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Valvoline Inc. (VVV) Q3 2024 Earnings Call Transcript

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10-Q

EPS of \$0.45 **misses by \$0.02** | Revenue of \$421.40M (12.01% Y/Y) **misses by \$3.75M**Valvoline Inc. (NYSE:[VVV](#)) Q3 2024 Earnings Conference Call August 7, 2024 9:00 AM ET

Company Participants

Elizabeth Russell - IR

Lori Flees - President and CEO

Mary Meixelsperger - CFO

Conference Call Participants

Steven Zacccone - Citi
Simeon Gutman - Morgan Stanley
Peter Keith - Piper Sandler
Mike Harrison - Seaport Global Research
David Bellinger - Mizuho
Lydia Huang - JPMorgan
David Lantz - Wells Fargo
Bret Jordan - Jefferies
Jim Chartier - Monness Crespi Hardt

Operator

Hello all, and welcome to Valvoline's Third Quarter Fiscal 2024 Conference Call and Webcast. My name is Lydia and I'll be your operator today. After the prepared remarks there will be an opportunity to ask questions. [Operator Instructions].

I'll now hand you over to Elizabeth Russell with Valvoline to begin. Please go ahead.

Elizabeth Russell

Thanks. Good morning, and welcome to Valvoline's third quarter fiscal 2024 conference call and webcast. This morning, Valvoline released results for the third quarter ended June 30, 2024. This presentation should be viewed in conjunction with that earnings release, a copy of which is available on our Investor Relations website at investors.valvoline.com.

Please note that these results are preliminary until we file our Form 10-Q with the Securities and Exchange Commission. On this morning's call is Lori Flees, our CEO and President; and Mary Meixelsperger, our CFO.

As shown on Slide 2, any of our remarks today that are not statements of historical facts are forward-looking statements. These forward-looking statements are based on current assumptions as of the date of this presentation, and are subject to certain risks and uncertainties that may cause actual results to differ materially from such statements. Valvoline assumes no obligation to update any forward-looking statements unless required by law.

In this presentation and in our remarks, we will be discussing our results on an adjusted non-GAAP basis, unless otherwise noted. Non-GAAP results are adjusted for key items, which are unusual, non-operational or restructuring in nature. We believe this approach enhances the understanding of our ongoing business. A reconciliation of our adjusted non-GAAP results to amounts reported under GAAP in a discussion of management's use of non-GAAP and key business measures is included in the presentation appendix.

The information provided is used by our management and may not be comparable to similar measures used by other companies. As a reminder, the Retail Services business represents the company's continuing operations, and the former Global Products segment is classified as discontinued operations for the purposes of GAAP reporting.

Today, Lori will begin with a look at the key highlights from our third quarter, and Mary will then cover our financial results.

With that, I will turn it over to Lori.

Lori Flees

Thanks, Elizabeth, and good morning, everyone. Thank you for joining us today.

For the third quarter of fiscal 2024, we saw growth at the top line across the network, with system-wide store sales growing 12.4% to \$809 million. With our growth rates from both company and franchise being consistent with the first half of the year. As we expected, we saw transactions grow each month throughout the quarter as we moved into the summer drive season.

Our same-store sales growth for the quarter was 6.5%. We did see growth moderate in our customer base for the same-stores in Q3, as we lapped strong growth in the prior year quarter, and we saw increasing competitive advertising spend in the current year quarter. The fundamentals of our business are strong, and demand for preventative maintenance has historically been resilient.

From a customer behavior perspective, while we continue to not see trade-downs or deferrals, we are seeing very slight differences in discounting and annual change service penetration. For our stores and areas with lower income demographics.

Moving to our profit performance, adjusted EBITDA improved almost 12% to \$123 million, despite strong comparison in the prior year. Operating income increased 8% to \$93 million. We added 33 new stores to the network this quarter, with 15 coming from franchise. This brings our year-to-date net additions to 109, which includes 48 net new franchise stores.

Following the close of the quarter, we also announced a \$400 million share repurchase authorization, consistent with the commitment for share repurchases to be part of our ongoing capital allocation framework. Before Mary covers the details of the quarterly results, I'd like to share some additional insights on how these results fit into our strategy.

Our first strategic pillar, is to drive the full potential of the existing business. We do this by driving traffic to the stores, both returning and new customers, by executing our SuperPro process to deliver a great customer experience, and by managing costs. We continue to focus our advertising investment to drive traffic to our stores, and believe our data-driven approach will help us get the right message to the right customer, at the right time in the most cost-effective manner.

During this quarter, we saw benefits from the work our team has been doing to drive more organic search traffic to our website, which is a more cost-efficient acquisition channel. We also renegotiated one of our marketing contracts. These types of actions help ensure our return on ad spend, is optimized in this more competitive environment. Once customers are in our stores, we want to provide a comprehensive service offering.

A key component of that is our non-oil change service menu. This quarter, non-oil-change service penetration was again the largest contributor to same-store sales growth across the system. The team continues to focus on how we educate our guests on the additional services recommended for their vehicles. We saw growth across the menu of services we offer.

We continue to believe that the retention of the teams in our stores and their increasing tenure, is what enables this improvement. Managing costs is always an important part of the success of our core business. We shared in Q2 that management of labor costs had exceeded our expectations. This quarter, the teams continued to manage labor costs well and delivered labor, as a percentage of sales consistent with the prior year.

Now I'd like to touch on our second strategic pillar, accelerating network growth. We're really pleased with the 33 store additions this quarter. It brings our total network to 1,961 stores, representing an 8.7% growth over the prior year. Following the end of the quarter, we closed a transaction to re-franchise 17 stores in the Las Vegas market. We talked for some time that we would consider re-franchising.

And although this deal is relatively small, it is a capital-efficient way to help fuel growth with one of our longstanding franchise partners. Also, following the end of the quarter, we closed on a transaction to purchase five stores in Texas from a retiring franchise partner. In this instance, the stores are part of a company-operated geography, and acquiring these stores will help us build regional scale, and have more efficient SG&A spend in the region.

Our third strategic pillar is customer and service expansion. Our fleet business is an important component of this strategy, and we continue to see positive momentum with sales still growing at a higher rate than the company-wide growth. The growth is driven by both ticket and transaction from the addition of new fleet customers and increased volume within existing fleet accounts. We see a long runway for growth for this part of our business.

Now I'll turn it over to Mary to walk us through our third quarter financial results.

Mary Meixelsperger

Thanks, Lori.

On Slide 5, we'll start with a closer look at our top-line performance. Net sales grew to \$421 million, a 12% increase over the prior year. System-wide same-store sales grew 6.5% and 19% on a two-year stack. The growth for the quarter continues to be consistent and balanced between company and franchise stores, with 6.7% and 6.4% respectively this quarter.

As a reminder, in the prior year, the 12.5% same-store sales included a very strong contribution from transaction growth as well as considerable inflationary price increases. This quarter, ticket growth is the primary contributor to the comp. As Lori shared, increased non-oil-change revenue service penetration is the largest driver of ticket growth.

The remainder of the ticket growth comes from a balanced contribution, from net pricing and premiumization. We saw a strong start to Q4 from the 4th of July holiday shift, which was more than offset by the regional impact from Hurricane Beryl in our Houston market and a one-day impact across the system related to the global CrowdStrike outage in mid-July.

Slide 6 looks at the other drivers of financial results. We saw a 40 basis point decline in year-over-year gross margin rate in the quarter. Depreciation caused 60 basis points of deleverage in the quarter. Without the impact of depreciation, the gross margin rate would have improved 20 basis points. Labor costs continued to be managed well, and as a percentage of sales was consistent versus the prior year.

We also saw some modest deleverage from company versus franchise mix in the quarter. As a reminder, in the prior year, we benefited in Q3 from the timing of changes to franchise incentives. The franchise incentives introduced in fiscal year '24 have been more consistent on a quarterly basis, and are focused on driving network and same-store sales growth.

Sequentially, we saw gross margin expansion of 210 basis points, primarily driven by volume from the start of the summer drive season. Adjusted SG&A as a percentage of sales increased 40 basis points over the prior year, driven largely by increased advertising spend. Overall, adjusted EBITDA margin declined 10 basis points over prior year, driven primarily by investments in advertising. Sequentially, we saw a 220 basis point EBITDA margin expansion due to higher volumes.

On Slide 7, we'll take a look at overall profitability. For the third quarter, adjusted net income decreased 16% to \$58 million, a result of operating income growth of \$7.5 million, offset by a reduction in interest income of \$23 million. This interest income primarily relates to the short-term investment of the proceeds from the sale of the Global Products business in the prior year.

We completed the \$1 billion share tender offer near the end of Q3 last year. Adjusted EPS grew 5% from \$0.43 to \$0.45 per share, impacted by both the reduction in interest income and lower share count. The balance of the change came from the improvement in operating income.

Turning to Slide 8, we'll look at the balance sheet and cash position. During the third quarter, we completed the tender offer to repurchase the \$600 million of 2030 senior notes, the last step for the use of net proceeds from the sale of Global Products. Recall that we were required by the indenture covenants to repay these notes.

Year-to-date cash flows from operating activities were \$170 million, a decrease of \$80 million versus the prior year. As a reminder, the establishment of the supply agreement with Valvoline Global Operations in the prior year drove a one-time benefit to net working capital, which represents most of this change.

In the third quarter, we did see improvement in accounts receivable as we continue to normalize our billings to franchisees, following the implementation of our new ERP system in Q2. As Lori mentioned, we announced a \$400 million share repurchase authorization subsequent to the end of the quarter.

Our capital allocation priorities remain unchanged. First is to fund profitable growth. Next is to stay within our targeted net leverage ratio. And third is to return excess cash flow to shareholders.

On Slide 9, we'll look at fiscal year '24 guidance. Our guidance is unchanged from last quarter's update. Taking into account the impact of the CrowdStrike outage and the recently announced refranchising, we are expecting to be towards the low end of the revenue range, with same-store sales for the year being at or slightly below the midpoint of the range.

For EBITDA and EPS, we are expecting to be at or slightly below the midpoint of the range as well. We are pleased with our store additions so far this year, and are expecting to be at or above the midpoint of the \$140 to \$170 range.

I'll now turn the call back over to Lori.

Lori Flees

Thanks, Mary.

Through the third quarter, we've delivered substantially in line with our expectations for both financial performance and network growth. I'd like to thank our more than 10,000 team members, and our strong franchise partners who together helped us surpass \$3 billion in system-wide store sales over the past 12 months, just 10 quarters after we hit the \$2 billion milestone.

Now I'll turn the call back over to Elizabeth to begin Q&A.

Elizabeth Russell

Thanks, Lori.

Before we start the Q&A, I want to remind everyone to limit your question to one and a follow-up, so that we can get to everyone on the line.

With that, please open the lines.

Question-and-Answer Session

Operator

Thank you. [Operator Instructions] Our first question today comes from Steven Zacccone with Citi. Please go ahead. Your line is open.

Steven Zacccone

Great. Good morning. Thank you very much for taking my question. I was hoping we could start with just understanding that fourth quarter same-store sales outlook. Could you help us understand how large the CrowdStrike impact is? And then I think I heard you correctly, but the full year sales guidance, you're now tracking towards the low end. So then in terms of that fourth quarter comp, should we think that's - out of 6% or could it be a little bit below that?

Mary Meixelsperger

Yes. In terms of looking at the fourth quarter comp Steve, in the month of July, we started strong, but we did have some bumps, both from the hurricane and the Houston market and along the Gulf Coast as well as an issue with CrowdStrike that affected us. We did see a pretty rapid recovery throughout the day, that day. So it didn't - we didn't have stores down for a full day.

We estimate across the system-wide revenue impact was just below \$5 million. And so that does have an unfavorable impact in terms of the July comps probably in the 30 to 50 basis point range. And I'm happy to say that we did see a nice recovery from that. And we're back to business for almost all stores by the end of the day, that day. In terms of the outlook for same-store sales for the full quarter.

I think if you're able to just kind of run your models and do your math, you'll see that we think same-store sales for the quarter will likely be coming in towards the low end of the range. There's a potential for it to be slightly below. But I think for the most part, we're looking toward the low end of the range for the quarter.

Lori Flees

And Steve, I'll just comment briefly on the in the 19th of July, the impact actually required the stores to go into a manual mode, which given the way our technology work slowed the rate of service and that was across the network. But by noon, we had about half of our stores back up and running, having to go to each store.

And our franchise partners were amazing in terms of working with us so that we could get the entire network backup, except for a handful of stores that needed a new server back up and running within 24 hours. So really good response rate by the entire team, including our franchise partners, which is why the impact was really limited to that one day.

Steven Zaccone

Yes. That's good to hear. My follow-up question is just on the decision to rebrand some stores. How should we think about the potential for more rebranding in the future?

Lori Flees

Thanks. It's a good question. We've talked about rebranding for some time. And when we have an existing or a new partner that can drive accelerated network growth, and shareholder returns, we're absolutely going to consider and pursue that. Obviously, they need to align with our brand and people standards, because that's what drives the results over time.

But this is one where you've got to have the right partner, putting the right capital work, not just to acquire the business, a very strong business that we have at an attractive rate, but also committing and having the capital to accelerate the growth of that market faster than what we would. So it is a needle to thread, particularly given where our value is tracking in the market.

But they get fit exactly in that sweet spot. We had a long-term partner who has personal and business connections to the Las Vegas market, and they have been wanting to put more capital into the Valvoline Instant Oil Change business. And we were able to work with them to create that opportunity. They're committed to add more new units than what we would overall and that just drives overall growth in the business, it is capital efficient.

It delivers a good long-term shareholder return, and it provides growth opportunities for our people. So I can't tell you how many of those will continue to do. It really is an opportunistic, but we'll continue to evaluate it. And our conversations with new and existing partners continues to be very robust.

And it just ties back to our desire to drive network growth with the bias to increasing our franchise new unit growth 3x, but doing that in both the capital efficient, but also one with an eye towards overall shareholder return.

Operator

Thank you. Our next question today comes from Simeon Gutman with Morgan Stanley. Please go ahead.

Simeon Gutman

Good morning, everyone. I want to ask about the 6.5%. Can you talk - the 6.5% comp. Can you talk about the spread across markets? Is it normal? Is it widening? Is it narrowing? Can you talk about it in certain geographies and then performance gap between mature and immature stores?

Lori Flees

I'll cover the regional, and I'll ask Mary to cover the mature versus new stores. We are looking quite closely given the macro environment to see what trends we're seeing regionally. But I would just reinforce that our business fundamentals are strong and our business has historically been a very resilient business to any consumer macro trends. We're not seeing significant differences in regions.

As I mentioned in my comments in the presentation, we're seeing very slight changes as it relates to discounting, meaning a slightly higher discount rate and a slightly lower non-oil-change service penetration in store areas where they have lower income demographics.

So where we have a cluster of stores in a region, that's really the only thing driving any regional difference that we're seeing. And I would just underscore, it's very slight, so much less than 1% on either metric.

Mary Meixelsperger

And so we. No, you go ahead, Simeon.

Simeon Gutman

No, you go ahead, Mary, sorry.

Mary Meixelsperger

I was just going to comment on the mature versus immature stores. We continue to see nice comp performance in our mature stores. And then the younger stores that are part of the comp base, do add some nice incremental benefit to the overall comp. We've estimated that in the past to be in the 100 basis point range, in terms of what younger newer stores to the comp are adding overall, but we continue to see nice performance in our mature stores as well.

Simeon Gutman

Okay. And my follow-up, and I may have missed this on the prepared or even the question. If the 6.5% maybe, I don't know, maybe slightly below Street expectations, or your own and there was some macro factor and/or deferral. But at the same time, you said the largest driver of sales growth was non-oil-change. Does that - is that showing a sensitivity by the customer? Or is that showing your success in converting a customer at a time of economic sensitivity?

Lori Flees

Yes, it's a great question. I think it really is around the process and the team. So, we're really proud of what the teams have been doing in non-oil-change revenue. And this comes down to them following the process, not doing a really - not doing the pressure sales pitch, just an educational sales pitch, where they explain to the customer what the vehicle needs from a preventative maintenance standpoint to really preserve the value and the longevity of the asset.

And by doing that, customers may get the service done at the time or they may come back and do it within a relatively short period of time. And that's really what's driving the strong NOCR benefit in our comp. Now we've said, and it's been this way for a while, where we've - we believe it will contribute 100 to 150 basis points of comp. I mean it has been, and we believe it will continue to do so.

And I think this is more around executing a process of education to the customers making sure the customer knows how our pricing for those services compares to others and making sure they know that as they want to maintain the asset, which many customers are wanting to hold on and do the maintenance on their vehicles, so they don't have to buy a new car in the current interest rate environment. So I do think it's a combination of teams and consumers holding on to their vehicles longer. Those two things coming in.

Mary Meixelsperger

And Lori, I'd just reiterate that as we shared in your comments, we're not seeing any deferral in our customer base. So when we're looking at oil drain in a roll and we're looking at customer performance. It's been very, very consistent.

Lori Flees

Yes. Across the core oil change, we're not seeing deferral or trade down. There's not a lot of trade down opportunity in our service mix. I think the only areas of potential deferral would be battery, but it's really not the season where people - if the battery is testing yellow in a stronger economy, you can see, and I'm talking personally, you can see people wanting to get ahead of that.

But when they're feeling a little tighter in the wallet, they might defer and wait until it turns red. So those are very small pieces of our business. And again, we're not seeing deferral on the core.

Operator

Thank you. Our next question comes from Peter Keith with Piper Sandler. Please go ahead.

Peter Keith

Hi, thanks. Good morning. I want to touch on advertising. So you'd flagged competitive advertising as maybe a bit of an issue to traffic. At the same time, you've stepped up your ad spend. So I guess a two-part question is, is the asset increase are you being forced to spend more? And then related to that, as the spend increase has picked up, does that tend to come immediate with traffic? Or is there a bit of a quarter or two delay?

Lori Flees

Typically - so one, the advertising climate, I think we started to see that at the beginning of the quarter, where we had an increase in lower funnel advertising dollars coming into the market. As we get a little bit further into the quarter, we did see some steeper discounting from a couple of competitors. They didn't last long, but they were fairly significant. We chose not to follow.

We chose to continue to push our value proposition relative to those competitors, but we did give our stores and have always given our stores the full authority, to ensure that they cap to loyal customers and not had them going to a competitor, for a slightly steeper discount. So one, that's what we saw in the environment, how do we respond. What we're seeing is that, for example, search terms, the cost of search terms slightly elevated with more dollars in the market.

That then in order to drive the traffic that we wanted to drive that cost went up a little bit. So that return on ad spend went down a little bit. Again, we really try to make sure that we're - driving the right amount of traffic on the right days to the stores to maximize the economics. And I think those are some of the things that you'll see. As we started to see that, the team quickly started to, as we always try to do is be agile with where we spend the money.

Moving it to lower cost channels or affiliates, et cetera, renegotiating a contract, as I mentioned. In orders such that we can maintain a really strong return on ad spend and keep our cost of customer acquisition our CAC down to, an appropriate level that drives overall margin and return for the business.

Peter Keith

Okay. Very helpful. And then I guess just on a broader question on the same-store sales. So the Q3 result at 6.5%, and then it looks like Q4 will probably be closer to 6%. I mean on an absolute basis, they're nice numbers, but they are towards the lower end of your longer-term framework. Doesn't seem like the economy is having that much of an impact. So maybe characterize why right now this year - at least these two quarters are trending towards the lower end of that long-term outlook?

Mary Meixelsperger

So if you're looking just at Q3 performance, we did have a modest impact in Q3 of day mix versus Q2. And so, when you're looking at any individual quarter, you're going to see some impact from a day mix perspective. Over the year, we do expect about a 40 bps benefit from day mix really related to leap year that happened in Q2. And we talked about that in our last quarterly call.

I would tell you that in terms of what we're seeing, we are comping against both in Q3 and Q4, some really strong transaction growth last year. We mentioned that last quarter, and that's certainly part of the equation here in terms of what we're looking at in terms of comping against that. We are seeing overall nice transaction growth in the system and pretty consistent with our expectations.

I wouldn't say that we see anything in particular that is significant cause for concern. And we're continuing to focus in terms of our marketing efforts to both attract new customers and retain existing customers. Lori, would you add anything?

Lori Flees

Yes. The only thing I would add is I think we were fairly clear for FY '24, that ticket would be a big contributor, led largely by premium mix and an OCR given the actions that we were taking. I think we were specifically suggesting that we were going to be very cautious on price given the macro environment, and particularly as we saw advertising and discounting activity.

We just have to be very careful on price not to have our posted price, get away from us in a competitive market. So I think when we started the year, we knew that price would not be as much of a contributor, but overall, felt pretty good that we would that - we would fit within Algo. And I think that's really when you look at the broader - the broader same-store sales in any year based on what you're lapping last year.

And what actions you're taking and the results of those actions, there are many pieces that get us well within the guidance range. I think this year, we expected ticket would be muted. We did see in the comments that our growth of customer base moderated a bit and that's largely due to the lapping and the aggressive advertising that we're seeing in the marketplace. But we feel at about 6.5% given all the dynamics that we're facing.

Peter Keith

And just to clarify on that, the lack of pricing this year, I think normally, it's a 1% to 1.5% lift. And so that's just something you just don't have this year, which you might in a normal year?

Mary Meixelsperger

Actually, we did see around that average for Q3. We did see benefits from pricing in Q3. Now it really doesn't come from across the board pricing changes. They're more targeted pricing changes across the services we offer, but we did benefit from what I'll call net pricing, if you look at our pricing, net of any change in discounting, we did see benefits of that in the comp in the quarter.

Peter Keith

Okay. Thank you very much for all the feedback.

Operator

Our next question comes from Mike Harrison with Seaport Global Research. Your line is open.

Mike Harrison

Hi, good morning. I was hoping that we could talk a little bit about the refranchising and kind of the impact that, that has on the P&L. How much annual EBITDA and revenue headwind should we expect from that refranchising transaction? And then, can you talk at all about the proceeds that you're presumably receiving as part of that transaction? And where would you expect to deploy those proceeds?

Mary Meixelsperger

Sure, Mike. I'm happy to take that. When we look at the second quarter - excuse me, when we look at the remainder of fiscal '24, the refranchising transaction has a relatively modest impact for the remainder of the fiscal year. It's less than \$2 million of EBITDA in terms of the impact on Q4. And we'll provide more specific detail on our '25 guidance on the full year impact. So I'll look for that in our next quarter update.

As it relates to net proceeds - initially, of course, we've got some revolver debt outstanding, and we'll use it for reducing our outstanding debt. But then we'll be looking at the use of the share repurchase authorization. And we just recently announced that new share repurchase authorization, and then we'll be moving forward in terms of evaluating what we think is the right thing to do, from share repurchase versus debt reduction.

Mike Harrison

All right. Thank you for that. And then I was also hoping that we could kind of rehash the labor leverage discussion that came up last quarter, you guys kind of warned us that we would not see as much gross margin leverage as we might anticipate going into the seasonally stronger period, and that is kind of what happened here. So help us understand again why there wasn't as much leverage at that gross margin level in Q3. And maybe some insights on your expectations, for labor leverage and gross margin leverage as we look at Q4 and start to get into fiscal '25?

Mary Meixelsperger

Yes. So we talked last quarter about the fact that we didn't expect to see incremental labor leverage in Q3. We had really started our labor focus on labor management activities in Q3 of last year. And so, while we saw a really nice sequential labor leverage in terms of where we performed in Q2 versus Q3, we saw almost 100 basis points of leverage.

In Q3 itself, we were essentially flat from a labor perspective to last year. My expectation for Q4 is that will hold pretty consistent. Again, we had started a lot of the labor management practices that we are focused on in the back half of last year. And my expectation for Q4 is that labor as a percentage of sales will be pretty consistent, with the prior year quarter.

So overall, in terms of overall gross margin, if you exclude the impact of depreciation and amortization, we are seeing modest leverage. In my comments on the earnings call this morning, I did mention we had some unfavorable impact of mix from franchise versus company. And if you recall, last year, we had some timing differences with franchise incentives being heavier in the front half of the year and lighter in the back half of the year.

And those have really normalized this year between the front and back half. And so that company versus franchise mix is being influenced, by being up against a tougher comp, if you would, from last year in Q3 and Q4.

Lori Flees

Yes. And Mike, I'll just add that this is the first wave of work on labor that the team's implemented. We're already working through technology deployment, process deployment that may - that we believe will have further impact in terms of being more efficient on the labor side, whether it's from an inventory management standpoint is one example. And those things will take time to implement across the network.

They'll benefit both company stores and our margin, but also they'll also impact the franchisees, which will be very positive as they continue to want to invest in the business. Now those investments that we have are in baked into our plan and would always be in our guidance.

But it will allow us to continue to get more labor leverage and offset, the wage increase that typically comes every year, whether it's minimum wage increases at a state level, or just competitive dynamics on wage.

Operator

Our next question comes from David Bellinger with Mizuho. Please go ahead.

David Bellinger

Hi, good morning. Thanks for the question. First, can you help us size the percentage of stores with this heavier low-income exposure? And also on the increased promo activity you're seeing, is that more pronounced in these lower income markets? Or are you seeing some type of widespread element to these promo activities picking up?

Lori Flees

We don't - so early in the quarter, we saw it across many players, not so much the small players, but across many of the brands. And again, it's more advertising dollars being put into the market, not necessarily deeper discounts. We did see one player for a short period of time offer a deeper discount that most did not follow and was quickly pulled out of the market.

So, we do see just pockets and they're not across the board, and they're not limited to low income areas as far as we know. They tend to be a very operator-specific. And it could be based on where they're seeing their business track and just trying to generate more traffic in a period. So I don't really know the drivers behind it. But I wouldn't say there's anything that correlates or is driving.

What you do see is in lower-income demographic areas where our stores operate, customers will be more coupon savvy. They will go out and search for those things, which will get a high - slightly higher discount rate. And when I say slightly, I mean, very slightly. These are not significant differences across our business.

Mary Meixelsperger

And as it relates to the household income approach we used, we really quartiled our stores, and looked at income demographics by quartile. And so for us, the lowest income quartile would be demographic areas with an average household income of less than \$60,000 a year.

David Bellinger

Okay. Thanks for all that. And then just my second question. I just think it's still pretty early here, but can you provide us with any initial commentary towards 2025, and should we continue to expect a typical Valvoline comp sales and earnings algorithm to hold true next year? Or are there some other considerations we should all be thinking through?

Mary Meixelsperger

Well, thanks for your question. We typically don't provide guidance this early or at Q3 as we're looking forward in the year. We'll update you when we do our year-end earnings call. As we talked about in the quarter, we did have refranchising in one of our markets. And so, I think you'll hear more about that and what that impact would be in terms of as we're looking out for - into fiscal '25.

And of course, any similar transactions that might happen will also be there. In terms of unit counts, we have a really robust pipeline, and we feel really good about unit growth in both franchise and company. And so, we won't see any surprises there. We're continuing to work with our franchise partners, to accelerate the growth of the franchise pipeline system, and we'll be excited to provide you with some updates around that when we provide guidance next quarter.

Lori Flees

Yes. Really happy with the progress on the franchise unit. You'll notice we did 48% year-to-date relative to 25% last year year-to-date. So I feel really good about the progress that we're making on the franchise unit growth.

Operator

Thank you. Our next question comes from Jeff Zekauskas with JPMorgan. Please go ahead.

Lydia Huang

Hi. This is Lydia Huang on for Jeff. Thanks for taking my question. Still on the VIOC store growth, last year, your store count growth had an upswing in the fourth fiscal quarter, and it's mostly because of franchise stores. It seems like we should expect a similar step off in this fiscal quarter. Is that also franchisee driven? And what drives the seasonality here?

Lori Flees

So, I would just say that we feel really good about where we've delivered to-date. You're right. The franchise unit growth for year-to-date is much stronger. And part of that was driven by the gap in Q3 as fiscal '23, relative to a more evenly paced development program for our franchisees. As Mary mentioned in her prepared remarks, we are expecting that our new unit count will be at, or above the midpoint, which is 140 to 170 is the range.

And within that franchisees, we expect to be at 55 to 70. Now with franchisees already at 48, we feel very strong that they'll be well within that range. So I think, we feel pretty good. Just looking at last year, Q4, we delivered 46 or 48 units, I believe, 48 units, which shows that our business can start up that many stores within a quarter. And so when you look at where we are to-date, we're at 109 to-date.

That 48, if we just repeated and didn't build on it, would put us well at the midpoint or above. So we have the capacity, we have the pipeline, and we're just executing it to close the year out strong.

Mary Meixelsperger

And I would just reiterate, Lori, if you recall last year, in Q3, we had a relatively small number of franchise stores that opened in Q3 that got pushed into Q4. As you mentioned just now, where franchise is much more consistent over the quarters this year. So I would expect franchise growth in Q4 to be relatively more consistent with Q3 this year than what we saw last year.

Lydia Huang

Thank you. And for my second question, can you talk about pricing for the September quarter? So base oil seems relatively stable, how should we think about price cost for the September quarter and maybe next year? Thank you.

Mary Meixelsperger

Yes, you're right. We have seen our lubricant costs be very stable. Really through the year-to-date, we've seen some modest ups and downs, but that's been really stable. We are keeping a really close eye from a macro perspective on the recent activities and news coming from the Middle East. Of course, if that causes crude oil to spike that will eventually work its way through into base oils, and cause our underlying lubricant costs to increase. But even if that were to happen, we have not seen it yet.

If it were to happen, I wouldn't expect it would affect our fiscal Q4. The supply chain length in terms of how long it takes for that - those types of cost increases to come through the supply chain takes a few months. And I wouldn't expect that it will have any impact short-term in terms of - for the balance of the fiscal year here in April - excuse me, in August and September.

Lydia Huang

Thank you.

Operator

The next question comes from David Lantz with Wells Fargo. Your line is now open.

David Lantz

Hi. Good morning, guys, and thanks for taking my question. Curious if you can talk about the fleet business in a bit more detail. It's outperforming. Curious where penetration sits today and where you think that could get longer term?

Lori Flees

Yes. Thanks. Fleet has been a great opportunity that we've over the past few years really leaned into and professionalized. We continue to sign new accounts with fleet owners, and we also work with the - as we signed up to increase the number of vehicles and/or the penetration that we have within those accounts. We - in this past year, we've had a focus on expanding our fleet sales team's focus to include some franchisee geographies where the franchisees have requested that support.

And this adds attractive four-wall EBITDA to their business, but obviously, is an attractive growth level. Both ticket and transactions are higher than an average consumer, and that leads to really good margin contribution, both for company and franchise stores. We - it's - from an overall market, we're building our business on a small base. We've talked about the fact that our fleet business is less than 10% of our sales and given the ticket is higher, it is slightly lower on a car count basis.

We have not sort of set any expectations on where we think, we will get to target. We just continue to see very strong growth in excess of our overall company growth. And that's because we believe this market is not very well served. There are not very many providers of preventative maintenance who have a broad national network that can meet their needs.

We've invested in a number of services for the fleet account owner in terms of them being able to select the services that the drivers taking the driver out of the mix of deciding what services shouldn't be done, and then direct billing. So there's just a number of things that we've invested in overtime to add value to the fleet owners.

And that's on top of just keeping their assets in service as close to 100% utilized as we can, with a 15-minute or less service with us direct billing them not having them preapproving services. It ensures that their vehicles or their assets are being put to business a greater period of time. And that's the reason why it's growing so quickly.

David Lantz

Got it. That's helpful. And then just one more from me. Can you just provide an update on the ERP implementation that was called out last quarter, and how that's tracking relative to internal expectations?

Mary Meixelsperger

Yes, I'd be happy to. So we implemented the new ERP system on January 1 of 2024, and had some challenges around the IT general control environment that, we called out last quarter. I'm happy to report that we've made really significant progress in our remediation efforts of those control changes. And my expectation, is that the material weakness that we spoke about last quarter, will be fully remediated by the end of this year.

We'll have some more details in the Q that talk specifically around the remediation steps and what we've done and what's still open to do. But the open items are still really around testing and validation through the end of the fiscal year, to ensure that all of those controls are functioning as we've designed them, through the end of the fiscal year. But as I said, we've - I'm really pleased with the remediation progress that the teams have made and feel really good about it.

Operator

Our next question comes from Bret Jordan with Jefferies. Please go ahead.

Bret Jordan

Hi good morning, guys.

Lori Flees

Good morning.

Bret Jordan

To keep pricing, good morning - to keep logging the pricing question. I guess, one of the larger softer service and tire chain about a week ago said they expected to use oil pricing as a traffic driver. And I think you've said that you've seen relatively little price moves there. I guess, addressing sort of the more recent maybe July trends, have you seen sort of return to discounting that you saw abate in the third quarter? Sorry, in the third quarter?

Mary Meixelsperger

We haven't seen anything that's been any significant changes into July. So no. And we have historically seen different kind of pricing, from some of our other auto services providers out in the marketplace. And what really differentiates us is our quick easy trusted experience. And so, we found that our consumers are certainly value the convenience of those services.

And so, it's not a new phenomenon to see other providers on occasion, offer lower pricing on oil change services in an effort to try to drive traffic. And those activities are typically shorter lived and typically don't have a significant. We haven't seen an impact to us over time, as evidenced by what this year will be our 18th year of same-store sales increases. We really haven't seen evidence of a competitive impact from that perspective. Lori, anything you'd add?

Lori Flees

No, I think that's right. There are always going to be pockets and this is such a fragmented market that there are very few players that will have a broad - a broad-based promotional activity that will impact us. But it will happen in certain markets, whether it be a tire center auto services player that decides to try to use it as a traffic driver. We previously have seen dealerships do that, not as much anymore.

We see independent quick lubes. I would just say that we always look at where we attract our new customers from and the number one or the biggest source of customer acquisition comes from the dealerships, which continued to be a very fertile ground relative from a customer experience standpoint and an overall value standpoint. And so that hasn't changed much for us over the last several quarters. And just reviewing, as we're reviewing through the end of July, the same is holding true.

Bret Jordan

Okay. Great. And then a bigger picture question. I know you've talked in the past about a possible new store format, lower build-out costs. Any updates on that project?

Lori Flees

Yes. We - the team is making great progress to reduce the capital cost to both build new units as well as convert acquired locations to our brand. Many changes to the building design well that we made decisions on will not start to show in our CapEx until those units come online, which will be late fiscal '25 and into fiscal '26, given the contracts with general contractors have already been set for a lot of the units in the first half or two-thirds of the year.

And permitting also has to, in many cases, change, which we have to weigh that off in terms of extending the project's timeline in order to get some of the savings. But some of the easier changes that we started to implement, particularly on converting locations to our brand, we've already started to make, and really happy with the way our construction and operations team is accelerating that implementation where they can.

Also, the franchise partners as they're increasing their pipeline of new builds this quarter, two-thirds of our new units were new builds. And our franchisees are very engaged in how do, we continue to drive lower construction and equipment costs in our new units. And that engagement has been incredible, and we continue to find opportunities. So I would say, a little bit early in order to start seeing it, but the team is making good progress, and we're taking actions on everything that we can as quickly as we can.

Bret Jordan

Great. Thank you.

Operator

And our next question comes from Jim Chartier with Monness Crespi Hardt. Please go ahead.

Jim Chartier

Thanks for taking my question. I talked in the past about finding new large franchise partners. Can you just give us an update on that?

Lori Flees

Yes. As I mentioned earlier, we continue to have great conversations with prospective partners who are interested in being VIOC and GCOC franchisees. If we step back and look at our overall goal was to triple our new unit, our annual new unit number to 150 a year, of which two-thirds would come from existing franchisees. And that work and engagement is going incredibly well. I feel very good about that.

In the last one-third of the 150 would come from new franchise partners. Now we would expect that to be a handful. It doesn't need to be 50. It needs to be a handful of partners, and those conversations are going very well. And really, continuing to talk to them about seeding them an area, or wanting to take a white space in some areas, working with existing franchisees who are no longer developing and whether, or not now is the right time to transition.

So continuing to have good progress in the discussions being able to announce the Las Vegas refranchising. It's a part of that work. But the new partner discussion takes a little longer as trying to educate them on the system and understand exactly how they want to get started, does take time.

Jim Chartier

Great. Thank you.

Operator

Thank you. We have no further questions in the queue. So I would like to turn the call back to the Valvoline team for any closing comments.

Lori Flees

Yes. I just want to thank everyone for attending the call. We look at our business and feel the fundamentals are really strong. Historically, it's a very resilient demand that we see from customers and that is not and has not been changing for us. I think we feel really good, and Mary sort of alluded to it. We've delivered 17 years of same-store sales and have full expectations that we'll be delivering an 18th year of same-store sales as you look at our year-to-date same-store sales of 7.1%.

I just want to thank our team members and our franchisees, because it is a massive milestone for us to have hit \$3 billion in system-wide store sales, over the last 12 months and that coming 10 quarters after we hit \$2 billion. It just speaks to the acceleration that we're seeing in the business and our franchisees are investing, and we're building it together. So thank you, everybody, for your time.

Operator

This concludes today's call. Thank you for joining. You may now disconnect your lines.

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