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Q2 2019 Sportsmans Warehouse Holdings Inc Earnings Call

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PRESENTATION

Operator

Greetings, and welcome to Sportsman's Warehouse Second Quarter 2019 Earnings Conference Call. (Operator Instructions) Please note, this conference is being recorded.

I would now turn the conference over to Rachel Schacter of ICR. Thank you. You may begin.

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 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 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 the SEC today, which is also available on the Investor Relations section of our website at investors.sportsmans.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 second 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 pleased with our second quarter results, which were above our expectations on the top line and towards the high end of our outlook on the bottom line. For the quarter, net sales increased 4.2% to $211.8 million. Comparable sales increased 1.7%, which was better than expected due to continued strong performance across our mature stores and e-commerce platform. Gross margins declined 100 basis points for the quarter, largely due to product shift -- mix shift, and we had 90 basis points of operating expense deleverage. We reported adjusted diluted earnings per share of $0.13 for the quarter. Robert will provide additional details in his section.

Before reviewing our Q2 comp results in more detail, I want to take a moment to discuss the industry backdrop, the competitive environment, and our key growth strategies that are driving our market share gains. The outdoor sporting goods category remains highly fragmented with over 2/3 of all firearm units sold by independent dealers. Given recent industry rationalization and changing competitive dynamics, including the category exit decisions of some competitors, we remain one of a few national retailers dedicated to outdoor sports, including hunting and shooting.

We offer an expansive breadth of assortment at everyday low pricing with a high level of customer service. This offering combined with ongoing success of our merchandising initiatives, customer acquisition and engagement focus and omnichannel strategy is driving our outperformance relative to the industry, which was evidenced in our second quarter results. Importantly, at the front of our initiatives, they focus on innovation, which further differentiates us in the marketplace. The pace of innovation at Sportsman's Warehouse and the pipeline of innovation we see going forward reinforces our confidence in our ability to build on these market share gains.

I will now highlight a few of these initiatives and the progress we are making against them. Beginning with merchandising: during the second quarter, we continued to expand our exclusive product offering within our Killik marquee outerwear brand, including a new camo pattern for the fall. While we only recently launched this 4 weeks ago, we are already encouraged by the strong customer reception to the quality of the product and the value proposition of this private-label brand. As we said before, we will continue to increase our exclusive product penetration in other categories as we move throughout the year, including optics, backpacks and several unique firearms offerings.

Turning to our strategies around customer acquisition and engagement, we are particularly encouraged by the early performance of our previously announced partnerships with select licensed firearms dealers across the country. This allows customers that don't have a Sportsman's Warehouse nearby to shop and buy the largest assortment of firearms with any national retailer through sportsmans.com and then pick up the firearm at one of our partner locations.

As of the end of the second quarter, we expanded our network of third-party FFL partnerships to a total of 130 partners and 16 additional states outside our regions. Through a combination of our retail footprint and the FFL partnership program, we now serve 41 states and cover 67% of U.S. population within a 45-mile radius.

While still early, the trends of both volume and average unit retail price of these firearms is very encouraging and another proof point that Sportsman's Warehouse has a unique assortment that is not available at any other retailer. Over the coming months, we plan to continue on expanding these relationships with licensed firearms dealers with the goal of offering our assortment to a majority of the U.S. population within a short drive.

As we scale this program and to further our new customer acquisitions efforts, we began testing marketing outside of our existing store regions to drive awareness of this program. We will continue to test these marketing strategies as the year progresses.

Our newly launched used firearm program, where we buy, accept trade-ins and sell used firearms is now live in 5 stores and online. While still early, we've seen over 70% of used guns, gun transactions turned into a trade-up. Based on these initial results, we believe this service has the potential to drive increased customer engagement and strengthen customer loyalty, ultimately improving customer lifetime value. Given the margin profile of the used gun sale, these transactions have been accretive to the mix.

Our loyalty program remains a key component of our customer acquisition and engagement strategy and we experienced continued growth in Q2. We now have over 2 million members driving 48.3% of our revenue. As an extension of our loyalty program, we are on track to launch in October, our new Sportsman's Warehouse credit card program through a partnership with Alliance Data. This will provide greater access to credit for our customers through both a co-branded Visa and Alliance-backed credit programs. These programs will provide best-in-class benefits such as industry-leading points accumulations and a variety of financing offers we believe our customers will find valuable.

Another new service we're providing as part of our focus on customer acquisition and engagement is the introduction of free ladies-only Concealed Carry Training Classes. While we've always had training classes available for all customers, we thought it was important to create an informative, inviting environment for female customers who want to learn to use a firearm with proper instruction in a safe environment.

Moving on to our omnichannel strategy. We now have completed all 3 of our planned store openings for this year. These standard format stores result in a 2.4% square footage increase, and are in Lansing, Michigan; Murfreesboro, Tennessee; and Fort Wayne, Indiana. We are excited to announce and are on schedule to open our first small format test concept shop in the fourth quarter, as we focus on innovation and leveraging our expertise and outdoor sporting focus.

This small format concept shop will include a family-oriented indoor range and will be branded Legacy Shooting Center. The center will be physically located in the same building as our new corporate office and will consist of an indoor firearms and archery range, utilizing the highest level of technology and safety tailored for all firearms and archery enthusiasts. In addition, this facility will offer educational services, repair services and an extensive assortment of product related to these categories. Our goal is to provide a safe, fun and family-oriented experience to our customers.

Turning on to e-commerce. We continue to be very pleased with the strong results from our new website, sportsmans.com, and the success we've seen from buy online, pick up in store feature. Our customers enjoy BOPUS, given the convenience it provides, and we view this as an opportunity to further engage our customers when they visit our stores to pick up their purchases.

For the second quarter, buy online, pick up in-store orders increased over 80% versus the prior year. In the second quarter, we also launched ship from store, utilizing our omnichannel capabilities to ship product directly from a store to a customer's home. This new feature improves customer service, reduces transit times by shipping from an in-region store and leverages our in-store inventory.

Shifting gears to our Q2 comp performance and the composition of our second quarter comparable sales results. Firearm units across the company, again, performed better than the adjusted NICS data nationwide and within our states. This performance reflects our dominant positioning within the firearms industry, leveraging our extensive offering with value-added services that are driving customer acquisition and engagement.

For the second quarter, firearm units increased 3.3%, driven by growth across a broad spectrum of firearm products. Firearms and ammunition sales increased 5.3% in Q2 2019. Weather challenges in early Q2 impacted camping and footwear categories, which decreased 3.2% and 1.8%, respectively, which was offset by fishing and clothing increases of 4.3% and 3.3%, respectively.

In terms of our view of the industry backdrop as we enter hunting season and look to the rest of the year, our confidence continues to grow in the market opportunities, as some retailers lessen their focus on hunting and shooting sports and as the mix data becomes more stable.

In summary, we are pleased with our second quarter results on both the top and bottom line. Our omnichannel investments combined with the progress we're making on our innovative strategic priorities differentiates us in a consolidated but still fragmented industry, and strengthens our competitive position as we focus on driving continued share gains. As you saw on our press release, we are narrowing our full year sales guidance and reiterating our EPS guidance.

At this point, I will turn it over -- which -- I'm sorry, which Robert will discuss in more detail. Finally, as it relates to tariffs, we continue to work with our vendor base to understand the impact and identify the most effective way to offset the tariffs where possible. These actions may include vendor negotiations; sourcing actions; and where necessary and appropriate, pricing action.

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

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

Thank you, Jon. I'll begin my remarks with a review of our second quarter results and then discuss our outlook for the third quarter and fiscal 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 was issued earlier today.

Second quarter 2019 net sales came in at $211.8 million compared to $203.3 million in the second quarter of fiscal year 2018, an increase of $8.5 million or 4.2%. Same-store sales increased 1.7%, which was above the high end of our guidance range of minus 0.5% to plus 1.5%. We saw strong growth in our hunting department, particularly in the categories of ammunition and rifles. The fishing department also showed strong growth in Q2, particularly in the categories of rods and reels, terminal tackle and lures.

We also showed solid growth in apparel in e-commerce-driven sales. We ended the quarter with 94 stores operating in 24 states. Total square footage growth was 2.4% compared to the second quarter of fiscal year 2018.

Q2 2019 gross profit was $73.2 million compared to $72.3 million in the second quarter of fiscal year 2018, an increase of $0.9 million or 1.2%.

Gross margin decreased 100 basis points to 34.6% versus the prior year period. Product margins declined approximately 90 basis points due to mix and lower margins in apparel and hunting, which more than offset improved margins in camping, fishing, footwear and Gift Bar.

SG&A expense of $63.5 million for Q2 2019 was an increase of $4.4 million or 7.4% compared to the second quarter of fiscal year 2018. We incurred additional payroll expense of $1.8 million primarily due to minimum wage and benefit increases. Rent expense increased approximately $1.1 million primarily due to new store openings. Other operating expense increased approximately $1.5 million primarily due to increased marketing expense, software support fees, and taxes.

As a percentage of net sales, SG&A increased approximately 90 basis points from 29.1% to 30.0%. SG&A expenses for Q2 2019 also included $265,000 of senior management transition cost. Income from operations was $9.8 million in Q2 2019 compared to $13.2 million in the second quarter of fiscal year 2018. Again, excluding transition cost for team members of senior management, Q2 adjusted operating income was $10.0 million for the quarter. Our interest expense in Q2 2019 was $2.3 million compared to $4.3 million in Q2 of the prior year, a reduction of $2 million.

The improvement is the result of lower total borrowings, attributable to our inventory reduction efforts and a write-off of financing fees in Q2 2018 associated with the prior term loan. We recorded income tax expense of $1.9 million in Q2 2019 compared to $2.3 million last year.

Net income for the quarter was $5.5 million or $0.13 per diluted share based on a diluted weighted average share count of 43.2 million as compared to net income of $6.6 million or $0.15 per share based on a diluted weighted average share count of 42.9 million last year. Adjusted net income was $5.7 million or $0.13 per diluted share in the second quarter of 2019 compared to an adjusted net income of $7.6 million or $0.18 per diluted share in the second quarter of last year. Adjusted EBITDA for the second quarter of 2019 was $15.8 million compared to $19.0 million in the prior year period.

Turning now to the balance sheet. Q2 2019 ending inventory was $289 million as compared to $329 million at the end of the second quarter of last year, a reduction of $40 million. On a per-store basis, inventory was down 14.9% compared to last year. This success in managing our inventory is a result of investments in the team, better analysis and visibility into the data, and greater focus on inventory management by the entire organization.

We had $11.3 million of capital expenditures during the second quarter of 2019 compared to $6.1 million in the prior year period. This $5.2 million increase was primarily due to the acquisition of a new corporate headquarter building, for which we expect to enter into a sale leaseback arrangement by year-end.

Q2 2019 year-to-date operating cash flow was positive $35.4 million versus negative $11.2 million in Q2 2018. This nearly $47 million improvement in operating cash flow year-over-year is primarily a result of the considerable progress we have made in managing inventory. Our liquidity remains strong as we ended the quarter with $127 million in outstanding borrowings and $51.6 million of availability under revolving credit facility.

Turning now to our outlook for Q3 and fiscal year 2019. As you saw in our press release, we are slightly revising our full year guidance to reflect our Q2 top line results, which came in at the high end of our guided range. Our current outlook includes the following items that were previously discussed on our last call. We continue to make key investments in our team for the long-term success of the organization, including minimum wage increases, increased resources and new hires and improved benefits for our team members.

We expect the combined investment in our team to be just under $5 million, which we believe will make Sportsman's Warehouse a more competitive retailer as we execute our growth plans. We invested approximately $3 million in 2018 into our e-commerce platform and we'll continue to invest in the platform and the modernization of our systems this year.

We expect this additional investment to be approximately $1 million in 2019. We expect to incur additional expenses related to being a public company of approximately $0.7 million in 2019, including the additional costs associated with Section 404(b) compliance with Sarbanes-Oxley, as we prepare to exit emerging growth company status at the end of the fiscal year.

We no longer amortize the deferred gain from our 2012 sale leaseback transaction due to new lease accounting standards. We expect our occupancy expense to increase approximately $1.4 million for the year, resulting in an EPS reduction of approximately $0.02 per share for fiscal year 2019. We expect approximately $9 million of interest expense for 2019, as we realize the benefits of our new debt structure and our debt-reduction strategies.

We now expect net sales in fiscal year 2019 of $866 million to $884 million and same-store sales growth in the range of flat to up 2.0% compared to fiscal year 2018. We reiterate our expectation for 2019 adjusted earnings per diluted share of $0.48 to $0.60 on approximately 43.2 million weighted average common shares outstanding.

Our outlook for the third quarter of 2019 is as follows: Net sales in the range of $231 million to $239 million; same-store sales growth of 1.5% to 4.5% compared to the third quarter of fiscal year 2018; net income in the range of $9.0 million to $11.7 million; projected diluted earnings per share of $0.21 to $0.27, and approximately 43.2 million weighted average common shares outstanding. We continue to expect net capital expenditures of approximately $16 million to $20 million in fiscal year 2019, with approximately $28 million to $30 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) Our first question is from Peter Keith with Piper Jaffray.

Robert Adam Friedner ***Piper Jaffray Companies, Research Division - Research Analyst***

It's actually Bobby on for Peter. Nice results. So I want to ask about the camping and fishing category. For the last 2 years, there's been some noise there with a bunch of headwinds, sounds like Q2 was off to a challenging start but then improved as the quarter went on. So maybe discuss how you're thinking about the setup for Q3 this year?

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

Bobby, this is Jon. Just want to confirm your question. The setup for Q3 in camping and fishing -- is that -- was that the question?

Robert Adam Friedner ***Piper Jaffray Companies, Research Division - Research Analyst***

Yes. That's right.

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

Okay. So first of all, fishing in Q2 performed very well towards the end of the quarter. We had great fishing runs in the state of Alaska this year, which were slightly out of cycle; and the Northwest performed very, very well. The weather improvement at the end of the second quarter this year versus last year has also helped us. As we look into Q3, we're not seeing anything in the lower 48 states to make us believe we'll have a challenged fishing. We do have a series of fires in Alaska that we are watching right now because it is impacting the ability to travel. So all in all, we're fairly comfortable with fishing in Q3. Camping, again, nothing material to communicate on that. We're expecting that to probably be in the flat to slightly down in Q3, which has been the trend in camping.

Robert Adam Friedner ***Piper Jaffray Companies, Research Division - Research Analyst***

Got it. And just 1 follow-up on tariffs. So can you maybe just break out how you're thinking about potential for List 4 tariff impact versus how it's been impacted through List 3, and is that all that baked into earnings guidance at the moment?

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

So Bobby, this is Robert. We've actually seen fairly nominal minimal impact of tariffs so far this year. We have been working with our vendors. In some cases, some of that product was already on the water being delivered. In our -- we feel like the exposure in this year is relatively nominal. It's hard to predict what's going to happen with tariffs going forward, and we're not going to project the impact into 2020. We're not providing any guidance in that regard right now. But in the short term, the impact we found has been fairly nominal.

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

I think our -- if I may, Bobby, to add to that. I think our vendors are still little uncertain what's happening. Certainly, we're all watching the same news cycle together, trying to understand how each party is going to react. Some of our categories are influenced greater than others, and we're going to continue to stay very close to it. We are talking to our vendors on a daily basis. And given our scale, we have the ability to work through this better than most in our industry, so we'll keep watching it. We haven't built anything in for it, at this point, and we'll react if we can -- as we can.

I think like all ven -- all retailers, we will have to ultimately have some of the price increases on -- if they flow through to the consumer, and that's -- that will be the piece that we all have to monitor the most.

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

Yes. And relative to your question about guidance, if there's any risk relative to tariffs, it's captured within the ranges that we have provided on the top end and the bottom end. Nothing specific that's been built in for tariffs, but we feel like it's covered within the ranges that we're getting from the low end to the high end.

Operator

(Operator Instructions) Our next question is from Ronald Bookbinder with Bookbinder & Associates.

Ronald Bookbinder ***Bookbinder & Associates, L.L.C. - Advisor***

Congratulations on a nice quarter. On the inventory, the inventory is down a lot. It's even down sequentially from Q1, and we're headed into that, the largest -- larger season, and you have the expectation of positive comps. So do you have enough inventory? Are you chasing any inventory? Are there any out-of-stocks that are costing revenue? How should we look at that?

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

Ron, as I kind of communicated along this path of getting the process, the rigor in place. We have to balance both our in-stocks and inventory turns together, and we've been doing that nicely. I'm very pleased with our in-stock positions today as compared to prior quarters. Not to say we aren't all -- we're pleased but we're never satisfied, Ron. There's always a component here or there, we'll do better on; but we're actually in a very good spot as we go into Q3 for the upcoming season.

Ronald Bookbinder ***Bookbinder & Associates, L.L.C. - Advisor***

Okay. And on the training classes and the expansion into women-only training classes, do you use sponsors for those trading -- training classes, like Smith & Wesson with their Lady Smith & Wesson line? Is there any sort of co-advertising or something like that that you use?

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

Ron, we are. We're partnering with several of our vendors on these classes to make sure that not only do we have the very best training that can happen in the industry. But we're also providing those consumers with retail information to help them select the products that are right for them, not just in the concealed carry firearm: the ammunition, the security for it at their home, the carrying purse or holster, and the cleaning supply. So it's all working together with our key vendors.

Ronald Bookbinder ***Bookbinder & Associates, L.L.C. - Advisor***

And that must be benefiting the gross margin. Do they give you any revenue towards that or...

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

Well, Ron, I can't really speak to the exact details of each of the relationships, but we have very good partners, as you can imagine; and they are helping with these classes, and we look forward to growing this to all of our stores over the coming months.

Ronald Bookbinder ***Bookbinder & Associates, L.L.C. - Advisor***

Okay. And gross margin, how did transportation and the tight inventory impact the gross margin? And when should we anniversary the higher transportation costs or is it still increasing?

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

So we didn't see much of a variance, Ronald, in -- and freight and so on and gross margin. We did have a decline in gross margin. But as I mentioned in my comments, it was mostly due to product margin and mix. We had seen some pressure in Q1 on freight and so on. But in Q2, that really wasn't much of a factor in our gross margin variance.

Ronald Bookbinder ***Bookbinder & Associates, L.L.C. - Advisor***

Okay. And lastly, private-label kayaks, it's looked like a great product. How did it do to compare to branded? How did it do to -- compared to your expectations? How was it?

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

Ron, it's Jon. I said this, I think, last year on [the cooler as well], I probably underforecasted those kayaks we sold through them very, very quickly and bought several more containers to replace what was sold. So we're very pleased with the birth -- of initial season on it, and we will continue to build in the kayak business based on we learned -- on what we learned.

Operator

Our next question is from Peter Benedict with Robert W. Baird & Company.

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

Just a quick one here. So I think as we look at third quarter and in the guidance midpoint around 3% comp. I think the earnings suggest that you still got the EBIT margins down a good bit, not as much as they've been. But I'm just curious kind of the complexion gross margin versus SG&A, is the pace of SG&A growth just going to continue as we've seen it? And -- or is there a change there?

And then on the growth side, it is really just -- is it just the mix? I mean the strength in the firearms obviously is going to weigh on that. But just curious what the complexion of operating margins in 3Q?

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

Yes. So on operating margins, let's start with gross margin. We did see some pressure on gross margin in Q2; and Q2 came in about 80 basis points below the midpoint of our guidance. That was primarily due to challenges in product margin.

See, SG&A has actually been positive, not in terms of absolute spend versus expectation, but we are able to hold our SG&A expenses flat on a pretty decent beat on revenue and so we saw some leverage there.

As we projected Q3 and the rest of the year for gross margin, we do see a slight decline in absolute margin from Q2 to Q3 but that is typical seasonality in terms of the holidays and so on, maybe less so than the drop that we saw in the first half of the year.

On the SG&A side, we actually -- I talked about previously that there was a bit of a step function increase in SG&A going from Q1 to Q2 and that that would flatten out, and that is what we are projecting in the second half of the year. SG&A being relatively flat in absolute dollars but declining as a percentage of revenue as the 2 largest revenue quarters for us are in the second half of the year.

And so the guidance reflects that: a little bit of pressure on gross margin. On a full year, year-over-year basis, I think we're down about 30 basis points in gross margin. And then you see that we have that kind of step function increase in cost related to minimum wage increases and investing in people and so on. And I think on a full year basis, where I think we're also about 30 basis points higher as a percentage of revenue on SG&A. But the SG&A absolute spend should flatten out in the second half of the year versus Q2.

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

All right. That's helpful. That all makes sense. And then lastly, and I apologize if you already mentioned this. Just on the inventory over the balance of the year, I mean how -- where do we see inventory at the end of the year? And obviously, a great, great performance here in the second quarter. How are we thinking about that at the end of the year?

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

So our goal is to be at about 2 turns by the end of the year, and we are on pace for that. We continue to see some improvements. There's, of course, the change in inventory based on the seasonality as we build inventory. But we think on a year-over-year basis, you're going to see improvement both in turns and hopefully in our in-stock performance, and we're able to actually do both at the same time.

Operator

We have reached the end of our question-and-answer session. I would like to turn the conference back over to management for closing remarks.

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

Okay. First of all, I would like to thank everybody for their time today in the call and the follow-up questions. Special thanks to all of our team members, over 5,000 associates that every day do a great job, day in and day out. Their hard work is driving our results and we look forward to building on this performance as we move into the second half of the year. With that, I will close the call. Thank you.

Operator

Thank you. This concludes today's conference. You may disconnect your lines at this time, and have a wonderful evening.