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Sovos Brands, Inc. (SOVO)

Q4 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Thank you for standing by and welcome to the Sovos Brands Fourth Quarter and Fiscal Year 2022 Earnings Conference Call. At this time, all participants are in a listen-only mode. After the speakers' presentations, there will be a question-and-answer session. [Operator Instructions] As a reminder, today's call is being recorded.

I would now like to turn the conference to your host, Mr. Josh Levine, Vice President of Investor Relations. Please go ahead, sir.

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

Good afternoon and thank you for joining us on Sovos Brands' fourth quarter and 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 December 31, 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 risk 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 the 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 these 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.

Please note that all consumption data cited on today's call will refer to dollar consumption as of the 13-week period ended December 25, 2022 and growth versus the prior-year comparable period unless otherwise noted. And lastly, to avoid any confusion, organic net sales growth for the fourth quarter and fiscal year 2022 represents growth on a 13- and 52-week comparable basis that excludes the extra week. For discussions pertaining to fiscal 2023, including our guidance and growth expectations, organic net sales growth is calculated as net sales growth adjusted for Birch Benders and the 53rd week in 2022.

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'm very excited today to share with you our outstanding results for 2022, highlighted by double-digit volume growth, Rao's continued rapid march to $1 billion of net sales, and our strong fourth quarter performance that is carried into 2023. I will then hand it over to Chris Hall to provide greater detail on our fourth quarter and full year, as well as our initial 2023 outlook.

Sovos Brands delivered another year of sector-leading growth in 2022, with organic net sales up 19.5%, accelerating to 28.4% in the fourth quarter. In fact, organic net sales growth in the quarter was the highest for Sovos Brands and Rao's since the first quarter of 2021. Importantly, our top-line performance was driven primarily by volume as opposed to price, which highly differentiates us from the majority of our packaged food peers. Specifically, volume contributed 10.8% and 16% to full year and fourth quarter growth, respectively.

And by the way, this momentum has carried into the start of the year, with net sales in January and February coming in strong. The strength of our fourth quarter top line translated into equally impressive bottom line results, with adjusted gross profit and adjusted EBITDA dollars of 29% and 40%, respectively, versus prior year. It's important to highlight that we delivered our results against a very challenging operating environment.

Our teams responded tenaciously to overcome supply chain challenges during a year of global supply constraints and rapid inflation. Our customer service levels for sauce and yogurt are now at or above target levels. Our robust slate of automation and productivity projects are delivering on cost savings objectives. And our inventories are in a healthier position than at any time since the beginning of the pandemic.

We also divested Birch Benders at the end of fiscal 2022, allowing us to focus our resources on driving Rao's towards $1 billion of net sales and beyond. Excluding Birch Benders, our full-year organic net sales growth would have been 23.5% versus prior year. And as Chris will talk more about, the continued momentum we are seeing in our business and a much simpler portfolio will help us achieve our guidance of double-digit growth for organic net sales and adjusted EBITDA in 2023.

The volume-led growth of Sovos Brands underscores the strength of the Rao's franchise and the long runway of opportunities still ahead. Rao's had another impressive year, surpassing $0.5 billion of net sales, up 35% organically for the full year and accelerating to 45% in the fourth quarter. While we have quintupled household penetration for Rao's since we acquired the brand in 2017, household penetration is still just 15% today, with awareness at only 58%. With plans to grow our marketing and R&D spend double-digits in 2023, we are confident that we can continue to drive years of sustainable volume-led growth into the future.

Total Rao's franchise dollar consumption for the fourth quarter grew 24.8%, led by 16.6% unit growth, driven by broad-based gains in distribution and velocities. Total Rao's household penetration increased to 15.2%, up 210 basis points versus prior year, as a result of adding new households across all categories.

Rao's sauce achieved notable milestones during the year. Measured retail sales surpassed $0.5 billion, up 26.9% versus 2021, the fastest rate of growth for any scaled brand in the category. And for the first time, Rao's was the number two ranked pasta and pizza sauce brand, reaching a 14.7% dollar share for the year, up 150 basis points versus 2021, a remarkable improvement from the number 7 position when we acquired the brand. While unit share, household penetration, and awareness are all well below our peers, Rao's sauce dollar velocities are double the category average, while providing superior penny profits for the retailer, highlighting the massive opportunity ahead.

For the fourth quarter, Rao's dollar unit consumption in sauce increased by 20.3% and 8%, respectively, with high single-digit unit growth coming in ahead of flattish category growth. To build on our momentum, I am also excited to share that we will be launching some new flavor innovations within the Rao's sauce portfolio, seeking to meet consumer demands for elevated culinary experiences at home, specifically caramelized onion, vodka arrabbiata, and four-cheese alfredo pasta sauces, as well as arrabbiata pizza sauce, will be hitting retail shelves later this year. And if you happen to be at the Natural Products Expo this week, feel free to stop by to try them out.

Our newer Rao's beachhead categories of soup, pasta, and frozen all continued to grow well ahead of their categories in the quarter, generating combined dollar and unit consumption growth of 45.5% and 41.1%, respectively, with our business in each category growing dollars and units at least 30%. Household penetration and dollar shares are at or below 2% for the Rao's brand in each of these categories, reflecting material runway ahead.

In the second half of 2022, we conducted a test of Rao's frozen pizza across select retailers. Due to successful test market results, we will be expanding nationally in 2023. Our range of brick-oven crust frozen pizzas, made with Rao's authentic pizza sauce and whole milk mozzarella cheese, are a differentiated, case-led, premium offering in a large and fragmented category ripe for disruption. This is a natural extension of the Rao's brand and an exciting opportunity to continue to offer the consumer restaurant-quality food across the store.

Turning to noosa, our yogurt business grew consumption low single-digits on a dollar basis in the quarter, with pricing and mix driving the growth. We continue to fine-tune our promotional strategy and have seen our consumption data improve in recent periods, bolstering our momentum towards a fourth straight year of growth for the brand.

We're also delighted to announce some exciting news for the Michael Angelo's brand. We recently launched the brand's first innovation outside of the freezer, introducing four new mid-priced SKUs into the pasta sauce category exclusively with a select retailer. This new line of delicious sauces uses 100-year-old recipes inspired by Michael Angelo's Sicilian matriarch, Nonna Foti, and leverages the brand's authentically Italian heritage. This allows

Sovos Brands to capture more eating occasions by offering great tasting foods made with high-quality ingredients at multiple price points. We see this as a highly incremental growth opportunity for the company and our retail partners.

In January, as you likely saw, we disclosed that we divested the Birch Benders brand to Hometown Food Company, which resulted in a reduction in the categories in which we compete by nearly 50%. Our ongoing efforts to create a more focused portfolio allow us to direct more resources and investment towards our most meaningful value creation opportunities, notably accelerating Rao's to $1 billion of net sales and beyond.

In summary, we are very pleased with our fiscal 2022 performance and momentum as we enter 2023. We are excited by what the future holds for our portfolio of brands led by Rao's. Our growth trajectory and focused brand portfolio will enable another year of double-digit organic net sales and, importantly, robust adjusted EBITDA growth. This outlook notably includes continued increases in growth-oriented investments to support brand building, innovation and capabilities, helping us sustain our sector-leading growth.

I will now hand it over to Chris for more details on the quarter and year, as well as our guidance for 2023.

Christopher W. Hall

Chief Financial Officer, Sovos Brands, Inc.

Thank you, Todd, and good afternoon, everyone. For the full year, total net sales of $878.4 million increased 22.1%, or 19.5% on an organic basis, driven by 10.8% volume and 8.7% price. Excluding Birch Benders, our full year organic growth would have been 23.5%. Fourth quarter total net sales were $262.1 million, a $72.9 million or 38.5% increase over the prior year period. Excluding the extra week, organic growth of 28.4% was driven by 16% volume and 12.4% price. The extra week added $19.1 million, or 10.1%, to our quarterly growth. Excluding Birch Benders, our consolidated fourth quarter organic growth would have been 30.1%.

Looking at our portfolio, we grew across nearly all categories. And from a brand perspective, Rao's remained the key driver. As a reminder, Rao's is our largest brand, now accounting for nearly 70% of our annual net sales. Rao's is also our fastest-growing brand, up 34.9% on an organic basis in 2022. And our dinner and sauces segment account for the majority of our EBITDA.

For the quarter, Rao's increased total net sales 56%, or 44.6% on a comparable 13-week organic basis. This performance was driven, first, by approximately 25% net sales growth in measured channels that was generally in line with our consumption growth; second, we saw a particularly strong non-measured channel growth behind new events and distribution wins; and third, we benefited from some pipeline fill ahead of early 2023 distribution gains that will benefit us during the new year.

Beyond Rao's, total net sales growth in the fourth quarter was up 12.5% for noosa, down 0.3% for Michael Angelo's, and up 6.7% for Birch Benders. On an organic basis, noosa grew 4.3%, Michael Angelo's was down 7.1%, and Birch Benders was down 1.2%.

Adjusted gross profit of $76.5 million increased $17 million, or 28.6%, year-over-year. Double-digit volume and pricing growth, as well as productivity savings, more than offset the impact of low-double-digit inflation. Adjusted gross margins were 29.2% for the quarter, slightly ahead of our expectations, reflecting a 220-basis-point of decline versus the prior year period.

We made meaningful improvements on gross margin during the year with our second half gross margin of 29.5%, well above the 26.9% we generated in the first half, reflecting our commitment to improve margins while still growing the top line. Our CapEx-enabled automation projects in our Austin manufacturing plant are now up and running, delivering cost savings and improved service levels. Finally, note that the combination of our pricing and productivity efforts in 2022 will provide a tailwind as we enter the first half of 2023.

$42.4 million of adjusted operating expenses, inclusive of marketing and selling, increased by $6.7 million, or 18.8%, over the prior year period, driven by the growth-enabling investments primarily to support our talent and capabilities. Adjusted EBITDA of $37 million increased $10.5 million, or 39.7%, versus Q4 2021, while adjusted EBITDA margin was 14.1%, up 10 basis points versus the prior year period.

Net loss for the quarter was $28.7 million, or negative $0.28 per diluted share, compared to a loss of $3.8 million, or negative $0.04 per diluted share, in the prior year period. The loss in this year's fourth quarter was largely due to a loss on asset sale related to the Birch Benders divestiture. Adjusted net income was $19.6 million and adjusted EPS was $0.19 per diluted share compared to adjusted net income of $13 million and $0.13 per diluted share in Q4 2021. On a full year basis, adjusted net income was $60.4 million, or $0.60 per diluted share.

At the end of the fourth quarter, cash and cash equivalents were $138.7 million, and total debt was $482.4 million. We're very pleased with our progress on leverage, which finished the year at 2.9 times. Better than expected year-end net leverage was driven by strong cash generation and EBITDA in the quarter, as well as the proceeds from the Birch Benders divestiture. Our strong cash position gives us enormous flexibility to invest further in our brands.

I would now like to provide some detail on fiscal year 2022 results for Birch Benders. On a full year basis, total net sales were $41.2 million and adjusted EBITDA was negligible, reflecting elevated reinvestment into the brand, with bottom line performance relatively consistent by quarter.

I will now turn to our fiscal 2023 outlook and some of the underlying assumptions that support it. Specifically for net sales, we are guiding to a range of $900 million to $925 million. This reflects organic net sales growth of 10% to 13%, which adjusts for Birch Benders in the 53rd week in 2022. We expect our growth to be balanced across volume and price, with price moderating during the year as we lap last year's actions. We also assume that elasticities will normalize given the potential that macroeconomic challenges could materialize. Lastly, we are pleased with our overall promotional strategy, and anticipate our cadence in 2023 to be similar to 2022.

For adjusted EBITDA, we are guiding to a range of $130 million to $135 million, reflecting growth of 9% to 13%. Embedded in this guidance is moderate gross margin improvement for the full year, driven by pricing and productivity that we expect will fully offset mid-single-digit inflation. We also will increase our growth investments, specifically supporting our brands, people and capabilities, to help us capitalize on the multi-year opportunity ahead. This includes a strong double-digit increase in marketing and R&D.

Below the line, we are guiding net interest expense to be in the range of $36 million to $40 million. As a reminder, half our debt is floating, though we have capped the other half at an effective 7.5% interest rate. We expect our adjusted effective tax rate to be in the range of 25% to 27%. For a summary of these and other annual guidance items, please see slide 16 in our earnings slide deck posted on our Investor Relations website.

Finally, I'd like to provide some color on our expectations for the phasing of the year. Overall, we expect double-digit organic net sales growth in both the first and second half of the year. For adjusted EBITDA, we expect growth and margin expansion to be higher in the first half; and as a result, EBITDA dollar should be more balanced between the first and second half of the year than in 2022.

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 very proud of what we achieved in 2022. We generated volume-led 22% sales growth, year-on-year bottom line growth, and catapulted forward on our march to $1 billion of net sales for Rao's. None of this would have been possible without our great team and the incredible frontline employees that come to work every day to support our business and deliver these strong results. As we look forward, we are confident in executing against the comprehensive plans we discussed to deliver double-digit growth for the top and bottom line in 2023.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] One moment, please. Our first question comes from Ken Goldman of JPMorgan. Your line is open.

Kenneth Goldman Q
Analyst, JPMorgan Securities LLC

Hi. Thank you. Good afternoon.

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

Hey, Ken.

Kenneth Goldman Q
Analyst, JPMorgan Securities LLC

Just curious, Chris, how big was the shipping that you mentioned in the quarter for pipeline fills and some new distribution? And as we think about modeling the first quarter, I know you gave some cadence items there, but should we essentially just pull that amount out of the quarter or there are some offset that we should think about too?

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

Hey. Thank you, Ken. We did get some very nice distribution gains here as we kicked off the year. We're seeing that in our consumption results ramping up week after week after week. While we shipped out at the end of 2022 for that pipeline, had, I call it, a material impact on our Q4 results. It did account for some of our beat to our guidance, but it won't have an impact on Q1 because we're seeing that consumption growth that we would want from that space. So, I wouldn't reflect anything of a reduction to Q1 based on a small pipeline fill.

Kenneth Goldman Q
Analyst, JPMorgan Securities LLC

Got it. Okay. Thank you. And then, my second question. We've seen – you and I have talked about this, some of these sort of entry-level premium brands in sauce, for lack of a better phrase, sort of coming in, not taking a ton of share, but doing reasonably well on a small level. I'm just curious how they're performing now against your expectations and if you're doing anything in particular to combat them. And I guess where I'm going with that is this sort of where the Michael Angelo's introduction into sauce is going to kind of be that entry-level premium or is that more truly mid-tier?

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

A

No. I mean, I think – hey, Ken. How are you doing? It's Todd. You can call it kind of mid-tier or entry-level premium. I actually think they're a bit one and the same. So, yeah, I mean, honestly, there have been some competitive entrants in that area. That's a growing space, and we see that as an opportunity. I mean, look, we're a sauce company through and through. Clearly, Rao's is on fire, and I'll talk about that subsequently. But we've been looking at this for a while and felt that there was a distinct opportunity to leverage another equity, Michael Angelo's, which we have – we've tested this conceptually, we've tested product-wise, and it keeps hitting out of the park. But that price range of like $4 to $5-ish, which is about 50% premium to mainstream for perspective, that's about 30% less of average to average-ish to Rao's. That's like a – that's a nice area right now that we just felt was an opportunity to leverage our Michael Angelo's equity.

The products are very different, except what Michael – what we're offering, though, is a slow-simmered whole tomato-based sauce with real ingredients. So, at a premium to mainstream, albeit not as high as Rao's, you're getting something that is different than tomato paste plus water plus sugar plus canola oil plus dehydrated onions, which – that's mainstream sauce, that's the private label analog. But it's very differentiated versus Rao's, both label, proposition packaging, texture. We've made sure of that. And in the end of the day, with only 6% of the units, Rao's, your source of volume will come proportionately from all players. So, 95%-ish, 90%, 95% of the units that we will source from Michael Angelo's in this entry, which is only starting off with one customer, albeit a larger one. We'll be coming from competitive -the competition versus Rao's. So, we see this as a really smart thing to do. We have our eyes on this space for a while, and we're excited to see what's to come.

Kenneth Goldman
Analyst, JPMorgan Securities LLC

Q

Thank you.

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

A

Yeah. Thank you, Ken.

Operator: Thank you. One moment, please. Our next question comes from the line of Andrew Lazar of Barclays. Your line is open.

Andrew Lazar
Analyst, Barclays Capital, Inc.

Q

Good afternoon, everybody.

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

A

Hello, Andrew.

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

A

Hi, Andrew.

Andrew Lazar
Analyst, Barclays Capital, Inc.

Q

One quick clarification first with the pipeline fill that you were talking about earlier, did you say it was material to 4Q sales or immaterial to 4Q sales?

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

A

Yeah. No, it was immaterial, not material to Q4, which as you've seen was a tremendous quarter for Rao's and for the business in general.

Andrew Lazar
Analyst, Barclays Capital, Inc.

Q

Got it. So, was there much of a differential in between consumption and shipments for Rao's or not so much in the fourth quarter?

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

A

Yes. No. So, you will see for Q4 what we're seeing in our consumption reports, IR reports, is lower than our shipments, and there's a few drivers for that. When you look at pure retail, which was up roughly 25% and consumption really mirrors our shipments as well. So, we were right in line there both for Q4 and for the full year. We had a particularly strong quarter and not measured channels. We had a very, very favorable event as a single customer, and we also picked up distribution across a few other outlets that we had been building up across the year that really took flight in Q4. And that's true, not just in thought, but really across all the categories within Rao's and the totality of our beat to our previous guidance as well as our uptick from consumption to shipments, really was seen across the Rao's business.

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

A

Hey, Andrew.

Andrew Lazar
Analyst, Barclays Capital, Inc.

Q

Thanks for that, and – yes?

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

A

Yeah. Let me just [ph] fill there (00:30:07), because what is material is the distribution gain that we're seeing now in market. And I think that is really important. I'll give you perspective, just using sauce as an example. For the fourth quarter, TDPs were up about 7% year-on-year in the fourth quarter. If I look at the last 13 weeks ended 2/26, fresh data up 22% versus prior year. And again, that is on a brand now that organically was $566 million of sales, that's total franchise. But we have very meaningful distribution gains, as I've been talking about a lot, Andrew, with you and others on these calls, that there is still major wind to chop, major opportunities for further distribution gains, and I'll talk more about that in a bit. But in the end, right now, 22%. And so, what we're seeing is, we increased penetration in total franchise almost between 200 basis points – over 200 basis points from 13.1% to 15.2%. And we increased 100 basis points year-on-year in sauce. And we see both of those up meaningfully in two months into the quarter, not going to quote exact number. We'll talk about that in our next call. But those distribution gains are playing through right now in consumption, and most importantly to us in household penetration gains.

Andrew Lazar
Analyst, Barclays Capital, Inc.

Q

Got it. That's great to hear. I appreciate that detail. And then, just, Chris, could you just briefly walk us through some of the puts and takes around gross margin for 2023? Obviously, you've got pricing and productivity that sounds like it's going to take care of the mid-single-digit inflation that you're looking for for the coming year. What are the things should we think about? Because In theory, I would think that the potential for gross margin recovery, maybe I would have thought, could even be greater than moderate. But I'm probably not taking into account some things.

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

A

No. As we sit here today, first of all, we're very pleased with our H2 2022 versus H1, where we saw a material improvement in our gross margin as we had talked about as our pricing actions took place, which were somewhat spread across the year. And our productivity efforts that had been a little bit delayed earlier in the year really started to take wind in the back half and into 2023. So, given that, we definitely see margin improvement across the first half of the year more than in the back half of the year. As a result of that, our EBITDA growth will be greater in the first half of the year than in the second half year.

From an inflation point of view, we've dealt with low double digits in 2022. We do see that moderating across 2023. And right now, we're in more the mid-single-digit range on inflation, and we believe the pricing and productivity actions that we have in flight and our plan on the productivity front for the balance of the year will drive that margin expansion across the year, again, more heavily weighted to the first half. But you may have seen, we did take some pricing late in the year last year. We just passed through a latest round here in February. That's in the marketplace now. So, we will see some additional pricing flow through in 2023. And if you think of the totality of 2023, net sales growth, we talked about low double digits. That will be high-single-digit volume growth again and mid-single-digit pricing, again, weighted more heavily to the first half of the year.

Andrew Lazar
Analyst, Barclays Capital, Inc.

Q

Great. Thanks very much.

Operator: Thank you. One moment, please. Our next question comes from the line of Peter Galbo of Bank of America. Your line is open.

Peter T. Galbo
Analyst, BofA Securities, Inc.

Q

Great. Thanks. Good afternoon, everyone. Thanks for taking the question.

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

A

Hey, Peter.

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

A

Peter.

Peter T. Galbo
Analyst, BofA Securities, Inc.

Q

Chris, just to start on the EBITDA guidance for the year, I think in your prepared remarks you maybe mentioned more of an even split this year on EBITDA versus 2022. I just wanted to make sure I heard that correctly, and if you can put any kind of numbers around that. And maybe just the second part to that question is, given the level of sales growth on an organic basis, I guess I'm a little surprised that there's not more of it flowing down to the EBITDA line. I think that that's probably more of a ramp, as you said, in some of the capabilities and marketing expense. But just anything you can do to help us on that one as well.

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

A

Yeah. Sure. And you're right on both points. As I just mentioned, we do anticipate more of our profit growth and margin growth coming in the first half of the year. It has a little bit to do with how 2022 played out because of more midyear-ish and later pricing and productivity. That's what will drive us to more balance in 2023 versus 2022 across the year on the EBITDA line.

In 2022, we are roughly 44-ish percent of EBITDA was in H1. I think you would see, 2023, we anticipate not all the way to 50/50, but getting closer to an even split, maybe 47%. And then, on the EBITDA line, you're right, it's the reinvestments that we will make in 2023 below gross margin, as we did in 2022. And those are, again, within the marketing line, where we see a significant up-ramp in marketing supporting Rao's primarily and noosa in more kind of historical legacy rates.

For R&D, we're investing behind – in fact, we just opened up a new facility, R&D facility, down in Austin, that's attached to our plant there. And so, we're building out new capabilities there. We are adding – we've had that in 2022. We continue to add critical roles where needed, but more importantly, the tools required for those roles to be successful, where that's building relationships with retailers, things like master data, data mining and things like that, we're continuing to make those investments below the line. And that is why you'll see not quite the margin expansion that – on the EBITDA line that we anticipate on the gross margin line.

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

A

Importantly – Peter, hey, this is Todd – just to build on that, we've highlighted this. We are building a business for the long term and we're building Rao's to $1 billion and beyond. And there's no question in our minds that Rao's is going to blow by that $1 billion net sales mark. But the way to do that is to invest. And I'll just give you perspective.

In 2022, we invested and increased year-on-year and awareness for the Rao's brand – I'll just use that as a proxy – increased from 48% to 58%, 1,000 basis points, 10-fold percentage points year-on-year. The way to add households is through mental and physical availability, is making the brand more mentally available through awareness of the brand and physically available through distribution. And our playbook is "that simple." We have a growth-obsessed organization, and we look to do whatever we can in order to drive awareness and distribution, know that we have our leading brand across all the categories in which it competes.

We have plans now in 2023 to invest a larger increase year-on-year in 2023 versus 2022 than we did in 2022. So, we are confident that will lead to similar chunky gains in awareness of the brand. And when you combine it with the distribution gains I just talked about, that's what's going to lead to the highly differentiated volume growth that we're driving, as you can see in slide 7 that we put up on the website, vis-à-vis our peers, that's how you really drive volume.

Now, granted, we have a lower penetrated brand in Rao's, but it's now the number two brand in regards to dollar share. But it's still only 6% in units, only 12% household penetration, only 58% in awareness. And we still have just major, major runway in getting our top SKUs to full distribution.

Peter T. Galbo
Analyst, BofA Securities, Inc.

Q

Great. No, thanks ,Todd, for the color there. And then, just maybe as a follow-up. I think, Chris and Todd, there's a leverage target now in the slides. And you have some proceeds from the Birch sales. Can you just talk about use of proceeds and kind of how you're thinking about getting the leverage down, getting that interest expense burden down from where you are today? Thanks.

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

A

Yeah, you bet. So, we are very pleased with our progress on leverage, finishing the quarter below 3 times. I think we had guided that to below 3.5 times. And $140 million sitting on our balance sheet at the end of the year. That really allows us a lot of flexibility, first and foremost, to reinvest behind our brands, our current brands, to drive the core growth that we're seeing. That could take – either could drive the top line as we expand – our TAM expansion efforts. It could lead to improved profitability, which we are – where that's capital – where that's expense making those investments, and to secure supply. We're growing at the rates we're growing, making sure that we can adequately meet the demand is important. We did increase our inventory levels across 2022. And as we closed out the year, we're in a very nice position on inventory. So, that's where we will invest the money first and foremost.

Down the road, potential M&A, if it makes business and financial sense, as we've talked in the past, and then primarily to continue to de-lever. We've operated – we managed our debt very prudently. We've operated typically 3, 3.5, up to 4. We've gone higher than that when we've done acquisitions. But we're happy with where we are now, servicing the debt. We'll continue to de-lever. We generate a lot of cash from the business. And so, that's how we'll manage our capital allocation.

Peter T. Galbo
Analyst, BofA Securities, Inc.

Q

Thanks, guys.

Operator: Thank you. [Operator Instructions] Our next question comes from the line of Jason English of Goldman Sachs. Your line is open.

Jason English
Analyst, Goldman Sachs & Co. LLC

Q

Hey, guys. We covered a lot of ground already.

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

A

Jason.

Jason English
Analyst, Goldman Sachs & Co. LLC

Q

So, I'm just going to throw out one question. The gross margins, how have the expansion initiatives influenced your gross margins? So, can we go back in history and look at that as a reasonable reference point, a way maybe you can get back to you, or has the push into frozen, which is notoriously a lower margin category, and now Michael Angelo's into a lower price point, should we expect that to be structurally mixing lower – still driving great gross profit growth, but just naturally mixing the margin rate perhaps lower than it otherwise would have been?

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

A

Yeah, If you go back in time, let's just go back to pre-COVID, even back in 2019, we were making great strides in our gross margins. You may recall, we talked about investments that we were making at our two plants that we run up in Colorado, which produces noosa; and in Austin, which produces our frozen Italian entrées. That gross margin has surpassed 30%. In fact, I think it was as high as 31%. As the inflation had hit, we had a lag on pricing. Productivity got delayed. We ran 29.5% margin across H2 2022. So, we're building our way back up to what we believe will be 30% and better as we progress. So, we would have every intent that our efforts would get back to those levels that we were at pre-COVID, call it the low 30, may just take a little bit longer than we originally anticipated. But we believe that the activity, the initiatives we have in place, the opportunities ahead of us, we can get back there.

Jason English
Analyst, Goldman Sachs & Co. LLC

Q

Okay, that's helpful stuff. And I apologize. I got a little bit distracted during one of the questions. You may have already addressed this, but two questions on debt. First, you generate a lot of cash, why are you not paying down debt, given how high the rates are? And the $240 million that's locked, I had thought that it had been locked, I guess we read strike rate of 4%. So, I think we wrongly interpreted it to be lock of a 4% rate. I think I heard you say today it's 7.5%. Is what that locked component is capped at?

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

A

That's right. The floating portion is 3.5%. LIBOR is locked at 4%. So, that's a total of 7.5%.

Jason English
Analyst, Goldman Sachs & Co. LLC

Q

And at that point, do you – oh, yeah, continue. My apologies.

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

A

Oh, sure. And then, on the paying down of debt, again, the cash that we do have, it does give us great flexibility. We're holding on to it. By the way, we do have a pretty good rate on it as it's just we're sitting today. As we progress and we generate cash, we will make those decisions on, yeah, do we go back and truly de-lever that? Do we continue to hold on to it? We'll make the most, we think, as the highest use of that cash; and again, right now, we like the flexibility that it provides us.

Jason English
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Okay. Thank you.

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

A

Thank you.

Operator: Thank you. One moment, please. Our next question comes from the line of Robert Moskow of Credit Suisse. Your line is open.

Robert Moskow
Analyst, Credit Suisse Securities (USA) LLC

Q

Hey, thanks. I guess, one question is, I seem to remember you had some supply chain disruption in first half of 2022 last year, having to do with storms hitting in Texas at a supplier. Can you quantify how much of an easy comp that provides, and remind me what quarter it was? Any dollar amount to that?

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

A

Yeah. Yeah, thanks, Rob. Yeah, that was the winter storm down in the Austin area. So it impacted our frozen business. And then we also had an event at our pasta provider, which is also in Austin. So we were struggling to get pasta for the dinners as well. It was really – and then by the way, there was Omicron as well in Q1. So all of those really hit us at the end of the first quarter, but more importantly into the second quarter, which is when we canceled all of our promotions.

So, I don't think you'll see an impact in Q1. Across Q2, yeah, there will be – again, I can't call it material, but we are back up and running now. Our service levels are in good shape on frozen. We've talked a lot in the past about the investments we're making down that Austin plant to automate our manufacturing lines that then had gotten delayed to the back part of 2022 and really all the way almost to the end of the year. The great news there is those lines are now up and running, and we're starting to really see the benefits of that, taking the hourly head count out of the plant, a boost to capacity. So that's a great tailwind for us in 2023. But I would not model in a material impact for whatever volume was launched last year in Q2.

Robert Moskow
Analyst, Credit Suisse Securities (USA) LLC

Q

What about EBITDA?

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

A

I would say this, the same thing, sales weren't that high. We didn't really experience any incremental cost during that time, again, that I would call significant. So I would not – either top line or EBITDA, I would not set a large dollar impact for that from the storm last year.

Robert Moskow
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. Well, it felt material last year, so I figured I would ask. A second question, regarding this promotion you did with a non-measured channel customer in fourth quarter, is this a really big customer? And why did you decide to do it? And are you going to do it again in 2023? Like, I just want to make sure it's not creating a tough comparison in 2023.

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

A

Yeah. This is – hey, Rob, it's Todd. Well, I mean, I know it's – I guess my thought is like, first of all, the only reason we're talking about it, unmeasured versus measured, is because of the difference in net sales and whatever, it's – I mean, our philosophy is I want – we, our team, wants ubiquitous distribution of sauce in every single outlet in which the consumer shops. And some of those customers, notably some that are in the unmeasured universe, those come – those are big volume events.

So, while I understand what's behind your question, I've never been one to strategically think about, hey, I've done it in this quarter and now we need to lap it next year. I just – in the end of the day, we get the right distribution in the right places in the right events, and then we just need to figure out how to grow our business year-on-year, every quarter and every year.

So, I know that's not a perfect answer to your question. I'm just saying that, right now, we are just looking to make sure that we have full ubiquitous distribution in Rao's and all the items. We're still under-distributed vis-à-vis our peers, 12 average items versus 20 for the competition, 58% awareness versus 90-plus percent for the competition. And if we have the opportunities to run some large events to get what we call the world's best-tasting pasta sauce into more consumers' mouths, we will do that. And if that causes us some indigestion in regards to lapping in Q4, well then so be it. Our team is up to it. I don't mean to be flippant all with you, Rob, on that, but that is kind of our mindset.

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

A

Hey, Rob, I'll just add to that as well. It was a real enhancement to an event and a little bit of a shift in timing, but it was an overwhelmingly successful event. And you might have seen in the comments we just made previously, we do – we are guiding to lower double-digit top-line growth both in H1 and H2. So just to support Todd's comments, we're not seeing that as an overlap that we [ph] can't (00:49:50) overlap.

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

Okay. Thanks, Rob.

Operator: Thank you. One moment, please. Our next question comes from the line of Michael Lavery of Piper Sandler. Your line is open.

Michael S. Lavery
Analyst, Piper Sandler & Co.

Q

Thank you. Good afternoon.

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

A

Hi, Michael.

Michael S. Lavery
Analyst, Piper Sandler & Co.

Q

Just want to come back to the Michael Angelo's sauce. Could you touch on how that's sourced, if it's through La Regina and if it's not – does it have favorability on costs or more volatility or perhaps both? How should we just think about the cost profile on the supply chain for that?

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

A

Sure, sourced through La Regina. No similar volatility that Rao's sauce would have. But as I emphasized before, Michael, first of all, good to be talking with you, Michael.

Michael S. Lavery
Analyst, Piper Sandler & Co.

Q

You too.

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

A

It's a different formula than Rao's in regards to a lot of different attributes. It is important to highlight Rao's uses a very specific breed of Italian San Marzano tomatoes. Michael Angelo's uses what we call just a vine ripened Italian tomato. It's a shorter cook time, different sort of ingredient spec, etcetera, with the herbs and seasonings, olive oil, etcetera. That's different, all different from Rao's. That said, it is a slow simmered kettle cooked sauce that's highly different than mainstream/private label.

Michael S. Lavery
Analyst, Piper Sandler & Co.

Q

And would it be fair to say that it's similarly attractive economics relative to its price point at least, where even if it's still from La Regina, it's got a different recipe and different things that allow for the – it's got a better cost profile than Rao's. Is that fair?

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

A

That's fair.

Michael S. Lavery
Analyst, Piper Sandler & Co.

Q

And can you just touch on Rao's share? I know you gave the volume share. You had the dollar share. I might have missed it. But could you give that and then just remind us some of the seasonal drivers there? Because I know your competitive set has different, at least ways they approach it that can drive some share fluctuations for you. Can you just remind us how to think about how its cadence can evolve that way?

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

A

Sure. We entered the full year at a 14.7% dollar share higher than that in the quarter. It's very interesting. You may know, I'm so used to working on some other highly seasonal businesses like Halloween candy or even pet treats that I don't really think of shocks. But it is, there is a seasonal element to it. So I don't mean to joke. I'm just sort of thinking back on my – my history just came flashing before my eyes in regards to all the categories that I've worked on.

But, I mean, I think just like – it's not – I mean, you're seeing a little bit of a phasing more towards Q4 and Q1, colder months versus warmer months. But we still have a pretty darn robust business through Q2 and Q3. If you sort of look at the phasing of consumption data, all of the things kind of constant. Now it's difficult, because Rao's is just on a constant uptick of increased awareness every quarter-on-quarter, increased household penetration due to distribution. But like-for-like category, etcetera, you're seeing a little bit more in the Q4, Q1 than Q2, Q3 and Chris Hall [ph] has got some (00:53:33). No? Okay. I thought he's looking at me.

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

Okay. Did that help, Michael?

Michael S. Lavery
Analyst, Piper Sandler & Co.

Q

Yeah. No, that's helpful.

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

A

Okay.

Operator: Thank you. One moment, please. Our next question comes from the line of Jon Andersen of William Blair. Your line is open.

Jon Andersen

Analyst, William Blair & Co. LLC

Q

Hi, thanks. Thanks for the questions, guys. Just a couple quick ones. Wondering if you could talk a little bit more about the gross margin cadence through the year. Are you expecting kind of a sequential gross margin rate improvement quarter-by-quarter as you move through the year? And then on the OpEx line, is there anything for us to consider when you talk about incremental investment spending behind brand building in R&D? Is there any particular kind of cadence to that or timing-related factors that we should be considering as well, or is it more kind of spread evenly across the year? Thanks.

Christopher W. Hall

Chief Financial Officer, Sovos Brands, Inc.

A

Yeah, sure thing. On gross margin, I think that the main point there is that the majority of the increase, and there will be a strong increase in the first half of the year, year-over-year. And I think H1 will look more like H2 2022. And then as you cross over the year, the inflation that we're going to be seeing here in 2023, which is agro products, paperboard, things like that that you're hearing about, tomatoes, for example, fruit, it really is spread pretty evenly across the year because it's coming out of the new crop season that would have hit us across Q4 into this year.

So, the inflation, mid-single-digit pretty much across the year. We get the benefit of that pricing tailwind in the first half of the year. So that's how I think about gross margins. And then on EBIT and investments below OpEx, we have traditionally our highest – we've been more back half-loaded in our marketing efforts. I think you'll see that's going to be more spread evenly across the year. Other than that, I think it'll be pretty much the same type of cadence that you have seen in prior years across our OpEx, but with more marketing across the first half of the year as a percent of the total marketing spend.

Jon Andersen

Analyst, William Blair & Co. LLC

Q

Thanks. That's helpful. One quick one follow-up, just any color on noosa. Obviously, Rao's is the crown jewel here and performing extremely well. Just wondering what your expectations are for – and plans are for kind of noosa in 2023 and maybe how some of the TAM expansion work that you've done over the past 12 to 18 months kind of – how you're thinking about that at this point. Thanks.

Todd R. Lachman

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

A

Sure. Hey, thanks a lot, Jon. Good to talk to you. This is Todd. So, a couple things. So, headline is we're pleased with noosa. We grew the brand [ph] 4.3% (00:56:46) net sales in fourth quarter. We've averaged now three years at about 5% CAGR on the noosa brand, been a nice mid-single-digit contributor. And I think I've mentioned this on previous call, this has been, quite honestly, really very good acquisition for us. Some of the areas [ph] on full (00:57:05) visibility to is that dramatic improvement of profitability from when we acquired the business to call it a year ago pre increase in milk pricing that really benefited us immensely. And it's sort of a turbo boost to help fund the growth in Rao's. So, noosa has been a real nice acquisition for us.

The dollar consumption growth, very consistent around low-to-mid single digits all year, even as the full contribution from pricing increased. We're going to continue to make sure that this brand is a growth contributor. We did – as we think we talked on the last call, we've worked on the promotional plan, etcetera, to ensure that we've got consumption growth headed into next year. But it's – obviously the yogurt category is different and it's unique in regards to its competitiveness.

But noosa, as we've talked before, is a highly differentiated brand. It's a taste-led yogurt. We unapologetically talk that and trumpet that in regards to, while other competitors are taking the taste out of yogurt, we're putting taste in, and that's why it's been a consistent, nice mid-single-digit growth contributor to us. And we have similar expectations for that business this year and beyond.

In regards to the TAM launch in gelato, I'd say the headline there is the mixed – the results have been mixed. It has done honestly well in a variety of customers. And some customers it hasn't performed as well. Ice cream is also a different category, as I've always said, that was a smaller launch from us, different than something than – albeit this year we're launching pizza, but we're constantly fine-tuning. We've got a large variety of customers that have accepted the three new items that we're launching this year: cookies and cream, lemon bar, and mint chocolate chip.

So, you've got a variety of customers now that have all seven of our items on shelf, but unfortunately, you have some customers that don't have some of the ice cream on shelf. And we're going to continue to support that initiative, drive it forward, learn as we go. Not really a meaningful indicator of like our sales for this year, whatever else, but we think it's an important one for noosa. So, what else can I tell you there, Jon?

Jon Andersen
Analyst, William Blair & Co. LLC

Q

No, that's great. Super helpful. I appreciate all the color and good luck going forward.

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

A

Hey, Jon. I just have one clarification on the sequencing of gross margin in the first half of the year. Just note, Q1 historically and will continue to be the lower margin quarter, because it's our highest promotional quarter. So, I think the rate of improvement across Q1 and Q2 versus last year Q1, Q2 will be similar, but we'll still see Q1 as the lowest overall margin quarter for the year.

Operator: Thank you. Our next question comes from the line of Sarang Vora of Telsey Group. Again, Sarang Vora, your line is open.

Sarang Vora
Analyst, Telsey Advisory Group LLC

Q

Great. Great quarter, guys. Great guidance as well. When you look at Rao's as $1 billion brand, how do you think the mix of sauce versus outside the sauce categories, all these frozen pizzas stuff look like in $1 billion pie that you have? And then my second question is, outside the sauce category at Rao's growing very strong past several quarters. I mean, is it fair to assume that these categories will contribute almost half of the Rao's growth in 2023? Thank you.

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

A

Sure. So, Chris can hit the second point. But good talking to you. This is Todd. So, sauce is about 85% of Rao's today, using rough math based on our detailed modeling techniques. I'm just being facetious. I would assume that we get to $1 billion, you're talking sauce about 70% – 70%, 75%. But if you just look at that, where sauce is today, where sauce will be to $1 billion, I mean, sauce is going to be still a major growth driver of our growth.

And on top of that, you've got – we haven't talked a lot on this call on the beachheads, which are all still doing very, very well. And besides, the beachheads, which we talk about newer, I mean, this is the fourth year of soup. This is the third, fourth year, depending on when you use the exact start date of frozen. Dry pasta has been in market now for almost four years. So, these beachheads have been there for a while, but they're all growing robustly. That combined amount of [indiscernible] (01:02:10) $110 million, up 45% versus prior year.

So, those are all ticking up. And then we've got pizza, which is a $6.5 billion category. I mean, a 2% share of frozen pizza is – you can do the math, that's a sizable business for us. And that's what we have our sights on. And one area that I'll talk about pizza that is important, I'm sure you've heard in other calls from some of those that are in the delivery pizza business, I mean, we've launched out there, as we talked about in the script, our frozen pizza could not be testing any better than it's testing.

Now it's been in test for a while with four retailers, and it is a super-premium price. It's roughly $12.99 shelf, promoted down a little bit below that. But that is significantly less today than what a delivered pie costs to your home because of the inflation, the delivery fees, and everything else going on. So, you can get an absolutely delicious artisan, a super-premium pizza made by Rao's in the frozen sector, and we believe that's a clear reason of what's driving the success of that business is the fact that it's a real value versus a home-delivered pizza today, and that wasn't necessarily the case four years ago.

So, if you look at the $1 billion, you've got sauce being a core part of that, you've got the beachheads, you've got pizza, and then you've got some other elements. We've talked some light international opportunities for Rao's, etcetera, but I will still go back. The number one driver is sauce. Why? Awareness is still only 58%, albeit up 10 percentage points last year.

Household penetration only up 12%, although that's up significantly, we're really seeing an uptick in the first two months of the year. Unit share only is 6%, albeit growing significantly year-on-year. The last point I'll add is that we grew in every – we basically grew robustly household penetration and share in nearly every single measured geography of the United States last year. We were also the only brand in Q4 that grew across every income demographic and generational cohort versus the other top 4 brands. So, we are maniacally focused on growing that sauce business onward and upward, and that's key reason why we've got momentum heading into the year, and that we feel very good about the double-digit top and bottom line guidance for 2023.

Sarang Vora
Analyst, Telsey Advisory Group LLC

Q

That's great. And I can't wait to try some new product. Good luck.

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

A

Thank you. You too. Thanks.

Operator: Thank you. I'm showing no further question at this time. I'll turn the call back over to Todd Lachman for any closing remarks.

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

Awesome. Hey, thanks again, everybody, for joining us and showing interest in our 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 discussions. Until then, have a great evening and take care.

Operator: Thank you. Ladies and gentlemen, this does conclude today's conference. Thank you all for participating. You may now disconnect. Have a great day.