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Noodles & Company (NDLS) Q2 2024 Earnings Call Transcript

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EPS of -\$0.05 **beats by \$0.00** | Revenue of \$127.35M (1.76% Y/Y) **misses by \$3.34M**

Noodles & Company (NASDAQ:[NDLS](#)) Q2 2024 Earnings Conference Call August 7, 2024 4:30 PM ET

Company Participants

Drew Madsen - Chief Executive Officer

Mike Hynes - Chief Financial Officer

Conference Call Participants

Jake Bartlett - Truist Securities

Todd Brooks - The Benchmark Company

Operator

Good afternoon and welcome to today's Noodles and Company's Second Quarter 2024 Earnings Conference Call. All participants are now in a listen-only mode. After the presenters' remarks, there will be a question-and-answer session. As a reminder, this call is being recorded.

I would now like to introduce Noodles & Company's Chief Financial Officer, Mike Hynes.

Mike Hynes

Thank you and good afternoon, everyone. Welcome to our second quarter 2024 Earnings Call. Here with me this afternoon is Drew Madsen, our Chief Executive Officer. I'd like to start by going over a few regulatory matters. During the call, we may make forward-looking statements regarding future events or the future financial performance of the company.

Any such items should be considered forward-looking statements within the meaning of the Private Securities Litigation Reform Act. Such statements are only projections and actual events or results could differ from those projections due to a number of risks and uncertainties, including those referred to in this afternoon's news release and the cautionary statement in the company's Quarterly Report on Form 10-Q and the subsequent filings with the SEC.

During the call, we will discuss non-GAAP measures, which we believe can be useful in evaluating the company's operating performance. These measures should not be considered in isolation or as a substitute for our financial results prepared in accordance with GAAP. A reconciliation of these measures to the most directly comparable GAAP measures is available in our second quarter 2024 earnings release.

To the extent that the company provides guidance, it does so only on a non-GAAP basis and does not provide reconciliations of forward-looking non-GAAP measures. Quantitative reconciling information for these measures is unavailable without unreasonable efforts.

With that, I'd like to turn the call over to Drew Madsen, our Chief Executive Officer.

Drew Madsen

Thanks, Mike and good afternoon, everyone. I am pleased that we were able to deliver positive system-wide same-store sales growth of 2% during the quarter and matched the fast casual industry benchmark on both same-store sales and traffic despite the challenging consumer environment.

We also improved our restaurant contribution margin by 70 basis points, compared to 2023 aided by strong cost management. More importantly, we continue to make meaningful progress on our five key priorities to achieve sustained profitable growth and drive long-term shareholder value. Although the current operating environment may cause some variability in our near-term results, we are focused on what we can most directly impact and continuing to position Noodles to capture the significant growth opportunity we believe it has long term.

Now, let's talk about progress on our five strategic priorities. Creating a foundation of operations excellence is our top priority. Our primary focus is on improving the dimensions of the guest experience that correlate most directly with traffic growth. Overall satisfaction, taste of food and accuracy. This is especially applicable at dinner, where we have experienced more traffic loss in recent years.

Our strategy to achieve this includes biweekly training sessions across the system to review proper execution of a new food execution standard, a new service standard, and a new accuracy standard during each training session. A few examples of training standards we focused on during the second quarter include cooking proteins at saute, caramelizing udon noodles in a sweet soy sauce, table check backs and checking drinks before bagging a delivery order.

In addition, we are doing a better job of adhering to our shift staffing standards that require General Managers and Assistant General Managers to be in our restaurants during our busiest dinner daypart shifts. These efforts are definitely paying off with guest satisfaction improvement accelerating each month of the quarter on all three of our priority measures and they improve the most at dinner.

In the near-term, it's difficult to correlate guest satisfaction improvement with traffic growth. but we are clearly establishing the culture and team member behaviors required for a more consistent and a more satisfying guest experience. And I'm confident this will drive stronger guest loyalty and improve traffic over the long term. Our second priority is to stimulate more guests' desire for noodles through a comprehensive menu transformation guided by our contemporary comfort kitchen culinary NorthStar.

As our work progresses, we will continue to use compelling limited time offers to bridge the gap until our core menu testing plan has been successfully completed. Phase 1 of this process involve concept testing to identify the most compelling ideas for both new and improved dishes.

During phase 2, we placed the new and improved dishes created by the culinary edge in the central location taste test with Noodles customers to ensure they exceeded the guest satisfaction average on our current menu. These phases are largely complete. We are now starting Phase 3, where we placed the new and improved dishes in test locations to assess real-world guest satisfaction, operational feasibility and any related financial implications, including menu mix shifts.

Our goal is to impact roughly two thirds of our menu through new or improved offerings over the next year. Given the magnitude of change involved for both guests and operations, we are taking a very thoughtful and strategic approach to testing and we plan to stagger the national introduction of the complete updated menu over several months.

At the end of June, we placed two new dishes and one improved dish in our test locations. Crispy Chicken Bacon Alfredo is a more contemporary version of our current Alfredo MontAmore, which it will replace. So far, it sells nearly 50% more and has higher guest satisfaction than Alfredo MontAmore.

Lemon Garlic Shrimp Scampi will be added to address the need we identified for additional light and fresh menu options. This dish is selling well and has guest satisfaction scores well above our menu average. The third dish Chipotle Chicken Cavatappi will be added to address the need we identified for a Latin-inspired flavor profile on our menu. This dish is also selling well and has solid guest satisfaction. Our plan is to introduce all three nationally in October. We also deleted zucchini with roasted garlic cream sauce, linguine rosa and linguine fresca. Last week, we introduced five more new or improved dishes into the same test locations and deleted one more existing dish.

Assuming continued success, these dishes would be introduced after the holiday season during the first quarter of 2025. The timing of additional new and improved dish introductions is dependent on how our guests and operators adapt to the changes already described. But as I said, our goal is to have two thirds of our menu either new or improved by next year at this time.

As I mentioned earlier, our plan is to regularly include limited time offers as a bridge to bring excitement to our guests and help drive traffic until our menu transformation is complete. Our most recent LTO Baked Alfredo with Grilled Chicken did not perform as well as Steak Stroganoff, despite having stronger concept test scores and similar media support.

Our hypothesis is that three of our last four LTOs including chicken Parmesan, Chicken Prosciutto Tortelloni and baked Alfredo with chicken have all fallen into the classic Italian comfort category and felt too similar to each other to generate special visit interest.

With that in mind, we plan to feature an item from our existing menu, spicy Korean steak noodles starting mid-August. This dish has low awareness, but high guest satisfaction and strong appeal among younger consumers. Our belief is that it will be more newsworthy and do a better job of driving special visit interest for noodles. So, with Spicy Cream Steak Noodles featured starting in August, plus Crispy Chicken bacon Alfredo, Lemon Garlic Shrimp Scampi and Chipotle Chicken Cavatappi introduced nationally in October, we will have plenty of exciting menu news to effectively bridge to the full new menu introduction in 2025.

Our third priority is to drive profitable traffic growth by further leveraging our strong digital ecosystem. As a reminder, Noodles has 55% of total sales from digital channels and 26% of sales from loyalty members with loyalty members spending twice as much per year as non-loyalty members.

During 2023, we invested in a customer data platform that aggregates all information about our known customers in one area. This has enabled us to engage these customers using smart, relevant, personalized offers with fewer discounts to drive profitable traffic growth.

In particular, we focus on reactivating lapsed loyalty members, because our active members have frequency more than 50% higher and they have two and a half more visits per year than our loyalty program average. So far, this strategy has worked very well. Through Q2, active loyalty member traffic is up 5% and loyalty discount spending is down 32%. Third-party delivery has also been a strong channel for us this year.

Selective investment in sponsored listings, exclusive dishes and profitable promotions generated double-digit traffic growth in the second quarter. We will continue to prioritize marketing investments behind these proven loyalty program and third-party delivery opportunities going forward.

We will also continue our test and learn efforts with broader reach media to identify the most effective ways to attract more new customers to our digital assets and ultimately into our loyalty program. We're currently trialing connected TV, streaming audio, podcasts and direct mail. Our fourth priority is to maintain double-digit growth in our catering business, while we improve the fundamentals required to drive more aggressive growth in the future.

Catering has grown from 1% of sales in 2022 and 1.2% in 2023 to 1.7% year-to-date in 2024. And during the second quarter, system-wide sales were up 42% versus last year. We continue to believe catering has the potential to be at least 4% to 5% of sales in the future. And we believe that catering growth would be incremental and contribute to higher overall margins.

Going forward, we will continue to grow profitable sales by unlocking new catering occasions like teacher appreciation day last quarter and adding new menu categories like box lunches and other individual grab and go items. We will also add new sales building tactics like fractional catering managers in high potential markets to create strong relationships with local sports teams, schools and healthcare organizations. Paid LinkedIn advertising that targets the catering occasion decision maker is another tactic we will implement to support continued profitable sales growth.

Additionally, we will strengthen our catering operating model by reducing operator friction and increasing throughput in our restaurants. The biggest friction point right now is the need to manually rekey orders from ezCater, which is a third-party catering platform into our point of sale. By the end of September, we will have an integrated ordering solution implemented that will take this friction point away. We are also currently evaluating options to outsource delivery of catering orders placed through our website and a technology-driven solution to transfer catering orders between restaurants when needed.

Our final priority is to strengthen our financial foundation with proactive cash management and an increased emphasis on operational efficiency across the business. We have reduced our capital spending from \$52 million in 2023 to our projection of \$28 million to \$32 million this year. This is largely driven by the reduction in new unit openings and the completion of our digital menu boards rollout last year.

As we mentioned last quarter, during January, we implemented a major cost reduction effort that we projected would save approximately \$4 million this year. This included targeted headcount reduction in areas we have deprioritized in the short term like new unit openings, employee benefit adjustments that save money while still keeping us competitive in the marketplace and supply chain savings through improved vendor management and product optimization. Our smart cost savings team has continued to look for additional savings opportunities in both restaurant operating expenses and G&A. And we now expect to deliver savings of over \$5 million in 2024.

Finally, we performed a detailed portfolio review during the second quarter to identify underperforming restaurants with substantial negative cash flows. Through this review, we identified approximately 20 restaurants that we will evaluate closing before the end of their lease terms.

Mike will discuss in more detail, where we are in the process. but we believe closing underperforming restaurants will allow us to focus more on our restaurants with the most growth potential and provide an increase in company earnings and cash flow post closure. As you can see, we've made substantial progress on our strategic priorities and we believe we are positioning Noodles to capture the full growth opportunity we see ahead.

Now, I'll turn it over to Mike to review our financial results in more detail.

Mike Hynes

Thank you, Drew. In the second quarter, our total revenue increased 1.8%, compared to last year to \$127.4 million. System-wide comp restaurant sales during the second quarter increased 2.0%, including an increase of 1.3% at company-owned restaurants and an increase of 4.7% at franchised restaurants. Company comp traffic during the second quarter declined 1.1%, pricing contributed 0.9% and mix contributed 1.5%.

Company average unit volumes in the second quarter were \$1.32 million. We experienced two holiday shifts, Easter and 4th July, that benefited the second quarter in 2024. Combined, we estimate that the holiday shifts positively impacted our second quarter comp sales by approximately 120 basis points, meaning we still had a positive comp restaurant sales after excluding the impact of the holiday shifts. Our July comp restaurant sales were down 3.2% or down 0.7% after adjusting for the impact of the 4th July holiday shift.

Turning to profitability in the second quarter. Restaurant level contribution margin was 15.5%, up from 14.8% in the second quarter of 2023. The increase in our restaurant contribution margin was due to a combination of favorable commodity costs and strong cost controls.

Cost in the second quarter was 24.7% of sales, a 40-basis point improvement from last year, driven by pricing, and overall food and beverage deflation of 0.2%. Labor costs for the second quarter were 31.2% of sales, which was down 120 basis points to prior year, primarily driven by labor productivity. As a reminder, we will have last year's labor productivity improvements in the third quarter. So, the year-over-year benefit from labor productivity is expected to moderate in the back half of 2024.

Wage inflation continued to moderate in the second quarter with hourly rate growth of 2% versus prior year. Occupancy costs were flat versus prior year at 9.3% and other restaurant operating costs increased by 70 basis points in the second quarter to 19.2%. The increase in other restaurant operating costs was driven by third-party delivery fees due to an increase in revenue mix from that channel.

G&A for the second quarter was \$13.6 million, compared to \$12.5 million in 2023, primarily due to an increase in severance and executive transition costs and an increase in planned marketing spend. Net loss for the second quarter was \$13.6 million, or a loss of \$0.30 per diluted share compared to a net loss of \$1.3 million and a loss of \$0.03 per diluted share last year.

The loss in the second quarter of 2024 included a \$10.9 million non-cash impairment charge, primarily related to the portfolio review of underperforming restaurants, which I will discuss shortly. Adjusted EBITDA for the second quarter was \$9.2 million, compared to \$8.5 million in the second quarter of 2023. In the second quarter, we opened five new company-owned restaurants and refranchised six restaurants in the Portland, Oregon area to a new franchise group. One franchise restaurant was closed in the second quarter of 2024.

In July, we opened one new company-owned restaurant, bringing our year-to-date total company openings to eight. One new franchise restaurant also opened in July. As Drew mentioned, we recently performed a comprehensive portfolio review that identified a group of about 20 restaurants with combined annual restaurant contribution losses of approximately \$2 million that we will explore closing on or before their lease expiration dates. With the assistance of a national broker, we have begun discussions with the landlords for these restaurants. The timing of potential closures is uncertain and will be determined on a case-by-case basis.

Turning to full-year 2024 guidance. Although we're pleased with our second quarter results, we have revised certain expectations for the full year to reflect our recent trends given the more challenging consumer environment. For the full year 2024, we are providing guidance of \$495 million to \$505 million for revenue, inclusive of negative 2% to flat comp restaurant sales. We anticipate full-year restaurant contribution margin between 13.5% and 14.5%. G&A expenses of \$50 million to \$53 million inclusive of stock-based compensation expense of approximately \$4.5 million.

depreciation and amortization expense of \$30 million to \$32 million and the interest expense of \$8 million to \$9 million. For the full year, we expect to open a total of 10 new company-owned restaurants and three new franchise restaurants, and we continue to expect total 2024 capital expenditures between \$28 million and \$32 million. We currently expect to close a total of 10 to 15 restaurants in fiscal year 2024, which includes a few of the underperforming restaurants previously discussed.

Turning to the balance sheet. At quarter end, we had cash and cash equivalents of \$1.8 million, a total debt balance of \$86.5 million and over \$30 million of incremental liquidity available for future borrowings under our credit facility. Our final two company-owned restaurant openings for 2024 are scheduled to open later in the third quarter.

So, we are forecasting a decrease in our capital expenditure run rate in the fourth quarter that will carry forward into 2025 and better position us to be free cash flow positive on a sustainable basis.

With that, I'll turn the call back over to Drew for final remarks.

Drew Madsen

Thanks, Mike. I am pleased with our second quarter results and excited about our continued progress on our five key priorities. Our foundation of operations excellence is improving and our menu transformation is on track with encouraging early test market results. I look forward to sharing more progress with you soon.

Thank you for your time today. Operator, please open the lines for Q&A.

Question-and-Answer Session

Operator

Thank you. [Operator Instructions] Our first question comes from the line of Jake Bartlett of Truist Securities. Your line is now open.

Jake Bartlett

Great. Thank you so much and thanks for taking the question. My first is on the guidance on same-store sales and your expectations. It looks like the midpoint of the annual guidance implies a back half. It only shows maybe, a very slight improvement from where you're kind of running on a kind of a normalized basis in July. So, I just want to kind of confirm your thinking in terms of back half guidance. It doesn't seem to bake in much of an impact from the new menu items that are coming down the pike. Maybe, just to give a perspective on how you came to that guidance, what you have baked in and maybe, also what your view of the underlying demand environment is going to be that's baked into the guidance?

Mike Hynes

Thanks, Jake. I'll start and just give you some guidelines on what informed our guidance. So, year-to-date, through Q2, we're down about 2%. We know we're starting with a down 3% in July due to the holiday shift. Adjusted for the holiday shift, we're better at down 7% or down 0.7%, excuse me. And so, to get to positive, we would have to exceed a plus 2 in the back half of the year. And we are planning on incremental improvement from where we are today, but we wanted to be measured considering the environment and what we've recently experienced in our month-to-month progress.

Drew Madsen

Yes. I mean, I'd emphasize we're very excited about the progress we're making on all of our priorities operations excellence across the board in every quartile especially at dinner. On our menu transformation really encouraging early test market results. We're getting good progress on our loyalty program for sure. And catering, that's going to be a little bit longer-term play, but up 40% in the second quarter. So, really excited about the progress in all our priorities, but we recognize that the consumer environment is difficult and we're basically tracking with the fast casual industry benchmark now. And that's what we anticipate going forward.

Jake Bartlett

Great. And one of the kind of the -- I guess the headwinds that you faced about a year and a quarter now, maybe a year and a half ago, when you're kind of value that out of a little out of whack for your consumer, and you show the price of less this fee wasn't there. So, the question is, has your value perception started to improve? It seems like a big headwind something that you need to really improve. Are you seeing progress there? I know customer satisfaction has been improving, but how about just the value perceptions of the consumer?

Drew Madsen

Yes. they are gradually improving and we expect with our new menu improvements, they're going to accelerate even further and that's what we're seeing in the test market. We've chosen not to aggressively discount the way we did last year to try and artificially get value improvements. We're really focused on things that will fundamentally, sustainably improve our experience and improve the value perception basically driven by what our guests are feeling in the restaurant with the experience we're getting and we're really going to see more of that with our menu transformation.

Jake Bartlett

Great. And then my last question is, on the hiring of Scott Davis as the Chief Concept Officer. And obviously, Scott has a great track record at Panera for one. And so, my question is how his hiring -- how does that change your approach to menu innovation? I think before we were -- it was you're focused on kind of more outsourcing to that kind of menu development function.

In terms of the pace of the changes that you have coming down the pike, I know he's only been in the job for over a month now. So, does that delay or have any impact on kind of what the plan was as we last had heard it? I think in the last call, you mentioned touching about 40% of the menu by the first quarter. Now, you've talked about two thirds by the second quarter, it sounds like or by the beginning of third. Just any impact you expect Scott to make and as well as just impact to the plan as we understood it before his hire?

Drew Madsen

Yes. we're super-excited about bringing Scott on board. He is one of the really outstanding concept culinary innovation leaders in our industry and we're delighted to have him on the team. His presence is adding, I would say, a very strong voice on the leadership team as it relates to culinary excellence and not sacrificing our culinary standards in any way shape or form. His presence isn't going to impact the timing. but I think it will impact materially the impact to success we have in our menu transformation efforts. Just the things he's pointing out already in the work TCE has done and how to bring it to life inside our restaurant more consistently is going to make a difference. So, a great insight, higher standards, really strong partnership with operations. So, I can impact the timing. I just think it's going to impact the overall success of what we started with TCE.

Jake Bartlett

Great. I appreciate it.

Operator

Thank you. One moment for our next question. Our next question comes from the line of Todd Brooks of The Benchmark Company. Your line is now open.

Todd Brooks

Hey. Thanks for taking my questions. I have a few, if I may. One, Drew, I think when we were talking about LTO cadence and using some of those new menu items as an LTO bridge around the introductions in the fourth quarter. You teased kind of a brand partnership that was the promotional focus on the third quarter. And it sounds like now maybe, we've added an incremental LTO in August. Is there any detail around that brand partners that event still happening or are we kind of locked in on using the food and promoting those items as our traffic driver for Q3?

Drew Madsen

Well, they're both still happening. We're excited about Spicy Cream Steak Noodles for sure starting pretty soon. And then the three new dishes from the culinary edge. The partnership, we were referring to, isn't strictly a culinary partnership, it's with Care Bears partnership targeting families and that is still going to happen. So, all three will be in the market starting towards mid to end of third quarter.

Todd Brooks

Okay, perfect. Thanks. Secondly, Mike, I know you talked about the -- when you just updated the guidance, you talked about the lower range for revenues. But in the original guidance range, were these 10 to 15 closures by the end of the year contemplated? Or is that accounting for a decent share of the guide down in revenues for the full year?

Mike Hynes

That is a change, Todd, from our previous guidance. So, the portfolio review was initiated in the second quarter. So, we weren't aware of that with the original guidance and that does contribute to a portion of the revenue decline. We're anticipating that the closures associated the few that we have related to the portfolio review in 2024. There'll be late Q3 and into Q4, so not a huge impact to the 2024 full-year revenue number. But when we went through guidance in March, we were anticipating our normal historical closure rate, which is 1% to 2%. So, we're clearly stepping up from that now.

Todd Brooks

Okay, good. And then the final question I have. If you look at just the environment we're operating in, there's a lot of kind of specific price promotions at kind of hard price targets. And I know you're not trying to necessarily discount for the sake of just driving profitless traffic. But as you look at the menu and maybe the ability to combo or bundle, are you looking at any specific price point promotions that you either want to have in the quiver or you feel like you need to kind of pull that lever to be that much more competitive in the second half? I know you're equal to your peer average now on kind of traffic and same-store sales growth, but just thoughts on overt value where the customer seems to be gravitating to that? Thanks.

Drew Madsen

Yes. Well, we've seen some modest signs of check management related to add-ons, but it's modest. Our overall check growth in the quarter was on expectations 2.5%. And as we look at our share of traffic by income group, it's largely unchanged over the last 18 months.

So, we haven't seen a significant pullback from our lower income customers. But as you say, there is a challenging consumer environment for sure. So, to your question, we have chosen to lean into investments that we believe have the highest chance of driving profitable incremental traffic and that's around what we're seeing in our loyalty program.

Number one, leveraging our customer data platform and being more selective with where we choose to offer any sort of incentive and in our in third-party delivery marketplace, where we've had a good deal of success as well. We're avoiding broad based discounting. Our view is that it's just really hard to get enough incremental traffic to offset the margin loss that comes with this sort of tactic. And in addition to leaning into loyalty program, which is we think a competitive strength in our third-party marketplace success, we think the best way for us to drive sustained profitable traffic is just to continue to improve our guest experience through operations excellence and menu innovation, and also increase brand awareness and attract new users through the broader reach media vehicles that we're testing this quarter.

Todd Brooks

That's helpful. Thanks, Drew. Appreciate it.

Operator

Thank you. This does conclude the question-and-answer session. Thank you for your participation in today's conference. This does conclude the program. You may now disconnect.

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