04-Nov-2015

Performance Food Group Co. (PFGC)

Q1 2016 Earnings Call

CORPORATE PARTICIPANTS

Michael D. Neese
VP-Investor Relations

George L. Holm
President, Chief Executive Officer & Director

Robert Deaton Evans
Chief Financial Officer & Senior Vice President

Andrew Paul Wolf
Analyst, BB&T Capital Markets

OTHER PARTICIPANTS

Vincent J. Sinisi
Morgan Stanley & Co. LLC

John Heinbockel
Guggenheim Securities LLC

Meredith Adler
Barclays Capital, Inc.

Zack R. Fadem
Wells Fargo Securities LLC

Ajay Jain
Pivotal Research Group LLC

Edward J. Kelly
Credit Suisse Securities (USA) LLC (Broker)

MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to the Performance Food Group's First Quarter Fiscal 2016 Earnings Conference Call. Today's call is scheduled to last about one hour, including remarks by PFG's management and the question-and-answer session.

I would now like to turn the call over to Mr. Michael Neese, Vice President, Investor Relations, for PFG. Please go ahead.

Michael D. Neese
VP-Investor Relations

Thank you, Jackie, and good morning everyone. We are here this morning with George Holm, Performance Food Group's CEO; and Bob Evans, PFG's CFO, to discuss our first quarter fiscal 2016 business results.

During our call today, unless otherwise stated, we are comparing the results to the same period in fiscal 2015. Earlier this morning, we issued a press release regarding our first-quarter results. For a detailed review of them, please see our earnings release on the Investor Relations section of our website at pfgc.com.

Our remarks and the earnings release contain forward-looking and cautionary statements and projections of future results. Please review the forward-looking statements section in today's earnings release for various factors that could cause actual results to differ materially from projections.

On today's call, we may reference certain non-GAAP financial measures. Descriptions of these non-GAAP financial measures and reconciliations to the most-closely comparable financial measures calculated in accordance with GAAP are included in today's earnings release and in our presentation slides.

Now, I will turn the call over to George.

George L. Holm

President, Chief Executive Officer & Director

Thanks, Mike. Good morning to everyone and thank you for joining us today. Before I get into the first quarter details, I would like to share a short summary about our company, Performance Food Group. We're the number-three player in the large, attractive and growing food away from home industry. We partner with over 5,000 suppliers and we sell over 150,000 products. I believe we have substantial scale and meaningful opportunities to continue our track record of share growth.

Our business model is centered on serving customers and our entire team is motivated to execute; our simple strategy of growing our number of customers, driving our mix towards our most-profitable channels and products, and improving productivity and profitability. The company is focused on driving organic growth and will be opportunistic in accelerating that growth through accretive M&A activity. We firmly believe that our best growth opportunities lay in front of us, not behind us.

We have three segments to serve the food distribution universe that we will discuss in more detail later in our prepared remarks. Performance Foodservice and Vistar represent over 75% of our sales and the majority of our EBITDA and we've been investing and growing most rapidly in these two segments.

Last year, we sold $15 billion and earned nearly $329 million of adjusted EBITDA. We did this from 68 distribution centers across the country so we have high asset turnover and attractive returns on capital. Most importantly, we've a great team focused on serving our customers and I want to thank all of our associates and let them know how proud I am of the job they are doing so well.

Now, let's turn to our results. Performance Food Group's first quarter fiscal 2016 financial results reflect solid operating performance. Our case volume growth continue to exceed forecasted industry real growth, while we expanded our margins to grow adjusted EBITDA dollars faster than our sales growth.

Here's some highlights for the quarter. Case volume grew 5.1%. We achieved sales of $3.9 billion, an increase of 6.3%. Gross profit grew 7.1% to $481.1 million. We grew our adjusted EBITDA and adjusted net income by 14.1% and 65.5% respectively and we successfully completed an IPO in a very volatile market.

Now, let me focus on the business and segment performance in more detail. Organic case volume grew 4.9% during the quarter and 5.1% including acquisitions. Case growth reflects new and expanding business with independent Street customers and our Performance Foodservice segment, growth in Vistar sales in the theater, retail and hospitality channels and a small acquisition in our Vistar segment. Our net sales increase of 6.3% was driven primarily by case growth, inflation for the first quarter increased at an estimated annual rate of 0.1% compared to an estimated annual rate of 3.2% during the prior-year period. The rest of our net sales growth was accounted for by selling a different mix of products year-over-year and by a change in a customer contract that I'll discuss in a moment.

As we enter our second quarter, we are witnessing food deflation, especially in dairy, beef, poultry and seafood. That deflation has actually been accelerating during the first five weeks of our Q2. Gross profit of $481.1 million was 7.1% better than the prior year and grew 2 full percentage points faster than our case growth rate. Operating expenses increased 4.9% or slower than our case growth rate, despite an increased investment in our sales force.

Our Winning Together program, which is aimed at driving productivity in non-customer-facing areas, recognized cost savings benefits in the quarter and we believe will yield savings throughout the fiscal year.

Let's turn to performance in our three segments. In our largest segment, Performance Foodservice, net sales for the quarter were $2.4 billion, an increase of 5.2%. Growth in cases sold was driven by securing new Street and chain customers and further penetrating existing customers. Our definition of Street customers is an independent account with less than five locations and the large majority had just one restaurant.

Street sales as a percentage of total sales were up 20 basis points to 44.9%. Performance Foodservice's strong case growth, combined with both gross margin expansion from selling an improved mix of channels and products and a well-controlled operating expenses, drove EBITDA growth of 27% in the quarter.

Net sales for PFG Customized increased 6.7%, primarily as a result of an amended agreement with an existing customer, which we lapped during the quarter. The increase was a result of changing a portion of the Customized business from a distributions fee per case arrangement to buying product from the supplier and charging the customer both the cost of goods sold and the distribution fee.

Segment EBITDA decreased 3.9%, driven by lower case volume and expenses required to address driver shortages in some parts of the country. Turning to Vistar, net sales increased 9.8%, driven by case sales growth in the theater, retail and hospitality channels, EBITDA decreased $1.6 million versus an especially strong prior-year quarter that benefited from inflation-based inventory gains. Vistar's quarter also reflected investments in additional sales force capacity, plus transaction and integration expenses related to an acquisition.

In summary, we believe our company and business segments are poised for continued growth and market share gains. We remain confident in the ongoing growth potential of our business.

I will now turn the call over to Bob Evans, who will provide a more detailed snapshot of our financial results for the quarter and to our outlook looking forward.

Robert Deaton Evans
Chief Financial Officer & Senior Vice President

Thank you, George, and good morning, everyone. I'll briefly go through our financial results, discuss our IPO, cash flow and uses of cash and wrap up with our fiscal 2016 outlook. As George highlighted, our first quarter saw both strong top-line case growth and profit margin expansion. Case growth of 5.1% exceeded the industry real growth for 2015 forecasted by Technomic.

Our net sales growth of 6.3% was primarily driven by our case growth and by the contract change in Customized, which did not affect the case sales, but did add a little over $50 million to the bottom sales line. Absent that change, sales growth would have been 4.7%. Inflation was 0.1% and we sold a slightly less expensive mix of products in the quarter. Our gross profit dollars grew by 7.1%, or 2 full percentage points faster than our case growth. Our operating expense dollars grew by 4.9% or just slower than our case growth.

Above-average industry case growth accelerated by the gap between gross profit and operating expense growth rates drove adjusted EBITDA growth to 14.1% or $80 million for the quarter. Focusing for a moment on margin expansion, when we think of profit margins, we focus on how many gross profit dollars flow to the bottom line since seven-eighths of our P&L is a pass-through of cost of goods that we resale to our customers.

Adjusted EBITDA as a percentage of gross profit increased 103 basis points to 16.6% versus the prior year, which reflects selling a more profitable mix of channels and increasing the share of our sales mix in our proprietary Performance Brands. Adjusted net income advanced approximately 65.5% to $18 million or $0.21 per diluted share compared to adjusted net income of $11 million or $0.13 per diluted share in the prior-year period.

Turning to our IPO, on October 6, 2015, PFG completed our initial public offering of approximately 16.7 million shares of common stock at a price to the public of $19 per share prior to underwriting, discounts and commissions. PFG sold approximately $12.8 million primary shares and certain selling stockholders sold approximately 3.9 million shares, which included a fully exercised overallotment option. The IPO generated aggregate net proceeds to the company of approximately $223.7 million. Our primary use of proceeds was to pay off a portion of our second lien-term loan.

We at the company have a strong focus on cash flow. As we think about the business and its cash flow, we look at three primary uses for cash; working capital, capital expenditures and acquisitions. Focusing for a moment on working capital, like everyone else in the business, our working capital is dominated by inventory, accounts payable and accounts receivable. Our accounts payable offsets our inventory investment, so the real key is accounts receivable, which is driven both by case growth and by the rate of inflation.

In our first quarter, PFG experienced deflation at the end of the quarter, which lowered our investment in accounts receivable relative to year-end and generated substantial cash flow. In the first quarter of our fiscal year, we typically invest in working capital, which affects both operating cash flow and net debt.

In the first quarter, PFG used $25.9 million in operating cash flows versus a prior-year use of $82.7 million, which resulted in a year-over-year improvement of $56.8 million. The deflation at the end of the quarter was a large driver of this improvement, followed by the increase in our EBITDA.

PFG's net debt at the end of the first quarter stood at approximately $1.5 billion, a decline of $72 million versus the comparable prior-year period. Our investments in CapEx were moderate and have been at an annual rate of around 0.6% of net sales in recent years, though quarter-to-quarter numbers will vary as we ramp up or complete projects.

In the first quarter, we invested $17.7 million in capital expenditures. Following the close of the quarter, in conjunction with our initial public offering, the company repaid $223 million in borrowings under our term-loan facility. As a result, the company's pro forma net debt to adjusted EBITDA leverage, as defined in our lender agreements, is at 3.7 times.

Our post-IPO leverage, coupled with over $0.5 billion in available liquidity from our asset-based lending facility, provides us with dry powder for acquisitions. Many of the companies in our industry are family businesses, so we have to approach acquisitions opportunistically. Our acquisitions dollars have been focused on geographic expansion and capability acquisitions. We have been a proved – disciplined and proven acquirer, having bought and successfully integrated 14 companies since 2008.

As we look ahead for the full year, I would like to provide our outlook for 2016 fiscal year. PFG expects adjusted EBITDA growth to be in the range of 9% to 12% versus a fiscal 2015 adjusted EBITDA of approximately $329 million. The fiscal 2016 outlook for adjusted EBITDA includes a 53rd week, which will fall in the fourth quarter. On a 52-to-52 week basis, the company expects adjusted EBITDA growth to be in the range of 7% to 10%.

This outlook is based on the following assumptions; organic case growth in a range of 3% to 5%, which is a 52-to-52 week comparison. Interest expense in the range of approximately $72 million to $78 million, which includes the 53rd week and reflects the use of IPO proceeds to reduce PFG's long-term debt. And effective tax rate of approximately 41% and our annual weighted average diluted shares outstanding of approximately 100 million shares.

PFG also expects capital expenditures for the fiscal full year 2016 will be between $125 million and $150 million, while depreciation and amortization will be between $115 million to $125 million.

Thank you for your time. And with that, operator, George and I will now be happy to take questions.

QUESTION AND ANSWER SECTION

Operator: Investors, analysts and media representatives are now invited to participate in the question-and-answer session. We will take questions from the investment community first. Our first question comes from the line of Vincent Sinisi with Morgan Stanley.

Vincent J. Sinisi
Morgan Stanley & Co. LLC

Q

Hey. Good morning, guys. Thanks very much for taking my question and congratulations on a nice quarter out of the gate here. Sure. Wanted to ask first, in regard to the case growth, very solid growth this quarter. I know you had mentioned kind of coming from new as well as existing customers, wondering if you could shed a little bit more light on either the types of Street customers or if there were kind of any differences geographically as well, maybe just a little more color there?

George L. Holm
President, Chief Executive Officer & Director

A

Well, we increased our net new accounts per independent a little bit under 6% growth and that's been pretty much where we've been the last several years. As far as geographically, pretty much widespread. The growth that we are putting out doesn't vary much company-to-company. And we've talked about growing our cases for independents somewhere between 6% and 10% and we were right in the middle of that for the first quarter. So far in the second quarter, we've seen a slight uptick in our independent growth and a slightly less growth in our national account as far as cases go.

Vincent J. Sinisi
Morgan Stanley & Co. LLC

Q

Okay. That's helpful, George. Thank you. And maybe just a quick follow-up, if I can. I know you mentioned that you're seeing acceleration in deflation specifically. Can you give us just kind of what you're currently seeing today and expectations for the rest of this quarter as well as the year?

George L. Holm
President, Chief Executive Officer & Director

A

Well, we started out with slight inflation at the beginning of last quarter. And by the last month of the quarter, in September, we were experiencing some slight deflation. And then, in the month of October, we've seen the rate of deflation, particularly in our independent business, go up about 0.5 point week and lately it's been running in the 3% to 4% range.

Vincent J. Sinisi
Morgan Stanley & Co. LLC
Q

4% range. And is that something that you'd expect to kind of continue for this quarter and then moderate in the back half of the year?

George L. Holm
President, Chief Executive Officer & Director
A

We would suspect so. We're pretty over-indexed when it comes to cheese, that's a big part of our business. And last year we saw week-to-week deceleration in price, last year in December, particularly. So, we would expect it to moderate some, but I don't see it going away. At least we don't see any signs that we're going to go back into an inflationary period anytime soon.

Vincent J. Sinisi
Morgan Stanley & Co. LLC
Q

Okay. Very helpful. Thank you very much. Good luck.

George L. Holm
President, Chief Executive Officer & Director
A

Thanks.

Operator: Our next question comes from the line of John Heinbockel with Guggenheim Securities.

John Heinbockel
Guggenheim Securities LLC
Q

So, a couple of things on the – George, the 3% to 4% obviously includes ROMA and that obviously makes sense. If you strip that out, are you still seeing a fair bit of deflation right now?

George L. Holm
President, Chief Executive Officer & Director
A

Yes, we are. We track our product by 12 major product categories and we saw deflation in six of those 12 just last week, biggest being dairy. So, as that moderates, that will have an impact. But like I said, I still don't see us heading into an inflationary period anytime soon.

John Heinbockel
Guggenheim Securities LLC
Q

So then, two things. If you talk about pass-through on deflation, because the assumption or at least I think that there is some directional benefit to margin, clearly, not to dollars, but to at least margin on the kind of deflation you're talking about. And then, the competitive environment, I mean, it would just strike me that at some point here some of your large competitors obviously have to start showing better results that we would have more rational pricing, right, than we've seen historically. I assume we're not seeing that yet, but will we and when will we?

George L. Holm
President, Chief Executive Officer & Director
A

Okay. I'll start with kind of the first question and that's what impact deflation has. We have a very large percentage of our customers are on some type of contractual arrangement. So, if that contractual arrangement is based on margin and there is deflation, obviously, our gross profit dollar per case tends to suffer. Where we have it on a fee, which is a large part of particularly our Customized business, what we see there is no change in the amount of gross profit that we have come in, but it actually helps our margin. And then when you get to our Street business, we've done a very good job of maintaining or increasing, depending on the product category, our gross profit dollars per case. So, we tend to have a little bit more flexibility there and we've done a really good job.

As far as the competitiveness of the marketplace, I think it's very competitive. I think it's been very competitive for a long time. We happen to have a group of our district sales managers from around the country, and today and I was with them last night and they feel that it is a very competitive time right now. But that said, we are seeing a slight uptick in our case growth in independents. So, maybe we've got some rationality coming. I don't know, but it certainly isn't affecting us today.

John Heinbockel
Guggenheim Securities LLC
Q

All right. And then lastly, what does the M&A pipeline look like? And what's going on from sort of a top-level industry standpoint, particularly with all this deflation if it's going to last a while, which it typically hasn't, is that creating more potential supply of acquisition candidates?

George L. Holm
President, Chief Executive Officer & Director
A

Well, John, we are always talking to people and we certainly are now. We don't have anything that we consider real imminent. I think that deflation probably doesn't affect that. I mean, there's one thing you can count on with deflation in our business, it doesn't last very long.

John Heinbockel
Guggenheim Securities LLC
Q

Right. Yeah.

George L. Holm
President, Chief Executive Officer & Director
A

And also, deflation tends to help companies with their cash flow. And when you get some of these independent owners, that's a very important number for them. So, it actually sometimes can make things a little bit easier.

John Heinbockel
Guggenheim Securities LLC
Q

Okay. Thank you.

Operator: And our next question comes from the line of Meredith Adler with Barclays.

Meredith Adler
Barclays Capital, Inc.
Q

Thanks for taking my question. I guess I want to go back and talk a little bit more about competition and whether you can – are you seeing anything, in particular areas? And then, maybe also talk about is there – does inflation or deflation impact Vistar at all? So, I'll start with those two questions.

George L. Holm
President, Chief Executive Officer & Director

A

Okay. As far as competitive – it's just a very competitive industry and I think it has been for a long time. And I don't know that it's much different now than it has been. Clearly, everyone's focused on independent growth, which is understandable. I mean, it is a higher-margin part of our business. But I really don't see big differences. As far as inflation/deflation impacting Vistar, it had an impact on the quarter that we were just in, because of last year.

Prices in that industry tend to go up maybe once a year. Some companies don't even announce an increase every year. When one does, that typically ends up being a catalyst for several to do it. I think it goes back to kind of the vending industry. And if everybody is going to be out there changing the price on their machines, they tend to want to do it all at one time. And we had fairly significant increases in prices in the quarter a year ago. When that happens, we tend to sense that coming and we try to have additional inventory, when that happens and we tend to get some pretty good inventory gains, when it does.

The other thing that also happens then is, quite often, we'll see some decline in volume, because there is price sensitivity to that customer. And that's part of the reason we had such great sales growth in Vistar for the quarter. But when we look at that business, although any time you have an earnings decline it's disappointing, we feel we had a very good quarter and that volumes were good. That tends to be a good sign for the future.

Theater is a big part of our business and we've got some great movies that are going to be coming out with Star Wars and another James Bond movie and another Hunger Games movie and those are kind of proven ones that they'll do well. So, we feel really good with that business. And when inflation comes, like I said, it typically [ph] comes (25:00) all in one quarter and then you don't have to deal with it for a while.

Meredith Adler
Barclays Capital, Inc.

Q

Okay. That's helpful. And then one other question just about – if you think about underlying demand, I think some of the broad data is a little bit mixed in terms of traffic. What are your customers saying about demand? And are you also continuing to see or seeing any acceleration in the opening of new independent restaurants?

George L. Holm
President, Chief Executive Officer & Director

A

We can only speak to our customer base and that might not be reflective of the total market. We have a sense that the independent restaurateur is doing quite well. Our business is good. We are seeing plenty of openings. There doesn't seem to be a shortage of available capital for people to open restaurants. So, I think that's been good. We don't comment on any of the chain restaurants individually, never will. But as a group, if you look at it broadly, as a group that we sell, we are seeing some softness there. And the softness in the second quarter has been slightly accelerated from the softness in the first quarter.

Meredith Adler
Barclays Capital, Inc.

Q

Okay. Great. Thank you very much.

Operator: Our next question comes from line of Andrew Wolf with BB&T Capital Markets.

Andrew Paul Wolf
Analyst, BB&T Capital Markets

A

Thank you. Good morning. I just want to start with the Vistar. If you take some of the adjustments, like the acquisition costs and so forth, could you give us a sense of how the adjusted EBITDA would have been at the segment?

George L. Holm
President, Chief Executive Officer & Director

A

Yeah. Andy, we're not going to break the adjustments out by segment. But if you kind of take out both the – kind of the inflation-based inventory gains that we had last year as well as the small amount that we spent this year on the acquisition costs, Vistar would have been solidly profitable from a growth perspective in the quarter.

Andrew Paul Wolf
Analyst, BB&T Capital Markets

A

And that's what I was getting at. On the deflation happening, on a couple of your categories in particular, I just want to ask you what you think about the deflation in meat and what it could mean for restaurants. I mean, they've had a lot of menu price inflation in that steaks and the stuff. I mean, do you think you're going to be able to drop their menu prices and could that actually help their demand or are they doing it? What's your sense on that?

George L. Holm
President, Chief Executive Officer & Director

A

Well, first of all, the deflation that we're experiencing in meat right now is from a very high period a year ago. We see that the middle meats that – your meats that you're going to cut takes from, we think that's actually going to strengthen here, not necessarily the whole meat category, but we see some strengthening in strips and revise and those types of items, tenders. But I don't see – I wouldn't expect to see any menu declines. I don't want to speak for our customers, but I can't – I wouldn't project that.

Andrew Paul Wolf
Analyst, BB&T Capital Markets

A

Okay. And I just wanted to follow-up on the driver shortages you referenced. I think it was with, I guess, Customized. Why isn't that impacting or could impact the other segments? Is it more like for longer hauls or is it – or are you seeing that maybe as a issue for the other segments?

George L. Holm
President, Chief Executive Officer & Director

A

Yeah. We are seeing it across the board. And what we've done with that is just added additional drivers. We've also reduced a dependency on temporary drivers by making sure that we had an increase in full-time drivers. And then markets where we felt that we were under the market, we brought wages up to the market. And it hasn't really had a negative impact on us at this point, primarily because we're kind of getting some things from Winning Together to offset it and, of course, fuel has offset some of those costs.

Andrew Paul Wolf
Analyst, BB&T Capital Markets

A

Okay. Thank you. Appreciate it.

Operator: We now welcome any question from media representatives. [Operator Instructions] Our next question comes from the line of Zack Fadem with Wells Fargo.

Zack R. Fadem
Wells Fargo Securities LLC

Q

Hi. Good morning. I want to ask a little bit about the Vistar business. Can you talk a little bit about the long-term industry growth rate? Would you say that the business has a similar growth trajectory as a broad-line business or do you see more runway there? And if so, maybe you could walk through some of the drivers?

George L. Holm
President, Chief Executive Officer & Director

A

Okay. The theater business pretty much grows at about the rate of the population. So, that's going to be maybe a couple point grower. The vending business is kind of dependent on employment for the most part. So as we see employment come back, we should see that business get better. When you get into the other channels, I think it's difficult to get numbers. Our hospitality business, we're kind of creating demand as we get more and more of these particularly mid-scale hotels to put pantries in. And that's been a big driver of our growth. The retail business, which is a very good business for us, is really dependent on retail sales and the traffic that those stores get. And traffic has not been great, but we've continued to get our products placed in more locations. So, I guess, to some degree we're creating the growth there. But we do feel it's a business that we can grow in that, at least, mid-single-digit growth area.

Zack R. Fadem
Wells Fargo Securities LLC

Q

Okay. That's helpful. Thanks. On your capital allocation strategy, over the long term, how do you think about priorities in terms of M&A, debt pay-down, maybe buybacks over time? And In terms of the M&A, how would you prioritize opportunities across your business segments and geographies? And would you feel comfortable going back to kind of a 4 times to 5 times leverage ratio for the right opportunity?

Robert Deaton Evans
Chief Financial Officer & Senior Vice President

A

Yeah, Zach, this is Bob. In terms of kind of capital allocation priorities, right now, from both a CapEx and an M&A standpoint, we tend to look both to Performance Foodservice and to Vistar more so than to Customized. We just think the growth opportunities are a little better in those two segments. In Performance Foodservice this year, we are going to be adding modestly to our brick-and-mortar capacity. It's one of the things that's taking our CapEx up a little bit relative to what it had been over the prior few years on that. We just have some very good markets that we're doing well in, like the Southeast and out in Texas and up in the New England area, where we feel that we can add capacity profitably for ourselves.

From an M&A standpoint, we are going to remain opportunistic about that, because you just don't know when people are getting ready to sell. That's why we're talking to people as constantly as we are. I think that's also why we have a pretty high liquidity premium in the business. I think we always want to keep ourselves really liquid. So, certainly, we're not looking forward to any kind of share buyback program up until the time that our sponsors finish selling out at a minimum.

And in terms of the overall leverage, for the right thing, we would be happy to lever up. It'd have to be a business that we think is in our wheelhouse, that we think is got a good management team. We tend to leave these things alone, because we're a fairly decentralized organization and we think that's important to be kind of nimble at the point of the customer interaction. So, we really need a good strong management team there. And then last, but not least, we want it to be a business that we think has a lot of growth potential and that we can bring some of our magic to them and get them to become even more profitable than they are.

Zack R. Fadem
Wells Fargo Securities LLC

Q

Okay. Thanks, Bob. Really appreciate the color.

Operator: Our next question comes from line of Ajay Jain with Pivotal Research.

Ajay Jain
Pivotal Research Group LLC

Q

Yeah. Hi. Thanks for taking my question. I wanted to ask about the variability in your segment performance and how that's reflected in your guidance for the year. So, specifically for Customized and Vistar, do you expect the case volume trends from the Q1 and the EBITDA performance from the first quarter, do you expect those to continue or does your guidance assume some recovery? So, if you have any color on the segment, specific outlook, I would appreciate that.

George L. Holm
President, Chief Executive Officer & Director

A

Yeah. Well, Vistar will improve as far as comparisons to the previous year, just because they don't have the big inventory gain numbers that they had last year in the first quarter. There is a little bit of it in Q2, but we're very confident that that business will produce much better earnings growth as we get further into the year. And Customized, we don't have any new business or a new account imminent. So, I think that that business will be dependent on the success of our customers. And we continue to do a good job of reducing expenses in that business, but that business could be fairly flat from an EBITDA standpoint the rest of the year.

Robert Deaton Evans
Chief Financial Officer & Senior Vice President

A

Yeah. Ajay, Customized is a really stable business for us. We do like the business and it's got a very nice return on capital. So, it plays an important part in the portfolio. It's just that it reflects the customer base right now and the customer base is relatively flat from a growth standpoint.

George L. Holm
President, Chief Executive Officer & Director

A

But the earnings should be stable. It's a very well-run business and it produces a good amount of cash.

Ajay Jain
Pivotal Research Group LLC

Q

Okay. That's helpful. So, if we assumed kind of flat volume growth for Customized, I just want to make sure I understand the change in revenue recognition for that specific customer that you called out. So, if it was flat revenue growth, revenues would still be higher until you cycle that accounting change in Q1 of next year? Is that the right way to think about it?

George L. Holm
President, Chief Executive Officer & Director

A

No, we have cycled that accounting change and that was cycled in August. So, when we report Q2 numbers, that won't be something we'll have to talk about anymore.

Ajay Jain
Pivotal Research Group LLC

Q

Okay. And just one – go ahead I'm sorry.

Robert Deaton Evans
Chief Financial Officer & Senior Vice President

A

Yeah. Just to underscore that, all that affected was the top-line sales number. It did not affect cases and it did not materially affect the EBITDA at all.

Ajay Jain
Pivotal Research Group LLC

Q

Okay. And one final question, correct me if I'm wrong, I don't think you're hedged on fuel. But I was just curious if you can comment on how much the benefit from lower fuel prices was in Q1, if you could put a number on that at all?

Robert Deaton Evans
Chief Financial Officer & Senior Vice President

A

Yeah, Ajay, fuel is one thing in the industry that can be kind of unbundled from a pricing standpoint to customers. So, while we did benefit from a gross fuel expense standpoint in the quarter and we're benefiting here in the second quarter so far, some of that we give back in terms of less fuel surcharges to our customers. So, it's not as big a benefit as you might otherwise think. We don't – from a hedge standpoint, what we use are costless collars so that we kind of provide ourselves a little protection on the upside, and then on the downside, if it goes [ph] low (37:58) enough, we actually would have to pay on the collar.

Ajay Jain
Pivotal Research Group LLC

Q

Okay. Thank you very much.

Operator: Our next question comes from the line of Edward Kelly with Credit Suisse.

Edward J. Kelly
Credit Suisse Securities (USA) LLC (Broker)

Q

Hi, guys. Good morning and congratulations on a good quarter out of the box here. Just a few follow-ups, I guess, at this point. On the Vistar side, in terms of the price increases, how consistent historically are the price increases in this business and is there a visibility on when the next one may come?

George L. Holm
President, Chief Executive Officer & Director

A

There used to be, but there hasn't for the last several years. I think that it's more around what their ingredient cost is versus how well they think they can push a price increase through at that time. And I can't say that we have a great understanding for that. We try as best we can to anticipate when those are going to happen. This would more normally be the time of the year that it would happen. It typically happens November or December. So, last year was different. And then sometimes, we'll go a couple of years where there'll really be no increases, kind of at the machine level on the vending side of the business, which is what seems to drive the increases.

Edward J. Kelly
Credit Suisse Securities (USA) LLC (Broker) Q

So, I guess, at this point, you of think about, when you give your outlook, for instance, you don't really anticipate this, and if it happens, it happens, is that the way we should think about it?

George L. Holm
President, Chief Executive Officer & Director A

That's correct. And even in our budgeting process, we never budget for that to happen because it's too unpredictable.

Edward J. Kelly
Credit Suisse Securities (USA) LLC (Broker) Q

Yeah. That makes sense.

George L. Holm
President, Chief Executive Officer & Director A

But what is predictable is that, when it does happen, it will affect us positively on the EBITDA line or the profit line and it will impact us negatively on the revenue line. But it goes away within a couple of months.

Edward J. Kelly
Credit Suisse Securities (USA) LLC (Broker) Q

Okay. And then, George, there has been a lot of talk about deflation accelerating in the second quarter. How should we just think about generally modeling it, though, for Q2? If it's a down a few percentage points or if it's – a few kind of percentage points of negative inflation in Foodservice, there are some offsets, I guess, in the other businesses. I mean, would you expect the overall deflation for the company to be down 1%, 2% or more in Q2?

George L. Holm
President, Chief Executive Officer & Director A

I would say that's probably a good number. It would be more in our foodservice independent business. But overall, because many of our chains lock in their pricing for periods of time to protect their menu price, we don't see any real deflation coming on the Vistar side of our business. So, I would think that that 1% to 2% number is probably a good number.

Edward J. Kelly
Credit Suisse Securities (USA) LLC (Broker) Q

Okay. And then your gross profit per case has been strong. I mean, it's been strong for a while, but even the last two quarters with the lack of any real inflation. But as we progress into the second quarter, we see a bit more deflation, how should we think about the cadence of gross profit growth per case now for Q2 and kind of the rest of the year?

George L. Holm
President, Chief Executive Officer & Director A

We think even in this deflationary environment that we're going – we'll have better gross profit per case. And that's going to be driven by mix of business. And that's what it's been for us for several years in a row actually. The encouraging thing right now is we're starting to see the benefits of our change in mix of business, where before our change in mix of business basically allowed us to have consistent gross margins when the industry margins were declining. We were going through some of the same competitive issues. We were just fortunate enough to have this change in mix that offset it. And so, for us, if we can continue to change our mix of business, which we see ourselves doing and actually can benefit from that in maybe a less competitive environment, it's a real positive for us going forward.

Edward J. Kelly
Credit Suisse Securities (USA) LLC (Broker)
Q

I mean your results this quarter were good, but pulled down, I guess, by this sort of temporary lull in where we are in the inflationary environment. Is there a way to think about what profit growth, even like in a quarter like this, would look like in a more normalized sort of 2% to 3% inflationary environment?

Robert Deaton Evans
Chief Financial Officer & Senior Vice President
A

Yeah. Ed, that is just so difficult, because the pricing dynamics in the market really tend to be focused around kind of the gross profit per case you can get and that's even true on the short-run Street business, which kind of prices on a day-to-day, week-to-week basis. And it's just really hard to be able to project what that would be. So, would it have been better with a little inflation, yeah, we think so. But would it have been substantially worse if deflation have been even stronger in the quarter, kind of hard to say that either. But you use that number of 2% to 3% inflation, and that's kind of the somewhat ideal number for us, particularly in an environment where your costs are going up. If our costs are going up comparable to what inflation is going up and if inflation is low enough to where it's not causing issues for our customers, that seems to be a good period of time.

Edward J. Kelly
Credit Suisse Securities (USA) LLC (Broker)
Q

Okay. Great. Thanks, guys.

Operator: [Operator Instructions] Our next question comes from line of Meredith Adler with Barclays.

Meredith Adler
Barclays Capital, Inc.
Q

Hey. I just have a quick follow-up, I don't know if you mentioned what's your Performance Brand penetration was in this quarter and whether you've seen anything that leads you to believe it can continue to increase?

George L. Holm
President, Chief Executive Officer & Director
A

Well, we've always had a goal of growing our brands in independent a couple points more than we grow our independent cases. We don't sell much of our brands outside of our independent customer base, because in our Performance Foodservice we're mostly a QSR business when you get outside of the independent. And fortunately, we've been closer to [ph] 4% than 2% (44:39), and that's continued into Q2. And that's been another reason for our increase in our gross profit dollars per case, as we're just getting those benefits from the mix change. And Meredith, right now, that's accelerating for us, we're doing better. As to whether we can get that above the 4%, that I don't really know, but if we can stay around that 4% better than our case growth, that's a good number for us.

Meredith Adler
Barclays Capital, Inc.

Q

I'm sorry. You're saying 4% higher than case growth?

George L. Holm
President, Chief Executive Officer & Director

A

That's correct.

Meredith Adler
Barclays Capital, Inc.

Q

Great. Thank you.

Operator: There appear to be no further questions at this time. I would now like to turn the call over to Mike Neese for any additional or closing remarks.

Michael D. Neese
VP-Investor Relations

We would like to thank everyone for their participation on today's call. Have a great day. Thank you.

Operator: Thank you. This concludes today's conference call. You may now disconnect.