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Sovos Brands, Inc. (SOVO)

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MANAGEMENT DISCUSSION SECTION

Unverified Participant

Pleasure to have Sovos Brands with us here today. We've got Chris Hall, CFO; and Josh Levine from IR. Recent IPO, four brands that have been acquired, I'll let you go into it a little bit more. But the story we love, it's a great management team that it's got experienced, kind of deep strategic experience from bigger companies to be running any of those. But maybe kick it off with a quick overview of Sovos and just some of its key growth drivers.

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

Sure. So Sovos was founded back in 2017 started by a gentleman here Todd Lachman. Todd, like myself and like a lot of our management team, spent whole career in food really, and Todd has been global, but aligned North America big. Large companies, small companies, private, public, got a wealth of experiences. So while we've only been around five years, going on six years, the experience level is much higher than that.

The initial acquisition was [indiscernible] (01:08) Michael Angelo's Frozen Italian Entrées in Austin, Texas, early 2017. And then, later that year was the big bonanza acquisition of Rao's Pasta Sauce. Rao's [ph] is kind of (01:21) familiar with it. At the time, it was $60 million in sales. It will surpass $500 million in sales here as we close Q3. So it's like a seven-fold over that massive increase over that time. Continuing to grow, outsized growth 30% year-to-date in 2021. And that's actually grown 30% since the whole COVID overlap started. So we doubled the business here, and out of COVID, and then have grown 30% since then, continues to do very well.

That is our real North Star brand in Rao's. As I mentioned, $0.5 billion in sales. We're guiding us towards $1 billion brand here over the next few years. And I'll talk about that a little bit more in a minute. It represents 62% of our total sales. And Rao's Sauce alone is 50% of our sales. We've also launched Rao's Soup, Rao's Pasta, and Rao's Frozen Italian Entrées into the marketplace, doing very well.

That was late 2017. And then late 2018, purchased noosa yoghurt. noosa yoghurt out of Colorado, growth darling of the industry 2012, 2015; hit some speed bumps as a category; it was actually declining when we bought it. We've returned it to kind of mid-single-digit growth. Then in yogurt category, then we're starting to launch [indiscernible] (02:50) other category [ph] into (02:55) frozen yogurt gelato, which we just launched this year. That's about 25-ish-percent of our sales going mid-single-digit.

And then finally, Birch Benders that we bought at the peak of COVID, I guess – of late September of 2020, when everybody was at home, making pancakes and waffles and eating breakfast. Birch Benders is a prevalent pancake mix and frozen waffles help nutritionally advanced, a lot of keto, a lot of paleo, which again peaked kind of in that 2020 period. We've seen softening in those trends. So we still have work to do on that brand, it's not where we wanted to be; but they're less than 5% of our sales. So we are now in those four brands after all being around for about six years. The brands have been around longer. Sovos has been around – probably around six years.

QUESTION AND ANSWER SECTION

Q

You've talked about sort of one-of-a-kind brands in these categories and – but the current portfolio fits that, and some ways you've touched on, what makes a one-of-a-kind brand to Sovos? And partly thinking too, as you've grown from acquisitions [indiscernible] (04:11) to come how do you find new ones?

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

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Sure. The company was founded on the – I guess, the thesis of – again, all those of us have worked for large corporations. There was a study that came out – I think it was in 2016, 2017 – the top 100 brands in the US were actually losing share. And these were all big brands. [indiscernible] (04:40) called the insurgents. We call them one-of-a-kind brands, kind of being the same thing. They tend to be more premium, cleaner label, driving outsized growth, preferred by certainly retailers, because you're getting a higher ring of bringing growth into the categories that they participate in. Great taste, very high Net Promoter Scores, and proven loyalty to these brands.

So that's what we call one-of-a-kind brands. We go through a very strict set of criteria for an acquisition. Again, the company is built on acquisitions – four acquisitions. We look at not only how the brand can perform in a category within. Very importantly, though, does it have the brand equity and the right to move and grow through TAM expansion.

So I'll use Rao's as an example. Again, Rao's – we never viewed it as a pasta sauce, it was a Northeast brand. I guess, I mentioned $60 million in sales. We viewed it as restaurant-quality Italian food for home, which then and we proved that out. Okay. And that's what enables you to go into currently three other categories. And we're test-launching right now Rao's Frozen Pizza, bringing all those same dynamics to the pizza category. We're in four chains across the US. And we have lots of other ideas similar to that that we know that Rao's can play.

And there's noosa, noosa isn't the [ph] moat (06:20). It's a more great tasting, high Net Promoter Scores, very loyal base out of Colorado that stands for don't grade, allowable indulgence, if you will. We're not taking sugar out. We're not really making it healthier than it already is. But it's a very clean label. Basically whole milk, fruits, honey or sugar, which – that enabled us to then take it outside of spoonable yogurt into noosa Frozen Gelato Yogurt – frozen gelato that's what's used in the stores now, and the ice cream area off to a great start.

We can take that into more places now too, because [indiscernible] (07:05) again, that great taste, great texture, pure ingredients.

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For a short time I was on the inside of large cap food company, I don't think we could even spell clean label. We were focused on productivity savings.

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

A

Yeah.

Q

It was such an interesting contrast to that. Let's dig into Rao's a little bit more. It's such a big piece and an outsized driver of growth. What's some of the runway there and maybe in terms of things like household penetration and potential upside.

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

A

Sure. Yeah, that's a – so let's go Rao's Sauce specifically. Again, it's half our portfolio. When we purchased, it had – the distribution was primarily in the Northeast and on the West Coast through Albertsons, Safeway. Low household penetration therefore; a few items would be in a typical outlet. So what we are focused on – we call it our playbook is gaining mental awareness and then kind of like physical availability. So the physical availability comes from having on the shelves, getting that distribution now to over 85% nationally. It's ubiquitous. It's pretty much any store you'll go to.

Now, it's about how do you go from – we're currently 12 – an average of 12 items per store selling. If you look at the number one and the number three and number four brands, they might have 20 items or approaching 20 items. So now we're all about getting more items into the set. So we have a great story to tell. We actually have the highest, by far, dollar sales-reported distribution, or twice the category average. That gives our sales organization a great reason to go in and sell [indiscernible] (08:56) these incremental items.

We're a 14 to 15 share of a $3-billion-plus in sauce category. But we have customers who approach a 30 share when that items per store goes up and starts approaching 20. So we have many examples that across the country. If we get those items in there, we know we can get to that 20 share or better. So that's where the physical availability side of it. Then the mental awareness side of it really through marketing.

Q

Can I sort of put a point? So where you have 20-ish instead of 12 [indiscernible] (09:38) but not quite double. They think you roughly double your share or more.

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

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That's right. That's right. And by the way, we have regional opportunities, higher household penetration, highest shares on the coast. We have opportunities in the middle of the country, primarily because some of the larger grocers in the middle of the country were a little bit delayed in listing Rao's for various reasons, but they're now our fastest growing.

So if we get it on the shelf, it appeals really to all income brackets and all demographics as we've seen. So the mental awareness really is our marketing. We bought the brand. They were spending a little less than $0.5 million a year. And now we're well above $20 million a year in marketing. And it's very modern marketing. It's all digital, very targeted. Even we can go in heavy into a region if we want as we're expanding a regional grocer.

So that combination, mental awareness, physical availability has taken our household penetration of Rao's up to total Rao's brand is at 15. And again, it started less than three. And Rao's sauce within the total Rao's brand is just under a 12-household penetration, which is a great improvement over the last few years, but still see opportunity we have ahead of us to take that more like a leading brand, which is in the 30%-plus household penetration and 80%-plus awareness – we're still below 50% awareness as well.

Q

[indiscernible] (11:09). So you obviously have some of that household penetration difference from these extensions with pasta, soup and frozen. Can you give us a sense of some of the momentum on those and how they're doing?

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

A

Yeah. So on the Rao's portfolio, again, we'll call it a $0.5 billion of sales, 85% of it is sauce, 15% is soup, pasta and frozen – restaurant-quality frozen Italian entrées. They are doing very well. Distribution on those still has some ramping up on distribution-wise. So three years ago – it's now the number five soup brand and the fastest growing, well over 30% growth. We have been able to get IRR report, doing very well, then we're going to be adding more [ph] seats to (11:59) that lineup.

If you've seen it, it's in a beautiful jar. So it's not in a can. One of our advantages is we're not – we're agnostic towards self-production or [ph] co-pass (12:13). So we don't have a whole lot of – very moderate capital requirements. Now we run two plants. But we don't have a bunch of assets that have been sitting around for 25, 50 years idle. We don't have to come up with products to sell, because we have the assets.

So that just gives us the great advantage. We put in a jar. Look on shelf and see how nice it is versus a can. Pasta, which – we were a sauce company. Interestingly, like only two companies [indiscernible] (12:42) sauce and a pasta [indiscernible] (12:46) which seems like makes sense as an adjacency. We've built that into a $20-million-plus business. So overall, I think that's up over 50% this year.

Within the frozen Italian entrée of Rao's things like lasagna, there's the meatballs, again, if you haven't see it – that actually got added to our Michael Angelo's Frozen Italian Entrée business that we purchased back in 2017. The combination of those two brands is pushing towards $150 million of sales. It provides a really nice two-tier pricing presentation for us. So Michael Angelo is premium, Rao's is super-premium.

So we have a really good story to go in and tell our retailers of why to carry both and why to carry them because we're bringing again that premium growth for the category, a large category. And we have over a two share combined across those two brands. And we're maintaining distribution of those very well because their velocities continue to spend very well.

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And so you mentioned the pizza – test launch. Huge category, I think, what, $8 billion or so.

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

A

$8 billion.

Q

Possibly a really interesting opportunity. Can you talk a little bit more [indiscernible] (00:14:03) or just how the test is going and how that may unfold?

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

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Sure. So, we've been working on this one for a while. Again, we think of Rao's not as pasta sauce, but Italian quality, restaurant-quality Italian food, [indiscernible] (00:14:18) to that, you can see them in a number of places [indiscernible] (00:14:22) frozen pizza, again, [indiscernible] (00:14:24). The category really hasn't been [ph] premiumized (00:14:27) if you look at it, but it's a huge category, a high household penetration. So we are a test market now [indiscernible] (00:14:37). You can find it at Whole Foods or Sprouts or Harris Teeter or Giant Eagle. We really just put it out four to maybe six weeks ago, still building that distribution.

[indiscernible] (00:14:50) we're hearing that the demand is very good. Our repeat orders are coming in very nicely. We're getting a lot of queries from both consumers as well as other retailers on where they can get it. But we're using this test market really to make sure we get the product right, the positioning, how do competitors react [indiscernible] (00:15:13) we're going to be continue testing it for a while, make sure we get those learnings.

And again, we don't – we're not – we don't need to launch it before it's ready because we're experiencing outsized growth right now, 16% growth in the first half of the year for the entirety of the business, 12.5% of which was on volume. So the first half of the year [indiscernible] (00:15:35) accounted for under 4% of our growth. So that velocity, getting those households, focusing on our core, which continues for now to be sauce, yogurt and now kind of the entirety of the frozen [indiscernible] (00:15:48), which is frozen entrées, frozen waffles under the Birch Benders brand and then [indiscernible] (00:15:55).

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[indiscernible] (00:15:57) volume growth [indiscernible] (00:15:59) organic volume growth. And so what are you seeing from the consumer, how sensitive are they to the price increases and how sustainable do you expect that volume momentum will be?

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

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Yeah. Sure. We – as a reaction to the inflation that we're seeing, we took relative pricing like all others have [indiscernible] (00:16:27) Q2 of this year and so we're still seeing that pricing. Our back half of the year will be leaning more towards pricing than to the volume growth we expect, because we are [indiscernible] (00:16:39) our financials the assumption that we'll ultimately get to more kind of historical levels of elasticity, which – again, our financial model and purpose we think of it as like one. We've done better than that, right, as most of the industry has. So our first Rao's sauce pricing went in place in Q1, hit the marketplace in Q1, the balance in Q2. We really saw no elasticity impact on Rao's sauce. We were growing 30% [indiscernible] (00:17:08) the prices.

We did take a second list price in July and it's kind of too early to do the reading on that. But that second level of pricing really just took us the company – the category average. So the competitive structure of pricing in that category remains as moved up and we're very pleased with what we're seeing elasticity there. Underneath the side, we have seen a little more elasticity below – better than what we had modeled, but very consistent with that category. [indiscernible] (00:17:45) elasticity, but we are pleased with what we're really seeing across, we're taking pricing on our entire portfolio at this point, somewhere between 8% to 10%, depending on the specific category.

And then one more fact is back to Rao's sauce, we did a third-party analysis that looked at demographics, including income brackets between low income, median income, high income, and it looked at demographics of millennials, Gen X and baby boomers, [indiscernible] (00:18:25) and we were green growing in every one of those boxes and the only other brand that was doing that was a private label. So, private label and us were the only two that were growing in every demographic. What we're finding is there is trade down from the other mainstream sauce manufacturers to private label, because they're very similar products, tomato paste and water and dehydrated onions and they're made through an extrusion process.

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They don't advertise that very loudly.

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

A

Yeah. You don't see that in the ad, but – and there's definitely a taste difference if you [indiscernible] (00:19:11). Rao's is slow cooked in big kettles, whole Italian tomatoes actually made in Italy, fresh garlic, fresh onions, not extruded as there's a huge difference and we're seeing as folks who perhaps aren't eating out as much are really migrating towards the premium restaurant-quality sauce. We're still gaining share, we're still growing and on the low end, we are seeing kind of that tradeoff between some of the other brand, mainstream brands and private label. So we're seeing [indiscernible] (00:19:54) kind of barbell effect that you may have heard of where premium and value are really the ones [indiscernible] (00:20:00).

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So I wanted to touch on the Italian tomatoes that you mentioned. I had a hallway conversation with an investor this morning that was curious about the drought conditions in California and what tomato costs for sauce might look like. But you're positioned differently and a little uniquely. Could you elaborate on that a little bit on how [indiscernible] (00:20:22)?

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

A

Yes, sure. For Rao's sauce [indiscernible] (00:20:26) portfolio and by the way a great – our highest profit margin item as well, that is produces Italian tomatoes and we co-pack that. We don't self-produce it. And like 80% of Rao's sauce comes directly from Italy through our co-packer whose plant fits in tomato field. They own the largest tomato canning business in Italy as well. So that is a great advantage for him and for us for our long term exclusive agreement with them to produce for us for – it's a ten-year agreement, I think we're in year three, and then it extends beyond that.

They have had some higher costs in Italy, which we've – where we put into our forecasts. We know exactly what that costs would be going into next year. So they've had some drought conditions, higher energy costs, they had inflation. But it's not like California, I'm sure you'll hear a lot about, was pretty severe drought conditions. We do purchase California tomatoes for our frozen Italian entrée business, so not for the sauce, but for the [indiscernible] (00:21:43) eggplant parmesan, lasagna, [indiscernible] (00:21:49).

We've already – we got in early with the California producers. So we've already secured a whole year's worth of tomatoes. Yes, it's at a premium. It's actually roughly at 30% premium [indiscernible] (00:22:06) this year. It's, you know, not a major commodity that we purchase. So it's not a big part of our cost structure. So we're very confident in that we're going to be able to fulfill, that we're going to get what we need. We're building inventory right now, baking it into our financials. And we have – yes, if we could talk about inflation, love to hear from everybody, there are some things that are going to continue to be inflationary, there's other things that we're starting to see relief. So, yes, it's going to be little more inflationary on tomatoes. We expect to see some relief on dairy. So we're starting to kind of see that happening right now. [indiscernible] (00:22:47). So you're starting to see that come down. So, mainly across all those commodities, we're going to have some go up, we're going to have some go down. So we believe it's all manageable with the price that we have in place, which is a tailwind in the next year. Because [indiscernible] (00:23:02) market for Q2, it would take a little bit of additional Q3, and our productivity, which, because of, you know, Omicron we had in Q1, we were not able to engineer it into our plan to drive productivity. The laser equipment delivery really pushed a lot of our productivity into back half of this year. We're starting to realize that now [indiscernible] (00:23:25) 2023.

So we feel very confident now that the productivity and pricing, positive mix with [indiscernible] (00:23:33) leverage that we're going to get off of growing our top line double-digits year-to-date, [indiscernible] (00:23:41) back half of the year, we'll get some scale off our G&A as well. So, we're feeling good about that ability to get sequentially improved margins [indiscernible] (00:23:50).

Q

No, that's great color. And maybe just a little bit drilling more into sort of how the rest of this year unfolds from a margin perspective – gross margins, because you've got the pricing coming in. It sounds like there's some inflation that, there are a lot of components to it, but also the productivity, how should we think about how those [indiscernible] (00:24:12)...

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

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Sure, sure. We had operated – we still does feel a little bit unique in that. We've had double-digit growth – top line growth since day one, which now goes back six years. As I mentioned, we're [indiscernible] (00:24:25) year-to-date and we've been profitable from day one. So it's not a, we're going to drive the top line and not worry about profit or cash. We've generated profit, we've generated cash since day one. As we ended 2020, which was the first year of pandemic, actually our gross margins were 33%. [indiscernible] (00:24:46). And then as we moved into the first half of 2021, we were operating I think it was 31% gross margins. Then the inflation hit. And so it dropped in the back half of the year, [ph] lag up until (00:25:00) our pricing and our productivity actions.

Q1 of this year, we actually I think bottomed out at a 26% margin. Very pleased now in Q2 that we were able to get 200 basis points improvement, where really the majority of that pricing has ended Q2 at 28% gross margin. Now, as we go into the back half of the year, as we have all our pricing in place and a little bit more, lots of productivity that we didn't realize in the first half of the year, we do see margin improvement in Q3 versus Q2 and then in Q4 versus Q3, not that same 200 basis points that we saw from Q1 to Q2, but we do see ourselves as existing the year really kind of with a visibility about that 30% margin. And then those tailwinds, as I mentioned, heading into 2023, really setting us up as we see 2023 right now with that 30% margin, and then hopefully again that improve it from there, typically at that point on, the kind of the rate and pace of the inflation or relief from the inflation, and then we're always ready to react to that as necessary, whether that's additional productivity or pricing, we have lots of ideas in place to help mitigate that if we need to.

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No, that's great detail and then great color. Maybe just one last one as, you know, we operate in this sort of challenging volatile macro environment, there's clearly lots of positives in your business. What excites you most looking ahead, ignoring just some of the noise at the moment?

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

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Yeah, absolutely, it's a [indiscernible] (00:26:43), like it's again a $0.5 billion business, fairly 30%, with tons of helpful penetration upside, tons of license to go, continue to expand beyond the categories we're in, and continued high profit margin growth [indiscernible] (00:27:06). Again, we're only in 12.5% of households. That's a lot of usage occasions for us to go after. And that's exactly what makes me most excited about ultimately getting what was our long-term guidance, high-single digit top line growth [indiscernible] (00:27:26) double-digits. But that's our long-term guidance, with moderate margin expansion as we move forward to get up to double-digit – to low double-digit EBITDA growth.

Unverified Participant

It's been great. Thanks so much, Chris.

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

Thank you.

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

Thank you.

Unverified Participant

And I appreciate your time.

Christopher W. Hall

Chief Financial Officer, Sovos Brands, Inc.

You bet. Thank you. Thank you, everyone.