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United Natural Foods, Inc. (UNFI)

Q3 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Chris, and I'll be your conference operator today. At this time, I'd like to welcome everyone to the UNFI Fiscal 2022 Third Quarter Earnings Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions] Thank you.

Steve Bloomquist, VP of Investor Relations, you may begin.

Steven J. Bloomquist

Vice President-Investor Relations, United Natural Foods, Inc.

Good morning, everyone. Thank you for joining us on UNFI's third quarter fiscal 2022 earnings conference call. By now, you should have received a copy of the earnings release issued this morning. The press release and the supplemental slide deck are available under the Investors section of the company's website at www.unfi.com.

Joining me for today's call are Sandy Douglas, our Chief Executive Officer; John Howard, our Chief Financial Officer; Chris Testa, President of UNFI; and Eric Dorne, our Chief Operating Officer. Sandy, Chris and John will provide a business update, after which we'll take your questions.

Before we begin, I'd like to remind everyone that comments made by management during today's call may contain forward-looking statements. These forward-looking statements include plans, expectations, estimates, and projections that might involve significant risks and uncertainties. These risks are discussed in the company's

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earnings release and SEC filings. Actual results may differ materially from the results discussed in these forward-looking statements.

And lastly, I'd like to point out that during today's call, management will refer to certain non-GAAP financial measures. Definitions and reconciliations to the most comparable GAAP financial measures are included in our press release.

I'll now turn the call over to Sandy.

J. Alexander M. Douglas

Chief Executive Officer & Director, United Natural Foods, Inc.

Thank you, Steve, and good morning, everyone. We appreciate everyone joining us for today's call. Our third quarter results again validate our team's ability to successfully perform in the face of a challenging and unpredictable environment with capabilities that we believe will continue to create value for our various stakeholders.

During the quarter, we continued to navigate industry-wide challenges, including inflation where the latest food-at-home reading was 10.8% higher than last year, record-high fuel costs, low but improving fill rates, and challenging labor shortages, all of which continue to impact our business and our customers.

While we expect many of these issues to persist through the fiscal year, we're encouraged by the improvements we're beginning to see. Supply levels for many products are increasing which led to our finishing the quarter with the second highest fill rate month of the fiscal year. In addition, we continue to make strides in stabilizing our workforce, even against a constrained labor backdrop. These improvements are in large part due to the actions that we're taking to proactively secure product on behalf of our customers and improving the associate experience.

Many of the associate-friendly programs we've spoken about before, including scheduling flexibility and accelerated pay options, and they're now positively affecting our driver vacancy rate which decreased to 9% at quarter's end. In addition, we continue to make progress in lowering our DC vacancy rates which improved to less than 7% at the end of the third quarter.

While consumer mobility has undoubtedly improved from the early days of the pandemic, the fact is that more people continue to work from home and take advantage of more flexible ways of working. Coupled with tighter management of household budgets in the face of high levels of food inflation, we expect food at home sales to remain strong.

Our diverse customer base paired with our expansive portfolio positions us favorably to serve customers and consumers as they react to inflationary pressures and the macroeconomic trends. Whether consumers stay upstream with more premium offerings or downstream in the value segment in the downturn, we are there to serve both markets. In short, we have the breadth and agility to win, and to help our customers succeed in a variety of macro environments, including one with shifting customer preferences.

We're pleased that our performance reflects continued sales gains from both existing and new customers, and allows us to increase our full-year sales and earnings guidance under what we believe to be a more transparent and meaningful definition of adjusted EBITDA and adjusted EPS which John will address shortly.

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Our Fuel the Future strategy is working and it is setting us up for long-term sustainable growth and positioning us to grow our share of the $140 billion addressable market that we outlined last summer.

As we improve our execution and move further along the spectrum from distributor to value-added partner for our customers and suppliers, we continue to see the benefits of several clear differentiators that we're working to build upon: our core customer service capabilities and the over 30,000 independent, innovative and segmented retail food locations we service, the scale and capability of our North American supply chain, the breadth of our product and services assortment; and finally, our talented, experienced and incredibly dedicated associates. By leveraging these competitive advantages to better serve our customers and suppliers, we see significant opportunities to accelerate growth, expand margins, and create incremental value for shareholders.

To that end, we've identified four focus areas to guide our execution of the Fuel the Future strategy that we believe will enable us to successfully deliver the three-year fiscal year 2024 financial targets that we outlined at last summer's Investor Day. These four priorities are: one, to deliver significant value to our customers; second, to improve the way we partner with our suppliers; third, to provide our associates with unmatched clear opportunities; and fourth, to support our communities and the planet through our wide-ranging and ambitious ESG initiatives.

To deliver more value to our customers, we are focused on improving all aspects of our sales and supply chain execution to provide our customers the products and services they need when they need them so that they can compete and win in the marketplace. We're implementing a wide range of improvement initiatives to enhance our customer value proposition by making it easier to do business with us. A cornerstone of this effort is our One UNFI initiative, which aims to create a single point of contact for our customers, one ordering system for all purchases, a single delivery of all products on one truck and a single invoice.

In addition, we're bringing customers new and innovative ideas and solutions that go well beyond selling them traditional grocery products. Bringing more value to new and existing customers will drive future success with cross-selling and help us convert our robust new business pipeline into actual sales. We've spoken before about the key growth platforms that sit at the heart of our ability to enhance our customer value proposition fresh, own brands and professional services.

We are actively investing in people, technology and infrastructure to deliver fresher produce, in continued brand innovation at a time when customers and shoppers are increasingly seeing the value in these products, and in services ranging from data analytics to revenue growth management that position us as more of a consultant to our customers. These platforms are a critical component of our plan to drive continued earnings improvement and are expected to deliver 25% of UNFI's adjusted EBITDA by the end of fiscal 2024.

Chris will speak to these platforms in more detail shortly.

To improve the value we delivered to suppliers, we have a real opportunity to provide value-added insights to strengthen their segmented marketing efforts by helping our customers become more visible to our suppliers. One example of this is the high-volume ethnic stores we service that may not report scanner information to traditional data analytic companies. The broad insights we can provide on an aggregated basis make UNFI a more valuable partner to the supplier community as companies are able to develop incremental programs to build their brands, and in the process, bring more investment and growth to our entire ecosystem.

Our clear focus is to be the best partner we can be to our customers and our suppliers through better execution and expanding our capabilities. Our commitment to providing unmatched opportunities for our associates stems

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from the recognition that they are what truly sets us apart. Our associates are the key to our culture of innovation, our ability to execute and our ability to deliver on our mission of helping make our customers and suppliers stronger, our supply chain better, and our food solutions more inspired.

As a testament to how instrumental our associates are to our business, many of our customers that I visit with talk about our people as our greatest strength, and their dedication is evident in everything they do. We are, therefore, intensely focused on our people plan, which has been designed to ensure that UNFI is a preferred employer that offers unique opportunities for career growth. At the same time, our people plan aims to equip employees with the tools that they need to help the company achieve its goals.

And finally, our efforts to support our communities and the planet builds on our long-standing commitment to doing what's right, and the recognition that better food can only come from a healthy planet, and that clean air and water are crucial to a safe and nutritious food supply. We view this as a critical opportunity to innovate and leverage our scale to address the impact that our company and our partners have on our people, our communities and our world.

Under our Better for All plan, we have ambitious goals to reduce waste, lower greenhouse gas emissions and advance sustainable agriculture to ensure a lasting supply of high-quality, helpful and nutritious food. This plan helps us stay laser focused on the issues where we can move the needle the most over the next decade. We are pleased that UNFI is the first public food distributor and wholesaler to have its climate targets, which were announced last month, validated by the science-based targets initiative.

I am proud of the many initiatives we're undertaking and urge you to read our 2021 ESG Report that we issued this spring. As the report outlines, we are now in our second year of integrating both SASB and TCFD-recommended disclosures, and we are continuing to evolve and improve our reporting.

For example, we reported that in fiscal 2021, we saw a 2% improvement in fuel efficiency, which was largely the result of working with our customers to consolidate orders so we could further optimize deliveries and reduce fuel consumption, and continue to make additional progress in fiscal 2022.

Before I turn it over to Chris, let me underscore a common thread across my comments, which is to simplify and communicate the operating focus underpinning our Fuel the Future strategy. As I mentioned earlier, we have a very large and attractive addressable market opportunity. Our strategy to capture the opportunity is simple; we are focused on getting better at what we do.

We're working toward enhancing our capabilities and improving our end-to-end execution for the benefit of our customers, suppliers, associates and by doing so, importantly, our shareholders. We will be taking a very disciplined approach to value creation through focusing on those strategic areas that will drive economic profit, instead of growth simply for growth's sake.

We believe this will contribute most to shareholder value creation. And as we get better, we expect this to create a flywheel effect in which the business will grow, will gain market share and, in turn, enhance shareholder value.

In summary, as pleased as I am with the progress we are making and our confidence in meeting or surpassing our three fiscal 2024 financial KPIs for growth in sales, adjusted EBITDA and adjusted EPS, I'm even more excited by the improvement opportunities that we see ahead.

Chris?

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Christopher P. Testa

President, United Natural Foods, Inc.

Thanks, Sandy. Good morning, everyone. On today's call, I'll provide further color on our sales for the quarter and our sales pipeline that we expect will deliver future growth. I will also highlight the performance of our growth platforms and our Wholesale operations, and comment on the operating environment and performance of our retail stores.

Total net sales for the quarter were $7.2 billion, a 9.2% increase over last year's Q3 with widespread growth across all channels. We continue to believe that our customer-centric approach is driving results, and we're pleased that growth in the quarter again came from both selling more to our existing customers as well as the acceleration in business we're now doing with new customers; each, a key growth component of our Fuel the Future strategy.

Cross-selling gains with existing customers added an incremental $95 million of revenue in the quarter, bringing our year-to-date incremental total to $260 million. This keeps us on pace to achieve nearly $1 billion in cross-selling revenue in fiscal 2022; volume that would have not happened without the Supervalu acquisition.

Our continued success in selling more to existing customers, coupled with new customer wins, contribute to volume gains of approximately 2.5%, with the balance coming from inflation. Looking ahead, we remain optimistic about our ability to grow our business further, based on our unmatched product and services portfolio.

Our new business pipeline remains robust, with opportunities that range from expanding category and product penetration with existing customers to new business wins with retailers who operate captive distribution centers.

For both smaller volume wins as well as larger new customer business, we believe our customer-centric approach to growth will help us earn new business and allow us to help make our customers stronger; a key part of our mission that lies at the heart of everything we do.

The strength of our pipeline is largely attributable to the breadth of our assortment as well as the growth platforms we spoken about on past calls, including own brands, fresh and our professional services. I've spoken before about the scale of our own brands portfolio which includes over 5,000 SKUs across multiple categories and price points that give our customers a competitive advantage in the marketplace.

We're pleased that own brands are gaining momentum as sales increases accelerated throughout the quarter. We believe this reflects the strengthening of our program and increasing consumer demand in light of higher food and gas prices.

We're also communicating to our customer, opportunities to drive business where national brands are on allocation or fill rates into UNFI are challenged. Inbound service level on own brands were, again, higher than those of national brands this quarter by approximately 700 basis points.

On the product side, we've updated the packaging of our Wild Harvest free-from line. Our new plant-based meats were the first category to roll out featuring the new brand refresh, and we're excited for additional categories launching this summer.

As for fresh, UNFI's produce sales in the third quarter outpaced the US produce market by more than 300 basis points, which we believe reflects the continued investments we're making in people, processes and infrastructure to improve the quality and freshness of the produce we sell.

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This includes the addition of several new experienced leaders with backgrounds in large produce operations. Leveraging the growth of the perimeter to private label, we've recently expanded our Wild Harvest organic produce offering to include organic bananas. And we have over 110 more private label SKUs in process, all packaged with our new look in clear organic communication.

Lastly is our professional services business that we've spoken about before and which we believe is a key differentiator for UNFI. The growth rate in adjusted EBITDA from our services business was more than double that of our Wholesale business as more and more customers recognize the value we bring to their operations by leveraging our scale and expertise.

Among the wide variety of services and solutions we offer, our retail shelf services continues to be one of the most widely used. UNFI has over 1,000 associates who manage a variety of in-store services on behalf of our customers. These services include ordering, item assortment and packing out shelves.

In addition, we regularly update a significant amount of planograms across our network and last year completed over 1,100 store resets that keep store offerings current and relevant to the consumer.

These services are in high demand for both customers and suppliers, especially considering today's labor market challenges. Retailers love it because UNFI experts manage their shelves, which allows them to focus more strategically on store operations, competition and other parts of their business.

We continue to add services to our portfolio based on customer feedback and the evolution of the industry. Our professional services business is constantly evolving, building upon UNFI's culture of innovation and embracing what's next to help our customers drive profitable, sustainable growth and gain market share.

Touching briefly on operations, our third quarter operating cost again reflected the investments made to ensure we can service our customers in the very best way possible, as well as the continued improvement being made on the labor front.

As Sandy stated, our distribution center vacancy rate improved again this quarter moving from 9% at the end of Q2 to 7% at the end of Q3. After stabilizing our driver pool in Q2, we are pleased that the vacancy rate improved to 9%, a three-point gain that we view as a clear signal that the programs we've described before are taking hold.

Our results also included a modest net impact from higher fuel prices Sandy spoke to, despite the portion of the increase shared by our customers, as well as the fuel hedges we have in place.

Finally, our retail stores continue to perform in a challenging environment. Sales were up over last year, although margin investments led to lower adjusted EBITDA compared to last year's third quarter. Our strategy continues to be optimizing our retail network which includes appropriate levels of investment in facilities and technology.

We're pleased with the performance of our recently remodeled stores whose sales gains have significantly outpaced total retail and technology investments have helped simplify the business and improve performance.

Looking forward, we'll open our 31st Cub Wine and Spirit store before the 4th of July and have approved the replacement of an older, outdated store that we expect will improve its already strong market position. We're also planning to invest in enhanced promotional planning tools that will bring us additional capabilities around customer-specific promotions based on individual buying habits.

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One of the benefits of having operating stores in two markets is we're able to test and refine merchandising and operational ideas that we can then share with our wholesale customers to help make them stronger.

As Sandy said, we're pleased with our performance this quarter and optimistic about the finish to fiscal 2022. The environment remains unpredictable in several ways, but we're confident in our agility and our resilience as we help our customers succeed through all that UNFI has to offer.

Let me now turn the call over to John.

John W. Howard

Chief Financial Officer, United Natural Foods, Inc.

Thank you, Chris, and good morning, everyone. On today's call, I'll cover our third quarter financial performance, balance sheet, capital structure, and our fiscal 2022 outlook.

As Chris stated, third quarter sales were $7.2 billion, an increase of 9.2% from last year's third quarter, which brings our year-to-date sales to $21.7 billion, a 7.1% increase compared to last year. As stated in this morning's press release, we've revised our definition of both adjusted EBITDA and adjusted EPS to exclude the impact of LIFO expense. LIFO is a noncash item which impacts gross profit, as well as adjusted EBITDA and adjusted EPS, as previously calculated.

Historically, the effective LIFO has been relatively small, stable and predictable but the recent inflationary environment has driven it meaningfully higher. Because we believe the volatility in this year's noncash LIFO expense meaningfully distorts our underlying operating performance, beginning with this quarter, we will adjust LIFO expense out of GAAP net income and the GAAP EPS in computing adjusted EBITDA and adjusted EPS.

This revision has no impact on the economics, cash flows or GAAP results of our business. It more closely aligns UNFI with how our industry peers treat LIFO and we believe better reflects the company's underlying operating performance. We also believe it will help investors assess our underlying performance in a manner consistent with how we make business decisions. On this revised basis, adjusted EBITDA for the third quarter totaled $196 million, a 5.9% increase, compared to the $185 million in last year's third quarter when computed on the same basis.

On a year-to-date basis, adjusted EBITDA totaled $616 million, compared to $564 million last year, a 9.2% increase compared to last year. Our third quarter GAAP earnings per share totaled $1.10, including the impact of the noncash LIFO charge described above and a gain on sale from our Riverside distribution center purchase and sale leaseback transaction that we've discussed before.

Including several smaller items and the tax impact of the adjustments, adjusted EPS on the revised basis also totaled $1.10 for the third quarter, compared to $1 in last year's third quarter on a revised basis, an increase of 10%. On a year-to-date basis, adjusted EPS totals $3.56 per share, a 22% increase over fiscal 2021 year-to-date total of $2.93 per share.

Within the P&L, our gross profit rate, excluding LIFO, increased approximately 30 basis points compared to last year's third quarter, driven by the impact from inflation and the ongoing benefits from our ValuePath initiatives. Retail gross profit rate declined modestly in the quarter compared to last year.

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Third quarter operating expense rate increased approximately 30 basis points over last year's third quarter. As Chris discussed, our elevated operating expenses continue to reflect investments we're making to ensure the best possible service to our customers in a rapidly changing environment and the impact of inflation.

Turning to the balance sheet, we finished the quarter with outstanding net debt of $2.38 billion, a $34 million reduction compared to the second quarter. Our adjusted EBITDA net leverage ratio, which now also excludes the impact of LIFO in the denominator, improved to 2.9 times. Our supplemental slides present the adjusted EBITDA net leverage ratio for previously reported periods under the revised definition.

We've successfully refinanced and extended the maturity on our $2.1 billion asset-based revolver by over 3.5 years, which bring its maturity to June 2027. We're pleased to have completed this transaction which leaves our secured term loan as the next material scheduled maturity in October 2025, over three years from now. We've also upsized the ABL to $2.6 billion, immediately increasing available liquidity by $500 million.

We've reduced the rates on borrowings and the unused portions under the facility. And we've transitioned from LIBOR to SOFR as the benchmark rate for the borrowings under the ABL and the term loan facilities.

Let's turn to our outlook for fiscal 2022. As outlined in our press release, we're raising our full-year outlook for net sales to a new range of $28.8 billion to $29.1 billion, a 7% increase over fiscal 2021 reflecting the underlying performance of our business.

As for adjusted EBITDA and adjusted EPS, our original ranges were $760 million to $790 million and $3.90 to $4.20 per share, respectively. These included a LIFO charge of $25 million or $0.30 per share. Under the revised definition I spoke to earlier which excludes the LIFO charge, our original guidance for full-year adjusted EBITDA would have been within a range of $785 million to $815 million and adjusted EPS within a range of $4.20 to $4.50 per share.

In light of our performance year-to-date, improved net sales outlook and a careful assessment of the current operating environment, we're increasing our guidance for both adjusted EBITDA and adjusted EPS. We now expect adjusted EBITDA to be in the range of $810 million to $830 million and adjusted EPS to be in the range of $4.65 to $4.90 per share.

For comparison purposes, the tables in our press release and slides 10 and 11 of our supplemental slides illustrate these changes. Our outlook for full-year capital spending remains unchanged at $250 million as does our outlook for full-year debt reduction which continues to be in the range of $150 million to $200 million, using our revised definition for adjusted EBITDA, we now expect year-end net leverage to be approximately 2.6 times.

As for the longer-term fiscal 2024 targets we provided at last June's Investor Day, we're affirming the average annual growth rates provided for net sales of 3% to 5%, adjusted EBITDA of 6% to 10% and adjusted EPS of 12% to 18%. Under our revised definitions for adjusted EBITDA and adjusted EPS, which exclude LIFO, our fiscal 2024 target for adjusted EBITDA would be at least $950 million and adjusted EPS would be at least $6. As Sandy stated, we remain confident in our ability to achieve these targets.

As you've heard, today's operating backdrop continues to be both challenging and unpredictable, yet we remain optimistic about serving our customers and delivering on our updated outlook for the year.

Operator, we're now ready to take questions.

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QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question is from Andrew Wolf with C.L. King. Your line is open.

Andrew Wolf
Analyst, C.L. King & Associates, Inc.

Q

Thank you. Good morning. I know you don't guide on specific quarters, but is it fair to assume that the quarter you just reported, you beat your internal expectations decently? And could you comment how that is carrying through in the fourth quarter and your sense of the quarter on a profitability basis. And any color you can give as we start to think about fiscal 2023 as well? Thank you.

John W. Howard
Chief Financial Officer, United Natural Foods, Inc.

A

Sure. Appreciate the question, Andy. This is John. I'll start. I think with your questions there, I think, what I would say, we were in line with what we're expecting for Q3 internally. As it relates to Q4 guidance, you're absolutely right, we generally don't provide quarterly guidance, but this is the one quarter of the year where it actually is indirectly provided with our full-year guidance change. And by increasing our full-year guidance, I think you can get into – back into the Q4 number for you.

And say again what was the third question, Andy? I forgot. For FY 2023 – yeah, obviously, for FY 2023, at this stage, we're not going to provide any guidance other than what we provided with the long-range plan Investor Day we did last year, showing what our three-year CAGRs would be for 2022, 2023 and 2024. And as I think all three of us said in our prepared remarks, we are on track to achieve those.

Andrew Wolf
Analyst, C.L. King & Associates, Inc.

Q

All right. On the LIFO charge itself, it's $72 million. I mean, the first half was $30 million. So clearly, I guess the accrual rate went up a lot. Could you comment on how that relates – did inflation jump that much or you had to increase – did you increase your accrual rate, or is there a catch-up in there? Could you just give us some color on why the actual number is so high compared to what you're accruing at, and also just I guess tie that to what's going on with inflation.

John W. Howard
Chief Financial Officer, United Natural Foods, Inc.

A

Yeah. And you're absolutely right, Andy, it is all tied to the inflation that we saw, that uptick that we saw in Q3. That's what's driving that number. There's no other dramatic or fundamental change in the calculation or in the underlying business. Our inventory balances are substantially where we thought they would be. It's all being driven by the uptick in inflation that started in Q3 for that noncash increase that you're seeing.

And you're absolutely right, the way the math works on LIFO, there's a full-year catch-up as that inflation rate changes throughout the year. We have to capture the full rate impact every time we go through the calculation in our quarterly results, and that does represent a little bit of catch-up in Q3 on the noncash. Sandy?

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J. Alexander M. Douglas
Chief Executive Officer & Director, United Natural Foods, Inc.

A

Yeah. I was just going to comment on the second part of Andy's question regarding inflation. Obviously, inflation continues to be elevated, and it's a complicated topic through the P&L. It drives top line and margin, but it has a negative impact on sales lift. It's really a direct result of continuing fill rate issues. And then, you got the whole dynamic with promotions.

Our focus is really on how we can help our customers through it, help them stay competitive by working to ensure that they have the most possible lead time on price increases; and then, specifically through the summer, working with our suppliers to give our customers good, sharp promotional price points, particularly in key value items.

I'd also mention own brands. Chris mentioned the consumer energy around own brands and our focus on providing the best possible offer there. And then, finally, as it relates to any margin that's moving around, we have our ValuePath initiative, which the company fielded to yield a gross amount of $70 million to $100 million of savings by 2023 so that we can make it all work as the different parts of the external environment move around.

Andrew Wolf
Analyst, C.L. King & Associates, Inc.

Q

Thanks. And I'll just ask a quick follow-up instead of my third question. Sandy, you mentioned trying to get promotions and KVIs to your clients – your customers. How challenging is that when product is basically short and there's so much inflation? I mean, are you dipping into your own pocket to help out your customers in a sense?

J. Alexander M. Douglas
Chief Executive Officer & Director, United Natural Foods, Inc.

A

Well, it's actually a process of working with our customers and our suppliers. Our customer base is a really important source of growth for our suppliers. And as I mentioned, one of our initiatives is to help make them more visible and to connect the dots. And so, we're having, I think, good success with a number of our merchandising programs.

And, for example, we have a very big sales show that starts this afternoon in Connecticut, where we have literally thousands of customers coming in to meet with suppliers to put in place programs, to buy products, set in place promotional plans for the rest of the year.

And by working hard to make them visible to each other and connect the dots, I think we're having pretty good success in terms of doing everything we can to help them be as competitive as possible.

Andrew Wolf
Analyst, C.L. King & Associates, Inc.

Q

Great. Thank you. I'll get back in line.

Operator: And the next question is from Scott Mushkin with R5 Capital. Your line is open.

Scott Mushkin
Analyst, R5 Capital LLC

Q

Hey, guys. Thanks for taking my questions. So I wanted to explore a little bit more the better, I guess, offering that you guys have to your customers and understand how quickly you think you can gain some market share. What

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I'm specifically referencing is the single truck, single invoice accompanying the services as we rent those – or you guys seem to have a fairly meaningful competitive advantage. How quickly can you move to maybe gain more market share with that?

J. Alexander M. Douglas
Chief Executive Officer & Director, United Natural Foods, Inc.
A

Yeah. Thanks, Scott. This is Sandy.

Scott Mushkin
Analyst, R5 Capital LLC
Q

Hey, Sandy.

J. Alexander M. Douglas
Chief Executive Officer & Director, United Natural Foods, Inc.
A

One UNFI is really a multi-year process. It started and was made possible by the acquisition that the company made of Supervalu a few years ago. Actions have already been taken to align the sales force, to align how we show up for suppliers. But there are incremental opportunities that involve our supply chain, involve our network of distribution and how our IT is set up, invoicing, et cetera. And I describe it as a road map of continuous improvement.

The market share gains really come, and Chris talked about it, by virtue of the immediate impact, which is that we have a really wide assortment. And customers need different kinds of products for different kinds of strategies and different kinds of formats. And we've seen in the cross-selling results that Chris described impact; impact to market share, impact to give customers flexibility.

And then, finally, I would say that – and this has been particularly important in the last couple years – when the network is stressed as it is, having backup and the ability to move distribution from one center to another has been helpful in times of stress.

So as you look at our sales results and think about the industry, we're gaining share, but I think the share opportunity is really more about serving a broader range of customer needs. And as the company mentioned, we think that total opportunity is around $140 billion, of which we've captured a small part of it.

Scott Mushkin
Analyst, R5 Capital LLC
Q

So as a follow-up – thanks, Sandy – as a follow-up to that, though, how many customers have the ability to have one truck, one invoice? I mean, how far along, is it – is this like a handful or is that something you can offer to more? That's my first follow-up.

Then my second follow-up is, if this is successful, how should we think about CapEx spending and your capacity if you start grabbing a lot of share, if you're able to execute the One UNFI?

J. Alexander M. Douglas
Chief Executive Officer & Director, United Natural Foods, Inc.
A

I would describe the transformation as early stage on some of the supply chain and distribution changes. From a capital standpoint – and Eric's here and you can comment, Eric – I think it offers us an opportunity to get both

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effective and more efficient as we redesign the supply chain. We have a big initiative right now to understand the network design and to plot that plan.

And then, finally, as it relates to capital, to the extent that we're able to drive the capacity of the supply chain, that's obviously capital friendly. But it also creates the opportunity for us to make progressive estimates in technology and, potentially, automation that will drive up our quality level; and obviously with each investment, sweat a very disciplined rate of return.

But Eric, do you want to talk a little bit about your plans there?

Eric A. Dorne
Chief Operating Officer, United Natural Foods, Inc.
A

Yeah. I mean, Scott, thanks for that question. As Sandy mentioned, we are looking at incredible options across the country to maximize the use of our current capacity, as well as capacity that we need to add to sustain growth. And as far as automation goes, we are actively pursuing options where it makes sense. As a reminder, we just added automation in Southern California, in the Pacific Northwest, and we are expanding our automation capability in the mid-Atlantic states in the coming months. So I think we're making the right choices and we're keeping pace with the options we have to support our growth.

Scott Mushkin
Analyst, R5 Capital LLC
Q

Perfect. Thanks, guys.

Operator: The next question is from John Heinbockel with Guggenheim. Your line is open.

John Heinbockel
Analyst, Guggenheim Securities LLC
Q

So first thing, guys, maybe you can address the power of scale in this environment, right, with inflation as high as it is, should be more valuable than ever obviously, but then you've got to get the product, right? So maybe talk about the ability to lean into scale. And is the benefit to come more down the road, right, when supply is a little more readily available? So that's sort of number one.

And then, two, right, if you think about the opportunities, right, versus new customers coming onto your platform versus picking up new items, right, from some of the existing players, where is the opportunity bigger right now?

J. Alexander M. Douglas
Chief Executive Officer & Director, United Natural Foods, Inc.
A

Hi. This is Sandy, and I'm going to pass this over to Chris in a second, but scale shows up for the company in a lot of ways. It shows up, as I mentioned, in flexibility when we need to be able to move distribution around. Clearly, we're an important customer to our suppliers. So we're able to show our suppliers a large opportunity and make a important case to them that they should take good care of 32,000 customers that we have.

And as the fill rates have, and I think we mentioned in the script, started to stabilize and slightly improve here towards the end of the third quarter. What we hope will happen is that we'll start to see further acceleration in promotional activity from our customers – or sorry, from suppliers, and that in turn will drive value for our customers and the flywheel that I mentioned will be started.

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But, Chris, why don't you drill into a few more specifics.

Christopher P. Testa
President, United Natural Foods, Inc.
A

Yeah. Hey, John, so...

John Heinbockel
Analyst, Guggenheim Securities LLC
Q

Hey.

Christopher P. Testa
President, United Natural Foods, Inc.
A

...absolutely, our scale, if you look at our private brands business, we're able to have a very large private brands portfolio that we can pass on to our customers. We have buying power in our professional services business where we're able to acquire services at rates of our scale that we can pass on to our customers. And then if you look at just our buying power on our fresh business, we're a very, very large fresh – national fresh player. And there's not many, if any, national fresh players and we have some purchasing power with that as well.

As far as the size of the opportunity, as we laid out, that's a $140 billion addressable market, the largest portion of that, $78 billion, lays with new customers.

John Heinbockel
Analyst, Guggenheim Securities LLC
Q

Yeah.

Christopher P. Testa
President, United Natural Foods, Inc.
A

But reality is that the $38 billion opportunity with existing customers, those are the wins that we're putting on the board every week. If you think about a conventional customer that wants to get into natural products, we can flip the switch on that. A conventional customer that wants to expand its meat and produce with us, we can flip the switch on that very quickly because we've already set them up as an account, we already have the truck going from the warehouse. And so, I would say, we get more frequent wins through our existing customers, and we're very excited about more than doubling the business, the opportunity to more than double the business with existing customers. But from a pure scale standpoint, of course, there's more whitespace of customers that we're not currently serving.

J. Alexander M. Douglas
Chief Executive Officer & Director, United Natural Foods, Inc.
A

John, Sandy here.

John Heinbockel
Analyst, Guggenheim Securities LLC
Q

Yeah.

J. Alexander M. Douglas
Chief Executive Officer & Director, United Natural Foods, Inc.
A

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One other comment about scale is – the other thing is the flip of the coin, a couple of weeks ago, I was on a Northern Midwest tour of local customer meetings, one in Minneapolis, one in Green Bay, and in those meetings, our merchants were working on local product supplier opportunities, promotional plans for the summer. I saw our deli and specialty team bring together a cheese merchandising opportunity that leverages local cheeses in those markets. And so there's a lot of very, very local conversations going on between our regionally based sales and merchandizing organization. And obviously, supply chain is very local as well. So, on the one hand, there's scale, but the flip side is to stay really close to the independent customers in markets around the country which is core to our culture.

John Heinbockel
Analyst, Guggenheim Securities LLC

Q

And maybe a quick follow-up. You talked about volume up 2.5%, right, which would include new customers. Is there any way to tell on a comp basis what volume our cases are doing? And is it possible, if inflation stays elevated, that volume could be, I don't know, flat to down on a comp basis? And I guess as long as drop size is up, it wouldn't really impact the economics, right, of the drop?

J. Alexander M. Douglas
Chief Executive Officer & Director, United Natural Foods, Inc.

A

Yeah. We're not going to talk on a forward basis about that, John. But what I would say is, I think, our volume growth has stayed pretty consistent through the second and third quarter that we just reported. And our focus, as I mentioned, around inflation is to work really hard with suppliers to give our customers the right kind of merchandising opportunities and price points to support their unit volume as they compete. So, we'll continue to watch that and report out each quarter. But it's been fairly consistent for the past couple of quarters.

John Heinbockel
Analyst, Guggenheim Securities LLC

Q

Okay. Thank you.

Operator: The next question is from Eric Larson with Seaport Research Partners. Your line is open.

Eric Larson
Analyst, Seaport Global Securities LLC

Q

Yeah, thanks, everyone. Thanks for the question. Nice quarter. John, maybe – either John or Sandy, in this environment that we're in, obviously, it's pretty fluid, you've got high inflation, you've got consumers scrambling to probably pay their bills and meet their – and get their groceries at a reasonable price. Are you seeing any meaningful shifts from branded to private label to different alternatives? And then when you put that into perspective of a CPG actually doing more merchandising here, are the values of the merchandising programs higher? And as for you, you generally have a pretty good profit center is when you have high levels of merchandising. Can you give me a update on what those two questions – kind of what I'm asking there.

J. Alexander M. Douglas
Chief Executive Officer & Director, United Natural Foods, Inc.

A

Sure. And I'll maybe comment, this is Sandy, and then I'll give it over to Chris. I think we mentioned that we saw some acceleration in the quarter, strong acceleration in private label brands. I think the interesting thing about our customer base and our product line is that we actually show up wherever the customer and the consumer is

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positioned. And so, you've really got both. You've got high-end customers who are still spending money on high-end things and then there's this acceleration in own label.

And then as it relates to suppliers, it's still kind of dynamic as fill rates are still stressed, but they're getting a little bit better. And the conversation with our suppliers that we had at various industry conferences and I sat through about 30 meetings is all about the opportunity that our customers bring them.

Diverse channel structures are really important to CPGs and UNFI's customer base is nothing but that. And so, while there's still a dampening in promotional efforts versus where we wanted to be and where we expected to be, we're, I think, being successful with our merchants at working with vendors and we continue to focus on improvement to get promotional dollars to the proper places with our customers so they can be successful.

Chris, do you want to add any more detail?

Christopher P. Testa
President, United Natural Foods, Inc.
A

Yeah, just a quick addition is, look, we saw the fill rates declined from Q4 to Q1 and then again Q1 to Q2, but they stabilized in Q3, actually slight uptick sequentially. The promo dollars have a lag behind fill rate. So it's not immediate to the fill rate improvement and we fully expect as fill rate continues to improve and we're hearing from manufacturers there's less temporary unavailables, they're feeling optimistic about get healthy dates, and the promo dollars will follow. But there's a lag, called a three-month lag between the fill rate improvement and the promo dollar improvement.

In the meantime, as Sandy mentioned, we are seeing a shift towards private brands, and we had private brands acceleration. And we are working with our suppliers to get those key value items and all the promo dollars we could secure through our shows for our customers to help them get through this period.

Eric Larson
Analyst, Seaport Global Securities LLC
Q

So, without – and thanks for those comments. So without actually talking much about any kind of fiscal 2023 guidance or anything, it sounds like the promo environment could be a bigger tailwind for you in F2023 than in F2022. And can you quickly compare F2022 to F2021 on the promo rates and the programs. Does it benefit this year or no?

Christopher P. Testa
President, United Natural Foods, Inc.
A

Well, no, and promo dollars are slightly above flat year-over-year, and that frankly wasn't to expectations, right? We expected fill rates to continue to improve like they were doing through the end of the last year at this time, but they're roughly flat year-over-year.

Eric Larson
Analyst, Seaport Global Securities LLC
Q

Got it, okay. Thank you.

Operator: The next question is from Mark Carden with UBS. Your line is open.

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Mark Carden
Analyst, UBS Securities LLC

Q

Good morning. Thanks a lot for taking my questions. I wanted to dig into the market contraction you mentioned that continued into 3Q. So we've heard from some of the large mass merchants that they've seen some wallet share shift from discretionary categories into consumables. Is this slowing up with what you're seeing and how does it impact your view on market contraction over the next few quarters? Could the degree of contraction ease more than you're anticipating? Thanks.

J. Alexander M. Douglas
Chief Executive Officer & Director, United Natural Foods, Inc.

A

Yeah. I mean, our – as we mentioned, the volume that we saw in the quarter really was consistent from Q2 to Q3. And in fact, we saw independents actually start to gain share a little bit in February and March and April. And I'm not sure whether the dynamic is that fuel prices are going up and therefore the drive to – away from home has kept people closer or just that independents are continuing to do a really good job of staying close to their customers with meal replacement and other unique offers.

As I've traveled around the country, I have seen some extraordinarily agile and very, very creative approaches to customer retention in the independent customer base. And so, the general outlook that we would have is that the winners are going to continue to win, and our job is to be front and center to try to help them whether it's core execution or value-added programming or connecting with suppliers, and that's exactly what we're going to do.

Mark Carden
Analyst, UBS Securities LLC

Q

Great. And then another follow-up on inflation. I know there's a ton of variability, but as you plan out your business, how long are you now expecting for these kinds of elevated rates to last? And then if we do start to – a year from now, we'll see deflation, how much of an impact could that have on your margin structure?

J. Alexander M. Douglas
Chief Executive Officer & Director, United Natural Foods, Inc.

A

We spend 100% of our billable hours looking at how we can get better for our customers and very little at playing amateur economist. They certainly are elevated right now and we don't see a real change.

Having said that, as you would expect, we scenario plan multiple potential scenarios. And interestingly enough, the actions that we were taking virtually, every scenario are approximately the same. We have to make sure that we're showing up for our customers and buying right and keeping them competitive. We have to work hard on our execution, so that we're a partner of choice. And then, we've got to keep our cost structure tight so that we stay agile in the face of whatever the scenario is. And that's been our focus as we prepare for next year. And I think we'll be in strong shape, regardless of the scenario.

Mark Carden
Analyst, UBS Securities LLC

Q

Great. Thanks so much, guys, and good luck.

J. Alexander M. Douglas
Chief Executive Officer & Director, United Natural Foods, Inc.

A

Thank you.

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Operator: Our final question comes from Kelly Bania with BMO. Your line is open. Kelly Bania, your line is open. Please go ahead.

Kelly Bania
Analyst, BMO Capital Markets Corp.

Q

Hi. Thanks for taking our questions. Wanted to ask a couple about retail. First, the retail growth of about 2% was just a little lower than the rest of your segments, and I was wondering if you could just help us unpack that a little bit and understand the factors driving that. Maybe cross-selling could explain some of that as that benefits your other segments. But any color you can comment on there?

J. Alexander M. Douglas
Chief Executive Officer & Director, United Natural Foods, Inc.

A

Sure. I mean, our retail business has been performing really well since the acquisition and has held and I think, in some cases, grown share, particularly in Twin Cities. Sales in the quarter were solid from a market perspective. It was very competitive up there. We invested in promotional dollars. But more importantly, for that business, we invested in capability – in digital capability to craft more personalized promotions, to understand pricing and revenue management capability and several operating initiatives.

So the net-net is, we're pleased with our retail business. The volume in the quarter was market competitive. But a number of initiatives that give us confidence that the outlook for our retail business is strong.

Kelly Bania
Analyst, BMO Capital Markets Corp.

Q

Okay. And can you also just expand on the factors driving the EBITDA margin rate decline there? You mentioned some of these investments. But could you help unpack that between gross margin, SG&A? Were these planned? Or how reactionary were these to the need to maybe do some more promotions?

J. Alexander M. Douglas
Chief Executive Officer & Director, United Natural Foods, Inc.

A

Yeah. No, I think, in general, one of our KPIs is to expand EBITDA margin, and we expect to do that and have actually year-to-date. In the quarter, we invested in the supply chain as we continue to make sure that we're giving our customers the best possible service in what continues to be a pretty dynamic operating environment. And the operating margin contraction was really minor.

That said, we have a number of initiatives through ValuePath. And we expect, as we look forward, and there's a little bit of a crystal ball, but our strategy to continue to make our operating expense more efficient, should be back on track as we go ahead.

John W. Howard
Chief Financial Officer, United Natural Foods, Inc.

A

And Sandy, if I can build on that a little bit, there were some specific items that were cycling in 2022 that we've talked about before, including that monetization of Riverside which creates a rent expense which didn't exist last year. We knew health and wellness expense was going to come back on in 2022 as more people are going back for medical procedures. And we've been open about the Save-A-Lot transaction, that service fee that we're providing them for the past five years that also ended in FY 2022.

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J. Alexander M. Douglas
Chief Executive Officer & Director, United Natural Foods, Inc.

A

Yeah. John, thank you. And importantly, I guess, the last point to share with everybody is that as the business has proceeded, it has performed in line with the expectations that we had in that regard. So...

Kelly Bania
Analyst, BMO Capital Markets Corp.

Q

Okay. That's very helpful. And I guess, I'm sorry if I missed this, but could you just provide the inflation rates and any color you are seeing across the different customer segments? And if you can or willing to just help us understand a little bit more what you're hearing from your supplier landscape in terms of more price increases on the horizon?

John W. Howard
Chief Financial Officer, United Natural Foods, Inc.

A

I'll start with the number on the inflation. So as we talked about for Q3, of our 9.2% growth, roughly 2.5% of that was volume-driven. So when you think about inflation making up the rest of that, and that's net of elasticity and other aspects related to our pricing and business model, but volume was roughly 2.5%. And then the rest would be attributed to the inflation. As it relates to some of the supplier information, I'm not sure if we have or if we've disclosed that.

Christopher P. Testa
President, United Natural Foods, Inc.

A

No, we haven't. Hey, Kelly. This is Chris. Inflation isn't really a channel thing; it's a product segment thing, right? So it's based on the suppliers. And the fresh business, you're seeing changes happen daily as the commodity prices go up and down depending if we're talking about produce or proteins or so forth.

With the Center Store, the thing that we are focused on is making sure we have enough lead time to inform and adapt to our customers, and making sure we're doing everything we can to get corresponding promo dollars to keep the volume and our customers going.

I can't pinpoint any single category in the Center Store grocery where inflation is higher than the other. As you've read and we've all heard, it's really across the entire segment. Certainly, there's been some certain categories, sunflower oil, for example, that have been impacted by the war, but those are sort of really small, targeted segments. But, in general, it's been across the entire Center Store.

Kelly Bania
Analyst, BMO Capital Markets Corp.

Q

Okay, that's helpful. And I guess, as you look across your customer base between the different retail strategies that they have, between value or mainstream or premium, are you seeing some shifts in terms of trends, particularly on the volume standpoint or promotional standpoint as you just communicate with your retailers?

J. Alexander M. Douglas
Chief Executive Officer & Director, United Natural Foods, Inc.

A

Yeah. Kelly, this is Sandy. I think, again, we're seeing some macro trends on categories. We're seeing acceleration in own brands, in particular, as – almost in parallel to the spike up in inflation. Relative to retailers, they're really operating where they're positioned. And as I mentioned earlier, the situation with the customer base

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is bifurcated. Upper-end consumers are still spending money and they're spending money on upper-end things. Now, there may be a little shifting between restaurants and there's dynamism between restaurants and meal replacement strategies with retailers.

And then as sort of mainstream retailers and then those that are the more value-oriented are certainly seeing that side of the customer base emphasize value for money, and there's a lot of price sensitivity and time-demand sensitivity as folks move away from their SNAP payments.

So, the net effect of all that is that we have to show up where the retailer strategy is, and we're seeing the winners win and we are fortunate enough to be doing business with a lot of winners.

Kelly Bania

Analyst, BMO Capital Markets Corp.

Q

Thank you.

Operator: That concludes the Q&A portion of today's call, and I'll turn the call back to CEO, Sandy Douglas, for any closing remarks.

J. Alexander M. Douglas

Chief Executive Officer & Director, United Natural Foods, Inc.

Thanks, operator, and thanks to everybody for joining us this morning. I hope you've heard and take away from today's call that UNFI is growing and performing within a changing environment by steadfastly focusing on our four operating principles that underpin our execution of the Fuel the Future strategy, bringing value to our customers, improving the way we partner with suppliers, creating unmatched clear opportunities for our associates, and supporting our communities and the planet. And through all of this, our ultimate focus is on adding significant value for you, our shareholders.

For our customers, we thank you for your continued partnership and the business we do together. And for our suppliers and UNFI associates listening today, my thanks to each of you for everything that you do for our business, our customers, our communities and each other. And for our shareholders, thank you for the trust you put in us through your continued investment in UNFI. Thanks, everybody.

Operator: Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.

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