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United Natural Foods, Inc. NYSE:UNFI

FQ3 2024 Earnings Call Transcripts

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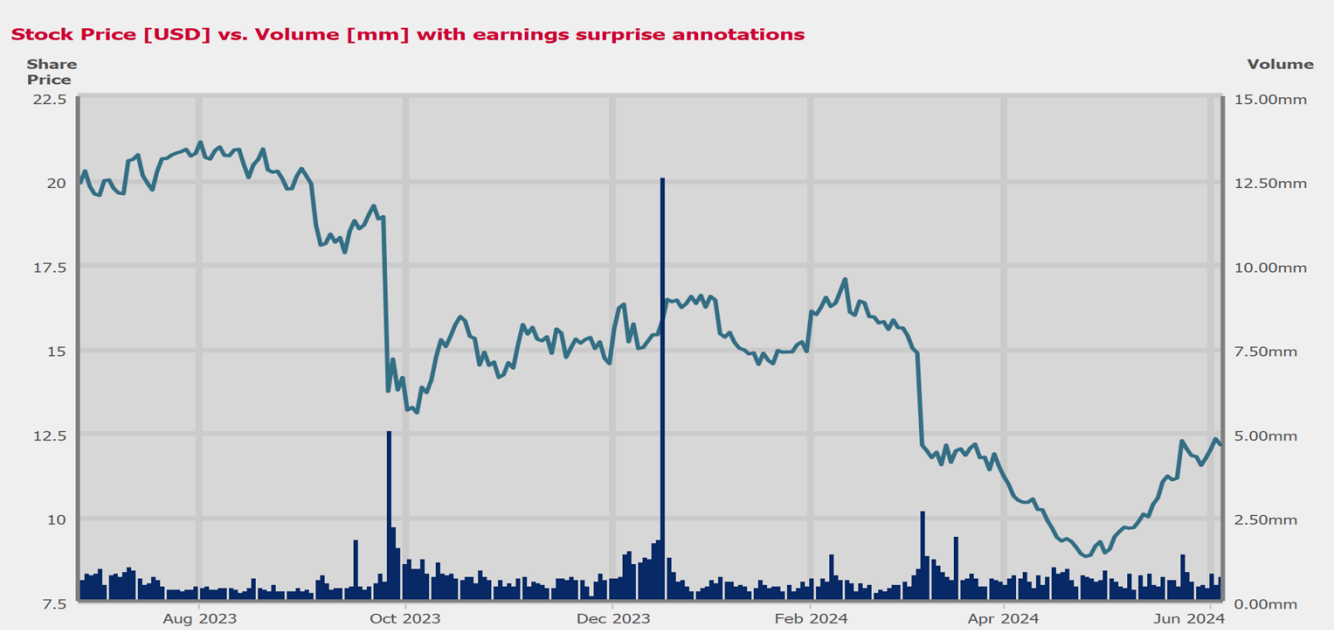
S&P Global Market Intelligence Estimates

	-FQ3 2024-			-FQ4 2024-	-FY 2024-	-FY 2025-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.03	0.10	233.33	(0.10)	(0.03)	NA
Revenue (mm)	7515.05	7498.00	(0.23 %)	7930.09	30772.02	NA

Currency: USD
Consensus as of Apr-29-2024 12:12 AM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2023	(0.39)	(0.25)	NM
FQ1 2024	(0.34)	(0.04)	NM
FQ2 2024	(0.02)	0.07	NM
FQ3 2024	0.03	0.10	233.33 %

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Call Participants

EXECUTIVES

Giorgio Tarditi
President & CFO

James Alexander Miller Douglas
CEO & Director

Steven J. Bloomquist
Vice President Investor Relations

ANALYSTS

Andrew Paul Wolf
CL King & Associates, Inc., Research Division

Carla Marie Casella Hodulik
JPMorgan Chase & Co, Research Division

Leah Dianne Jordan
Goldman Sachs Group, Inc., Research Division

Sachin Verma
UBS Investment Bank, Research Division

Unknown Analyst

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Presentation

Operator

Hello. My name is Ellie, and I will be your operator for today. I would like to welcome everyone to UNFI Fiscal 2024 Third Quarter Earnings Call. [Operator Instructions] It is now my pleasure to turn today's meeting over to Steve Bloomquist, Vice President, Investor Relations. Steve, please go ahead.

Steven J. Bloomquist
Vice President Investor Relations

Good morning, everyone, and thank you for joining us on UNFI's Third Quarter Fiscal 2024 Earnings Conference Call. By now, you should have received a copy of the earnings release issued this morning. The press release and earnings presentation, which management will speak to are available under the Investors section of the company's website at unfi.com on the Events tab. We've also included a supplemental disclosure file in Microsoft Excel with key financial information.

Joining me for today's call are Sandy Douglas, our Chief Executive Officer; and Matteo Tarditi, our President and Chief Financial Officer. Sandy and Matteo 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 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 and the end of our earnings presentation.

I'd ask you to turn to Slide 6 of our presentation as I turn the call over to Sandy.

James Alexander Miller Douglas
CEO & Director

Thanks, Steve, and thank you all for joining us this morning. We delivered another quarter of results in line with our fiscal 2024 plan, and we progressed on our near-term operational and efficiency initiatives to reset profitability. We've also taken important actions to strengthen our foundation, including extending our relationship with Whole Foods through 2032 and extending the maturity of our term loan to 2031.

Our ongoing Board and management-led financial review is also nearing an important milestone, which is our new multiyear strategic plan that will begin in fiscal 2025. We have benefited from the Board's engagement during this process, and we will continue the review to ensure strong guidance and oversight as we implement the plan and evaluate further opportunities to improve our capital structure and drive short- and long-term shareholder returns.

Today, I will discuss our view of the industry, how it informs our go-forward strategy and some of the financial improvements we expect to generate as a result. I will also preview our new multiyear plan, which will include a disciplined resource reallocation and prioritization to enhance the drivers of customer and supplier success, including the expansion of our high-margin services portfolio, which we believe will incrementally remargin our business and drive a significant increase in free cash flow, a reduction in our leverage and an overall strengthening of our balance sheet starting in fiscal 2025.

Given our industry-leading position with a diversified product and service offering, and our expansive and innovative customer base, we have a unique perspective from which to evaluate the evolving dynamics impacting food retailers, suppliers and consumers. We've applied this perspective to analyze our business against today's operating environment, which is markedly different from 3 years ago, when UNFI last refreshed its long-term strategy.

Our analysis points to how we can support retailers to differentiate and compete by providing increasingly relevant product and service offers to help them deliver a compelling consumer experience and a unique assortment in an environment where many consumers remain sensitive to price and large mass and discount retailers are gaining share.

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Our analysis of our current and potential customer base has identified that there is a resilient segment of the industry that totals over $90 billion of sales today and includes many conventional, specialty, natural and ethnic operators. It is expected to grow at a low single-digit rate over the long term and will likely be led by natural and specialty volumes. Importantly, the large majority of our existing customers are in this segment, and we believe these retailers will be increasingly important to suppliers focused on brand building and profitable growth.

Our strategic work and customer interactions has given us greater conviction about the importance of the professional and digital services we offer and how we can generate mutually compelling economics. As we've discussed on prior calls, we've been working to utilize the competitive advantages we have through our scale, relationships, data and insights to develop new business initiatives that help our retailers and suppliers compete.

Most recently, we've launched our UNFI Media Network in partnership with Swiftly. We believe this initiative will help democratize modern media marketing capabilities for our retail customers and provide consumer products companies with unique data insights from across our network that services more than 30,000 diverse customer locations and covers over 90% of the U.S. population.

We expect to develop and invest or partner to provide other capital-light services in the future. We have also continued to advance our revamped commercial go-to-market program for suppliers and expect this to be additive to our results starting in the next fiscal year.

Turning to Slide 7. In addition to refinements in our customer and supplier strategies, our updated view leads to important actions we are taking to better position our business for the future. These actions represent a shift in our strategic direction to continue to remargin and increase the cash flow generation of our business focused on controllable variables in 4 key areas: intensifying and expanding our network optimization; reducing annual capital spending; optimizing our cost structure; and materially reducing our net working capital position.

We see a meaningful opportunity to streamline our supply chain footprint and drive capital efficiencies beyond what we've already actioned. As we've discussed previously, we've been focused on realizing network optimization benefits, but we now see an even larger opportunity to do so. We are still scoping and prioritizing the options and details. But we expect these changes to our DC network will meaningfully reduce our ongoing capital expenditure requirements and fixed asset base, resulting in higher free cash flow and improved returns on invested capital.

We've also worked to reevaluate and prioritize capital investment needs and see substantial opportunity to reduce CapEx beyond the benefits we anticipate from our larger network optimization plan. We currently plan to spend approximately $300 million in fiscal 2025, a $70 million reduction compared to our updated outlook of $370 million for this fiscal year. This reduced level of capital spend continues to prioritize maintenance and targeted network enablement and technology enhancements.

Importantly, we believe this will help us to reallocate resources and strengthen our broader business and balance sheet while enhancing our ability to strategically invest in higher-margin parts of the business such as services. Additionally, we've worked to better understand the full operating potential of our business, the improvements that we can make without incremental capital expenditures and the long-term expense efficiencies we can realize.

We expect to build on the initial work we've done over the last year to improve our expense structure and believe we have an opportunity to recognize additional efficiencies over the next few years, approaching a similar magnitude to the $150 million that we've already removed over the last year. This expense optimization includes taking a more unified and strategic approach to our customer and supplier-facing work as well as better prioritizing our corporate resources, consistent with our updated strategy.

We believe this will improve our financial trajectory and the commercial experience for our customers and suppliers. Working capital management is another area where we believe we can drive stronger free cash flow by improving metrics that have been pressured in recent years, partially due to the challenges of the pandemic and our desire to ensure product availability for our customers and partially due to business complexity.

We've thoroughly scrutinized our working capital processes and believe there is a sizable opportunity to improve cash flows by lowering inventory days on hand while reducing days of sales outstanding and optimizing days to pay. We expect to be able to accomplish this without impacting our customer experience. We are beginning to take actions to drive benefits from these opportunities. We are taking a similar approach to achieving this fundamental operational improvement that we did in tackling and rapidly achieving the $150 million in annualized near-term reductions we previously discussed as well as the broader supply chain efficiencies we've actioned.

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This includes reductions in transportation costs and shrink, which is about 30 basis points lower as a percent of sales than the rate at which we exited fiscal 2023. In summary, we've made significant progress in our financial review and are beginning to see tangible benefits to our financial performance stemming from this process.

Our new strategy will reallocate and prioritize our resources to enhance the drivers of customer and supplier success, including the expansion of our high-margin services portfolio, which we believe will result in a re-margining of our business, a significant increase in free cash flow, a reduction in our leverage and an overall strengthening of our balance sheet. We expect these actions will lead to significant and sustainable returns for our shareholders.

We're using the findings of our work to inform our fiscal 2025 budgeting process, which is underway now. We will provide further detail on our multiyear strategic plan and fiscal 2025 outlook after we complete our target setting process. One call out is that we expect to generate free cash flow approaching $100 million next fiscal year, and plan to use these funds to reduce net debt. And over the next several years, we expect to generate stable and dependable profit and cash flow growth, improving returns on capital and reducing net leverage with our more focused strategy.

While we're still working to finalize our multiyear strategic plan based on the full spectrum of controllable levers we've identified, we see a path to reduce net leverage to 2.5 turns or less, and to increase ROIC to a higher historical levels we've previously generated by fiscal year-end 2027. Our leadership team is highly motivated and directly accountable for rapidly improving profitability, free cash flow, net leverage and financial and shareholder returns.

We look forward to updating you on our progress during our Q4 call, and I'll now turn the call over to Matteo to provide more details on our Q3 results.

Giorgio Tarditi
President & CFO

Thank you, Sandy, and good morning, everyone. I'm pleased to join you for my first earnings call as President and CFO of UNFI. I'm excited to be here and look forward to building relationships with the UNFI investment community. Prior to joining UNFI, I spent my career at GE, building lean and efficient businesses and executing turnarounds. I'm confident this experience will be valuable as we implement the new strategy Sandy just described. With that, let's dive into our Q3 results, balance sheet and cash flow update.

Please turn to Slide 9. Our sales came in at $7.5 billion, which is roughly flat compared to last year's third quarter. Overall, we saw muted but improving volume performance and decelerating inflation. Unit volumes started to sequentially improve during the quarter, which resulted in wholesale volumes declining by nearly 100 basis points less than in Q2. This favorable trend has continued into the fourth quarter.

As anticipated, our product inflation rate slowed modestly from Q2 to approximately 2%, and we continue to expect inflation to gradually decline as we move through the fourth quarter. Our retail business continued to see top line pressure as many consumers in our retail markets remain highly price sensitive. Our team, led by our new retail CEO, is working with our Cub franchisees to take actions to accelerate the performance of our Cub brand, the Minneapolis [indiscernible] market leader. We also believe we are rapidly cycling changes in government benefits, which we expect will help improve retail comparisons.

Moving to Slide 10. Let's review profitability drivers in the quarter. Our gross margin rate, excluding LIFO, improved 30 basis points sequentially over the second quarter and was about flat compared to the prior year period. Within the segments, our wholesale gross margin rate increased about 10 basis points while our retail gross margin rate declined more than 100 basis points, partially reflecting the challenging operational environment and our efforts to increase store traffic and units per transaction.

Our improving wholesale margin includes the benefit of continued shrink improvement, which is now approaching pre-COVID levels at roughly 30 basis points as a percent of sales. As we highlighted last quarter, we believe that there is further opportunity to drive this even lower, which improves our profitability and had no impact on customers or suppliers.

Adjusted EBITDA declined $29 million compared to last year. However, this quarter included $13 million in incentive compensation expense compared to last year, where results included a $20 million benefit, resulting from the reversal of incentive compensation due to financial underperformance relative to our targets. Excluding this impact, we improved our operating expense rate by 10 basis points year-over-year, which reflects our continued focus on driving performance by managing what we can control.

We have conducted further G&A rationalization particularly focused on our corporate organization to help drive savings and increase the GDP as we prepare to execute our new strategic plan. The savings are expected to yield more significant benefits in fiscal 2025 and as we fully annualize these actions.

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As Sandy also highlighted, we expect to build on these efforts by further reducing our structural cost as part of our new strategy over the next few years. We believe there is a meaningful opportunity to create a more dynamic customer and supplier-facing organization. We'll have additional detail on this as we work through these efforts.

In summary, excluding incentive compensation in the third quarter of both years, adjusted EBITDA would have increased by $4 million, which reflects the benefits of our near-term cost savings initiatives and supply chain efficiency improvements, including our shrink management efforts.

Looking at Slide 11. During the quarter, we generated about $49 million of free cash flow, enabling us to reduce net debt by $30 million during the quarter. We also took strategic actions in the first week of the fourth quarter to solidify our long-term capital structure by amending and extending our secured term loan by 5.5 years to 2031. We continue to believe that a secured term loan is an important part of our capital structure as we value the prepayment flexibility this loan provides us. The majority of our outstanding debt is prepayable without penalty.

As Sandy detailed in his remarks, improving free cash flow and reducing net debt is an important focus of the financial review, and we have identified meaningful controllable levers that we believe will enable us to return to generate these significant free cash flow and further repay debt starting next fiscal year.

We are already undertaking work to help bolster cash generation and are quickly implementing daily management actions to optimize working capital levels, while we execute the longer-term structure of plans to increase free cash flow through EBITDA, CapEx discipline and lower interest expense. We believe there is a sizable opportunity to drive reduction to inventory days on hand in the short term, without impacting the customer experience.

We have assembled a cross-functional group that spans network operations, finance, logistics and our commercial team to help us structurally improve our processes to unlock this cash and prevent inefficiencies from creeping back into the business. This work is expected to be a meaningful part of helping us meet our fiscal 2025 free cash flow goals and we will have an update on it in our 4Q earnings call in September.

Turning to Slide 12. Let's review our revised fiscal 2024 outlook. We continue to be focused on closing out the year with improving operational and financial performance. Based on our expectations for 4Q, we are maintaining our outlook for sales, slightly raising the midpoint of our adjusted EBITDA and adjusted EPS ranges, and reflecting charges related to cost reduction actions, which lowered the guidance ranges for the net income and EPS.

We now expect adjusted EBITDA of $505 million for the year at the midpoint of our updated outlook, which is up from the $500 million midpoint in our prior outlook. We will continue to look for opportunities to optimize our performance by driving execution across controllable variables. We're also reducing our outlook for capital and cloud investments from approximately $400 million for the year to around $370 million. This partially reflects our more focused strategic capital allocation priorities.

Moving to Slide 13. I'm pleased to be joining UNFI at such a pivotal time. I'm optimistic about the future of our company and the returns I believe we can generate for our shareholders. There is significant value creation opportunity from improving processes and efficiency, which is a vital part of my prior experience.

I'm motivated and energized to tackle these challenges so that we can create a financially resilient company for our shareholders, customers, suppliers and associates. I value dialogue with all our stakeholders and look forward to developing relationships with our investor community. We will seek your feedback as we work to execute our updated value creation strategy.
With that, operator, please open the line for questions.

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Question and Answer

Operator

[Operator Instructions] Our first question comes from Leah Jordan from Goldman Sachs.

Leah Dianne Jordan
Goldman Sachs Group, Inc., Research Division

On that, seeing if you could provide some more detail on the working capital improvements you highlighted. What is achievable near term to support the fiscal or the free cash flow outlook for next year? And then what could take longer in your multiyear outlook? And then just on the CapEx [reaction]. Why does it make sense now? And how should we think about the long-term run rate, is it that $300 million beyond '25?

Giorgio Tarditi
President & CFO

Thanks for the question. It's Matteo here. So let me talk a little bit about how we're thinking about free cash flow for next year and then talk a little bit about the working capital question. So Sandy mentioned $100 million of free cash flow -- positive free cash flow for 2025. And you can think about the positive free cash flow in 3 elements.

We're going to work to improve EBITDA, and we're going to give you more details as we discuss the full year 2025. We're going to reduce CapEx from $370 million to $300 million. So we pick up a $70 million tailwind on that. And then we have a number of actions going on, on working capital. So that specifically, I would like to talk about what we're doing on inventory. We look at inventory days on hand and compare it to the pre-COVID levels. Put a number of tools that work, including lead times, flow, pool systems and identify an opportunity to reduce the inventory levels and the debt on hand. I would say, relatively quickly on the first step of the improvement and then going more structurally into, again, fixing all the inefficiencies that we built post-COVID to support customers and to sustain the levels that we saw in the last few years.

So expect probably some level of improvement relatively quickly on inventory. But then on the structural fixes, it is going to take time, and we want to make sure that we take the time not to compromise our safety, quality, delivery, cost in this order with the customers.

Leah Dianne Jordan
Goldman Sachs Group, Inc., Research Division

Great. And for my follow-up, I just wanted to ask about the Whole Foods contract. Great to see that extension there. But just given the term was longer than typical you guys renegotiate for. Can you talk about and how that came about? And how we should compare it to your prior agreement? Any updates around volume commitments or profitability from here?

James Alexander Miller Douglas
CEO & Director

Leah, it's Sandy. The way I would describe it, obviously, we don't comment on specific customer situations other than, obviously, the renewal is sizable. And so we issued an 8-K on it. The way I would describe the relationship is extremely healthy and built on win-win. And this agreement does that. And I think both Whole Foods and we saw the opportunity to make an even stronger strategic commitment to each other and I think we've set an exhibit in the 10-Q that's obviously got some [reactions]. But if you want to review it, you can find it there.

Operator

Our next question comes from Mark Carden from UBS.

Sachin Verma
UBS Investment Bank, Research Division

This is Sachin Verma on behalf of Mark Carden. My question is, are you still seeing much of an uptick in demand for your value-add services for independents given the challenging macro? Or are they being more cautious with their spend?

James Alexander Miller Douglas

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CEO & Director

Yes. I think, frankly, what we're seeing is stronger need for them because retailers are looking for opportunities to grow and opportunities to save money. And so if anything, I would say demand is growing rather than receiving. The value proposition is key, but that's the whole premise of pro services is that it creates value and helps our customers right away. From a strategic perspective, they're also capital-light, so they drive our economics and similarly, drive customer economics. So it's a win-win, and it has a pretty quick benefit for both.

Sachin Verma
UBS Investment Bank, Research Division

And my follow-up is, how is promotional activity trending relative to your expectations?

James Alexander Miller Douglas
CEO & Director

Promotions continue to slightly increase or gradually increase. They're a little bit below pre-pandemic levels in terms of frequency and depth, but we continue to see them increase and we expect them to continue to do that, and that's consistent with what we see industry-wide, based on what some of the large retailers are reporting.

Operator

[Operator Instructions] Our next question comes from [Eli Lach] from BMO Capital Markets.

Unknown Analyst

I was wondering if you could just spend a minute going through the line item, the working capital line item from the past 6 months, the $165 million versus 15 last year. Just you could give us some of the intrinsics there, that would be helpful.

Giorgio Tarditi
President & CFO

Yes. So a couple of comments here. If you unpack it, so if you bear in mind, last year, we entered a monetization program, which is broadly flat in the third quarter. But on a year-to-date basis, created a benefit in 2023 versus 2024. And against that, we continue to do work on inventory. We have, again, some early signs of improvement in the third quarter, and we're going to see more as we execute our action plans in 4Q and 2025.

Operator

Our next question comes from John Heinbockel from Guggenheim and Partners.

Unknown Analyst

This is [Willy Mark] for John Heinbockel. So you mentioned you had gotten through the $150 million of cost reductions. And I also mentioned in the second round. Is there any way you can maybe size that opportunity for us? Or maybe partial -- pick apart where that might be coming from? And then a quick follow-up on the lead productivity results from the Centralia Automation. What's the scope of the opportunity there for existing facilities with this new modified version?

James Alexander Miller Douglas
CEO & Director

Sure. The way we describe the cost opportunity was we achieved $150 million in run rate improvement this year. And the way we communicated the strategic planning element on that is that we saw a similar sized-opportunity that we could achieve over the next few years. And there's a series of more detailed sources underneath that, that will communicate in the future as we finalize our targets.

From a Centralia perspective, Centralia is about to come online. What we've said publicly about it is that we will get returns that are healthy relative to our cost of capital, and it's obviously drives efficiency. It makes growth more efficient and it also significantly increases the quality of the customer experience.

Operator

[Operator Instructions] Next question comes from Andrew Wolf from CL King.

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Andrew Paul Wolf
CL King & Associates, Inc., Research Division

As sort of an open-ended general question about automation and long term, obviously. What is the role of automation going to be for United Natural Foods versus sort of where you're thinking about CapEx and trying to generate free cash flow?

James Alexander Miller Douglas
CEO & Director

So Andy, the way I think about automation is linked completely to network optimization and efficiency. And our network is the largest and widest spanning network and brought us from a product line perspective in the industry. And as we implement technology and we rightsize our footprint, we look for ways to use technology to drive customer service improvement and improve financial returns.

Automation is not an end unto itself, it's a component of that strategy. And our approach to it is to execute it in a highly disciplined way with in-depth project management. And we've learned a lot about that over the last couple of years as we've successfully -- or nearly successfully implemented our new projects as Centralia is just about to come online.

Operator

[Operator Instructions] Our next question comes from Carla Casella from JPMorgan.

Carla Marie Casella Hodulik
JPMorgan Chase & Co, Research Division

In the slide, you showed the $500 million term loan and $130 million FILO as a sub facility to the ABL. So does the $130 million count against your availability on the ABL going forward? And can you say where availability is pro forma today?

Giorgio Tarditi
President & CFO

Yes. So it's Matteo. Thanks for the question. So the $130 million counts in the ABL availability and our liquidity right now is about $1.3 billion.

Carla Marie Casella Hodulik
JPMorgan Chase & Co, Research Division

After quarter end?

Giorgio Tarditi
President & CFO

That is correct.

Carla Marie Casella Hodulik
JPMorgan Chase & Co, Research Division

Okay. Awesome. And then in your multiyear plan slide, you mentioned DC network changes to reduce fixed asset base. Does that mean you're looking at consolidating or selling or closing facilities? Or would you potentially consider sale leasebacks to reduce debt? And any sense you have there in terms of where the cap rates are today?

James Alexander Miller Douglas
CEO & Director

Yes. Thanks. This is Sandy. As part of our intensified network optimization work, we're assessing options for the most effective and efficient configuration of our DCs and how we can best profitably service our customers. Among our customer set, as I mentioned, we have, by far, the most expansive distribution network. And so we see opportunities to take better advantage of economies of scale within the business and obviously, more specifics to come.

Carla Marie Casella Hodulik
JPMorgan Chase & Co, Research Division

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Okay. Great. And just any more color you can give us, in terms of the margin on the -- and maybe it helps if you give us some sense of the margin between the different businesses? And where you're -- how it may differ, if you're offering more services to one of your channels versus another.

James Alexander Miller Douglas
CEO & Director

Sure. The way to think about services is there, by far, our highest margin segment. We issued a couple of years ago, details around our services component, which was that they were about 20% to 25% of our profitability. They're not currently reported as a segment. But we see the opportunity going forward to accelerate their growth, and they have been growing and will continue to grow significantly faster than the total company.

Operator

We have reached the end of our question-and-answer session. I'd now like to hand back over to Sandy Douglas for closing remarks.

James Alexander Miller Douglas
CEO & Director

Thank you, operator. Our new multi-year plan is being finalized and we're motivated to implement this strategy to deliver stable and dependable profit and cash flow growth, improving returns on capital and declining net leverage. We shared with you the levers we'll be pulling to improve our short- and long-term performance, and we believe that this plan will create significant and sustainable value for our customers, suppliers and our shareholders.

I'm excited to have Matteo on the team and believe the skills, experience and focus on process excellence and value creation that he brings to UNFI will help us immensely as we move into our next chapter.

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

Thanks again for joining us this morning. I look forward to updating you as we continue to drive progress improving our business.

Operator
Thank you for joining today's call. We hope you have a wonderful day. You may now disconnect.

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