is from Peter Benedict of Robert W. Baird. Please proceed with your question.

Peter Benedict:

Hi, guys. Yes, related to kind of the promotional environment and John, how are you thinking about demand pull forward in the market firearms? I mean clearly it doesn't sound like you're doing the promotions, but others are. So that's kind of my first question. And then my second one, is really more around inventory and the accounts payable, the payables ratio down big. Just curious if you guys are taking advantage of early pay discounts or what's driving that? Thank you.

John Schaefer:

Sure. We haven't seen any indication of demand pull forward. What we're seeing is the same stuff we saw a couple of years ago where the independents are trying to create cash and that's been going on for a while now. When they start doing promotions and when our competitors start doing promotions that they're bringing their price down to our everyday price.

So the demand—we haven't seen any instances in terms of unit demand or in the types of products being purchased on the firearms side that would lead us to believe that there's any pull forward going on, on the firearms side. We don't have the issues that some people have, where they have to promote because of the Gander closing.

We only have three stores that were impacted by Gander and frankly all three of those stores are just fine. We're not in the Midwest, where other competitors are probably seeing a larger impact from those liquidation sales and are being forced to promote their way down to compete with that.

Kevan Talbot:

Peter, with respect to your second question, yes, you're exactly right. We are seeing quite a bit of opportunities for early pay discounts and particularly with the increased availability that came with the increase in our line of credit. We are taking advantage of these and so that's what you're seeing there with respect to the accounts payable. We're making that up through terms discounts and early pay discounts and we are taking advantage of those items.

Peter Benedict:

Okay, great. And just one follow-up, if I could. How are trends in the camping category? Can you give us maybe what the comps were in 2Q for that and what kind of trends you're seeing there? Thank you.

Kevan Talbot:

Camping was down 3.7% on a same-store sales basis during the quarter. Access early on in the year was a bit of an issue with the high snowpack in the West. We have had a little bit of fire certainly not to the extent that we had last year, but that also limited the access and limited the sales in the camping department. Overall, we're still pleased with where we are in the camping department and expect good things as we continue to go forward with the rest of the year.

Peter Benedict:

Okay, great. Thanks guys.

Operator:

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

Andrew Burns:

Thanks. Good afternoon and congratulations on the year-to-date performance. Just curious, since we've heard from a lot of brand vendors as well as other sporting goods retailers, there is a lot of different sort of points of view about the current environment. How is it different today versus what you thought it would be at the start of this correction and start of the year? Is it materially sort of on plan or has there been any surprises that have come up? Thanks.

John Schaefer:

We're not surprised, Andrew. We saw this coming with the Orlando tragedy and the run up to the election, so we knew this would be a tough year. I think we were a little surprised at how the fourth quarter ended last year, which gives us a certain amount of confidence for the fourth quarter this year.

But I think by the fact that we're hitting our sales numbers and we're hitting our same-store sales numbers and firearms are doing exactly what we thought, we're somewhat lucky in that. We're in a high use part of the country as opposed to a use/protection part of the country. So we have a little more stabilization.

That doesn't mean we're not going to see the down cycles when you have those big upticks. But also allows us to be pretty confident when we look at the environment and the stable nature of our customer base to not really be surprised a whole lot. And I would say, other than the fact that I think the vendors have waited too long to price the high use promotional type loads properly, that's really I think everything else and as we expected.

Andrew Burns:

Okay, thanks. And then just a quick one in terms of footwear and apparel. Good performance in the quarter. Clearly, those are smaller categories for you, but they're probably most at risk for online promotional activity and online competition. Once you anniversary the inventory benefit here later this year, do you think you can continue to grow those categories? What's the outlook there?

Kevan Talbot:

As we've factored into our guidance for the remainder of the year, we are coming up on the anniversary of the inventory position in the third quarter. We have seen and expect good trends out of both of these categories albeit coming down slightly from where they are. So I would say for the remainder of the year slight increases in both of those categories or what is our expectation and what is built into our guidance.

Andrew Burns:

Okay, thanks and good luck.

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.

John Schaefer:

We want to thank everyone for joining us today and we will hopefully talk to all of you soon. Thank you very much. Have a nice day.

Operator:

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