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Performance Food Group Co. (PFGC)

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MANAGEMENT DISCUSSION SECTION

Operator: Good day and welcome to the PFG Fiscal Year 2018 Q4 Year End Earnings Conference Call. Today's call is scheduled to last about an 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, sir.

Michael D. Neese

Vice President, Investor Relations, Performance Food Group Co.

Thank you, Crystal, and good morning, everyone. We're here this morning with George Holm, Performance Food Group's CEO; and, Jim Hope, PFG's CFO. We issued a press release regarding our fiscal fourth quarter and full year results this morning. The results discussed in this call will include GAAP and non-GAAP results adjusted for certain items. The reconciliation of these non-GAAP measures to the corresponding GAAP measures can be found at the back of the earnings release.

You can find our earnings release in 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 and our SEC filings for various factors that could cause our actual results to differ materially from forward-looking statements and projections.

Now, I'd like to turn the call over to George.

George L. Holm

President, Chief Executive Officer & Director, Performance Food Group Co.

Thanks, Michael. Good morning, everyone, and thanks for joining our call today. Before I pass the call on to Jim, I'd like to discuss a couple of quick highlights of our full year results. And also, we're going to keep our introductory remarks short so we can get to questions early and have plenty of time to answer all questions.

Our business generated solid net sales growth, over 5%; gross profit increased nearly 8%; and adjusted EBITDA grew over 9% for fiscal year 2018. Our double digit earnings growth and strong cash flow are in line with our expectations. Excluding our close facility in Georgia, net sales would have grown by 6.5%. We are now more than a year past the closing in that facility so those comparisons will now be behind us.

Total case volume grew 3% which included a 6.1% increase in independent cases. Vistar had an exceptional year particularly the back half of fiscal 2018. Just the strategic investments we made two years ago paid dividends in the fourth quarter and we expect them to help fuel future growth. Our return on invested capital improved substantially.

I would like to provide a little bit more detail on Performance Foodservice's fourth quarter results which were below our expectations. Performance Foodservice's fourth quarter EBITDA decreased 5.8%, result of higher than expected operating expenses from higher labor cost and rising fuel prices, most notably in the month of June. We experienced cost increases associated with hiring sales, delivery and warehouse associates. Also, the vast majority of the overall increase in operating expenses are attributed to these short-term costs.

We also continue to invest in our customer facing technology which will further enhance our customer experience. We believe this is the right time to strategically invest in Performance Foodservices for future growth. Nearly two years ago, we made important and strategic investments in Vistar and they are clearly paying dividends.

The labor market may remain challenging for the foreseeable future. However, PFG, we believe we have a good approach to address this area of our business and we move forward. We expect Performance Foodservice to deliver mid-single digit EBITDA growth in fiscal 2019.

I want to thank all of our associates for their hard work and dedication over the past year. I'm proud to be part of such a great company that has so much potential for growth. We continue to be bullish on our growth prospects in the years to come. I'd like to highlight one of our associates. This quarter, we are honoring a dedicated associate who is retiring this year at the age of 76.

[indiscernible] (00:04:16) has served as a highly-skilled meat cutter with the Performance Foodservice Virginia for 16 years. His specialty has been tenderloins and fillets. So, if you've enjoyed a steak from one of our customers along the Atlantic coast in the past decade or so, you might want to thank [indiscernible] (00:04:32) is fluent in three languages and played professional soccer for both the Bosnian and German national teams.

His motto has been strong like a bull and [indiscernible] (00:04:42) embodies commitment and tremendous work ethic that sets a great example for his colleagues and all of us at Performance Food Group. We often say that PFG is a family company. And in [indiscernible] (00:04:54) case, we meant it literally. His wife, [ph] Sidika (00:04:56), is also a meat cutter for the PFG family, and his son-in-law, [ph] Zifo (00:05:02), is a driver. Thank you, [indiscernible] (00:05:03), for your dedication and we wish you the best of luck in your retirement.

I will now turn the call over to Mike who will – over to Jim, I'm sorry, who will discuss our fourth quarter results. Thanks, Jim.

James D. Hope

Chief Financial Officer & Executive Vice President, Performance Food Group Co.

Thank you, George, and good morning, everyone. Let me take you through our fourth quarter financial results to discuss the annual segment results and then provide some detail on CapEx, cash flow and return on invested capital, and I'll wrap up with some detail regarding our fiscal 2019 guidance.

Net sales grew 3.7% percent to \$4.6 billion, driven by growth in Vistar most notably in the theater and retail channels, case growth in Performance Foodservice specifically in the independent restaurant channel and recent acquisitions. The increase in net sales was also attributable to an increase in selling price per case as a result of inflation and mix.

Overall, food cost inflation was approximately 1.7% in the quarter, driven by eggs and seafood, offset by deflation in poultry and produce. Gross profit dollars improved over 6%. Gross profit per case increased \$0.13 while gross margin as a percentage of net sales was up 30 basis points over the prior-year period to 13.3%.

The gross profit increase was fueled by an improved sales mix of customer channels, and products primarily sold in the independent channel. Operating expenses grew 5% in the quarter to \$518 million. The increase in operating expenses was primarily due to acquired case volume, higher fuel prices, and acquisition integration costs within Vistar, as well as additional investments in sales and delivery personnel within PFS.

The vast majority of the \$25-million increase in PFG's operating expenses were driven by investments in sales, delivery and warehouse associates and higher fuel costs. We've taken the opportunity to revamp and recharge our sales training program to fit today's environment, and we're paying special attention to miles per route and opportunities to optimize fleet utilization. We believe the investments we're making will pay off and accelerate our independent case growth.

Operating profit was up 15.2% driven by strong profit increase of 6.4%. Net income for the fourth quarter of fiscal 2018 grew 59.4% year-over-year to \$64.4 million. The growth was primarily a result of an increase in operating profit and a decrease in income tax expense, partially offset by interest and other expenses.

The decrease in income tax expense was primarily a result of the impact of the Tax Cuts and Jobs Act. The effective tax rate in the fourth quarter of fiscal 2018 was 17.9% compared to 39.9% in the fourth quarter of fiscal 2017. The decrease in the tax rate was due to a lower statutory tax rate, the impact of the rate differential for temporary differences, and the excess tax benefits associated with the stock options exercised in the fourth quarter of fiscal 2018.

Adjusted EBITDA grew 3% to \$135.4 million. And as George mentioned earlier, we're investing in our associates and investing for future growth. If you look at our fourth quarter two-year stack, adjusted EBITDA has grown 12.8%.

Diluted EPS grew 56.4% to \$0.61 in the fourth quarter of fiscal 2018 over the prior period. Adjusted diluted EPS increased 10.4% to \$0.53 per share in the fourth quarter over the prior period. The increase in EPS was mainly driven by the \$11.9 million net benefit to income tax expense as a result of the blended statutory rate for fiscal 2018 and the resulting rate differential related to temporary differences.

Let's turn to each of our segments, beginning with Vistar's annual results. Vistar had a robust year with net sales growth of nearly 11%, driven by a broad-based case and sales growth, notably in the segment's theater, vending and retail channels, and as a result of recent acquisitions. The box office continued to outpace expectations and drove our theater business. Vistar's full year EBITDA increased 13.1%, driven by gross profit dollar growth of 18.4%.

These increases were fueled by an increase in the number of cases sold and a favorable change in mix toward higher margin channels. As we mentioned on last quarter's call, we expected to see some good momentum from the integration of CCI's (sic) [CCSI's] acquisition. Our CCI (sic) [CCSI] integration progressed well during the fourth quarter. And beginning in fiscal 2019, we expect solid synergies from the transaction.

Moving to Performance Foodservice, net sales increased 6.2%, driven by an increase in cases sold, including independent case growth and solid independent customer demand for Performance Brands. For fiscal 2018, independent sales as a percentage of total segment sales was up 100 basis points to 45.2%. EBITDA increased 3.3% for the full year.

Turning to Customized, net sales decreased 4.2% for the fiscal year. This decrease was primarily a result of the Georgia facility that was closed in the fourth quarter of fiscal 2017 and the challenging casual dining environment. PFG Customized EBITDA increased 16.6%, driven by strong operating expense control and the favorable impact of closing the Georgia facility, offset by higher transportation costs.

Let's turn to cash flow. PFG generated \$367 million in cash flow from operating activities, an increase of \$165.3 million versus the prior year period. The improvement in cash flow from operating activities was largely driven by

higher operating income, lower taxes paid and improvements in working capital. We also delivered free cash flow of \$226.9 million, an increase of approximately \$165.4 million.

We came in on the high end of our revised range for CapEx and invested \$140.1 million in capital expenditures in line with capital spending versus prior year. Our return on invested capital significantly improved during the year. The increase was driven by strong operating profit, a lower tax rate, and strong cash flow which was used to reduce debt. We're pleased with the progress and will continue to focus our attention on these important metrics.

Also, our net debt-to-adjusted EBITDA is at 2.8 times. We are very comfortable with our leverage and still see many opportunities in our M&A pipeline. For fiscal 2019, we expect adjusted EBITDA growth to be in the range of 7% to 10% over fiscal 2018 adjusted EBITDA of \$426.7 million.

We expect that the 7% to 10% adjusted EBITDA growth for fiscal 2019 will reflect first half growth in the low to mid-single digit range. Second-half adjusted EBITDA growth is expected to be in the high-single to low-double digit range. Fiscal 2019 first half growth is expected to reflect strategic investments in sales, warehouse and delivery associates. We also expect fiscal 2019 adjusted diluted EPS to grow in the range of 10% to 16% to \$1.72 to \$1.82 over fiscal 2018 adjusted EPS of \$1.54.

This outlook is based on the following annual assumptions: organic case growth in the range of 3% to 5%; interest expense in the range of approximately \$60 million to \$70 million; an effective tax rate on operations of approximately 27%, and capital expenditures between \$170 million and \$190 million, with depreciation and amortization between \$145 million to \$155 million.

The fiscal 2019 capital expenditures estimate is higher than fiscal 2018 because of our ongoing investment to drive growth and the timing of certain projects.

And now I'll turn it back to George.

George L. Holm

President, Chief Executive Officer & Director, Performance Food Group Co.

Thanks, Jim. We believe PFG is well positioned for growth over the next several years and we are taking strategic actions in the face of certain short-term headwinds to fuel our performance. We have some near-term OpEx challenges; however, I don't believe they are structural in nature. There is a highly publicized driver shortage in our country. We are working on attracting the right drivers. We have some early successes and plan to continue to be successful.

Higher costs including labor and fuel were a headwind in the quarter. This will continue for the next two quarters, but it is manageable. As we've previously discussed, we fell behind on hiring sales associates in the prior year and the early part of fiscal 2018. As we ramped up our people investment in the fourth quarter, we believe this will help drive our continued market share gains in foodservice in fiscal 2019.

In summary, our associates are determined to provide the best customer experience and we believe we have the right strategies to deliver best-in-class service and sustainable annual growth. We're investing in people and technology and most importantly, investing in our customers so they can compete and grow and we remain committed to the M&A pipeline, potential acquisition opportunities in specialty and Vistar remains strong.

With that, we're here to take your questions. Thank you.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] And our first question comes from the line of John Heinbockel with Guggenheim Securities.

John Heinbockel
Analyst, Guggenheim Securities LLC

Q

So, let me start, George, independent case growth, maybe touch on the cadence as we've kind of moved through the fourth quarter here into the first. And then at what point do you think is the step-up that you've had in hiring here has been pretty substantial? When does that begin to impact independent case growth incrementally? Is it much stronger in the second half than the first half or not?

George L. Holm
President, Chief Executive Officer & Director, Performance Food Group Co.

A

We expect that to be better in the second half than we are in the first half. Let me just give you a quick run through numbers because it's a question that was also discussed on the last call.

So, we were weaker earlier in the fiscal quarter as you go back to May, and we've had a tough fiscal third quarter weather-related, we had an excellent April. And I think with looking back on that, I think part of that was just cabin fever. And there are people that are going to spend a certain amount of money eating out, when they can get out, they get out. And when the weathers are bad, they don't.

We ended up having what we would call somewhat mediocre Mother's Day, and that seems to be a holiday that tends to be a record week every year, but tends to have less impact year to year in the last several years. We finished May out what we would call okay, June was good, and July has been better. Now, we've hired people as part of it. We expect to get a good return from the people. We found more opportunity to get experienced people than we expected and we took advantage of that.

And we would have our issues, needless to say, from an expense standpoint. That would be the one area that was self-inflicted, and we feel confident that we'll be looking back at the end of this fiscal year and saying that that was a good decision.

John Heinbockel
Analyst, Guggenheim Securities LLC

Q

All right. And then maybe for – two things for Jim. Maybe talk about opportunities in the field, right, apart from the strategic investments you're making to be – maybe a little tighter on cost containment broadly, right, and share best practices. And then in your D&A and interest guidance, I assume that the D&A step-up is related to CapEx. The interest is that – because you ought to, I would think, pay down debt this year. Is that – does that reflect a big step-up in the rate on the ABL?

James D. Hope
Chief Financial Officer & Executive Vice President, Performance Food Group Co.

A

Yeah. On the last question, it does not reflect a big step-up at the rate on the ABL [indiscernible] (00:18:45). On the first question on opportunities in improving operating expense. Look, we're a solid food distribution company

and we have many different operating companies. They all come up with great ideas and best practices, and we're constantly talking about how can we cross-pollinate some of those best practices.

We also do some really good work with our operating companies in regards to routing and I mentioned route optimization, it's very important and we know this to pay attention to miles driven. And we have a team that's always looking at how to help and support our operating companies in how they route their trucks.

So, there are opportunities out there. We're optimistic about being able to find them. And at the same time, we know that it's very important to the run the trucks, take care of our business and take care of our customers.

John Heinbockel

Analyst, Guggenheim Securities LLC

Okay. Thank you.

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Operator: Our next question comes from the line of Edward Kelly with Wells Fargo.

Edward J. Kelly

Analyst, Wells Fargo Securities LLC

Hi, guys. Good morning. So, I wanted to ask some questions just about the investments that are taking place now. If we think about the last few quarters, you've been delivering fairly robust gross profit per case growth. Expenses have tracked a bit higher over the last few quarters. And, I think, one of the things, George, that we sort of sensed to me, right, was that you were a bit more excited about the idea that cost per case going forward could begin to improve.

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And, I think, we're all okay with investing for growth. It's just harder to digest when it seems more like a surprise. So, I guess, the question that I have for you is, really, could you just take a step back for us and help us understand what sparked your strategic change around investment? How much of this is really proactive to drive growth versus reactive in a tougher environment? And does any of this at all relate to potential new business that's coming in?

George L. Holm

President, Chief Executive Officer & Director, Performance Food Group Co.

Okay. Those are all good questions, Ed. Like I said, the sales part of it is something that is a decision that we made. We overshot the decision that we made. We found a lot of people available, but I also have to say that that's not the biggest part of the issue that we're dealing with from an expense standpoint.

A

We typically have a flow of people as we go through the year, basically through the – if you want to look at it through the fiscal year, Q1 tends to be our biggest hiring time. Our sales ramp-up at the – towards the later part of the month of August. And we tend to grow our number of people in warehousing and delivery. Up until just before the holidays, it tends to drop off. After the holidays, comes back up again as we get into better weather. And then as the season will change and the business comes maybe a week or two after Mother's Day that we run into a lower volume period of time, and we typically adjust down our number of employees for that period of time.

And what we saw this year was that we had issues getting the right number of people, getting the quality of people that we wanted. We begin to see that as the labor market became more difficult, the temp market became, I like a better way to put it, lower quality, Ed. So, we made the decision not to let our number of people drift down and we probably overshot that as well.

But as we went through the last half of May, and particularly the month of June, we continued to hire to run the service levels that we wanted to run at a time, historically, where our number of employees were dropping. So, you kind of have that geometric progression there, where you've got expenses going up at a time they were going down the previous year, helped our service levels. I think that it will prove to be a good thing for us. But definitely, it was problematic.

As far as business goes, we're trying to be pretty careful about – about talking about certain accounts for long periods of time. But we do have a fairly significant amount of business coming in in the month of September. The days where you could start hiring three or four weeks before that, train the people that are ready to go when the account comes.

That was probably a good route to go from about 2002 until maybe a year and a half ago, but you can't do that today. You have to make sure you have experienced people. Our business is more systems-oriented, so the training, the learning curve is a little bit more. And you can't disappoint and you can't particularly disappoint customers immediately out of the chute when you start supplying them. I don't I think I answered [indiscernible] (00:24:09) but go ahead.

Edward J. Kelly

Analyst, Wells Fargo Securities LLC

Q

I think at least one of your competitors had problems with fill rates this quarter. How were your fill rates relative to your expectation?

George L. Holm

President, Chief Executive Officer & Director, Performance Food Group Co.

A

Well, we didn't really have a big issue with fill rates. We had a few markets that wasn't what we felt it should be. We've had issues with not getting as good a fill rate from the supplier as we've had in the past, and that's caused some fill rate issues. But I couldn't say that that's been a major issue for us. Our – percentage of the cases that we fulfill is still at this high rate as it was a year ago, two years ago.

Edward J. Kelly

Analyst, Wells Fargo Securities LLC

Q

And then just the last thing I wanted to ask you about on this topic is on the driver side. When you talked about the things that you're investing in, the driver portion of it was mentioned the last. Is the size of the cost around the driver side reflective of that? Is that the lowest cost you're experiencing?

And then just generally, what are you seeing in the marketplace and what are you having to do on that front? And should we get a bit more concerned that that's just a multi-year problem that the industry has to deal with and it could potentially weigh on the cost of growth going forward?

George L. Holm

President, Chief Executive Officer & Director, Performance Food Group Co.

A

Well, I think the labor issues that we have today are here to stay, at least in the near-term. I don't see anything that tells me that that is going to lessen. A lot of publicity, a lot of air time around the driver shortage. I would say that the shortage of getting people in my crew is fairly equal, it just isn't to the extent of the expense that a driver is.

We've done a very good job even in this fourth quarter, even within Performance Foodservice of adjusting our margin mix to help us with these expense issues that we've had. And I think we've done enough of the job there that as things settle in even in the current environment, we'll be in a better position.

I mentioned on the last call that fiscal 2019 will be less about margin growth for us, more about case growth and more about better expense ratios. And that's what we see through the year. I don't see the issues that we're dealing with from a warehouse and transportation abating by the end of this quarter, say I think we're going to have this for a while but I think that by the end of the fiscal year we'll be glad that we had spent the money to get people on board and to retain those people.

Edward J. Kelly

Analyst, Wells Fargo Securities LLC

Great. Thank you.

Q

Operator: Our next question comes from the line of Karen Short with Barclays.

Karen Short

Analyst, Barclays Capital, Inc.

I had just two clarifications and then a bigger picture question. So, on July, your comments, George, was that July was better. Can you just clarify though, would that imply north of 6% in terms of independent case growth?

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George L. Holm

President, Chief Executive Officer & Director, Performance Food Group Co.

Yes, it would. And I just want to repeat that that's one month. But we're feeling good and we feel like we'll get a return on the investment that we've made in the salespeople.

A

Karen Short

Analyst, Barclays Capital, Inc.

Okay. And then, another clarification. Just in terms of your guidance for the first half versus the second half, maybe this is just a function of top line, but your – all these new expenses that you've layered on, in my mind, they should cycle in the fourth quarter not by the third quarter. So, I'm just – I'm a little confused as to why these wouldn't be headwinds for the first three quarters as opposed to just the first half. And again, maybe that's a function of sales.

Q

James D. Hope

Chief Financial Officer & Executive Vice President, Performance Food Group Co.

Yeah. Karen, you are correct. Some of it will last a little longer than others. Some of it is transitory; some of it isn't. We know that we can manage down some of these costs as we level-set on the right number of people. But, look, we certainly want to make sure that we staff correctly and we're able to handle our customers.

A

Karen Short

Analyst, Barclays Capital, Inc.

Okay. And then, I guess, just – I guess, bigger picture. Obviously, you gave us very significant details on the cadence throughout the quarter and into July. And we know one of your competitors also experienced a slowdown. So, I guess, the question is you didn't seem to necessarily benefit from their slowdown and, obviously,

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you did see a slowdown in your business. So, is it more of a broad-based issue or is it macro or is it the competitive landscape or is there anything that you could point to?

George L. Holm

President, Chief Executive Officer & Director, Performance Food Group Co.

A

Yeah. I don't see it as a slowdown for the industry. I really, Karen, I don't see it really as a slowdown for us. We had a tough quarter a couple of years ago and I remember we had five issues that we had to deal with and a lot of issues to deal with, and we dealt with them, we made our way through it and came in where we were expected to come in, and actually a little bit better.

We had five issues to deal with. And I think here, really, what we're dealing with is just additional costs that we're experiencing in warehousing and delivery. Like I said, the sales was self-inflicted and we'll be happy we did that. I see this as really not revenue related at all. And I think if our expenses had grown more than our sales and – but not to the extent it did, we probably wouldn't even be talking about it. I don't really see it as a slowdown.

Karen Short

Analyst, Barclays Capital, Inc.

Q

Okay. And then just last question, you said that the M&A pipeline remains fairly robust. I'm just kind of wondering what you're seeing in terms of sellers' expectations on multiples. Just has the multiple expectation been raised just given the multiple that was most recently announced?

George L. Holm

President, Chief Executive Officer & Director, Performance Food Group Co.

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I think it's too soon to tell that. I think that was a unique transaction or potential transaction. And I think there was some big scarcity value there, and it was also large. So, I don't think, for the most part, people in our industry have the expectation level of when it was a fairly unique situation.

But I guess we'll really find out in the next few months. We've been active. We're confident that we'll continue about the pace we've been at as far as adding sales and EBITDA from M&A. But our biggest focus today, as it should be, is on fixing the labor issue and our organic growth.

Karen Short

Analyst, Barclays Capital, Inc.

Q

Thanks.

George L. Holm

President, Chief Executive Officer & Director, Performance Food Group Co.

A

Thanks, Karen.

Operator: Our next question comes from the line of Vincent Sinisi with Morgan Stanley.

Vincent J. Sinisi

Analyst, Morgan Stanley & Co. LLC

Q

Hey. Awesome. Good morning, guys. Thanks for taking my question. So, just once again, just on the expenses. So, it seems like the buckets basically were the op expenses, the fuel and the labor. Just to make sure, labor,

obviously, we're doing the most discussion on. Versus a quarter or two ago, is it fair to say that maybe, versus your estimations then, that is the biggest divergence?

And then, George, I know you said you kind of had some trouble finding the right talent at least earlier on. Has that been improving? Maybe any color on kind of where those folks may be coming from. That'd be great.

George L. Holm

President, Chief Executive Officer & Director, Performance Food Group Co.

A

Yeah, I'm not so sure I can give you great color on where the folks are coming from. I would say, with the labor issues, it appears as if they were sudden and just quick. And I'm not so sure that that's how things happen. And I think that when you first run into these type of issues that you have a certain tolerance for maybe less performance to the customer and maybe not the service levels you want to have, as opposed to a tolerance for any significant increase there would be in expense.

And as you go through this for a period of time, then you just realize that you've got to provide the level of the service that the customers expect and that you want to grow. And we've had a track record where we've had compounded EBITDA growth of 9.9% for 10 years. And the last two years have been 9.2%. We've always been mostly organic and 9.2%, probably not a lot to apologize for. If we can continue that that's a very good thing. If we don't make the moves that we need to make to be capable of continuing to put out those kinds of results, that is a very bad thing. And we needed to get our service levels where they were at. I think the biggest impact we had was taking this trough of labor expense that we typically experience through the year and leveling that off.

And like I said, it's kind of a geometric progression. You got something going up that normally goes down. So, it doesn't have to go up much for it to look like it went up a whole lot. And we'll work through our – we'll work through that period of time. Like I said, we have business coming on. And we'll see what the impact is then. But we are going to provide our customers with the level of service that they expect.

Vincent J. Sinisi

Analyst, Morgan Stanley & Co. LLC

Q

Okay. And then, maybe just as a quick follow-up, just by customer type. I know you said kind of better July performance, but don't read a month into it. I get that, of course. But just kind of longer term, maybe not even just quarter-specific, but do you still feel, I guess, first on the independent side that that kind of targeted 6% to 10% range, you feel good about that longer term?

And then maybe just quickly on the casual dining. I know last quarter you said there was some improvement. It didn't sound like in the release at least that that continued this quarter. So, any thoughts there would be great. Thanks a lot.

George L. Holm

President, Chief Executive Officer & Director, Performance Food Group Co.

A

Yeah. Let me go through each one of those. First of all, from a mix standpoint, obviously we want to continue to grow our independent business at a faster rate. We've done really well there but we've had to really push hard and that's the way the business is. And I think that by getting more people on board, stepping up the training that Jim mentioned, the mix of business will continue to help us. That is still the driver of our margin growth in our gross profit per case growth.

One of the reasons that I've discussed on the last call and brought up again, that will be a bit more about expense management, ratio management. Part of that is because we probably won't get quite as much benefit from mix because we do have business coming in that is good business for us, well-thought out. I have spent a great deal of time with the customer that will help the bottom line of this company but will not be a contributor to increased mix.

Then as far as casual dining, you're probably right. It probably doesn't read that way. The numbers don't read that way that there would be improvement, but there is improvement. If you take our business for the quarter, once again, you back up the closed down facility which we won't have to do any longer, and then we had a bankruptcy that goes back to last January with Ignite. And if you factor out their business, we're actually running some low single digit growth. So, we see that as something that is better for us today. We had a fairly good Customized June. We certainly don't expect big earnings increases from that area but we don't see it as the kind of anchor that it has been for quite a while.

And then in our – yeah, and our Vistar business as well, Vinnie, we continue to see the change in mix of business. Our older higher penetrated lower margin channels are not growing as fast as some of our newer channels that command a higher margin – a higher expense ratio as well but higher margins.

Vincent J. Sinisi

Analyst, Morgan Stanley & Co. LLC

Great. Thanks, George. Good luck, guys.

Operator: Our next question comes from the line of Judah Frommer with Credit Suisse.

Judah C. Frommer

Analyst, Credit Suisse Securities (USA) LLC

Hi, guys. Thanks for taking the question. Maybe first, we're coming up on a year post Investor Day or Analyst Day. And I mean, it sounds like any delta between kind of the multiyear targets and what's going on currently versus next year is really operating expense. Can you just kind of confirm that, is that the only thing that's really changed in your mind? I mean, the top line guide for next year seems healthy. So, I think it would help to have confirmation that the industry backdrop from a sales perspective is fine.

George L. Holm

President, Chief Executive Officer & Director, Performance Food Group Co.

I agree with that. This is isolated to our operational expenses.

Judah C. Frommer

Analyst, Credit Suisse Securities (USA) LLC

Okay.

George L. Holm

President, Chief Executive Officer & Director, Performance Food Group Co.

And by the way, not isolated to just Performance Foodservice, we're experiencing that in Customized as well. We've done the same thing there. We've added people to bolster our service levels. The only difference is that the company has performed so well on the top line that you can overcome a lot with that kind of top line performance.

Judah C. Frommer

Analyst, Credit Suisse Securities (USA) LLC

Q

That makes sense. And can you help us for next year with kind of puts and takes for a high and low end of the EBITDA guide? At the high end, you'll hit that multiyear target at 10%, but what should we be thinking about? Are sales the biggest question mark in your mind, or are expense the biggest question mark between the 7% versus 10% growth?

George L. Holm

President, Chief Executive Officer & Director, Performance Food Group Co.

A

No. Sorry about that. Other than some unforeseen loss of a customer, I kind of look at sales as the least of our problem. Would you agree with that, Jim?

James D. Hope

Chief Financial Officer & Executive Vice President, Performance Food Group Co.

A

Absolutely. Strong sales.

George L. Holm

President, Chief Executive Officer & Director, Performance Food Group Co.

A

Yeah. I think every company goes through ebbs and flows and somewhat easier times and somewhat more difficult times. We don't see our OpEx as something that's going to correct itself overnight. That's for sure. I don't know that I'd see it lasting until the fourth quarter, but I'm optimistic.

But what we do have here is something that's very identifiable. We know what the issue is. We've made moves that we hope will correct it. But it's not structural, and it certainly isn't sales, and it certainly isn't margins. And I've got a long history in this business and sales have always been hard to come by and margins have always been hard to come by and expense ratios were almost taken for granted.

James D. Hope

Chief Financial Officer & Executive Vice President, Performance Food Group Co.

A

Yeah. I would reiterate what George said. We have very strong sales and we feel confident in our ability to continue to develop sales. And we've invested heavily in what it takes to deliver sales growth. We have shown a track record of being able to manage margins and effectively manage pricing to the point that we take care of our customers and yet deliver the margin growth we need.

Operating expenses, we clearly have an opportunity there to work and we have a plan. And we're working on it and we want to manage operating expenses closely to make sure it's managed as an investment, not so much as an issue, but an investment from a position of strength so that we support the rest of the P&L as well as our customers. So, I feel good about where we're going to head and, I believe, we need to work through it across the next six months and we will.

Vincent J. Sinisi

Analyst, Morgan Stanley & Co. LLC

Q

Okay. And if I could sneak one more in. I mean, clearly, a lot of focus on PFS and Customized. But you had a great year in Vistar, which you mentioned. How should we think about lapping this great Vistar year next year?

George L. Holm

President, Chief Executive Officer & Director, Performance Food Group Co.

A

We didn't recognize much of the synergies from the CCSI acquisition until we got to the latter half of Q3 and into Q4. So we have a pretty good runway with that. Sales continue to be strong and we're seeing that in the month of July. I would characterize Vistar if you think about how I look at PFS today that it's going to be more around case growth, less around margin growth but better expense growth or less expense growth.

In Vistar, we're going to lap the sales from CCSI, so we're not going to be running as robust sales growth as we have been running, although our sales growth has been good without CCSI. We're also going to lap the expenses that we incurred from all of the movement of product around distribution centers in CCSI and you'll see better expense ratios develop in Vistar than we had in the previous fiscal year.

So, all in all, I would say still what we consider to be good sales growth. Not quite the margin growth that we've had in the past year, say, but better expense ratio of growth as we get further into the year.

Vincent J. Sinisi

Analyst, Morgan Stanley & Co. LLC

Q

Okay. Great. Thanks.

George L. Holm

President, Chief Executive Officer & Director, Performance Food Group Co.

A

Better expense ratio control as we get further into the year. Thanks.

Operator: Our next question comes from the line of Andrew Wolf with Loop Capital Markets.

Andrew Wolf

Analyst, Loop Capital Markets LLC

Q

Hi. Good morning. So, just on the competition side, I just want to be clear because Sysco really ramped up, and they're the sector leader. It sounds like you're saying that is not causing you either a material sales or gross margin kind of response or issue. I just want to get a definitive sense for that.

George L. Holm

President, Chief Executive Officer & Director, Performance Food Group Co.

A

No, in the past we've always been a big competitor that typically grows. Presently, they are, and I believe they will be in the [audio gap] (00:43:53), so not a lot of change in there. But I don't think that affects our world very dramatically.

Andrew Wolf

Analyst, Loop Capital Markets LLC

Q

Great. And then on your labor issues, I also want to clarify for myself. Just sort of in absolute dollars, is it more the pressure on the warehouse side? The variance versus your expectations because you already mentioned the sales side. Is that more of the warehouse side, and how you had to manage around quality of labor and so on, or is it more on the trucking side or anecdotally I'm hearing about some big signing bonuses at competitors and stuff like that?

James D. Hope

Chief Financial Officer & Executive Vice President, Performance Food Group Co.

A

Yeah. Andy, I'd tell you, if I were to rank them, I'd go sales investment first and delivery and warehouse close second and third. I don't know there was so much about quality of worker. We are really pleased with the delivery team and the warehouse team we have. We have strong folks, well-trained, executing. We just wanted to invest in more.

It was about bringing on more, getting them trained, and getting them ramped up. And we believe we did it. I told you we invested a little heavier on the sales side but – probably heavier than we thought we would. But sometimes that actually pays out well as the dust settles. But I think that's how I'd look at it in that order.

Andrew Wolf

Analyst, Loop Capital Markets LLC

Q

Okay. And just one big picture, you all have a lot of experience over – a lot of cycles. I mean, we've had low employment – unemployment rates before, but I don't think we have seen kind of this wage cost ramp at least in the industry. My question there or to this extent or this [ph] pass (00:45:40), but can this be – can wage inflation be passed through in the industry's pricing? Have you seen that before? And if so, what kind of lag is there when that happens?

James D. Hope

Chief Financial Officer & Executive Vice President, Performance Food Group Co.

A

Yeah. Well, look, the market sets prices to some degree. We look at our costs on two types of business, you have contract customers, you have independent customers and we're paying close attention to what is the right price for both of those. And we want to make sure we're in market. And, I guess, the answer to your question would be, yes, it can be passed through as we pass through carefully and fairly. And I would stand on our results of strong sales growth and strong margin management.

Andrew Wolf

Analyst, Loop Capital Markets LLC

Q

Okay. Thank you.

Operator: Our next question comes from the line of Karen Holthouse with Goldman Sachs.

Karen Holthouse

Analyst, Goldman Sachs & Co. LLC

Q

Hi. Thanks for taking the question. So, was actually focusing [ph] lot on (00:46:41) operating costs. Could you give us an idea of what sort of inflation expectations you have next year? And then, it looks like there is a decent mix headwind just looking at sort of case growth and inflation growth versus revenue growth this quarter, how to think about what drove that and maybe sort of those dynamics next year as well.

James D. Hope

Chief Financial Officer & Executive Vice President, Performance Food Group Co.

A

Yeah. Well, I'll take the first one. On inflation, I don't have a crystal ball and you're probably expecting me to say that. But based on what I've been seeing and in the 1% to 2% to 2.5% range in the past, I have no reason to believe that randomness of mix will make it fall out between 1% and 2% again. And for the ongoing near future, probably the rest of the year, that can change. There's a lot of things that can have an impact on inflation.

As our mix of products and what we're working on, we believe we have room to penetrate in just about every product category. We're doing some exciting things on the protein side and we're working very hard there. We have a very skilled protein team. And I think I'll leave my comment at that. There's room for us to grow multiple product categories. And from a product mix shift, difficult to predict, but it typically and will most likely lead to good, solid margins. From a customer channel mix, we continue to invest in salespeople, which drives independent case growth. And as we've always said, we'll stay true to independent sales growth remains very important to us.

Karen Holthouse

Analyst, Goldman Sachs & Co. LLC

And then also trying to understand the pickup in D&A this year, which – CapEx was a little bit higher in fiscal 2018, but still seems like a pretty big jump. How should we sort of break that down into what D&A tied to equipment versus is there any amortization that's more related to the M&A or the M&A pipeline there?

James D. Hope

Chief Financial Officer & Executive Vice President, Performance Food Group Co.

I don't believe there's a significant amount of depreciation and amortization related to the M&A pipeline. I don't have those numbers in front of me right now, but I would think current trends would hold.

Karen Holthouse

Analyst, Goldman Sachs & Co. LLC

Okay. Thank you.

Operator: Our next question comes from the line of Kelly Bania with BMO Capital.

Kelly Ann Bania

Analyst, BMO Capital Markets (United States)

Hi. Good morning. Just a couple more questions on expenses. So, it sounded like sales was the main area of investment; and then delivery and warehouse, number two. But can you just clarify, are you making investments in the same number of personnel there, and it's just the cost of that is higher or are you actually increasing the head count in those areas?

And then, two, I guess not much quantification yet of the fuel expense and where that came relative to your expectations for the fourth quarter and what you're planning for in fiscal 2019 on that front as well.

James D. Hope

Chief Financial Officer & Executive Vice President, Performance Food Group Co.

Yeah. So, on the first one, look, we invested in more salespeople, and I think we've managed that well, and we built a training program, we ramped up our training program. And as we've been saying, we actually put more people onto the street selling.

In regards to fuel cost, hey, the fuel cost went up, and everyone in the industry saw it. Diesel prices accelerated. But we like many companies worked very hard on appropriately hedging fuel cost, and for the last several years, we've managed a fuel hedging strategy. I think we've executed well on the strategy, and it balances the trade-off

to an accelerating cost then locking at a higher price in an unforeseen declining market. So, we don't get upside down on a hedge that doesn't work.

In our contract business, we have fuel escalation clauses. We do have a fuel surcharge. We have [ph] cost of scholars (00:50:49). And in the end, our fuel expense was up 25% to 30%, but that was buffered a bit from where it could have been.

George L. Holm

President, Chief Executive Officer & Director, Performance Food Group Co.

A

Kelly, this is George. Let me make a few comments on those costs with the new people. First of all, sales would be the most expensive. And the big cost in sales is the short-term cost from the standpoint that that was in really one part of our country. You're not going to get immediate productivity from those people and they come with a one year no compete, and it is expensive. And it's worthwhile but very expensive. So, it doesn't take as many people in the sales area to provide the type of cost and that's why Jim gave you that as the number one cost.

Then, if you actually turn to people, we've been hiring more excess warehouse people than drivers, but there's also a big difference between the two there. A driver is much more expensive to hire, higher compensated people. The learning curve is greater. The systems are more complex and you're not going to get a payback on that person for a period of time. When you get to a night crew, it's the one area where we are used to high turnover. The learning curve is very short. People can be productive within a matter of days. So that would be the lower cost of those three, but it would actually be the most number of just sheer people.

Kelly Ann Bania

Analyst, BMO Capital Markets (United States)

Q

Okay. That's helpful. And I guess, maybe can you help us understand what you're expecting in your guidance for fuel expense in 2019?

James D. Hope

Chief Financial Officer & Executive Vice President, Performance Food Group Co.

A

Yeah. Basing it off of what we've seen this year, I would expect fuel to continue to be high. I don't have any reason to believe it will be – go down, and I'll leave it at that.

Kelly Ann Bania

Analyst, BMO Capital Markets (United States)

Q

Okay. And then just one more for me. So, I think, George, you made the comment that fiscal 2019 less about margin growth. And I just wanted to clarify if you're talking about gross margins because the gross margins have been strong for a couple of years now. Should we expect that a little bit more of that is going to be reinvested, and do you think some of that needs to be reinvested to maybe drive a little bit stronger growth? And then I guess I have one more. Within your guidance for fiscal 2019, what kind of case growth with independents is in your plan? Thank you.

George L. Holm

President, Chief Executive Officer & Director, Performance Food Group Co.

A

Okay. As far as when I mentioned margins that's always gross margin. When I mentioned that if it would be EBITDA margins I would say EBITDA margin, so that is definitely gross margin. Like I say, year-to-year for us our margins are more about our change in mix of business than they are, I guess, I would say just sheer price

increases. We're certainly getting some increases due to the labor issues that people are aware of and, of course, many customers are aware of as well.

Then as far as guidance around independent growth, no different than it's ever been really. We have that goal of staying above 6%. I can't remember when you guys probably know how many years in a row we've done that, I can't even remember now. Over seven? Yeah. So, that's our goal. We want to continue to do that. We do recognize that will take more people and we've made the investment that we needed to make to get that done.

Kelly Ann Bania

Analyst, BMO Capital Markets (United States)

Okay. Thank you.

Q

Operator: Our next question comes from the line of Chris Mandeville with Jefferies.

Christopher Mandeville

Analyst, Jefferies LLC

Hey. Good morning. Jim, I'm just trying to square some comments that were made with respect to the cadence on the year. So, investment clearly in the first half of the year; is the acceleration in EBITDA for the back half purely is the function of moderating operating expense dollar growth or are you expecting, I don't know, some element of acceleration on gross profit dollars as it was alluded to that you're picking up some incremental business?

Q

James D. Hope

Chief Financial Officer & Executive Vice President, Performance Food Group Co.

Yeah. It's simply the OpEx will begin to abate in the second half of the year. The part that is affixed will soften.

A

Christopher Mandeville

Analyst, Jefferies LLC

Okay. And then, on the CapEx and D&A step-up, what projects are the predominant drivers to that increase? And then, just thinking about the out-years, is 1% of sales now kind of the new norm on CapEx then going forward or is 2019 an exception?

Q

James D. Hope

Chief Financial Officer & Executive Vice President, Performance Food Group Co.

Yeah. The type of projects are building expansions and fleet maintenance and equipment. I think in that 1% to 1.1% range of sales is probably the right way to think about CapEx.

A

Christopher Mandeville

Analyst, Jefferies LLC

Okay. And the last one for me just on the quarter itself for Vistar specifically, the 6 basis points or so of margin expansion, a bit surprised by the moderation relative to what we saw in Q3. And, I think, George even referenced that you're starting to begin realizing synergies from your prior acquisition. So, did I hear that correctly? And if I did, what was weighing on profitability when you had that kind of start? Are there like further robust sales growth in the quarter?

Q

George L. Holm

President, Chief Executive Officer & Director, Performance Food Group Co.

A

You're talking about specifically within Vistar?

Christopher Mandeville

Analyst, Jefferies LLC

Correct.

George L. Holm

President, Chief Executive Officer & Director, Performance Food Group Co.

Okay. Yeah, we were operating seven of these CCSI distribution centers and a corporate office for CCSI through most of fiscal 2018. And the – by the end of the first half of fiscal 2019, all of those would have been closed. The corporate headquarters was closed at the end of this fiscal year. So, we just had expenses that are dropping off as we realize the synergies in CCSI. So, that's one of the reasons I said as we go into 2019 that expense ratio is going to be a big part of our story for Vistar.

Christopher Mandeville

Analyst, Jefferies LLC

Okay. Thanks, guys.

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

Ajay Jain

Analyst, Pivotal Research Group LLC

Yeah. Hi. Good morning. I wanted to ask you a question about bad debt expense. It sounded like you've cycled a customer bankruptcy earlier in the year, but is there anything of significance that you're seeing with bad debt expense right now and based on the latest quarter?

James D. Hope

Chief Financial Officer & Executive Vice President, Performance Food Group Co.

No, you are correct. We cycled a Chapter 11, yeah, bad debt expense, but we don't see anything going forward that's any different than what we've experienced in the past. The climate is good and productive for us.

Ajay Jain

Analyst, Pivotal Research Group LLC

Okay. And I know you talked extensively about the investments and staffing. But, George, you mentioned that in some cases you overshot, and I wasn't sure if that might be that you're now overstaffed in certain areas.

And in follow up to an earlier question, I was also curious how much of the increase in head count was a net increase in marketing associates, which would have been on top of replacement and may have left the business due to attrition? So, can you give any color on the labor impact and how much of that is incremental in terms of the latest quarter and based on year-over-year comparisons?

George L. Holm

President, Chief Executive Officer & Director, Performance Food Group Co.

Sure. When I say overshot, we just found more opportunity than we expected to as far as available people in the industry, and particularly experienced available people. And when those opportunities are available for the most part, you need to take advantage of that.

So we ended up with a higher percentage increase in sales people at the end of our fiscal year than we've experienced here actually. And we'll see that win as we get further into the year and as we get these people productive. It should produce good benefits. I'm not sure I got the other part of that question.

Ajay Jain

Analyst, Pivotal Research Group LLC

Yeah. I guess more specifically, I was wondering if you can give a breakdown of how many marketing associates you might have had at year-end and how that compares year-over-year and sequentially from Q3?

James D. Hope

Chief Financial Officer & Executive Vice President, Performance Food Group Co.

Yeah. We don't provide that kind of information. I'm sure you can understand. Marketing associate is very important to us and we'll work the details of that information getting out. But we feel pleased about how we've hired and the kind of people we've hired and their future and we're optimistic about the results they can deliver.

George L. Holm

President, Chief Executive Officer & Director, Performance Food Group Co.

I think just – Jim's comment that the hiring of sales people was the biggest increase that we had in the OpEx, I think that tells you probably a lot right there.

Ajay Jain

Analyst, Pivotal Research Group LLC

Okay. I just wanted to ask you finally as you're heading into fiscal 2019, it doesn't seem like the recent labor issues were necessarily a function of the competitive environment. It seems like it was mostly based on company specific factors. But do you feel like the strategic investments are an ongoing process, or is the ramp up in hiring pretty much behind you at this point?

James D. Hope

Chief Financial Officer & Executive Vice President, Performance Food Group Co.

I believe the ramp up in hiring is behind us. We're at a level we can manage now. And I think we'll maintain the right level. We'll see a little a little decrease and we'll become much more efficient as well while we're at it.

George L. Holm

President, Chief Executive Officer & Director, Performance Food Group Co.

And the other important part of that equation is when you're running that type of increase and people in both delivery and warehouse. The big key is to get them to your company's typical productivity levels. And that's when you get your pay back. And we're not sitting at that point today. So that's probably the unspoken part of the biggest challenge that we have is that we also need to get these people to the level of productivity that we've become accustomed to.

Ajay Jain

Analyst, Pivotal Research Group LLC

Great. Thank you very much.

Operator: At this time, there are no further questions. Are there closing remarks?

George L. Holm

President, Chief Executive Officer & Director, Performance Food Group Co.

Great. Everybody, thank you so much for your time and thanks for the questions.

Operator: This concludes today's conference call. You may now disconnect, and have a wonderful day.

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