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Sovos Brands, Inc. (SOVO)

Q3 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by, and welcome to Sovos Brands Third Quarter Fiscal Year 2022 Earnings Conference Call. At this time, all participants are in a listen -only mode. After the speakers' presentation, there will be a question-and-answer session. [Operator Instructions] Please be advised, that today's conference may be recorded.

I would now like to hand the conference over to your speaker host today, Josh Levine. Please go ahead.

Joshua A. Levine
Vice President-Investor Relations, Sovos Brands, Inc.

Good afternoon and thank you for joining us on Sovos Brands' third Quarter fiscal year 2022 earnings conference call. On the call today are Todd Lachman, President and Chief Executive Officer, and Chris Hall, Chief Financial Officer. By now, everyone should have access to the earnings release for the period ended September 24, 2022 that went out this afternoon at approximately 4:00 PM Eastern Time. The press release, as well as supplemental slides, can be found on the company's website at ir.sovosbrands.com. And shortly after the conclusion of today's call, a webcast will also be archived and available for replay.

Before we begin, let me remind everyone that today's discussion contains forward-looking statements based on the environment as we currently see it, and as such does include risks and uncertainties. If you refer to the company's earnings release, as well as its most recent SEC filings, you will see a discussion of factors that could cause Sovos Brands and actual results to differ materially from these forward-looking statements. Please remember, the company undertakes no obligation to update or revise these forward-looking statements in the future.

We will make a number of references to non-GAAP financial measures. We believe that these measures provide investors with useful perspective on the underlying growth trends of the business and have included in our earnings release a full reconciliation of non-GAAP financial measures to the most comparable GAAP measures.

Lastly, please note that all consumption data cited on today's call will refer to dollar consumption as of the 13-week period ended September 25, 2022 and growth versus the prior year comparable period unless otherwise noted.

With that, I would now like to turn the call over to Todd.

Todd R. Lachman

Founder, President, Chief Executive Officer & Director, Sovos Brands, Inc.

Thanks, Josh. I would like to start off today's call by discussing a few highlights from the quarter and then provide an update on the current operating environment before turning it over to Chris Hall for greater detail on our third quarter results, as well as our updated outlook for the remainder of the year.

First, I would like to highlight the recent one year anniversary of our IPO. I couldn't be more proud of our performance over the last four quarters, having delivered 16% organic sales growth on an LTM basis and recently passing $800 million of net sales. Growth has largely been volume led in a period when most of our peers have not only been almost entirely reliant on pricing, but also are without the ample opportunities we have to drive strong sustainable growth.

Our growth is particularly impressive in light of the challenging operating conditions for our industry. Our largest brand, Rao's, continues to grow robustly, passing $500 million of net sales and growing 30% net sales and growing 3% on an LTM basis. And from a profit perspective, we have been able to essentially maintain our EBITDA despite experiencing double-digit inflation and numerous disruptions to our supply chain while simultaneously stepping up investments to support our growth. This has truly been a remarkable last 12 months of tenacity and perseverance against a very challenging operating environment. We purposely built a team of agile, energetic and talented leaders and have benefited from their industry experience and growth mindset.

We continue to add to our already strong team. We've recently announced that Yuri Hermida has joined Sovos Brands as our Chief Growth Officer. Yuri brings with him proven leadership and experience in building and scaling brands globally, most recently at Reckitt, we successfully ran their North America hygiene business through the pandemic, and prior to that, at P&G where he spent over 20 years in multiple countries and category leadership positions. The confidence we have in our team and their improvement ability to execute is a key reason we can sustain our sector leading growth rates.

Looking to our third quarter results, we delivered another solid quarter, generating 16.9% organic sales growth. Pricing was up 14.4%, primarily the result of the previously discussed list price increases we've taken year-to-date. Volume increased 2.5%, inclusive of a negative 8 point headwind to total company volumes from lapping two large volume-driving events from a year ago for the Noosa and Michael Angelo's brands that we did not repeat this quarter. And as expected, our gross and EBITDA margins showed nice sequential progress amidst persistently elevated inflation, even as we continue to support our brands with robust investment.

Our core business sauce, yogurt and frozen, which represent 90% of our portfolio, delivered strong dollar consumption growth rates of over 17%. Sauce grew dollar consumption 24.3%. Once again, ahead of the category. Yogurt grew 3.6%, supported by pricing. And finally, frozen, which includes entrees as well as waffles grew 16.1%, a nice acceleration versus last quarter as our in-market support normalized and supply chain performance improved.

Shifting to our largest brand, Rao's surpassed $500 million in LTM net sales this quarter and is now over seven times larger than when we acquired it five years ago. Rao's continues to be one of the fastest growing center store brands of scale in the US and is well on its way to reaching $1 billion of annual net sales. For the quarter, total Rao's franchise dollar consumption grew 27.7%, led by nearly 20% unit growth that was driven by broad based gains in distribution and velocities. Total Rao's household penetration increased by 230 basis points versus prior year to 14.8% as a result of adding new households across all categories.

Specific to sauce, Rao's dollar consumption increased by 24.3%. This rate of growth translated into a 100 basis point increase in dollar share versus the prior year to 14.1% as dollars in units were driven by velocity and distribution gains. Unit growth of 15% came in well ahead of flattish category unit growth. Importantly, Rao's sauce has only a 5.3% share of category units today, further highlighting the immense upside potential for this brand. Additionally, household penetration for Rao's sauce continues to grow, finishing the quarter up 160 basis points versus the same time last year to 11.8%.

In addition to sauce, Rao's continues to build its newer beachheads in soup, pasta and frozen, categories that we see as highly incremental opportunities for the brand. In totality, these businesses have now surpassed the combined $100 million of IRI measured annual net sales, with dollar growth up nearly 50% year-over-year on an LTM basis as well as in the third quarter. Consumption is being led by double digit volume growth across all three categories as we implement our Sovos Brands playbook, working to increase physical availability on store shelves and then supporting them by growing awareness.

While our market shares and household penetration levels today are relatively modest in the context of these multi-billion dollar categories, we see material growth opportunities for the Rao's franchise in these and other categories for years to come.

Turning to noosa, our yogurt business once again grew consumption mid-single digits on a dollar basis, with pricing and mix driving the growth. Much like the broader yogurt category, we are increasingly benefiting from a greater shift towards larger sizes as consumers seek out value. We will continue to focus on fundamentals to ensure we grow in this large and competitive category while providing new and delicious offerings for consumers. Lastly, on Birch Benders, sales trends were largely as expected. Our teams are working hard to improve performance, as we continue to experience challenged trends in the core keto offerings.

Shifting to supply chain. Performance across manufacturing and logistics operations saw a marked improvement versus last quarter with service rates approaching target levels on sauce, yoghurt and frozen. On inflation, although we are starting to see cost increases moderate in some areas of our business, we continue to realize elevated inflationary pressures across our cost basket, most notably in dairy, glass and pass-through inflation from our North American co-packers.

To offset these costs, in addition to our pricing actions taken to-date, we are executing against our full suite of productivity projects, including the automation of multiple packaging lines in our frozen plant in Austin, internalization of food prep at our Noosa plant in Colorado and other process improvements across our entire network. These actions will help improve our margins over time. And as we've stated in the past, we will not hesitate to respond with additional actions if warranted by the market.

In summary, we are very pleased with our top line growth year to date and confident in our growth trajectory. As a result, we are once again raising our sales guidance for the year by $15 million or 2 points of growth at both ends of the range. We are excited by what we have achieved so far this year and what the future holds for our portfolio of brands led by Rao's on the path to $1 billion of annual net sales.

While we will not be offering any concrete guidance for 2023 today, know that we will remain focused on capitalizing on the opportunities to drive household penetration by expanding distribution and awareness. And we will continue to make strategic investments from a position of strength spending behind sales, marketing, innovation, supply chain and other necessary capabilities to drive growth for our one-of-a-kind brands, even in the face of a challenging cost environment.

I will now hand it over to Chris for more details on the quarter and our updated perspective through year-end.

Christopher W. Hall

Chief Financial Officer, Sovos Brands, Inc.

Thank you, Todd, and good afternoon, everyone. Before I begin, I also would like to echo Todd's comments and complement our team and their execution in this challenging environment. Third quarter total net sales were $208.9 million, a $30.2 million or 16.9% increase over the prior year period. This growth was entirely organic and was driven largely by the price, up 14.4% in the quarter.

Our volume grew 2.5% in the quarter, inclusive of a negative 8 point headwind due to lapping two prior year volume driving events for the noosa and Michael Angelo's brands, which we did not repeat this quarter. Excluding Birch Benders, our consolidated organic growth would have been 20.8%. Our core categories, sauce, yogurt and frozen, drove our growth in the quarter. And at the brand level, Rao's remained the driving force behind our growth, increasing net sales 33.7% driven by sauce. On a year-to-date, the total Rao's franchise has grown 31%. And, importantly, this is in line with consumption. When comparing total Rao's franchise net sales to 2019, the brand grew at a three-year CAGR of 50%, reflecting our ability to sustain leading volume driven growth rates.

Beyond Rao's, noosa net sales grew 2.4%, Michael Angelo's declined 3.7%, and Birch Benders declines moderated as expected.

Moving to the rest of the P&L, adjusted gross profit of $62.3 million increased $12.2 million or 24.2% year-over-year, benefiting from our strong top line results. Adjusted gross margins were 29.8% of net sales for the quarter, reflecting a 170 basis point increase versus the prior year period and another quarter of sequential progress towards improving our margins.

Pricing, increased productivity savings, and mix were tailwinds helping to offset inflation, which was in line with our forecast for the quarter in the low double-digit range. The year-over-year gains were also helped by lapping higher shipping and port congestion related costs.

Adjusted operating expenses inclusive of marketing and selling of $35.8 million increased by $8.7 million or 32.3% over the prior year period as we continue to invest behind our talent, brands, and capabilities to drive sustainable growth for the long term. Similar to last quarter, we prioritized our growth investments defined as marketing plus R&D, the total spend in the third quarter up nearly 20% versus last year, and up over 32% versus the second quarter of 2022, which itself was also up materially on a year-over-year basis. OpEx growth also included public company costs, which were not present in the prior-year period when the company was private.

Adjusted EBITDA at $29.5 million increased $3.7 million or 14.5% versus Q3 2021, while adjusted EBITDA margin was 14.1% versus 14.4% in the prior-year period. Net income for the quarter was $1.5 million or $0.01 per diluted share compared to a loss of $4.6 million or negative $0.06 per diluted share in the prior-year period. Adjusted net income was $14.3 million and adjusted EPS was $0.14 per diluted share compared to $7.1 million and $0.10 per diluted share in Q3 2021.

Due to the timing of our IPO in September 2021, our fully diluted share count of 101.6 million shares in the quarter was 37% higher than the prior-year period and represented a 5% headwind to our Q3 2022 adjusted EPS. At the end of the third quarter, cash and cash equivalents were $81.9 million and total debt was $482.2 million, resulting in a net debt-to-adjusted EBITDA ratio of 3.7 times. As a reminder, last quarter, we entered into an interest rate hedge and capped the LIBOR rate for half of our debt at 4%.

I would now like to discuss our updated outlook for the balance of the year with some of the underlying assumptions that support it. On the top line, we are raising our fiscal 2022 guidance to $840 million to $850 million, reflecting approximately 17% to 18% growth. This compares to our prior guidance of $825 million to $835 million or 15% to 16% growth. Our updated guidance reflects 16.3% organic sales growth year to date and our confidence in a strong finish to the year. Remember that this guidance includes the benefit of a 53rd week in Q4. Further, this guidance also had the approved supply chain performance that Todd spoke about a moment ago, which had put us in a strong inventory position as we head into Q4. Lastly, we continue to assume some normalization of elasticities into year-end.

Regarding profitability, we are maintaining our full-year adjusted EBITDA range of $116 million to $122 million with guidance at the lower end. For the fourth quarter, we will begin to lap our first list price increase. In addition, relative to the third quarter, we are expecting a smaller mix benefit, as well as slightly higher pass-through costs from our North American co-packers. Finally, I want to reiterate that we will continue to invest in the business to enable the multiyear growth opportunity that we see ahead. This includes supporting our brand, people and capabilities. These investments align with our primary focus on growth for our portfolio of one-of-a-kind brands, with a particular emphasis by taking Rao's to $1 billion.

From a balance sheet perspective, we continue to expect that our leverage will be below 3.5 times at year-end. For a summary of these and other guidance items, please see slide 10 in our earnings slide deck.

Let me now turn the call back over to Todd for some final remarks.

Todd R. Lachman

Founder, President, Chief Executive Officer & Director, Sovos Brands, Inc.

Thanks, Chris. We are proud of what we have achieved in the first nine months of 2022. We generated 16% plus organic growth, materially raised our top line guidance multiple times and maintained our EBITDA range despite double-digit inflation and numerous supply chain disruptions. Further, we have stepped up our investments behind our brands, talent, supply chain and capabilities, all with an eye towards driving growth well into the future.

As we have said many times in the past, while sales growth is our top priority, we are also working tirelessly to improve our margins and deliver long-term profitability.

With that, Chris and I are now available to take your questions. Operator?

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] . And our first question coming from the line of Andrew Lazar with Barclays. Your line is open.

Andrew Lazar
Analyst, Barclays Capital, Inc.
Q

Great, thanks so much. Appreciate it. Maybe to start off, I think on the second quarter call, you had talked about expecting pricing to be pretty close to what it was – in 3Q, pretty close to what it was in 2Q, were around 9% or so. It obviously came in much stronger than that. So, I was hoping first just to get a sense of what the differential was or what came in so much stronger on pricing than you would thought.

Todd R. Lachman
Founder, President, Chief Executive Officer & Director, Sovos Brands, Inc.
A

Hey, Andrew, I'm going to pass it, I'm Todd, but good to hear from you. I'm going to pass it to Chris.

Andrew Lazar
Analyst, Barclays Capital, Inc.
Q

Yeah.

Christopher W. Hall
Chief Financial Officer, Sovos Brands, Inc.
A

Thanks, Todd. Thanks, Andrew. Yeah. In Q3, we saw really higher than expected pricing primarily from mix as we saw way off above 30% growth. That drove the majority of the upside on pricing. And we just saw pricing flow through better than expected across the board. So, we talked about in Q2 that we were repeating a couple of events from the prior year. So we knew it'd be elevated, higher than we saw in Q2. We don't anticipate Q4 being at that same level as we just made it back to our normalized promotional cadence in the quarter. But mix was a big driver in Q3, not only for pricing, but also for our gross margins.

Andrew Lazar
Analyst, Barclays Capital, Inc.
Q

Got it. And that was – I guess the next question, which is – I think you also had mentioned that you were looking for sequential margin improvement in 4Q, but that gross margins would still be down year-over-year. Does that still hold even though your third quarter gross margins came in, again, far better than you had thought?

Christopher W. Hall
Chief Financial Officer, Sovos Brands, Inc.
A

Well, we were very pleased with our margin in Q3, 170 points improvement year-over-year, 180 points better than Q2. That was a bit of a surprising and really driven by mix primarily and then that flow through of higher pricing across the board. We don't anticipate that same level in Q4. Q4 is a higher promotional quarter four. I said we returned into our winter months, we do promote more. We do anticipate good solid margins, not at the same level we saw in Q3 as we're also going to be a little bit higher.

We thought that high single – double digit inflation covering across the back half of the year. We mentioned The North American co-packers passing across some additional costs. That will be reflected more in Q4 than it was in Q3. So, we see good strong margins, but not at the same level as we saw in Q3.

Andrew Lazar
Analyst, Barclays Capital, Inc.
Q

Great. Thank you so much.

Christopher W. Hall
Chief Financial Officer, Sovos Brands, Inc.
A

Thank you.

Todd R. Lachman
Founder, President, Chief Executive Officer & Director, Sovos Brands, Inc.
A

Thanks, Andrew.

Operator: Thank you. One moment please for our next question. And our next question coming from the line of Jason English with Goldman Sachs. Your line is open.

Jason English
Analyst, Goldman Sachs & Co. LLC
Q

Hey, guys. Thanks for [ph] spot (00:24:12) me in and good afternoon.

Todd R. Lachman
Founder, President, Chief Executive Officer & Director, Sovos Brands, Inc.
A

Hi, Jason.

Jason English
Analyst, Goldman Sachs & Co. LLC
Q

Quick question on your core business with Rao's sauces. We've been tracking the market share throughout the course of the year and there's been some ebbs and flows. But right now, if we look at it, whether it'd be your volume share or dollar share. You're tracking a bit below where you were when you enter this year, raising concerns that you could actually flip into declines.

Now, recently started to pick up off the lows. I guess my question is, A, what's driving the recent sequential improvement and how or should we be expecting you to be able to continue to drive that higher to stay market share growth as we enter next year.

Todd R. Lachman
Founder, President, Chief Executive Officer & Director, Sovos Brands, Inc.
A

All right. Hey Jason, It's Todd. So, look headline, we have absolutely no concern that the growth on a Rao's sauce is going to slow. I mean, we've got total Rao's franchises went to reinforce just passed a $0.5 billion LTM, 7 times larger than when we acquired it, up 30% versus prior year. You've got sauce dollar consumption for the quarter, up 24% and unit consumption up 14.7%. So, what are those opportunities? And actually on the – we posted online, there's a slide 7 that talks about the different opportunities for the business on the debt. But a couple of those things are we're in mid-teens today in regards to share, but you look at the category leader at 20%. We generate 2 times more dollars per TDP, 223 and you look at everybody else like highest, like 130, number of items 12 versus the category, and our penetration, although, up significantly versus prior year, it's only 12 and you've got the market leaders above 30. We grew units. We grew dollars. We've got household penetration up significantly.

So, look, share is going to bounce around going back and forth. It's like [ph] obviously (00:26:23), need to be flip, but we can't control some of the elements that lead to the arithmetic behind what our share is. What we can control is growing this brand at the rates we are today and the rates we are going forward. So we are controlling the significant amount of investment that we're putting behind the brand from a TDP standpoint, promoting it effectively, making sure we're gaining more and more distribution. So you see velocity up for the quarter. You see distribution and TDP is up for the quarter.

And actually, if you look at the two fastest-growing brands, I'm putting in quote, "Rao's and private label." Those are the two fastest-growing of all the brands. And Rao's and private label grew across all generational cohorts and all income cohorts, again, for the second quarter in a row. Rao's sourced no volume from private label, zero. But private label is going almost the same rate as Rao's. Private label is sourcing significantly from mainstream-wide because there's a lot of great private label sauce out there that's a perfect analog for mainstream sauces. There is not a private label sauce that's an analog for Rao's.

So, private label growing robustly. Rao's growing robustly. Consumers are cutting back from out-of-home dining and spending in chunks right now, and they want great restaurant quality cuisine and they're buying Rao's. So, what we can control is keeping that Rao's franchise lock in, and we are with sauce. And as we talked about, we're growing the other beachheads as well, dry pasta, soup, and frozen.

Jason English
Analyst, Goldman Sachs & Co. LLC

Q

Good stuff. Thanks for the context. I'll pass it on.

Todd R. Lachman
Founder, President, Chief Executive Officer & Director, Sovos Brands, Inc.

A

Awesome.

Operator: Thank you. One moment, please, for our next question. And our next question is coming from the line of Anoori Naughton with JPMorgan. Your line is open.

Anoori K. Naughton
Analyst, JPMorgan Securities LLC

Q

Hi. Good afternoon.

Todd R. Lachman
Founder, President, Chief Executive Officer & Director, Sovos Brands, Inc.

A

Hey, Anoori.

Anoori K. Naughton
Analyst, JPMorgan Securities LLC

Q

I have – hi. I just had a question actually following up on Jason's question, but more about just the sauce and frozen in particular for Rao's. How are these products performing relative to what your internal plans were when they were launched? And in your view, what are the main playbook milestones that you need to hit for penetration rates to really begin to accelerate from here?

Todd R. Lachman
Founder, President, Chief Executive Officer & Director, Sovos Brands, Inc.

A

Sure. Hey. It's Todd, Anoori. Good to be talking to you. So right now, let's just talk soup, pasta, frozen. And I know you specifically asked about frozen. Look, I'll be really honest. I mean, did we expect the Rao's franchise today to be over $0.5 billion growing at 30% in 2017? No. But we certainly understand why it's growing and it's growing fast. And for that reason, we didn't expect that we would have created a $100 million business combined and growing at 50% of frozen, pasta, and soup.

And all those businesses, our soup brand, our Rao's pasta brand, our Rao's frozen brand is growing faster than any other leading brand, call it top five, top seven, that's in the category today. So – and they are all honestly exceeding expectations from the year that when we launched them. But we certainly are taking them for real now, and we are doing everything we can to make sure we're growing robustly going forward.

Now, you asked a really good question because all of those businesses and it's an enormous opportunity, are less than 2% household penetration. So, you've got – our soup business is less than a 2% household penetration. You've got to drive pasta business almost at 2% and you've got our frozen business at a 2%. So, it's 2% or less from a household penetration standpoint. But what have we done to get it from 0% to 2% in such a short amount of time? Our Sovos playbook is pretty simple. We have a great selling organization. We focus on banner penetration, so ACV and item penetration, TDPs.

And we basically make sure we've got a great tasting product, the right package and we get it in as many stores, many items, the right assortment as we can. And then, right – when we get that right level of distribution, we just really drive significant awareness with our advertising and marketing spend that we've increased significantly year over year over year. And you can see how much we increased our marketing and R&D spend just in Q3 alone, which is also a differentiating factor. You see a lot of peer companies cutting back on that. We are [indiscernible] (00:31:13) increased investment.

So, how do we double that to a 4% level of penetration? We're just going to keep adding the right items in the right stores, adding line extensions to those brands, making sure that we're advertising and supporting them effectively with marketing and awareness.

We expect them to keep – continue to keep growing into the future along with our sauce business, and quite honestly along with new category entrants that we expect over the next several years as well.

Anoori K. Naughton
Analyst, JPMorgan Securities LLC

Q

Great. Thank you for that. And as my follow up, I know it's a bit early, but perhaps you could share how you're thinking about cost inflation as we go into 2023. What are some of the high level puts and takes? And how much you might have already been able to lock in? Thank you.

Christopher W. Hall
Chief Financial Officer, Sovos Brands, Inc.

A

Very good. Well, we're not going to talk to you specifically about 2023 today. And what we are very confident in is certainly the continued momentum we have in the top line as Todd just kind of laid out. On the cost side, what we have visibility to today. We feel confident in the plans that we've implemented or will be implementing across our productivity platforms, value engineering and packaging as well as our net revenue management as we move forward.

So, where our visibility stands today, we feel we've got that in hand for 2023 and we are still seeing the same pressures that you're hearing about really across the board could be agro issues one day. We are also starting to see relief on transatlantic shipping, which is a positive for us. As we balance across all of those, but we have visibility too, we're still confident in our plans.

We don't hedge, so we don't have a lot of coverage right now for 2023. We're entering into some agreement on what we buy quarter out or a couple quarters out of some of our specific packaging and even some of our raw material. We're fully covered basically for 2022 [ph] as long as some open (00:33:25) on things like dairy and chicken and meat, but basically covered for Q4 2022 and remained to our agreements now for 2023.

Anoori K. Naughton
Analyst, JPMorgan Securities LLC

Q

Got it. Thank you.

Christopher W. Hall
Chief Financial Officer, Sovos Brands, Inc.

A

Does that answer? Okay, Anoori. Thank you.

Operator: Thank you. And our next question coming from the line of Cody Ross with UBS. Your line is open.

Cody Ross
Analyst, UBS Securities LLC

Q

Great. Thank you so much for taking our questions. If we exclude the promotional event, your sales would have been up roughly 25% in the quarter. Your guidance assumes a sequential slowdown of about 5 points or so in the fourth quarter even though you're lapping a much easier comp. Are you seeing anything in the marketplace right now that suggests there would be a slowdown?

Christopher W. Hall
Chief Financial Officer, Sovos Brands, Inc.

A

No, we're not. But as we have talked about at our prior calls, as we're approaching Q4 and as we've put pricing in place mid-Q3 on Rao's, couple of items, we're assuming a normalization of elasticities as we move forward. We're still in an uncertain environment. Todd may had mentioned, we are seeing growth across all demographics, all income levels, but we're still modeling and assuming that there's going to be a return to more normalized elasticities going forward. If that doesn't occur, that would suggest there could be upside to those numbers, but that's what we have baked into the guidance that we provided.

Cody Ross
Analyst, UBS Securities LLC

Q

That's very helpful. Appreciate that. And then as my follow-up, you noted the Rao's franchise is on path to deliver over $1 billion in sales. Can you just remind us and walk us through the building blocks to get there and are you concerned at all that the Rao's franchise growth will cannibalize Michael Angelo's and frozen? Thank you.

Todd R. Lachman
Founder, President, Chief Executive Officer & Director, Sovos Brands, Inc.

A

Okay. Hey, Cody. It's Todd. So, we're – I mean, we're not concerned about cannibalization. Actually, we've seen in accounts where both those brands are. It's been quite incremental. Our combined share now of Michael Angelo's, Rao's frozen is about, a [ph] 2:2 (00:35:48), up from, call, roughly a 1.5 when it was just in the Michael Angelo's franchise before frozen. So, we've seen additive. We see household penetration of the combined. This is significantly greater than it was just by Michael Angelo's.

So, no, I mean Michael Angelo's has a real reason for being. It's price premium to the market leader but Rao's is priced super premium to the market leader and they're differentiated. There's items on Michael Angelo's like eggplant parmesan that's different than some of the items on Rao's such as meatballs. So, they're differentiated and we don't see that as an issue.

Now, in terms of your bigger question, what are the building blocks? Number one is sauce. Sauce is still the majority of our Rao's franchise today, even though we've created this sort of enormous other beachhead of non-sauce businesses that I just talked about. So, the number one building block is basically continuing to grow sauce and taking it from called a roughly a 15 share today to a 25 share. I think you've seen in previous slides that we provided. Rao's is greater than a 20 share in a lot of accounts today. And that correlates just having the right number of items on shelf.

So, we see a clear path to getting Rao's to a 20, 25 share. That's building block number one. Building block number two is continuing to grow the three beachheads that we're in. And those are dried pasta, soup and frozen for reasons that I previously articulated. We will be launching between now and more than – the time we achieved that milestone into at least one, maybe two other categories. So, that's another building block as well. And as I've talked in previous calls, there's some very close in international, okay, non-complex, easy international, for example, Canada, where we are still very robustly, but we're under shared. And that is another sort of lever to blow past the $1 billion in net sales for the Rao's franchise. So, those would be the building blocks.

Cody Ross
Analyst, UBS Securities LLC

Q

Great. Thank you so much. I'll pass it on.

Todd R. Lachman
Founder, President, Chief Executive Officer & Director, Sovos Brands, Inc.

A

Thanks a lot. Great to hear from you.

Operator: Thank you. And our next question is coming from the line of Michael Lavery with Piper Sandler. Your line is open.

Michael S. Lavery
Analyst, Piper Sandler & Co.

Q

Good evening. Thank you. Just wanted to...

Todd R. Lachman
Founder, President, Chief Executive Officer & Director, Sovos Brands, Inc.
A

Hi Michael.

Christopher W. Hall
Chief Financial Officer, Sovos Brands, Inc.
A

Hey Michael.

Michael S. Lavery
Analyst, Piper Sandler & Co.
Q

...I want to start with the long-term opportunity, and you pointed out slide 7. There's a lot of ingredients there for a compelling sale story to the trade. Just in terms of getting more items on the shelf, are you getting any pushback from retailers for sort of near-term driven by macro uncertainty? Is there any more hesitation to do resets or to change the mix on the shelf? Or is it still sort of business as usual at the moment?

Todd R. Lachman
Founder, President, Chief Executive Officer & Director, Sovos Brands, Inc.
A

No. I mean, I'd say – hey, Michael. It's Todd. Good to hear from you. I think, I mean, if we – I mean, I'm looking literally now for like the latest numbers through [indiscernible] (00:39:09). We're still – we've consistently grown distribution on this business for every quarter since we've owned it. That's ranging from double digits to high-single digits.

But we're growing distribution now, high single digits for this last quarter 52, 26, year-to-date, 13-week, 4-week periods. We still have significant opportunity in a variety of our retailers for that. So, we're not seeing pushback. But I think if I talked about before, it's not like we're – the objective is to go in and grab nine items at once. I mean, we look to grab two or three items, where we should. Retailers has been very receptive. Some of the areas that I've talked about before. One of my favorite statistics is that the amount of profit that a retailer makes on a jar of Rao's 24-ounce sauce is basically equal to what they sell a jar of the market leader for.

So, the shelf price of the market leader is the profit that they make from a jar of Rao's. We have been of the top, call it seven brands, the fastest growing for the last five years. So, if I can add items that are going to spin in the top three quintiles and 75% of our items spending quintiles, one or two, all the Rao's spend in third quintile. So, if I can add fast selling items that drive my category, like I mentioned before, in at least two years, I need to look back maybe three, we've driven almost 100% of the category growth in sauce.

So – and that's why you see them not only adding Rao's but other premium players as well, which I think is great for the category. It can train the consumer on paying more for slowly simmered, basically cattle meat sauce. And it's a real – it's a real boom for Rao's. So, we have seen no headwind in regards to gaining distribution for Rao's sauce and we don't foresee that in the future, given the role that it plays for our customers.

Michael S. Lavery
Analyst, Piper Sandler & Co.
Q

No, that's a great color. And then, just to follow up on some of the composition of the fourth quarter, I think the mix and price lift in 3Q, you unpacked pretty well. As far as how that looks sequentially coming into 4Q, would 4Q's price mix maybe similar to the 9 or slightly more percent in 2Q. Is that kind of a good starting point for us to think about it? And then, you touched on some of the ways, gross margin will be impacted sequentially. I just want to maybe at least clarify, you were referring to gross margin, not EBITDA margins. Could that be up sequentially versus 3Q?

Christopher W. Hall
Chief Financial Officer, Sovos Brands, Inc.

A

Yeah, this is Chris. So as you think about Q4, yeah, what you said is exactly right. We would anticipate pricing more in that very low-double-digit area, similar what we saw in Q2. And then, we – return on the volumes up to mid-single digit. That would be the makeup of Q4 top line. [audio gap] (00:42:28) on the gross margin we talked about – yeah, I only anticipate that same level of mix upside as well that we saw in Q3, along with the pricing upside. Well I do anticipate – our EBITDA margin, I do anticipate sequential improvement there versus year ago and versus Q3.

Michael S. Lavery
Analyst, Piper Sandler & Co.

Q

Okay. Great. Thanks so much.

Todd R. Lachman
Founder, President, Chief Executive Officer & Director, Sovos Brands, Inc.

A

Thanks, Michael.

Operator: Thank you. One moment for our next question. And our next question coming from the line of Brian Holland with Cowen. Your line is open.

Brian Holland
Analyst, Cowen and Company, LLC

Q

Good afternoon. I guess, I wanted to ask about what we're seeing in – you talk about lapping pricing in 4Q. Obviously, we're going to see some sequential gross margin pressure, I guess, off of, a really strong 3Q or relative to expectations. We've heard from several food companies about taking price. Yours are lapping pricing. I didn't hear anything about taking any incremental pricing.

Any reason why you would hesitate on taking another round of price action just in the context of obviously where we're seeing your gross margin trend right now year-on-year, year to date, and what's implied for 4Q. And also, just given, you're one of the more – you have one of the more inelastic portfolios that certainly we track looking at the scanner days. So with that as context, just understanding how you're thinking about pricing and you're right to price from here.

Christopher W. Hall
Chief Financial Officer, Sovos Brands, Inc.

A

Yeah. So, today we've been very successful on executing a couple rounds of pricing on Rao's sauce and have taken pretty strong pricing across all of our brands to our portfolio. As we think going forward, considering the uncertainty of the economic situation, consumers are not – they're strapped for cash in 2023. We're taking a prudent approach to how to think about pricing going forward.

As I mentioned earlier, we believe the combination of pricing that we have in the market now, along with the productivity really a tailwind we have moving forward given some delays that we had in productivity initiatives here in 2022 that we have adequate tailwind to take us into 2023 based on the visibility that we have on inflation.

So, we also anticipate those pricing windows are getting tighter at retail. And we're taking that into account as well. But we're pleased now with our relative pricing position. As we think about our net revenue management, price gaps and things like that. We thought we're in a good position rally focus on driving that top line, maintaining volume growth. Very important to us that we grow our unit sales and growing household penetration across our key brands.

So, we take all that into effect, into consideration and as we base our pricing decisions on that. As I mentioned, we're very pleased with the pricing value in the marketplace currently.

Brian Holland
Analyst, Cowen and Company, LLC

Q

Appreciate the color, Chris. And then maybe following on to Mike Lavery's question asked in a slightly different way. A lot of your runway or a fair amount of your runway is sort of tied to the incrementality of this innovation pipeline, which looks really robust. I'm curious how retailers are responding in this environment to your new product launches. So, maybe this is entree to ask about the [ph] new soup (00:46:33) frozen gelato, which I appreciate is small today. But just wondering how customers are reacting to your innovation? How receptive they are in this environment? And how the consumers are responding to maybe trialing new products but premium price products?

Todd R. Lachman
Founder, President, Chief Executive Officer & Director, Sovos Brands, Inc.

A

Hey, Brian. How you're doing? I think did you wait in line like six times at the last show to get tasted that gelato?

Brian Holland
Analyst, Cowen and Company, LLC

Q

No comment. They lost count.

Todd R. Lachman
Founder, President, Chief Executive Officer & Director, Sovos Brands, Inc.

A

How you're doing? It's Todd. Before I talk about gelato, I do want to reinforce – I don't think this is what you're implying from the thing. Well I know what you're saying – I know you're talking about being innovation dependent, but soup and dry pasta was launched – were both launched four years ago and they're both growing. Basically, soup is up 20% – in the last quarter, up 26%, units up 18%, velocity up 20%, fifth largest brand growing household penetration. Dry pasta launched over four years ago, up 50%, fastest growing brand of the top five as a soup. Unit is up 34%, velocity 56% and frozen is in its fourth year now launched three years ago and dollar is up 55%, unit is up 50%.

So I'm just saying from those just great examples of, yes, they were innovation four years ago, but they are seeded in the marketplace doing extremely well. We're doing everything we can to continue to grow those businesses today. Yes. There will be new beachheads in the future and we test those very rigorously. But I do want to say, sauce and soup and pasta and frozen, which combine to now equal $515 million LTM business growing at 30%, all pretty well-established.

Now in gelato, sell-in better than expected as we talked. As a matter of fact, the sell-in that we had ACV not only in regards to what we delivered by others in the marketplace. Some of the quickest ACV that we've seen on an item continue to build velocity. We're launching some incremental items this year. So, it's on shelf, taste delicious, but it's early on. So it's been in the marketplace, really started showing up in shelf in Q2. So we're pleased so far and more to come behind gelato.

Did I address what you're asking, Brian, or do I have to take it in a different direction?

Brian Holland
Analyst, Cowen and Company, LLC

Q

No, Todd, that's fine. I appreciate that color.

Todd R. Lachman
Founder, President, Chief Executive Officer & Director, Sovos Brands, Inc.

A

Okay.

Operator: Thank you. One moment for our next question. And our next question coming from the line of Peter Galbo with Bank of America. Your line is open.

Peter T. Galbo
Analyst, BofA Securities, Inc.

Q

Hey, guys. Good afternoon. Thanks for taking the question.

Todd R. Lachman
Founder, President, Chief Executive Officer & Director, Sovos Brands, Inc.

A

You bet.

Peter T. Galbo
Analyst, BofA Securities, Inc.

Q

Chris, maybe just to start, and I know you're not giving 2023 guidance, but can you just remind us how you contract for some of your inputs? So, I mean, if you're seeing deflation in some of the major proteins and still seeing inflation in things like dairy, just how far out when you do contract does it kind of go for next year? Is it a three-month window or can you kind of contract for the full year in one shot?

Christopher W. Hall
Chief Financial Officer, Sovos Brands, Inc.

A

Yeah, sure. And it really varies by category. There are some items that we will contract out a year. So, for instance, tomatoes, tomatoes coming out of California. We've locked in a whole year of the crop season. We locked that in a few months ago. So, we know exactly what our domestic tomato costs will be for the balance of really 2023 through the next harvest.

Then there are items like dry or wet eggs that we'll contract out for a year. Sugar, things like that where the price looks advantageous or work within our cost structure, we'll go a year out and we have done so. There are other items that things like cheese, butter, we may go three to six months out, and we have done that in the past. And we're looking at those agreements right now for 2023.

Milk is an example of something we don't hedge at all. So, we're paying kind of the monthly FDA rates that are published every month. Things like resin, diesel will actually be on a variablized rate, and we typically pay for like the – the average price for the quarter, the prior quarter will flow through. So, all of our packaging or raw inputs, we treat each one differently. And we do try to take advantage where we can and lock in prices. Obviously, that's been helped us lock in pricing in the other market driving activities that we would anticipate that we're managing through our plan. [indiscernible] (00:52:10) built across the year, we're always are forward but on some level of our input costs.

Peter T. Galbo
Analyst, BofA Securities, Inc.

Q

Great. No, that's very helpful. And maybe just as a follow up, Todd. There's been a couple of questions and obviously some headlines just around European natural gas prices, and obviously, your large co-packer in Italy, I would think uses a fair amount of natural gas. So, just kind of how you're thinking about that or working through that with them as we get towards the winter months and into next year. Thanks very much, guys.

Christopher W. Hall
Chief Financial Officer, Sovos Brands, Inc.

A

Yeah. You bet. So, yeah, absolutely. Our current Italy based manufacturer, La Regina, produces the vast majority of our sauce. Great partner for us. They've grown with us from, whatever, $60 million, $70 million business, we bought it to over $500 million today. They've been willing to make the investments at that plant to drive capacity, automation, and cost savings along the way.

Today, we talk to them daily. They feel they're at very good position on the reserves that they have in place to run their plants, primarily gas and hydro-based production. They have Italy as a country as well, has done a very good job of diversifying their – where they acquire their gas from another types of energy. So we feel – they feel that they're in a good position now. Yes, costs are up and we baked that into our projections as well. But we're confident in the ability to continue to supply to our very high growth rate.

In addition, we are at a very strong inventory position today. We've been running the plants very, very aggressively and we're entering into Q4 and this year in a great inventory position. And then, finally, we have Alba plant down in Georgia, which will be capable of producing up to 30% of our requirements on top of what we can produce in Italy. So, with that, we feel like we've got ourselves well covered and we'll continue to make the adjustments and the plans we need to ensure we can meet that, what we're seeing as a 30-plus-percent growth rate around [indiscernible] (00:54:40).

Todd R. Lachman
Founder, President, Chief Executive Officer & Director, Sovos Brands, Inc.

A

And the train is coming in.

Operator: One moment for our next question. And our next question coming from the line of Robert Moskow with Credit Suisse. Your line is open.

Robert Moskow
Analyst, Credit Suisse Securities (USA) LLC

Q

Hi. Thanks. Maybe this has been asked already. But I was wondering why you chose not to repeat the promotion that you cited the prior year and caused the 8-point volume hit? And maybe more broadly speaking, is your promotional activity down a lot this year from an overall perspective or does it all kind of even out when you go quarter-by-quarter?

Christopher W. Hall
Chief Financial Officer, Sovos Brands, Inc.

A

Yeah. No. Very good. On the first question specifically on why not repeat the event, you may recall if you go back to prior earnings calls, we had some capacity, some service issues specifically on Michael Angelo's and our frozen entrée business. As we worked across Q1, Omicron hit early. You may recall we had tornado hit our pasta plant – our third party pasta plant. So, we knew we were going to be up against some capacity constraints as we were going to be hedging across Q2 and Q3.

In fact, we then canceled basically all of our frozen promotional events in Q2 because of that supply and supply challenges. We did then execute to a much better position and we put those promotions back into the marketplace in Q3. In fact, on frozen, very pleased with our consumption results on the combination of Rao's and Michael Angelo's frozen, really 20% growth in consumption during the quarter where our shipments for Michael Angelo's were below year-ago because of not repeating the event.

Really that capacity constraint and really the efficiency of the program itself led us to a path to make that choice. And then on a general question on promotion, we've maintained a lot of the elements of our promotional plans that we would out of place pre-COVID, during COVID and post-COVID.

We have taken – as we take on list prices, there are areas where we've risen our key promotional price points. There are situations where we might have reduced some frequency. We may have reduced some duration of events. But overall, at the general statement, we've been successful maintaining a good, strong level of in-store promotion. While as Todd mentioned, we've elevated our investments in out-of-store marketing to support the brands even as our price points are increasing. We really see that continuing into Q4 and beyond. We got good strong. We have great support from our retailers, a good quality merchandising, and even if the situation [ph] were bringing our debt (00:57:59), we are still seeing very nice progress on the promotions.

So, we don't see a big downtick and then uptick in our promotional strategy. That really is the same basic strategy looking backwards as well as looking forward.

Robert Moskow
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. Thank you.

Todd R. Lachman
Founder, President, Chief Executive Officer & Director, Sovos Brands, Inc.

A

Thanks, Rob.

Christopher W. Hall
Chief Financial Officer, Sovos Brands, Inc.

A

Thanks, Rob.

Operator: Thank you. One moment for our next question. I'm showing we have a follow-up question from Brian Holland with Cowen. Your line is open.

Brian Holland
Analyst, Cowen and Company, LLC

Q

Yeah. Thanks. Appreciate you letting me sneak a follow-up back in here. But maybe just in the – given everything that we've talked about today, all the puts and takes, obviously, your top line continues to perform as it had, significant momentum, but also makes the comps incrementally tougher as we go forward. And then, obviously the puts and takes below the top line, inflation, etcetera, productivity. Can you help us have us – help give us a sense of as we look into 2023, whether that give us a sense of as we look into 2023, whether that shapes up as you're seeing it right now as an on algorithm year, I think your guidance at the time the IPO was sort of high single-digits top line, low double-digits EBITDA. I'm just wondering if you feel like you've got the levers in place to drive that next year.

Todd R. Lachman
Founder, President, Chief Executive Officer & Director, Sovos Brands, Inc.

A

Yeah, simply put – well, Brian, first of all, good to have you back. Boomerang, boomerang question back into the – into the mix. But, yeah, we feel that the lever is in place to have an on algorithm year in 2023. I mean, I won't say anything more than that, but I will basically assertively say yes.

Brian Holland
Analyst, Cowen and Company, LLC

Q

I just think that you needed to be. I appreciate it, Todd. Thank you.

Todd R. Lachman
Founder, President, Chief Executive Officer & Director, Sovos Brands, Inc.

A

You got it. So that's...

Operator: I'm sorry.

Todd R. Lachman
Founder, President, Chief Executive Officer & Director, Sovos Brands, Inc.

A

Any other questions?

Joshua A. Levine
Vice President-Investor Relations, Sovos Brands, Inc.

A

No.

Todd R. Lachman
Founder, President, Chief Executive Officer & Director, Sovos Brands, Inc.

Great. So, look, thanks. Thanks again, everyone, for joining us. Showing an interest in the Sovos Brands story. We look forward to engaging with many of you in the coming weeks. Please feel free to reach out to Josh for follow up questions. Until then, have a great evening and take care. Thanks a lot, everyone.

Christopher W. Hall
Chief Financial Officer, Sovos Brands, Inc.

Thanks all.

Operator: Ladies and gentlemen, that does conclude our conference for today. Thank you for your participation. You may now disconnect. Good day.