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PRESENTATION

Operator

Good morning, everyone, and welcome to the Sally Beauty Holdings conference call to discuss the company's third quarter fiscal 2024 results. (Operator Instructions)

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 - Vice President of Investor Relations and Treasurer*

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

Before we begin, I would like to remind everyone 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 obligations 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 Paulonis - *Sally Beauty Holdings Inc - President, Chief Executive Officer, Director*

Thank you, Jeff, and good morning, everyone. Our third quarter results point to improving trends across both segments of our business, Sally Beauty and Beauty Systems Group. We delivered net sales growth of 1.2% and a comparable sales increase of 1.5% above the high end of our latest guidance range. Our top-line performance reflects continued momentum and fundamental strength in our BSG segment as well as a notable improvement in performance at Sally, reflecting the traction we're gaining from our strategic initiatives.

Adjusted gross margin was strong at 51% and adjusted operating margin also came in above our guidance range at 8.9%. Our business generated solid cash flows from operations of $48 million, enabling us to continue to return capital to shareholders by way of share repurchases in the quarter.

Looking at performance by segment. I'll start with BSG. Q3 comparable sales increased 2.6%, representing our third consecutive quarter of positive comps. Comparable transactions in the quarter were up 4% and average ticket was down 1%.

From a category perspective, sales in both color and care grew for the second quarter in a row, up 3% and up 5%, respectively. Additionally, our expanded distribution drove strong performance across key brands, including Amika and Color Wow as well as Moroccan Oil, which we will launch in California, one of our largest markets in the fourth quarter.

We're pleased to see consistent underlying strength across our BSG business, reflecting the combination of stable salon demand trends, expanded distribution and robust product innovation. Sally's purchasing patterns remain healthy, although the trend of stylists buying closer to need may be the new norm post-pandemic.

As we continue to capture share gains, we believe the business is poised to build on existing momentum as we enter fiscal 2025. As the leader for the professional stylist community in North America, we are well positioned to leverage our size and scale to fuel continuing growth.

Turning now to our Sally segment. We saw a notable positive turn in the business driven by a number of our customer-centric initiatives, including performance marketing, marketplace expansions and digital enhancements. Q3 comparable sales increased 0.7%, with comparable transactions down 3% and average ticket value up 3%.

We continue to see consumers exercising caution around spending, and we are monitoring purchasing behavior closely, remaining nimble and adjusting tactics is needed. To that end, in Q3, we implemented changes to the design, depth and duration of our promotions, and customers responded favorably, resulting in a higher AUR.

We were also pleased to see that our focus on retaining and growing our loyalty base is bearing fruit. During the quarter, our target marketing campaigns drove strong customer reactivation and brought new customers into our loyalty program.

For the third quarter, we generated 78% of our sales at Sally US and Canada from our 16 million loyalty members. Additionally, our elite loyalty members, who represent our most valuable and frequent shoppers, grew by 6% year-over-year.

The Sally brand has never been stronger. With a record Net Promoter Score of 86 for our third quarter, up 4 points versus a year ago. Across all of our businesses, our teams are delivering strong execution on our core strategic initiatives of enhancing our customer centricity, growing our high-margin owned brands and amplifying innovation and increasing the efficiency of our operations. For our third quarter, product innovation, territory expansion, and new services contributed over 250 basis points to our comparable sales results, and we remain on track to achieve our expected 200 to 300 basis points of contribution from these initiatives for the full year.

Looking at product innovation, a consistent pipeline in both the BSG and Sally segment is helping us drive growth and customer engagement. At BSG, new products like Money Mist from Color Wow and Neuro hair dryers from Paul Mitchell are fueling excitement, while other 2024 launches including Briogeo and epres are continuing to perform well. From a trend perspective, blonding, express coloring, and bonding remains strong, as well as conscious beauty. At Sally, consumers are responding to innovation in men's grooming and mindful brands, including Inspired by Nature and plantheory, our own brand focused on mood enhancing skin care.

In Q3, owned brand sales penetration for the Global Sally Beauty segment was 34%. Building on the momentum from our rooted in success marketing campaign, during Q3, we celebrated Pride Month with activation and collaborations across the country.

Turning now to customer centricity. Our newest concepts and services are performing and building momentum. Starting with Licensed Colorist OnDemand. In Q3, 44% of customers who engaged in this service were new to Sally. That's up from 40% in Q2 and tells us our top-of-funnel work is paying dividend. Additionally, color consultations averaged over 3,300 per week, and the average ticket value increased to $37, up from $35 in Q2.

Our marketplace initiative also continues to gain traction with strong performance across Amazon and Walmart as well as DoorDash, which is driving incremental growth since this launch in Q2. Most recently, we added Instacart and early results tell us this will serve another important platform to meet the consumer where they are in building awareness.

Wrapping up with Happy Beauty. As a reminder, this new concept further expands our reach, focusing on customers looking for beauty at value price points while not compromising on an engaging experience. Building on the learnings from our initial test pilot stores, we're on track to open an additional 10 pilot stores in the Dallas and Phoenix markets prior to the start of the holiday season. This includes six strip center locations as well as four mall locations, which will broaden our exposure to some of the demographic profiles that have done well in our initial pilots.

From a category perspective, we're seeing strong demand in cosmetics and fragrance. There's notable strength in units per transactions and average transaction value. And we continue to experiment with traffic-driving initiatives, including an increased focus on social. As we continue to advance our core strategic initiatives, we are also focused on driving profitability and progressing towards our long-term growth algorithm.

In addition to the efficiency work we had underway internally, we engaged a third-party expert to review our cost base and help us build our Fuel for Growth plan, which is an important component of how we deliver on our profitability target. We continue to engage third-party support to help us implement this important initiative that will benefit our gross margin, expense structure and bottom line. We remain on track to generate cumulative run rate benefits approaching $120 million by the end of fiscal 2026.

As we enter the final quarter of our fiscal year and we remain focused on driving profitable top-line growth, we're pleased to see improving trends throughout the P&L. I'd like to thank our teams across the organization for their ongoing focus, execution and dedication. This collective effort is an essential part of our culture and our ability to deliver an engaging experience for our customers. As always, we remain committed to our growth agenda and long-term value creation for our shareholders.

Now I'll turn the call over to Marlo to discuss the financials.

Marlo Cormier - *Sally Beauty Holdings Inc - Chief Financial Officer, Senior Vice President*

Thank you, Denise, and good morning, everyone. Our third quarter results were highlighted by positive top line performance in both our Sally and BSG segment. Solid gross margins and adjusted operating margin above our latest guidance range. The results reflect underlying strengths at BSG, which delivered a third consecutive quarter of positive comparable sales growth as well as renewed momentum at Sally resulting from our strategic initiatives that Denise just outlined.

Third quarter consolidated net sales of $942 million increased 1.2%, while consolidated comparable sales grew 1.5%. Global e-commerce sales were $92 million and represented 10% of total net sales.

Looking at gross profit, we again delivered solid gross margins, which came in at 51%, flat to last year. Excluding last year's true-up of the noncash inventory write-down related to the distribution center consolidation and store optimization plan that we executed last year, adjusted gross margin was 51%. That's up 10 basis points versus a year ago and reflects lower distribution and freight costs resulting from supply chain efficiencies, partially offset by unfavorable fixed cost absorption.

Third quarter adjusted SG&A expenses totaled $397 million, roughly flat to Q2 and up $13 million versus a year ago as we anticipated. The year-over-year increase can primarily be traced to higher labor and other compensation-related expenses as well as planned increases in advertising spend, including upper funnel marketing. This was partially offset by $4.8 million of savings resulting from our Fuel for Growth program.

We're pleased with the progress we are making with Fuel for Growth. We remain on track with our plan to achieve approximately $20 million of pretax benefits to gross margin and SG&A this year and up to $120 million in cumulative benefit in fiscal 2026. As is typical with this type of project, the nature and timing of benefit capture evolves as the work matures.

To this end, we now expect two-thirds of the $20 million in benefit in fiscal 2024 to come from SG&A, and a third to come from gross margin. There's a slight shift from our previously anticipated split of 75% SG&A and 25% gross margin.

As a reminder, for full year fiscal 2024, we expect to incur up to $30 million in pretax cash charges associated with the Fuel for Growth program, including $26 million that has been realized year-to-date. Strong performance across sales and gross margins, coupled with our Fuel for Growth program drove third quarter adjusted operating margin of 8.9%. Adjusted EBITDA margin was 12.4% and adjusted diluted EPS came in at $0.45.

Moving to segment results. We were pleased to see improved performance at Sally Beauty with comparable sales up 0.7% following a 4% decline in Q2. Net sales were also in positive territory, up slightly versus a year ago. At constant currency, Sally e-commerce sales were $37 million and represented 7% of segment net sales for the quarter. Customers responded to our strategic initiatives including performance marketing efforts, market expansions and digital enhancements.

For the Global Sally Beauty segment, color was essentially flat to the prior year, while care was up 2% and nails were up 5%. At Sally US and Canada, color was up 1%, care was up 2% and nails were up 6%. As Denise mentioned, we generated 78% of our sales at Sally US and Canada from our 16 million loyalty members. Gross margin in our Sally segment was 59.8%, up 100 basis points to last year, reflecting supply chain efficiencies and stronger product margins, partially offset by unfavorable fixed cost absorption. Segment operating margin came in at 16.2%.

Moving now to the BSG segment, where continued momentum was driven by expanded distribution and product innovation. Comparable sales increased 2.6%, while net sales were up 2.5%. On a constant currency basis, BSG e-commerce sales were $54 million, representing 13% of segment net sales for the quarter. From a category perspective, color was up 3% and care was up 5%.

Gross margin at BSG was 39.4%. That's down 110 basis points versus a year ago, primarily due to unfavorable fixed cost absorption as well as lower product margin, which reflects a higher participation rate in our customer appreciation sales as well as brand mix. This was partially offset by the benefits of our supply chain efficiencies. Segment operating margin was 11.5%.

Turning to the balance sheet and cash flow. We ended the third quarter with $97 million of cash and cash equivalents and $45 million outstanding under our asset-based revolving line of credit. Our net debt leverage ratio stood at 2.2 times.

During the quarter, we successfully repriced our term loan B from SOFR plus 225 to SOFR plus 175. The 50-basis-point reduction in the spreads translates to annual interest expense savings of approximately $2 million. Quarter-end inventory was slightly over $1 billion, which is in line with our expectations and reflects an overall healthy position.

Cash flow from operations remained strong, providing us with the flexibility to invest behind our strategic initiatives and return value to shareholders through additional share repurchases. During Q3, we generated operating cash flow of $48 million and operating free cash flow of $29 million. And we repurchased approximately 900,000 shares of stock at an aggregate cost of $10 million under our share repurchase plan.

Turning now to guidance. Based on the strength of our year-to-date performance, we are pleased to reiterate our full year expectations as follows: full year net sales and comparable sales approximately flat, gross margin in the range of 50.5% to 51%, adjusted operating margin of approximately 8.5%, operating cash flow of approximately $240 million and capital expenditures totaling approximately $100 million.

Looking at the fourth quarter, we anticipate that top line momentum will continue at both Sally Beauty and BSG. Additionally, we expect consolidated operating margin dollars and operating margin rate to expand on a year-over-year basis. More specifically, we expect net sales growth to be in the range of up 1% to 2% with comparable sales slightly better.

We expect the gross margin rate in Q4 to be similar to Q3 and SG&A dollars to be slightly favorable to Q3. Additionally, we anticipate that fourth quarter adjusted operating margin will be approximately 9%. Lastly, we expect investments in share repurchases in the fourth quarter to be approximately $10 million.

In summary, we are pleased with our progress and third quarter results that are reflecting improving trends in both our business segments, as well as results from our growth initiatives. Entering the final quarter of fiscal 2024, we remain focused on driving our strategic pillars, including our Fuel for Growth initiative.

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) Oliver Chen, TD Cowen.

Oliver Chen - *TD Cowen (Research) - Analyst*

Consumer sentiment has been mixed. As you know, it's been pressured at the middle and low. Has that manifested in the banners currently and/or what are you seeing? And would love any thoughts on that difficult question we're getting around potential election impact and/or if you saw things in the past that might be related to now?

Also, the category call-outs were very helpful regarding hair, nail and color. Do you expect those trends to remain similar? Or what are your thoughts on each of those categories as they affect your banners?

And then finally, as we're all modeling, monitoring tariffs, any thoughts you have in terms of sourcing? You have a lot of different partners as well as a lot of private label.

Denise Paulonis - *Sally Beauty Holdings Inc - President, Chief Executive Officer, Director*

This is Denise. I'll start with some questions, and I'm sure Marlo will jump in. Overall in the market, let me break it out as we always do between BSG and Sally. BSG, we're seeing salon demand trends quite stabilized. I don't see any near-term catalyst for that to change. We're seeing the benefit of expanded distribution and product innovation. So I really believe that that salon client is enjoying their experience in shopping with BSG and look forward for that to continue.

On the Sally side, we've watched two consistent themes all year, right? That customer is remaining frugal and purchasing behavior is primarily driven by need. We also watch customers to be very price sensitive and leaning into promotion as they manage through the inflationary environment. We've seen that to be pretty stable. We're really pleased with what we were able to do in Q3 and adjusting some of our promotional strategies to kind of meet the consumer where they are, but improving our AUR in the process and also seeing the increased impact of our strategic initiatives coming through on the Sally side. So marketplaces, Licensed Colorist OnDemand.

So when we step back from all of that, as we're looking forward into our Q4 environment, the months ahead, we feel good about the trajectory of both of those businesses to deliver positive comps into the fourth quarter. And we're watching very closely what we always watch is we will see inflationary trends, perhaps influence the customer or other macro.

When it comes to the election, the thing I think we're always most sensitive to is what will happen to marketing rates and things like that to allow us to keep investing, to gain that top-of-funnel customer come through. We're navigating it and feel that it's within our control to do that. And we're pleased with what we've seen of the results there in terms of performance marketing, being able to drive new and reactivated customers into the fold.

And category call-outs, I think color and hair, we expect both to continue on positive trajectory. Nails in Sally, it's really fueled by some new innovation coming in, and we're feeling good about that as well. So all in all, from a category perspective, I don't expect there to be a substantial change from what we're seeing right now.

And then I think your last question on sourcing. And at the end of the day, about 10% of what we source comes in from Asia. So it's a pretty small percentage of exposure to us. We watch that pretty closely. We work with our manufacturing providers to be sure that we're well distributed and how we think about it. And for us, freight costs, while it's part of our equation, it's not nearly as material as it might be for some others who have more exposure.

Operator

Korinne Wolfmeyer, Piper Sandler.

Korinne Wolfmeyer - *Piper Sandler & Co. - Analyst*

I'd like to touch a little bit on the guidance and the expectations you laid out for fiscal Q4. You delivered a pretty good margins here in fiscal Q3. Noted they came in ahead of your guidance and your expectations. So what is the reasoning behind leaving your full year expectations unchanged? Is it just a little bit of conservatism? Are you seeing any shifts in demand trends or shifts in the cost structure that would cause you to leave it unchanged? Or any color there would be helpful.

Denise Paulonis - *Sally Beauty Holdings Inc - President, Chief Executive Officer, Director*

Yes. Happy to answer that. Our guidance really reflects the strength of Q3 as well as year-over-year improvement in top and bottom line that we expect in Q4. Given the macro we're in, we just feel like the guidance is good that we're providing. If you think about a little bit of the color, in Q3, we were modestly ahead in what we reported. We were pleased that a lot of that being ahead was on the path with our strategic initiatives in the right direction with the Sally brand.

And when we look to Q4, I mean, most important to us is we're really looking to build upon the positive top line and also deliver positive improvement around adjusted operating profit and adjusted profit margin. So I think we're just reading what's out there in the market. We don't see any material change in trend, but believe the right place for us is to hold guidance right now.

Korinne Wolfmeyer - *Piper Sandler & Co. - Analyst*

Got it. Very helpful. And then if you could just touch a little bit more on the promo situation called out in BSG. It sounded like there is a higher take rate in promos kind of like what you pointed out last quarter. Can you give any color, was this incrementally more than what you've seen last quarter? Is it unchanged? Is it improving? And then how are you thinking about the promo environment heading into fiscal Q4?

Denise Paulonis - *Sally Beauty Holdings Inc - President, Chief Executive Officer, Director*

On the BSG front, as I mentioned, we're really pleased with the strong sales trend that we've had. As we see part of that in the promotional piece of it, customer appreciation sale has been a higher take rate than what we've seen historically. And that's one of our promotions that is only partially funded by our vendors, and we fund that as well.

The impact to us in Q3 was very similar to Q2, so we aren't seeing any heightened activity there, but we are seeing people want to buy in and take advantage of that promotion. So we're going to keep managing that. But at the moment, we feel good about how customers are reacting as they're coming into the BSG environment, what we're seeing in sales and unit trends and believe that we're sitting in a pretty healthy spot.

And then on the Sally side, we talked a little bit about the fact that we still see customers being frugal. Our core customer coming in is buying what they need. We were pleased to see new and reactivated customers head in the right direction this quarter with a lot of our performance marketing and LCOD activity. But we're very aware of their also being promotionally sensitive.

What we've tried to do in our promotional strategy is still give them great value but drive value in ways that we can still improve AUR and drive frequency. So we're doing less quantity type discounts and more traffic-driving discounts to be getting people into the stores. We think both sets of trends on both sides are feeling consistent as we're entering Q4. And so that's what we're planning for and working with right now.

Operator

Olivia Tong, Raymond James.

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

Can you talk about any difference as the quarter progressed, particularly in SBS? And was there any change start of the quarter versus the exit rate?

And then just generally, as we think about fiscal '25, your plans in light of perhaps even more wallet tightness as we go forward? And then following on that, some of the manufacturers in hair appliances, notwithstanding today, have talked about general sentiment in the industry being a little bit more challenging, particularly in the sub-$100 appliance market. I would love to hear your commentary there.

Denise Paulonis - *Sally Beauty Holdings Inc - President, Chief Executive Officer, Director*

Absolutely. So I'll start on SBS and what we saw throughout the quarter. We saw a nice momentum and impact of our strategic initiatives to build as we went through the quarter. So marketplaces with our newly launched DoorDash program, Instacart coming online as well, tracked well. Performance marketing, we continue to hone in and be able to drive impact there. So positives that we saw throughout the quarter. We continue to believe those will be positives going into Q4, so feel good about that.

When we look to 2025, clearly, we're not providing guidance on this call today until our November earnings call. But we're confident that the initiatives have us on the right path to get to our low single-digit algorithm. It is a dynamic macro environment, but we're really finding a way to balance our way through and have those strategic initiatives start to be contributing more. So for the full year in 2024, the strategic initiatives, 200 to 300 basis points of benefit, which we feel good about and assuming that the macro continues at the pace that we're seeing today, expect that 2025 will be headed down a good path. So more to come as we get to our November earnings call on that one.

And then finally, the hair appliance category. I think it's a dynamic category and that it's one of those places that for most people, it becomes a more discretionary spend if they lean into it a bit more versus the necessary spend when something they have might break.

What we've seen is when innovation comes out and we talked about it on our BSG side, John Paul Mitchell came out with a Neuro hair dryer and hair dryer line. We saw a great response to that in Q3 on the BSG side because it really had new innovation that was benefiting the stylists and they were willing to lean in and take advantage and buy that. So we're excited by those types of innovations that we think keep the category moving, but clearly, in an environment where people might have a little bit more inflationary pressure as the performance right now is people primarily buying to need without that catalyst.

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

Understood. And then just following up on new products. That's obviously been a solid contributor this year. You mentioned the new hair dryer and a lot of new activity on the consumables side. To the extent that you have some insight into the next 12 months, what is the new product pipeline look like to you guys relative to the last 12 months?

Denise Paulonis - *Sally Beauty Holdings Inc - President, Chief Executive Officer, Director*

We're feeling good about it. And there continue to be, as we just talked about on our prepared remarks, we just expanded Moroccan Oil into California. So we believe we continue to have distribution gains with some of the brands that we already have.

And we have a nice pipeline of new products that we do see coming in. Clearly, nothing to share specifically on this call. But feel good that the trajectory is there and the underlying health of the combination of territory expansion, distribution gains, new product on that BSG side really sets us up well to leverage our scale in that business.

Operator

Ashley Helgans, Jefferies.

Ashley Helgans - *Jefferies LLC - Analyst*

Congrats on the quarter. Maybe if we can just dive a little deeper in gross margins. I know that you saw some improvement in the Sally Beauty Supply segment due to supply chain efficiencies. I'm just curious any of these efficiencies you can leverage with the BSG segment?

And then you also called out some stabilization in the salons. Just curious like where we are versus historical levels in terms of like appointment frequency and spend.

Marlo Cormier - *Sally Beauty Holdings Inc - Chief Financial Officer, Senior Vice President*

I'll start with the gross margin question. We are seeing some nice gains across both our businesses on our supply chain efforts. And that is part of our Fuel for Growth program and part of our $20 million that we're seeing come through for our target that we had for 2024. So that is across both segments. The difference between Sally and BSG is we're getting an offset to that on the BSG side, mainly from the unfavorable fixed cost absorption that we see, but also from product margin where we see some brand mix putting some pressure on the product margin.

Denise Paulonis - *Sally Beauty Holdings Inc - President, Chief Executive Officer, Director*

And then if we think about salon and salon stabilization, I'll go back to the point of we're really pleased with the trajectory of the BSG business and what we have there. We think underlying trends, it's hard to go back and compare to something.

But what I would say is our stylists are talking about people coming in for regular services a pace that is generally healthy. Where there's a little less health in the industry would be more in the chain salon group. But most of our exposure is to those independent stylists or in smaller salons, so feel good about where we are there. If I related it back, it's probably approaching pre-COVID types of territory in terms of what people see, but we're always conscious of the fact that people will trade up or down as they see fit, but stylists are feeling pretty good that this is a core course of business. So that's what we're building on our assumptions go forward as well and aren't hearing different news.

Operator

And at this time, there are no further questions in queue. Please continue with any closing remarks.

Denise Paulonis - *Sally Beauty Holdings Inc - President, Chief Executive Officer, Director*

Well, I want to thank everyone for joining today. And most importantly, I want to step back and thank our team. Really strong execution from the quarter, great cross-functional collaboration internally is letting us progress dramatically on our strategic initiatives, and I couldn't be more pleased with where we're headed.

As always, we appreciate all of our shareholders. We remain committed to long-term profitable growth in getting on our longer-term algorithm as well. And we look forward to updating everyone as we finish our fourth quarter in just a few months. Thanks.

Operator

Thank you. And that does conclude our conference for today. Thank you for your participation and for using AT&T TeleConference. You may now disconnect.
