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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Sally Beauty Holdings Conference Call to discuss the company's fiscal 2022 first quarter results. (Operator Instructions) As a reminder, today's conference call is being recorded.

Now I would like to turn the call over to Jeff Harkins, Vice President of Investor Relations and Treasurer for Sally Beauty Holdings.

Jeff Harkins - *Sally Beauty Holdings, Inc. - VP of IR & Strategic Planning*

Thank you. Good morning, everyone, and thank you for joining us. With me on the call today are Denise Paulonis, President and Chief Executive Officer; and Marlo Cormier, Chief Financial Officer.

Before we begin, I want to remind everyone that we have made a presentation available for today's call that can be viewed from the link provided on our investor site at sallybeautyholdings.com/investorrelations.

I would also like to remind you that management's remarks on this call may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Actual results may differ materially from those indicated by these forward-looking statements as a result of various important factors, including those discussed in the Risk Factors section of our most recent annual report on Form 10-K and other filings with the SEC.

Any forward-looking statements made on this call represent our views only as of today, and we undertake no obligation to update them. The company has provided a detailed explanation and reconciliations of its adjusting items and non-GAAP financial measures in its earnings press release and on its website.

Now I'd like to turn the call over to Denise to begin the formal remarks.

Denise A. Paulonis - *Sally Beauty Holdings, Inc. - President, CEO & Director*

Thank you, Jeff, and good morning, everyone. We are pleased to begin the new fiscal year with solid financial results, which reflects strong demand for our core categories of color and care among both DIY enthusiasts and professional stylists.

Our first quarter performance also reflects our ability to navigate and effectively manage macro headwinds from inventory and supply chain challenges, which has enabled us to maintain a healthy level in stock. I'm proud of our team for continuing to prioritize our customers, and remaining focused on delivering a superior experience at every turn, and believe we are well positioned to capitalize on the ongoing demand for our products and services.

Notably, we're managing through the current Omicron cycle, which is having various impacts globally due to restrictions and closures in certain countries. As this latest variant gained traction in the final weeks of the quarter, we continued to prioritize the health and safety of our team and our customers. I'm proud of how our teams rose to the challenge to serve our customers while navigating a number of mitigation actions around staffing, store hours, and fulfillment.

In the first quarter of fiscal 2022, comparable sales grew 6.1%. Net sales grew 4.7%. Gross margin increased to 51% and adjusted EPS was up 26% year-over-year. With this strong start to the year, and favorable industry dynamics, supporting our roadmap for 2022, we remain on track to achieve our full year guidance. When we spoke to you last quarter, I've been on the ground for just over 1 month. With another 12 weeks at the company, I've had the opportunity to dive deeper into the organization and have found the customer-first culture, talent and capabilities here at Sally to be remarkable. We're just beginning to leverage the infrastructure and extensive resources that were put in place over the past 4 years as we execute against our 4 strategic growth pillars.

As a reminder, these include: leveraging our digital platform; driving loyalty and personalization; delivering product innovation; and advancing our supply chain. I'm going to spend some time updating you on progress within each pillar.

On the digital front, we're creating a robust omnichannel platform for our DIY enthusiasts and stylists. Our Sally and BSG customers are utilizing our full suite of services across ordering and delivery which allows them to get products how and when they want it in as little as 2 hours. During the first quarter, we completed the work to connect our CosmoProf app to our BSG store network to further enhance our fulfillment options of BOPIS and 2-hour delivery for our stylist community.

Additionally, we are seeing increased engagement on the education section of the refresh of BSG website as well as improved customer satisfaction rates around functionality and ease of use. On the Sally side, we launched another convenience for our customers, a virtual color consultants, currently being piloted in approximately 35 Sally stores in the Dallas-Fort Worth area. By way of the live video call conducted on-site, this new service provides an incrementally higher level of touch and expertise for our Sally customers seeking color and care, advice and education.

Initial response has been positive and further strengthens our position as the leading expert in professional color. Overall, we're continuing to increase our digital velocity. This quarter, e-commerce sales increased 22% versus a year ago, driven mainly by BSG's refreshed e-commerce platform, and represented 8.3% of total sales in Q1. During the most recent quarter, our Sally U.S. and Canada stores fulfilled 35% of e-commerce sales as BOPIS comprised 19%, rapid 2-hour delivery represented 10%, and ship from store accounted for 6%.

As we continue to scale and optimize a full suite of omnichannel services for both our Sally and BSG customers, we believe e-commerce can reach 15% or more of sales in the coming years.

Moving to our second growth pillar, loyalty and personalization. In the first quarter, approximately 75% of sales at Sally U.S. and Canada came from our loyalty program. In fact, active member count continues to climb and stood at an all-time high at the quarter end. Additionally, approximately 9% of our BSG sales in Q1 came from our nascent and rapidly growing rewards credit card as compared to 8% in the previous quarter. This represents yet another way. We are becoming increasingly engaged with our stylist community who look to us as the go-to resource for helping them profitably run their business.

There's no question that our customers are our biggest asset, and we have the luxury of knowing who our customers are. This advantage, coupled with our growing data and customer insights capabilities, we'll feel more efficient marketing and position us to deliver increased personalization, and create stronger connections with our customers. All of which support accelerating revenue and increased customer lifetime value.

On the marketing front. We'll be investing further in digital marketing and social media campaigns to drive traffic and sales in fiscal 2022. As we aim to expand consideration and acquisition of new customers into the Sally Beauty funnel, we plan to broaden our footprint in 3 key areas that represent critical touch points to beauty discovery.

First, we're investing in brand ambassador who are viewed as authoritative voices on Instagram and TikTok that drive brand awareness and create content for their followers. Beginning in Q3, we'll also be building our own Sally community of DIY micro-influencers. This is a grassroots, organic, community-building initiatives that will incorporate smaller influencers to receive samples, new products, and invitations to events. Lastly, we're creating a DIY 2.0 education platform for YouTube that is expected to launch in the third quarter.

Turning now to our third growth pillar, product innovation. The pipeline of innovation slated for fiscal 2022 is rich, and we expect this to be a significant growth driver of growth throughout the year. A few noteworthy call-outs: at Sally, our new vivid color line, Strawberry Leopard, continues to gain traction, both in stores and online on our dedicated Strawberry Leopard website. Additionally, in the first quarter, we launched Dashing Diva Glaze and at-home gel manicure as well as the ion Luxe turbocharge dryer, a high-end hair dryer that goes head-to-head with the best in tech brands at a more affordable price point.

With more innovation coming and higher-end appliances in the second half of the year, and we'll also be introducing Strawberry Leopard hair care products to supplement the recent color launch.

At BSG, the Q1 launch of the new 4P toning shampoo, was among the best new product launches we've seen from the Olaplex brand. Another key partner to us is Wella, which represents BSG's largest color brand. This month will see an exciting launch from their sub-brand at Shinefinity, which adds glossing to color. This is expected to be the biggest launch for BSG in 2022. Overall, a great deal of excitement around innovation and much more to come during the year.

With the customer at the forefront of our strategy, our fourth and final growth pillar is supply chain. Our mission is to be in-stock in color and care every time, and we've made great progress towards building a highly automated, integrated supply chain network that will take us well into the future and allow us to meet growing demand. We're in the final phase of JDA implementation. And as of this week, the system will be up and running in all Sally and BSG locations. The remaining step is fully integrating with our North Texas, DC. Once completed, we'll be positioned to leverage and scale our new capabilities across inventory forecasting, localized assortment, pricing and promotion, as well as shortened ship-to-me fulfillment times for 15% to 20% of our customers.

As we look ahead, even with the uncertainties that COVID creates, we continue to have a great deal of confidence in fiscal 2022, and believe we are well positioned to continue driving top-line growth at structurally higher operating margins in the years to come. We are reiterating our financial outlook for fiscal 2022 and expect the business to generate strong cash flow, and provide meaningful capital allocation optionality moving forward.

In addition to the 4 growth pillars I discussed, we are focusing on building out additional opportunities that will fuel our business and create meaningful shareholder value over the long term. I'd like to express my thanks to our talented and passionate team who are committed to delighting our customers and drive our confidence in the future.

With that, I'll turn the call over to Marlo to discuss the financials, and then we'll look forward to taking your questions.

Marlo Cormier - *Sally Beauty Holdings, Inc. - Senior VP & CFO*

Thank you, Denise, and good morning, everyone. We are pleased to start the new fiscal year with solid performance across our key financial metrics. For the first quarter, comparable sales rose 6.1%, and net sales increased 4.7%, reflecting strong consumer demand. As a reminder, effective this quarter, we replaced our same-store sales metrics with comparable sales which includes sales from our full service divisions and franchise operations, including any related e-commerce sales. First quarter traffic and conversion remained fairly consistent with recent trends as customers continue to shop less frequently, but spend more when they transact with us.

On the whole, traffic was dumb, but units per transaction, average unit retail, and average ticket, all increased versus prior year. Global e-commerce sales increased 22% to $81 million, representing 8.3% of total net sales. The year-over-year increase reflects ongoing strength especially with our recently refreshed BSG e-commerce site as we continue to scale our digital capabilities and utilize our new tools and resources to drive customer engagement.

Looking at gross profit. First quarter gross margin came in at 51%, up 70 basis points to last year, reflecting strength in both the Sally and BSG segments, which both delivered increases in product margins that was partially offset by higher distribution and freight costs.

Moving to expenses. First quarter SG&A totaled $386 million, up 6% versus a year ago. The year-over-year increase is primarily attributable to higher labor costs, increased expenses in our international markets related to reopening this year, and planned increases in marketing spend.

As anticipated, from a rate perspective, SG&A increased modestly up 30 basis points versus a year ago. We continue to expect that our store optimization program will begin serving as an offset to wage inflation beginning in the latter part of 2022.

Turning now to earnings. We delivered strong profitability in Q1. Adjusted operating margin increased 70 basis points to 11.9%. Adjusted EBITDA margin increased 50 basis points to 14.8%, and adjusted diluted EPS rose 26% to $0.63.

Looking at segment results. At Sally Beauty, consumer demand was strong across the U.S., Europe, and Latin American markets. Comparable sales increased 4.4%, and e-commerce sales totaled $32 million for the quarter. For the Global Sally segment, the color category increased 5% while hair care grew by 17%. For Sally U.S. and Canada, vivid colors grew by 12% and represented 27% of our total color sales. Gross margin at Sally expanded 70 basis points to 58.4% compared to the prior year as we continue to generate solid product margins, driven primarily by pricing leverage. Segment operating margin was also strong, up 50 basis points to 17.9% compared to the prior year. In the BSG segment, comparable sales increased 8.6% as (inaudible) were essentially operating at full capacity in the U.S. and Canada. E-commerce sales totaled $49 million for the quarter, representing growth of 47% compared to the prior year. The color category grew 12% while hair care was up 10% compared to the prior year.

Gross margin and profitability at BSG improved significantly on a year-over-year basis. Segment gross margin was up 120 basis points to 41.1% compared to the prior year, driven by improved product margins as a result of pricing leverage, while operating margin expanded by 150 basis points to 14%.

Moving to the balance sheet and cash flow. We ended the first quarter in strong financial condition with $298 million of cash and cash equivalents and a $0 balance outstanding under our asset base revolving line of credit. At December 31, inventories were approximately $1 billion, up 12% versus a year ago. And as we discussed on our last earnings call, we plan to continue building inventory levels, and made the strategic decision to put forward purchases in order to mitigate from ongoing supply chain disruption. We expect our inventory levels to remain elevated in the short term, and come down in the second half of the year.

For the quarter, cash used from operations was $5.7 million, driven by the expected carryover of working capital requirements from the fourth quarter of fiscal 2021 as well as the planned buildup of inventory during the first quarter of fiscal 2022. Capital expenditures in the quarter totaled $26.4 million. We expect the business to generate strong operating cash flow in fiscal 2022, primarily in the second half of the year. Importantly, we remain focused on prioritizing strategic growth investments, as well as returning cash to shareholders.

Last quarter, we stated our intention to restart our share repurchase program. During the first quarter, we used excess cash to repurchase 3.7 million shares at an aggregate cost of $75 million. This leaves more than $600 million remaining under our current authorization. At the end of the first quarter, our net debt leverage ratio was 1.87x.

We are pleased to have entered the year with strong momentum, and we remain focused on our core growth pillars to drive the business forward. We are reiterating our full year 2022 outlook against the backdrop of a dynamic macro environment, including the recent Omicron surge, and supply chain challenges. While we experienced some impact to traffic and sales in January, we expect this surge to pass quickly, similar to recent waves. In addition, with nearly 2 years of pandemic experience under our belt, our teams know how to execute and navigate during these dynamic periods.

Our guidance for 2022 includes the following: net sales growth in the range of 3% to 4%. Net store count to decrease by approximately 1% to 2%, driven primarily by Sally U.S. stores as we continue to optimize our portfolio. Gross margin expansion of 40 to 60 basis points. GAAP operating margin growth of 90 to 110 basis points. And adjusted operating margin approximately flat to fiscal year 2021.

We appreciate your time this morning. Now I'll ask the operator to open the call for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question will come from the line of Rupesh Parikh with Oppenheimer.

Rupesh Dhinoj Parikh - *Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst*

So just going back to the commentary on the variant. So it sounds like it didn't have much of an impact on your Q1, but you expect it to have an impact on Q2. Is that the right way to think about that?

Marlo Cormier - *Sally Beauty Holdings, Inc. - Senior VP & CFO*

Rupesh, thanks so much for asking the question. We certainly saw a little bit of impact at the end of the -- end of our first quarter, particularly the last 2 weeks of December. There were things where we just had employees that were needing, to be out sick, and that change kind of rippling through. We've seen a little bit more impact in January, but I think for us, the big part is it looks like, this wave went and increased very quickly. It looks like it's coming down quite quickly. And we really figured out how to navigate our way through this.

So while we haven't seen as great of a result in January, as we might have hoped, we're very pleased with where we are and I think we're well set up for the rest of the year.

Rupesh Dhinoj Parikh - *Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst*

Okay. Great. And maybe just a related question to that. Like I know with your last call, you guys mentioned that you expect sales to be stronger higher in the first half of the year than the back half. And I think you also mentioned that you expect the majority expansion in the back half of the year on the gross margin line. If you can just update us in terms of how to think about the quarterly cadence for sales and margins going forward.

Marlo Cormier - *Sally Beauty Holdings, Inc. - Senior VP & CFO*

Yes. I'll take you through the various points of the P&L, starting with the sales pacing. As we just mentioned, Q1 was a great start to the year. So again, feeling really good about the full year. Given the surge in Omicron in January, we are looking at Q2 sales being a little bit lower than Q1. Q2 historically has been our lowest volume quarter as well. So we do have that plan down a bit, still growth, but the growth just on a year-over-year basis is going to be a strong as Q1. As Denise mentioned, we see the surge come in the quarter, but we also expect -- and actually are starting to see a taper. We think that we're starting to see cases peak in a lot of geographies. So we expect to move past it. But as I mentioned, in Q2, from an overall perspective, will be a little bit lower from a growth rate perspective than Q1 was.

When we look at the back half, those comparisons get a lot tougher when we're looking at it from a year-over-year basis. Keep in mind, last year, at the beginning of the year is when we had some significant closures, and restrictions, and then that starts to loosen and we go into reopen markets in the back half of the year.

So we have more normalized comparisons when you're looking at the back half. All that said, our full year -- our full year outlook contemplates all of this. And we have confidence in the full year guidance that we have.

When we look at the gross margin line, we did have a really strong performance here in Q1, had a good benefit from pricing leverage that we were able to execute. And so we're looking at on a full year basis, expansion of 40 to 60 basis points. We see that as relatively consistent from here on out as we look at the quarters. And then just finishing out with the SG&A, on a full year basis. We do expect as we've highlighted in the past to increase year-over-year. It will be increased in dollars and then rate will be up slightly. And our expectations on this line takes into account the inflationary pressures we've been talking about, mainly from labor. We're seeing high freight costs as well. We also have increased expense planned in our international markets as we reopen those markets in 2022. And then we also are investing in our growth initiatives, as well as marketing.

So looking to get back to more normalized marketing rates. We did have increased marketing dollars in Q1. We made a little bit of progress towards the more normalized rates, but still have more room to go there. So we'll still work towards increasing that investment as we go throughout the year.

So as planned, SG&A dollars are expected to be relatively consistent from Q2 in-and-out, a little bit of a step-up from Q1 to Q2. And then so from a full year basis, that puts us in a great position to deliver the full year operating margins pretty much in line with where we've been last year.

Operator

Our next question comes from the line of Steph Wissink with Jefferies.

Stephanie Marie Schiller Wissink - *Jefferies LLC, Research Division - Equity Analyst and MD*

I had a follow-up on your comments on pricing. I'm wondering if you're willing to quantify the level of price that you took and saw in the first quarter, any incremental pricing you plan to take in the second quarter? Just trying to reconcile some of the inflationary pressures within the gross margin line.

Denise A. Paulonis - *Sally Beauty Holdings, Inc. - President, CEO & Director*

Yes. So this is Denise. I'll just start with some broader commentary and then Marlo can fill-in any additional details. I think importantly for us, the way that we're really thinking about pricing is ultimately looking to stay in line with the market, cover costs that we see coming through, and then strategically price where we can. And we're really able to do that with a new set of tools available to us stronger set of analytics around price elasticity and what we're seeing.

So while it is -- while pricing is a very important lever for us, we take it quite prudently to be sure that we're making those choices and staying in line with what the consumer expects. In general, our price inflation has been trending towards what CPI has been. We're not particularly outsized. So no surprises there from the customer perspective and look forward to continuing to use to do more as we go.

I think importantly, what I'd mentioned is in the first quarter, our sales growth was balanced. It came from both price and volume improvements, which is what we're really looking to be able to deliver.

Marlo, you want to add anything to that.

Marlo Cormier - *Sally Beauty Holdings, Inc. - Senior VP & CFO*

Yes. And I guess just to reiterate, Q1, the expansion of 70 basis points, that was driven largely by the pricing actions that we took. We're also having to overcome the inflationary pressures, both in the margin line. We talked about it in the SG&A line, but we also have rising freight and DC costs that we're overcoming on that margin line. So really pleased with the delivery by the team to be able to expand the margins. They were strong at both Sally and BSG.

And then just in terms of the way that we think about it going forward, I think to Denise's point, those are our pricing objectives. But I think what gives us confidence is just our ability and our advantages to take advantage of when the market moves, we can move. And some of those things are -- if you think about our core categories, they're highly inelastic. We are in highly differentiated core and care product assortments.

Sally, we're the only ones that really do pro color for home use, 45% of our assortment is from owned and exclusive brands. And then on the BSG side, we're the largest wholesale distributor to the stylists, and we have over 50% of those sales coming from exclusive.

So we have a highly differentiated assortment. We have sticky and loyal customers. It's a unique position in the market that we're able to leverage. And then as Denise mentioned, we continue to build on our strategic pricing and promotion capabilities and tools. And then just finally to say, we have a proven track record of executing these price increases, and we really haven't seen a notable change in the customers' behavior.

Stephanie Marie Schiller Wissink - *Jefferies LLC, Research Division - Equity Analyst and MD*

Very helpful. If I could just with a follow-up on loyalty and marketing. I think that was one of your big strategic pillars. Talk a little bit about the marketing investment you've made in the quarter. I know traffic was down, but other KPIs were up.

So maybe help us reconcile how you're thinking about the return on investment on that marketing investment, and also on the loyalty program advancement that you've seen?

Denise A. Paulonis - *Sally Beauty Holdings, Inc. - President, CEO & Director*

Yes, absolutely. One of the things that when I came into the company and was so impressed by is the number of our customers that we actually know, and can associate 2 customers, about 75% of our sales in Sally, and 100% in BSG. Our opportunity with our marketing investment, while we want to continue to reach our existing customers. A big opportunity for us is to put more people in the top of the funnel, and understand who else that we can attract.

So when you think about the investments that we made in Q1, and it really was around digital and performance marketing and the pushes that we could do. Importantly, I think we did try to push a little bit harder upper funnel versus just for the customers that we knew. And so when we think about the return on the investment there, we know it's a little bit lower return when we go after top of funnel, but we do want to see that customer base increasing. And I think a really strong point to that is we finished the quarter with a record level of loyalty customers in our pool. That number went up again from the end of Q4 to Q1, and we have over 17 million customers on the Sally side that we can talk to. And we've got about 9% of our sales on the BSG side coming through our credit cards. So where we're trying to reach people and get them to be stickier, the metrics that we can measure, we feel pretty good about the trajectory that we're on.

Operator

Our next question comes from the line of Oliver Chen with Cowen and Company.

Oliver Chen - *Cowen and Company, LLC, Research Division - MD & Senior Equity Research Analyst*

The Sally operation was a little bit up here relative to (inaudible). What are some catalysts for going forward? And as we think about (inaudible) will those still be up relative to traffic. Would also (inaudible) versus the sales.

Denise A. Paulonis - *Sally Beauty Holdings, Inc. - President, CEO & Director*

Oliver, I think unfortunately, you're breaking up. Could you try to repeat your question?

Oliver Chen - *Cowen and Company, LLC, Research Division - MD & Senior Equity Research Analyst*

The Sally division comps ahead and key drivers at the Sally division.

Denise A. Paulonis - *Sally Beauty Holdings, Inc. - President, CEO & Director*

Certainly. So if we think about the business, and how our comp sales performed in the quarter, we saw particularly strong sales on the BSG side of the business as salons were really fully reopened, lapping last year where there was still a fair amount of challenge for a number of stylists in a number of states in operating their businesses.

When we think about what our performance was at Sally, we actually feel quite good about our performance. Performance was pretty consistent across geographies. Sally is the business where we saw a little bit more slowdown at the very end of December with the uptick in COVID, and we needed to have a few shorter store hours and things like that. But overall, we felt good about where we were, and what we were lapping, and where we came out with that business. Care was particularly strong in delivering in the quarter, saw good growth with our Strawberry Leopard product, continued growth with color, which are all the indications of us that we've got a very healthy business in that Sally chain go forward.

And then you think about our Europe and Latin America businesses, they were actually up against a little bit easier compares to last year. So that helps the number in the beginning of the year that tapers as we go through the year. So all in all, I felt good about our solid performance.

Operator

Next, we will go to the line of Simeon Gutman with Morgan Stanley.

Simeon Ari Gutman - *Morgan Stanley, Research Division - Executive Director*

I wanted to follow up first on Omicron in January. Can you give us a sense of now that maybe the back half of the month seems like things have gotten better at least in January. And if that's the case, are you seeing a recovery that's as rapid as the variant is going? And can you talk about the maybe the cadence of BSG versus SBS, if there was any nuance there, and how Omicron was handled by the consumer.

Denise A. Paulonis - *Sally Beauty Holdings, Inc. - President, CEO & Director*

Sure. I'll start, and then if Marlo wants to add anything. In terms of what we're seeing, I think in the last week or so, you can definitely see an improvement in traffic trend. We also see an improvement in the amount of our associates who might be out sick or experiencing other challenges in their lives. So we do see that, that normalization is starting happen.

We saw a fairly high case count, so I won't say it's completely behind us at this point. I think that there's a little bit more to go. And in general, I think Sally because it's just a retail business and has a lot more stores, and a lot more team members day-to-day operating in that environment. It saw a little bit more pressure than the BSG business did.

The [Sally] business stayed pretty sticky in terms of our sales and progress as we've gone through Omicron. Not to say that there wasn't a dip, but that I think we're seeing the same general pattern up and down. The BSG trend was just probably a little less noticeable than what we saw on the Sally side of the business.

The one thing that's unique this time in Europe that is different than prior times, this time, we really only saw true lockdowns or shutdowns in a very small part of our geographies. The Netherlands, for example, actually locked down again. But compared to other variants where that was a regular course of business for a lot of our European markets this time, while they certainly had some additional restrictions, they didn't go as far as shutting down businesses in most parts of Europe. So that was a pleasant surprise to us, and just in terms of how the variant is being managed.

Simeon Ari Gutman - *Morgan Stanley, Research Division - Executive Director*

And then my follow-up is, can you talk about the elasticity in both of the businesses. On the surface, this is just an observation. It looks like BSG seems to be more inelastic given how the top line is performing and some of the margin -- gross margin flow through, whereas it looks like SBS looks like there's maybe some pullback in units? I know you said units and AUR were up. I don't know how you're classifying those across the brand.

And then as a follow-up, within that follow-up -- sorry, but all the follow-up, is there anything you can share within your full year guidance? Is anything changing between BSG and SBS based on how Q1 played out?

Denise A. Paulonis - *Sally Beauty Holdings, Inc. - President, CEO & Director*

Start with the inelastic question. So yes, I would say, from both businesses, we have some advantage in terms of the inelasticity, but in different ways. If you think about the Sally side, and you think about the Sally customer. The Sally really is the only provider of pro color for home use. I mean, I would say it's at least 80% market share when you look at the market share statistics.

And so if you think about where does the customer go if not Sally. So their choice is either they trade down to box color and you're not going to get the quality result or you're trading up to a stylist or salon treatment. And now we're talking about going from an all-in, call it, $7 or $8 to buy a tube of color. And if you need to buy the [bowl] and everything else, you might be at $15 going up to $150 service.

So -- so it's just such a uniquely positioned place in the market. If you trade down to the box color, you may save $5, but you're really going to get not as good as a result. And so for a $5 difference on a $10 or $15 purchase, that's where we see the stickiness and the loyalty of the Sally consumer. So once we give them the confidence and teach them how to use the product, they're very loyal. So at that point, really, we have moved prices quite a bit over the last -- for sure, 6 months and almost up to a year in various ways, and really, haven't really seen that customer to change behavior.

And then I think you had a follow-up question there, is there anything changing on our full year guidance based upon what we saw in Q1? And I would say, in general, no. I think the cadence of the year is likely to play out the way that we expected. I think importantly, Marlo mentioned, we always plan every year that the second quarter is a little lighter quarter than the first quarter in terms of sales. We're seeing that play out, and we would expect the rest of the cadence in sales to be what we expected.

I think the 1 piece is a little bit different is we would say we had stronger gross margin performance in the first quarter with the strength of pricing really coming through and working to offset some of the other costs. So I think the 1 piece that's a bit more normalized is our gross margin gains throughout the year are going to be fairly consistent quarter-over-quarter and versus before assuming that they were going to be a little bit more back-half weighted.

Yes. I will say we did have some supply chain challenges this quarter. We talked about the Sally. There was some pressure in the electricals and the styling tools. And so -- as we've been dealing with these challenges and disruptions for some time now. One move we did make differently, and we started to talk about this on our call last quarter was really to front-load the year with the inventory. You saw our inventory levels going up, we're the healthiest place we've ever been for the pandemic. So with that, we feel good about being able to deliver the full year sales of the cadence that we've talked about.

Operator

Our next question comes from the line of Olivia Tong with Raymond James.

Olivia Tong Cheang - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Great. I wanted to follow up a little bit, put a little bit of a finer point on your expectations for this quarter.

So based on your modeling, do you have a sense on when you think you can get back to sort of what your pre-Omicron expectations were, and whether on top of Omicron, you've got weather, you've got inflation macros, et cetera, et cetera, sort of fall off of stimulus. Just wondering if you could touch on that a little bit.

And then just following up, with respect to the store footprint optimization. Have you identified the, let's call it, 50 to 100 doors you're planning to close? And what do you think is sort of the right run rate or ending expectation there? Is there a continued culling of the store base or is this sort of -- once you do this, you feel like we're back to a sort of stabilization in terms of the store count.

Denise A. Paulonis - *Sally Beauty Holdings, Inc. - President, CEO & Director*

I'll start with the first one, which is where we are, and what did Omicron did to us that we didn't know going into the planning process. We came into this year expecting the world to be dynamic. We've been living this up and down in this choppiness for 2 years now. And so we had expected some pressures, whether that be labor disruption, whether that be supply chain disruption, or are just uncertainties around the pandemic.

So I don't think, again, we're seeing a whole lot of difference in the way that we're thinking, and the way that we're planning, and the way that we expect the numbers to play out. We do think there's more pressure just in January, like we mentioned, but we also have lived to these waves, and our teams know how to navigate and deal with these challenges. And again, I think with our positioning with what we've done to get past and try and combat a lot of these supply chain disruptions with the earlier pull-ins. I just think we're really well positioned to really deal with all these puts and takes and all the dynamics that are going on. But if you look at last year, it's just as great.

You mentioned stimulus, you mentioned weather. You mentioned COVID wave. We've experienced it all, and we know how to deal with it. So we're feeling pretty good about what we've planned, and not a lot has changed other than we're learning new ways to deal with this, with the ups and downs.

Marlo Cormier - *Sally Beauty Holdings, Inc. - Senior VP & CFO*

And then I'll jump in a bit on the store optimization question that you threw out. I think that when we think about the store optimization opportunity for us, a big opportunity is really to focus on where we can get sales transfer. So I think as we've talked about before, our stores are generally all profitable. The opportunity for us is to shift the sales, be able to reduce the cost base a bit to help offset other pressures, and have that be positive to the business overall. We've been running a test. We continue to be pleased with the results of the test, which is about a 90-store closure. We'll make -- we'll continue to read that a little bit longer, but specifically for the stores that we have identified for closure this year, all those stores are identified.

So the path that we have for 2022 is very well known. It's 100-plus stores that will close, partially offset by some new openings since the markets that make sense for us to be in. But that is the path that we're already planning to go down, feel good about the selection of those stores.

I think when we bridge into the longer term and where this could go, and we want to continue to understand the sales transfer from the test, and also understand that compared to where we are today in the operating margin of the company, and the efficiencies of the company. Our stores now service more of our e-commerce customers with focus on 2-hour delivery. And overall profitability has gone up as we've been able to carry through pricing while still managing our cost base.

So that profitability in a number of our stores is even healthier than what it was before. So we'll read both of those and would expect as we get later in the year to have a stronger view post 2022 of where our path might take us here. But overall, feel good with what we've done so far.

Olivia Tong Cheang - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Got it. That's helpful. And then on the SBS, the people who are buying in SBS, but they're not loyalty members that 25% of customers. Can you kind of give a little bit more color on why you think they aren't members? Have you done any diagnostics about why they may not be joining or if they're just new to the store? Would just love a little bit of more color there.

Denise A. Paulonis - *Sally Beauty Holdings, Inc. - President, CEO & Director*

Yes, there could be all types of reasons. I'll throw out a few. One, I think when you first see customers come and shop in the store, if they're a new customer to Sally, we wouldn't really expect them on day 1 to sign up for a loyalty program. And we do continue to have new customers come into the store on a regular basis. So that's certainly a fraction of it.

There are some other folks who honestly just aren't as comfortable signing up for a loyalty program in terms of what their dollar amount of spend is when they come in terms of sharing information, we think there'll always be a population of people that if they're not actually required to participate that they might not choose to participate. And in and [all in all] is completely fine with us. We love those customers still coming in and shopping with us.

Generally speaking, a customer who's not a loyalty customer has a little bit smaller basket than what we would see as a customer who has an average loyalty customer. Clearly, our best loyalty customers have outside baskets and outside frequency. So overall, no specific other drivers about design of programs, or something that we need to be offering more or less to get them to sign up. I think it's much more macro issues as to why they might not have signed up for an account at this point in time.

Operator

Our next question will come from the line of William Reuter with Bank of America.

William Michael Reuter - *BofA Securities, Research Division - MD & Research Analyst*

So I have two questions. The first is you mentioned that you've been pushing through all the price increases that vendors have been sending your way. I guess what types of increases in price have you seen or maybe are you seeing on a year-over-year basis at this point?

Denise A. Paulonis - *Sally Beauty Holdings, Inc. - President, CEO & Director*

Yes, I'd say just one thing to point out to you from vendor price increases, that is a very normal thing. Vendors do this at least annually, sometimes more often than that. So when you think about it on the BSG side, that's another thing to point out for the stylist, they're used to price increase. This is a normal recording -- recurring part of their lives.

From a -- in terms of the actual amount, again, it's mostly keeping up with CPI and inflationary pressures. I would say it's been probably lower in past years, a little bit on the higher side and maybe a little bit more often, more than once a year several times a year, has been kind of more than the cadence in kind of recent history. But again, the shopping behavior hasn't changed especially for the stylist, their main concern is to keep their clients happy, and they know how to do that through the products that they have confidence and comfort with and again, very loyal to that. And so pricing really hasn't changed their shopping patterns.

William Michael Reuter - *BofA Securities, Research Division - MD & Research Analyst*

Okay. I guess the 6% comp, does that mean units were relatively flattish. Is that fair?

Marlo Cormier - *Sally Beauty Holdings, Inc. - Senior VP & CFO*

Denise was worth pointing out that it's coming from both pricing and volume.

William Michael Reuter - *BofA Securities, Research Division - MD & Research Analyst*

The second is your net leverage is down below 2x, and you have a 2.5x target. You repurchased $75 million of shares in the quarter. I guess, what does this say about the pace of your share repurchases? And I guess, how focused you are on getting to that target of 2.5x.

Marlo Cormier - *Sally Beauty Holdings, Inc. - Senior VP & CFO*

Yes. So maybe to rephrase, I'm not sure we've put a target out there. I think what we would say is leverage ratio at 187x -- 1.87x is a great place to be. We're really pleased with where we are. I would just go back to the overall -- our business is such a strong cash flow generating model our teams just really came through the pandemic, and just dealing with all the dynamics in this environment to really post a really strong balance sheet.

So we've got $300 million of cash on the balance sheet. Historically, we would usually run around $200 million. So we definitely have some excess on the balance sheet. We don't have anything outstanding on the ABL. So we're positioned well in terms of deploying excess cash. We'll continue to prioritize -- we'll continue to prioritize our growth initiatives. We did, like you say, restart the repurchase program. We've got $75 million deployed. That was about 3% of the company, I think we purchased there. We've got $650 million left on that. And then we have further opportunities to optimize our capital structure. You've seen us do that in the past where we can maybe get some additional interest savings on the P&L.

So you put all that together, you think about where we are in terms of free cash flow generation, $200 million is what we're predicting for this year, that will be back half loaded, but $200 million of cash on the balance sheet, $200 million of cash generation, certainly sets us up well to continue to return value to shareholders through share buybacks as well as optimize the capital structure.

Operator

Our next question will come from the line of Jenna Giannelli with Goldman Sachs.

Jenna Loren Giannelli - *Goldman Sachs Group, Inc., Research Division - Fixed Income Analyst*

On the inventory balance, you're being up a kind of a healthy amount year-over-year and said you're comfortable -- are very comfortable with it now. Just curious if you can comment a little bit more on how that looks across categories. And if there are anywhere you're kind of looking to still fill out or replenish on them back in some of the industry supply chain headwinds?

Denise A. Paulonis - *Sally Beauty Holdings, Inc. - President, CEO & Director*

Yes. So I'll start and let Marlo jump in. I think that we're really pleased with what we've been able to pull forward, and be sure that we service our customers. When we think about where some of that inventory really went, it's into our core products. It's our fastest moving product. It heavily supports our BSG business around color, also our Sally business on the color front, but much focused on that core category of color, and being sure that we're in stocking across the entire line for what people are looking for, and be able to continue to manage that demand.

So very focused where the step up has been. Our opportunity, we have a few categories where styling tools and some other things might be a little lower than where we need to be. But as we're able to get those in and into so we believe that's going to be offset by that [across] inventory being appropriately utilized through the business and through the quarters.

Jenna Loren Giannelli - *Goldman Sachs Group, Inc., Research Division - Fixed Income Analyst*

Okay. Excellent. And then just one additional question. You emphasized kind of the strong market share, particularly on the Sally side, around, call it, 80%, that's a good place to be. I guess, just comment a little more on the broader competitive landscape, whether it's [Mass] or even Amazon professional, that's been quiet. But any updates there on either of those in the broader competitive landscape?

Denise A. Paulonis - *Sally Beauty Holdings, Inc. - President, CEO & Director*

There really hasn't been much new news. I think we feel like we're watching all the competitors. They are certainly all the same players are out there that have been out there before, and we keep an eye on what is happening there. We haven't seen any of them meaningfully step closer to what our core offering is.

I think that if we looked at it the other way and said, how are we really looking to position ourselves for the future. I mentioned on our prior call, the work we're doing this year is to really start to say, how do we expand our view of what we can stand for, leveraging our capabilities, and our skills. So while we're watching competitors who might be looking a little bit more closely at places that we play, although I haven't seen any new traction there.

We're also really open to looking for places that now that the transformation is complete, we're set on a growth agenda. We have the data and analytics that we need to be drive our business forward, but the opportunity that we can also look for new areas of growth for ourselves.

Operator

And with that, we have no further questions. So speakers, if you have any closing comments.

Denise A. Paulonis - *Sally Beauty Holdings, Inc. - President, CEO & Director*

I'd just like to thank all of you for joining the call today. And importantly, I'd like to thank all of our associates around the world. It is never without a lot of effort that our customers are so well served, and I appreciate all that they do to serve us well and drive our profitable business and growth in the future. So thank you all for joining the call today.

Operator

Thank you. And ladies and gentlemen, that does conclude your conference call for today. Thank you for your participation and for using AT&T Executive Teleconference service. You may now disconnect.
