VIAVID communications simplified.

Sportsman's Warehouse Holdings, Inc.

Fourth Quarter 2016 Earnings Conference Call

March 23, 2017

CORPORATE PARTICIPANTS

Rachel Schacter, *Investor Relations, ICR, Inc.*

John Schaefer, *President, Chief Executive Officer and Director*

Kevan Talbot, *Chief Financial Officer and Secretary*

CONFERENCE CALL PARTICIPANTS

Seth Sigman, *Credit Suisse*

Peter Benedict, *Robert W. Baird*

Daniel Hofkin, *William Blair & Company*

Stephen Tanal, *Goldman Sachs*

Peter Keith, *Piper Jaffray*

PRESENTATION

Operator:

Greetings and welcome to the Sportsman's Warehouse Fourth Quarter 2016 Earnings Conference Call. At this time all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. If anyone should require operator assistance during the conference, please press star, zero on your telephone keypad. As a reminder this conference is being recorded.

I would now like to turn the conference over to your host, Rachel Schacter of ICR. Please go ahead.

Rachel Schacter:

Thank you. Good afternoon, everyone. With me on the call is John Schaefer, Chief Executive Officer; and Kevan Talbot, Chief Financial Officer.

Before we get started, I would like to remind you of the Company's Safe Harbor language. The statements we make today will contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, which include statements regarding our expectations about our future results of operations, demand for our products and growth of our industry. Actual future results may differ materially from those suggested in such statements due to a number of risks and uncertainties, including those described in the Company's 10-K for the year ending January 28, 2017 which we expect to be filed in the next few days.

We will also disclose non-GAAP financial measures during today's call. Definitions of such non-GAAP measures as well as reconciliations to the most directly GAAP financial measures are provided as supplemental financial information in our press release, included as Exhibit 99.1 to the Form 8-K we furnished to the SEC today, which is also available on the Investor Relations section of our website at investors.sportsmanswarehouse.com.

Now, I would like to turn the call over to John Schaefer, Chief Executive Officer of Sportsman's Warehouse.

John Schaefer:

Thank you, Rachel. Good afternoon everyone and thank you for joining us today. I will begin by reviewing the highlights of our fourth quarter and full year performance and then discuss our progress on our strategic initiatives and thoughts on the coming fiscal year. Kevan will then go over our financial results in more detail and review our outlook, after which we will open up the call to your questions.

Looking at our fourth quarter financial performance, net sales grew 6.2% to $221.4 million and same-store sales decreased 5.2% while EPS was $0.25, $0.02 below our expectations, mostly due to weaker than expected top line as a result of slower firearm demand post-election combined with anniversarying difficult compares in December and January due to the San Bernardino tragedy and executive orders in the prior year. Despite the challenging overall retail environment, there were some bright spots in the fourth quarter which I will discuss in more detail shortly.

For the full-year net sales increased 10.4% to $780.0 million; same-store sales decreased 0.7%; adjusted net income increased 13.4%; and adjusted EPS increased 13.1% to $0.69.

I'd like to briefly review a few accomplishments for the year.

Number one, we continue to set ourselves apart from the competition and outperform our peers through our best-in-class customer service, breadth of product, unique localization strategy, low-cost business model with high returns and disciplined execution, as demonstrated by our relative pure (phon) performance.

Number two, despite the promotional retail environment, we were able to maintain our everyday value pricing and disciplined promotional calendar resulting in flat gross margins for the year.

Third, we managed expenses well this year in a challenging operating environment, as evidenced by relatively flat adjusted SG&A as a percent of sales despite a 0.7% same-store sales decline in fiscal 2016. We continue to operate as efficiently as possible on a day-to-day basis while investing in a disciplined manner in our infrastructure and personnel to support our planned growth.

Fourth, we are pleased with our inventory position and the composition of our inventory. As of the end of fiscal year 2016, our inventory per store was down 3.5% year-over-year driven by our disciplined purchasing process which quickly adjusted for changes in customer behavior during the year, as well as our expectation of increased opportunistic buying opportunities in fiscal year 2017.

And fifth, we delivered on our plan to open 11 stores in fiscal year 2016 or 17% store growth and those stores are on plan to deliver our target 20% ROIC.

Looking more closely at our results for the fourth quarter, net sales increased 6.2% to $221.4 million. Same-store sales decreased 5.2% versus the prior year reflecting a combination of the following factors.

The most recent adjusted NICS data shows that firearm demand has slowed since the election. For the fourth quarter, our hunting and shooting department which includes firearms and ammunition, as well as related gear and equipment was responsible for 4.5 points of our 5.2 point comp decline in Q4 due to the difficult comparison in the prior year given San Bernardino and the executive orders in December and January.

This performance also illustrates the relative strength in our non-hunting category. Despite the year-over-year decline in hunting and shooting it is important to note that the underlying demand in this department remains strong when compared to historical levels. While the adjusted NICS background checks decreased 17.8% year-over-year for the three-month period since the election, the total firearms sold during this period of time represents the third highest total for this period of time since the inception of NICS in November 1998 behind only 2015 and 2013 which are two time periods that had unusually high event-driven demand.

As evidenced in these numbers, participation rates in outdoor shooting sports continue to rise as more people including an increasing number of women and children become involved in the hunting and shooting sports industry. In addition, while our store areas and many areas of the country rely on sales of firearms driven by protection purposes, our areas especially in the rural markets have a significant portion of sales in the use category which have been historically more stable and consistent over time. This is evidenced by our non-MSR rifle and shotgun unit sales in Q4 being up 22.3% versus the prior year indicating that the desire to participate in hunting and outdoor shooting continues to grow.

As we have discussed previously, the negative effect from new competition generally impacts same-store sales in a particular market until approximately the 18 month mark at which point the impact begins to lessen. Therefore, we continue to analyze our store base in three cohorts, one of which is new store competition.

During the fourth quarter, the negative impact from competition in newly competitive markets was 120 basis points. For fiscal year 2017, we expect only two stores to be impacted by new competition which is down from five stores in fiscal year 2016. Therefore, we expect the competitive impact to our comp to begin to diminish to approximately 100 basis points for fiscal year 2017, down from the 170 basis points impact that we absorbed in fiscal year 2016.

The impact to comp from our seven oil and gas stores in the fourth quarter was 60 basis points. This represents a 20 basis points sequential improvement from the third quarter. We will continue to monitor these stores but expect the impact to remain the same for the first half of fiscal year 2017 before showing improvement in the back half of the year as we anniversary easier comparisons.

Turning to our category sales performance for the quarter. Despite the recent slowdown in firearms demand that I just discussed, we continue to believe we are the best positioned retailer in our niche to continue to capture market share in the category given our breadth of brand name products and everyday low pricing in this category combined with the consolidating competitive environment. Also, our higher mix of use versus protection purchases skews toward the historical 5% to 8% annual growth that we have previously maintained and we believe allows for a more stable firearms business over time.

Our clothing and footwear business, which represents roughly 15% of our sales mix, remain positive in the fourth quarter on a same-store basis with gains of 0.4% and 1.8%, respectively. From a same-store sales composition standpoint, customer conversion and average order size continue to increase in the fourth quarter as has been the case over the past few quarters.

Now on to profitability. Gross margin decreased 40 basis points for the quarter from the same period of the prior year mainly due to increased promotional activity that began earlier in the season and in which we felt it necessary to participate at a somewhat higher level than previous years. We held or increased individual product gross margin in four of our six departments as compared to the fourth quarter of the prior year.

We feel it is especially noteworthy that we did not have to resort to substantial discounting compared to others in the industry this quarter, given the promotional environment we witnessed in our space which included firearms promotions by some of our competitors for the first time. This outcome again illustrates the appeal of our everyday low pricing model and the trust we have earned with customers as a result of our localized offering in combination with our reliable and consistent pricing.

While on the topic of gross margins, we continue to be pleased with our private label performance that represented 3.7% of our net sales as of the end of the fourth quarter. While still a soft small segment of our business, during the quarter, we increased our private label penetration by 19.1% from the fourth quarter last year. Our private label product not only offers our customers better quality at better price points but also carries a higher gross margin.

Operating income for the quarter was $21.1 million compared to $22.1 million in the prior-year period. Net income was $10.5 million or $0.25 per diluted share compared to net income of $11.4 million or $0.27 per diluted share in the prior-year period.

With the consolidating competitive landscape, we believe our results relative to our peers demonstrate that our customer base enjoys shopping in our stores. We offer a differentiated shopping environment, convenience as a neighborhood store in larger markets, or big-box appeal in smaller markets where we provide a greater assortment than the mom-and-pop competition.

We also continue to believe that we have an advantage versus online only options as our customer prefers to touch and feel the product before purchasing given the nature of our offering. As we've noted before, approximately 33% of our revenue has some sort of online restriction so our customer must buy these products in-store.

Also, our pricing is similar to and in many cases better than the pricing offered by other online players. Given all this, we continue to believe we are well-positioned to build on our market share gains.

Turning to our strategic initiatives; we continue to make progress across our key growth strategies in 2016. Let me briefly outline what our priorities were heading into fiscal year 2016, discuss our progress on each, as well as share how we are approaching fiscal year 2017.

First, in fiscal year 2016, we capitalized on the significant whitespace opportunity that we saw in existing and new markets and delivered on our stated strategy of unit growth rate of greater than 10%. We achieved our store growth goal by the third quarter of fiscal year 2016 with 11 store openings, representing 17.2% unit growth or square footage growth of just over 328,000 square feet or an increase of 11.6%.

For fiscal year 2017, we continue to see significant whitespace opportunity for our stores and have announced 12 planned store openings or square footage growth of approximately 350,000 square feet or an increase of approximately 11%. Two of these 12 stores opened during the first quarter.

Given our introduction of the smaller format stores, going forward, we are going to begin talking about our growth in terms of square footage, as opposed to unit growth. Our square footage growth target for fiscal year 2017 and beyond is 10% annual growth.

Our second priority for this year was to maximize the potential of our loyalty program. As of the end of the year, we had over 1.2 million members, an increase of greater than 42% over the prior-year period and the transactions from our loyalty members continue to grow representing more than 43% of our net sales in the fourth quarter. In fiscal year 2017, our plan is to continue to develop more personalized and effective marketing strategies to this important segment of our customer base.

Our third focus for fiscal year 2016 was to continue to enhance our e-commerce platform and increase our digital presence through continued investments. E-commerce still represents a small percentage of revenue for us; however it grew from $7.7 million in fiscal year 2015 to $9.3 million in fiscal year 2016, an increase of 20.5%.

Additionally, traffic to our website increased this year and we had 17 million visitors as customers enjoyed using our site for product research and pricing information, as well as completing transactions. Our recently added 5500 gun assortment online has been driving some of this traffic and also driving in-store sales within the firearm category, as customers ultimately have to complete the purchase process in-store.

Approximately 30% of our guns sold online and picked up in-store are special make-ups which expands our already substantial firearm offering even more and provides our customer with one of the largest online selections available. For fiscal year 2017, we will continue to make investments to our site that improve the search function and the overall customer online experience.

Another priority for fiscal year 2016 was continuing to invest in our store teams and associate training to maintain our high quality customer service for our loyal customers. We filled most of our new store manager positions by promoting from within in fiscal year 2016 and this ensures that we are providing top-quality, knowledgeable customer service in our new store locations given the store managers' previous in-store experience. In fiscal year 2017, we'll remain focused on this initiative as we know this is a unique competitive advantage that sets us apart.

Lastly, we are continuing to enhance our Executive Leadership Team. We're excited to have announced today that Jon Barker has been appointed as President and Chief Operating Officer. He will direct the marketing, the supply chain, operations, compliance and technology functions, as well as our e-commerce business, while store growth and operations, merchandising and business development will continue to report directly to me. Jon joins us with 25-plus years multichannel retail experience, most recently as VP Global Officer for Walmart.

At Walmart, he served in dual roles including President and CEO of Hayneedle.com, a leading online home furnishings retailer, as well as group leader for home and outdoor furnishings categories for US e-commerce across Walmart.com, Jet.com and Hayneedle.com. Prior to Walmart, he spent nine years as SVP of Distribution-Logistics at Cornerstone Brands. I've known Jon for almost 20 years and not only is he an excellent retail executive, he is also a passionate user of our products. His appointment as President and Chief Operating Officer will become effective March 31, 2017.

So overall, despite a softer Q4 than we had planned, we are pleased with our financial and operational results for 2016 as we continue to navigate a choppy macro backdrop in a challenging competitive landscape—and a changing competitive landscape. Importantly, we opened 11 stores, delivered steady product margins, managed costs well while investing in the business and made continued progress against each of our strategic priorities.

As we look toward 2017, we are taking a conservative approach when planning the first half of the year until we anniversary the unfortunate events that took place in Orlando in June 2016 that caused a spike in our firearm and ammunition categories. Therefore, we expect year-over-year trends in the second half of 2017 to show improvement relative to year-on-year performance trends in the first half of the year.

In addition, we expect 56 of our stores will be impacted by minimum wage increases in fiscal year 2017 that will drive up our SG&A cost for the year. We are planning accordingly and have every expectation of maintaining our superior customer service while also controlling our labor costs.

Before I end, I want to thank all of our team members for their hard work and passion that keeps our loyal customers coming back to Sportsman's Warehouse. We look forward to building on our progress and further strengthening our market position in 2017.

With that, I'll turn the call over to Kevan to discuss our financials.

Kevan Talbot:

Thanks John. Good afternoon, everyone.

I'll begin my remarks with a review of our fourth quarter and full year results and then discuss our outlook for fiscal year 2017. My comments today will focus on adjusted results. We have provided these results, as well as an explanation of each line item and reconciliation to GAAP net income and earnings per share in our earnings press release which was issued earlier today.

Net sales for the quarter increased 6.2% to $221.4 million from $208.5 million in the fourth quarter of last year with a same-store sales decrease of 5.2% due to slower postelection firearm demand combined with difficult comparisons in December and January as a result of the San Bernardino tragedy and presidential orders issued in the prior year.

We completed our planned 11 annual store openings or 11.6% square footage growth by the third quarter of this fiscal year. So we did not open any new stores in the fourth quarter.

Turning to our same-store sales by each of our three store groupings, which are: one, base stores; two, new stores or acquired stores that have been in the comp base for two years or less; and three, stores that were subject to competitive openings which we define as a new competitive entrant into a market within the past 18 months.

In the fourth quarter excluding the seven stores in our comp base that were subject to new competitive openings, our same-store sales decreased 4% compared to the fourth quarter of last year. Our 41 base stores saw same-store sales decreases of 5.1% in the fourth quarter. In addition, our 16 new stores saw a same-store sales increase of 0.5% in the fourth quarter compared to the corresponding period of the prior year.

Finally, our seven stores that were subject to new competitive openings experienced a same-store sales decrease of 12.6%. As John mentioned, we anticipate the 170 basis point impact from new competition in fiscal year 2016 to lessen to approximately 100 basis points in fiscal year 2017 given we anticipate only two stores to be impacted by new competition which is down from five stores in 2016.

Gross profit increased 4.9% in the quarter to $74.3 million compared to $70.8 million in the fourth quarter of fiscal year 2015. During the fourth quarter of fiscal year 2016, gross profit as a percentage of net sales decreased 40 basis points to 33.6% from 34% in the prior-year period as a result of increased promotional activity this year given the highly promotional backdrop.

SG&A expenses were $53.2 million compared to $48.7 million in the fourth quarter of last year as we continue to invest in previously mentioned personnel and resources to allow for continued growth in 2017 and beyond. As a percentage of net sales, SG&A expenses in the quarter increased approximately 60 basis points to 24% from 23.4%, as we deleverage fixed expenses on negative same-store sales.

Income from operations for the quarter was $21.1 million as compared to $22.1 million in the fourth quarter of fiscal year 2015. Our net interest expense in the fourth quarter of 2016 decreased to $3.3 million compared to $3.6 million of interest expense in the fourth quarter of 2015.

We recorded income tax expense of $7.3 million for the 13 weeks ended January 28, 2017 compared to $7.1 million in the corresponding period of fiscal year 2015. Net income for the quarter was $10.5 million or $0.25 per share based on a diluted weighted average share count of 42.6 million shares, as compared to $11.4 million or $0.27 per share based on a diluted weighted average share count of 42.4 million shares last year. Adjusted EBITDA for the fourth quarter increased to $26.4 million compared to $26.2 million in the prior-year period.

Looking at our fiscal year 2016 results, we grew our store base by 17% with the opening of 11 new stores and increased net sales by 10.4% to $780 million from $706.8 million in fiscal year 2015. These 11 new stores represent square footage growth of approximately 328,000 square feet or 11.6%. Same-store sales for the year decreased by 0.7% over the prior year.

Adjusted net income from operations increased 8.6% to $60.8 million as compared to $56 million in fiscal year 2015. Interest expense decreased 5.3% to $13.4 million in fiscal year 2016 from $14.2 million in the prior-year period. This decrease was a result of the previously announced $20 million of borrowings under our line of credit that we used to pay down our term loan in the first quarter of fiscal year 2016 and demonstrates our continued commitment to reducing the cost of our debt.

Adjusted net income in fiscal year 2016 increased 13.4% to $29.2 million compared to adjusted net income of $25.8 million in fiscal year 2015. Adjusted diluted earnings per share in fiscal year 2016 increased 13.1% to $0.69 based on 42.5 million diluted weighted average shares outstanding compared to adjusted diluted earnings per share of $0.61 in fiscal year 2015 based on 42.3 million adjusted diluted weighted average shares outstanding.

Overall, we are pleased to have delivered an 8.6% increase in adjusted operating profit and a 13.1% increase in adjusted earnings per share for the full year despite our same-store sales decline. For the full year, 2016 Adjusted EBITDA increased 12.6% to $82.3 million compared to $73 million in fiscal year 2015.

As of January 28, 2017, the end of our fiscal year, ending inventory was $246.3 million as compared to $217.8 million as of the end of fiscal year 2015. On a per store basis, inventory decreased by 3.5%. We are pleased with the quality of our inventory position as we begin fiscal year 2017.

During fiscal year 2016, we improved our compliance with our debt covenants on our term loan. Our debt to Adjusted EBITDA leverage ratio was less than 2.4 times as of the end of fiscal year 2016 which is a full turn of debt below our covenant. In addition, we also increased our interest coverage ratio year-over-year and were almost two times our covenant as of year-end.

Our liquidity remains strong as we ended the year with $61 million in outstanding borrowings on our $135 million credit facility. We also have access to a $15 million accordion feature on this facility that we expect to exercise this summer which will bring the size of our line of credit to $150 million. This increase will improve our liquidity as we build our inventory to meet our seasonal needs, as well as continue to execute our store growth plans. During fiscal year 2016, we incurred approximately $39.4 million in capital expenditures.

Turning to our outlook. As we look towards fiscal year 2017, we have considered the following items in our guidance. We expect the first half of the year to perform below the prior-year period as we face tough comparisons created by the previously mentioned events, as well as the unfortunate events that took place in Orlando in June and the build-up to last year's Presidential election.

As mentioned, we expect the impact from the new competitive stores to our same-store sales to be approximately 100 basis points for the full year. We expect modest improvement in the headwinds faced by our stores in the oil and gas markets in the second half of the year.

We anticipate a $1.5 million to $2 million impact to SG&A for the year as a result of state minimum wage increases that will impact 56 of our stores, the majority of which were effective January 1, 2017.

Also, as a reminder, fiscal year 2017 is a 53 week year. We estimate that the extra week will add $10 million to $12 million in revenue which will result in adding approximately a penny in additional earnings per share for the year.

Taking these factors into account, our outlook for the first quarter is as follows: revenue in the range of $150 million to $155 million; a same-store sales decline in the range of down 9% to down 11% compared to the first quarter of last year; and diluted loss per share of $0.06 to $0.08 on a weighted average of approximately 42.6 million estimated common shares outstanding.

Turning to our full-year outlook. With today's announcement of the final two stores in our 2017 class of stores, we are planning on opening 12 store locations with approximately 350,000 square feet in 2017 or an increase of approximately 11% over the prior year. Two of these stores have already opened in Cedar City, Utah, and Moses Lake, Washington. We expect revenue of $825 million to $845 million which includes $10 million to $12 million of revenue from the 53rd week.

On a 52 week basis, we expect a same-store sales decline in the range of down 4% to down 6% compared to fiscal year 2016. Our fiscal year 2017 expectations for earnings per diluted share are $0.60 to $0.68 on a weighted average of approximately 42.8 million estimated common shares outstanding. Our earnings per share guidance includes approximately one penny from the 53rd week in fiscal year 2017.

As it relates to capital expenditures, we anticipate incurring approximately $35 million to $40 million in capital expenditures in fiscal year 2017 which includes the 12 stores in our 2017 class of stores, as well as work on our 2018 class of stores that will begin at the end of this fiscal year.

With that, I will now turn the call back over to the Operator to open up the call to questions.

Operator:

Thank you. We will now be conducting a question-and-answer session. If you'd like to ask a question, please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your handset before pressing the star keys.

Our first question comes from Seth Sigman with Credit Suisse. Please proceed.

Seth Sigman:

Thanks and good afternoon. Obviously there has been a lot of volatility in this industry in the past, I guess we don't know if this time is going to be different or not but can you give us a sense of some of the steps that you may be taking internally to navigate this period whether that's expanding into new categories to diversify the mix, and really leverage some of those local advantages that you have or—I mean is there an opportunity maybe to take some cost out of the business to help navigate this period. Any sense of some of those steps you may be taking that that could help here. Thank you.

John Schaefer:

Well, Seth, I think we're obviously very cognizant of SG&A as we have been since we became a public company and well before that. So we as always we're watching payroll very closely. I think we're very good at managing payroll on a day-to-day and a week-to-week basis and that obviously will continue. There are certain programs that we are going to increase because they were very effective last year while there are other programs that we're probably going to decrease a little bit.

In terms of category expansion, we've been working for the past couple of years obviously on private label, which we're spending a lot of time and effort to continue to grow, and we've been spending a lot of time in the camping area, which we think is a big winner for us not only from a product innovation standpoint which unfortunately there hasn't been a lot, but I think there's still a lot of room for product innovation in camping, and from an attractive avenue for non-traditional customers if you will or millennials to really visit our store and look at our product offering.

We had 17 million visitors to our store and a lot of them are looking at the offering of guns online and a lot of them are looking at product reviews and a lot of them are looking at just information we have online and all these things I think will ultimately benefit us with more people coming into the store.

I think the fact that we're in the use category really is going to help us maintain that historical level of 5% to 8% growth in firearms. And frankly, Seth, I got to tell you from a long-term perspective not having a lot of these events blips really helps us as a company because we are more focused on the use firearms and hunting in the outdoor shooting sports, and while these blips are nice short-term benefits, it's really that solid base of customers that buy firearms for use that really is our bread and butter. And I think the more we go through this year the more that will become evident.

Seth Sigman:

Okay, that's helpful. And then I guess the other key change has been the competitive landscape quite a bit of disruption currently with Gander filing recently. I know you don't have direct overlap with them but is that—and the other disruption in the industry, does that create strategic opportunities maybe to expand into new markets that you've been less penetrated in? Does it create other benefits maybe working closer with certain vendors or getting access to products you haven't had historically? Clearly it helps solidify your position in the business and just trying to understand where that takes you. Thanks.

John Schaefer:

I think it's all of the above, Seth. I mean let's talk about the 162 stores—I think they closed four or five already—so around 157 stores that may or may not close depending on what happens in the filing. But one would certainly anticipate that there'll be store closings in the Midwest and while we've always said that we believe we have a 300 store opportunity, we've always said we're probably never going to go with the Northeast and the Midwest is probably one of the last places we'll go.

I think that's a huge opportunity for us. If you look at the Midwest you'll see that Cabela's and Bass are already in the major markets of Minneapolis and Milwaukee and Chicago and Indianapolis and Cleveland and Columbus and Pittsburgh. But there are an awful lot of small communities that you know you can only do $5 million or $8 million and that's our bread and butter.

There are places like Wausau, Wisconsin with 50,000 people that has access to the entire Northern Wisconsin area that has a Gander there and if should that go away that's just one example of a huge opportunity for us.

So I think there's a whole lot of whitespace opportunity for us. As you said we only compete against them in three markets so if they in fact have to liquidate a substantial portion of their inventory, that's really not going to affect us in any way. I think also, if it's a liquidation, the people that drive—that go to the website now can go to our website and will probably come more to our website.

And then lastly, you mentioned vendors, that's a whole lot of product being sold that's probably not going to be sold anymore. So I think there is going to be some significant opportunistic buying opportunities for us as we go through the year not only just on standard product but probably on special make-ups as well.

So I think the consolidation of the industry, not just from the mom-and-pop area but from some of the big boxes with Bass and Cabela's getting together now, Gander in a filing, really gives us a whole lot of runway and a whole lot of multiple areas in which we can grow. Our challenge is to grow effectively and cost effectively and in a steady pace such that we maintain our discipline and we maintain our customer service and that's kind of what we intend to do.

Seth Sigman:

Okay. Thanks for the color and good luck.

Operator:

Thank you. Our next question comes from Peter Benedict with Robert Baird. Please proceed.

Peter Benedict:

Hi guys. Just question on two things. First on the first half, John, you said you're taking a conservative stance there, I mean you clearly have a good feel for the first quarter but compares get tougher in the second quarter. I mean are you envisioning kind of that first quarter trend to get even worse in the second quarter and then start to get better? Just trying to understand how we should be thinking about you using the term conservative for the first half. That's my first question.

Kevan Talbot:

To answer your question there, Peter, yes, it is going to be a difficult comparison for us both in the first quarter, as well as in the second quarter. As we look to the back half of the year, obviously those comparisons get a little bit easier but it's a new firearm demand environment for us given the results of the Presidential election.

So we are continuing to monitor the demand situation and we'll look at things as we go forward, but that's how we see the year as we look at the events of the second quarter of last year and then looking beyond into the back half of the year.

Peter Benedict:

Okay, that's fair. And then how do you think with the cap ex flexibility I mean if the second half doesn't get much better—some of the cap ex this year is for stores for '18, but at what point, John, do you have to make a decision and say, "Hey, we need to maybe throw some of the store growth." What are the trigger points that you're going to be watching in order to make a decision like that?

Kevan Talbot:

Well there is a lot of factors—I know you directed that question to John but I'm going to jump in here. there is a lot of factors that we're looking into as far as store growth goes. Obviously rising interest rates will have an impact there, how close we are to our projections and how the cash flow ultimately ends up. As we've indicated, we've taken a very conservative approach. We think that we'll still be able to continue to carry out our 10% square footage growth increase into 2018 but given our relatively inexpensive model, our lead times as far as for our stores if we're remodeling an existing store can be as short as four months.

So we have a little bit of time still to make these decisions, we're evaluating that as we look at our 2018 growth plans, and certainly to the extent—the results don't deliver if that is indeed the case, we certainly can pull back on those growth plans which would lower the cap ex numbers for this year.

Peter Benedict:

Okay, that's helpful Kevan. Then…

John Schaefer:

Keep in mind…

Peter Benedict:

Sorry John, go ahead.

John Schaefer:

Just keep in mind that our strategy has always been to open stores with free cash flow and have enough money to pay down debt and we've been able to do that in a relatively positive manner over the last few years. And we are well-positioned regarding our debt covenants with our loan base.

So we have never taken the approach where we're going to grow and use a significant portion of debt to finance that growth. If we have a downturn and we have to use a portion of debt to finance that growth, we still have plenty of flexibility moving forward and plenty of cushion in our cash flow model and that gives me some real comfort that 2017 is pretty solid and we'll look at 2018 as we go through the year in 2017.

Peter Benedict:

Okay, that's fair, John. And just last question maybe, Kevan. You gave us a little color on the SG&A view for this year. How are you thinking about gross margin? I mean obviously hunting and shooting category have generally lower margin, so is that playing a role? You probably mix it up a bit there but when you think about consolidated gross margin for 2017, how are we thinking about that view on a year-over-year basis? Thank you.

Kevan Talbot:

A couple of factors that are playing into our guidance here. As you alluded to, it's the lower margins, firearms and ammunition categories softened a little bit. That does have a little bit of a tailwind from a margin perspective. However, as we've seen in past years and as we saw in the fourth quarter and John alluded to in his remarks, we do anticipate that there will be a little bit more of a higher promotional environment that is going to put downward pressure on the gross margin.

So as we look to the full year, we are expecting our gross margins to decline slightly, not significant because we do have some tailwinds as well, but overall we think that the promotional activity will continue throughout the year and ultimately that will have the negative impact year-over-year on our gross margin.

Peter Benedict:

Okay, fair enough. Thanks. Good luck guys. Thank you.

Operator:

Our next question comes from Daniel Hofkin with William Blair & Company. Please proceed.

Daniel Hofkin:

Good afternoon guys. A couple of questions. Just back following up on the guidance, negative 9% to 11% in the first quarter for the comp. It sounds like the second quarter especially with the Orlando events spilling over to June and July last year but that isn't going to be much better, it might be similarly negative, which implies to get to negative 4% to 6% for the year that you're talking about just barely down on balance for the second half.

I'm just wondering can you help us—give us some comfort that that's—or how you get to that level of improvement in the second half and whether—what gives you confidence that that's still conservative for the second half? That's my first question.

Kevan Talbot:

Part of it has to do with the fact that the seasonal nature of the business, roughly 60% to 65% of our business is in the last half of the year, so the back half of the year carries more weight than the first half of the year. So that's part of it. Obviously as we look at the fourth quarter and the results that we just delivered here, we're anticipating a much easier comparison as we go into the fourth quarter which is the largest quarter of the year.

In addition, we've got additional 11 new stores coming on board as we've historically seen and as our results have shown here, those new stores as they come on board, they outperform our base stores and they help bring that same-store sales up for the year. So all of those factors there help us feel comfortable that the annual guidance number from a same-store sales perspective is achievable.

Daniel Hofkin:

Achievable but maybe not as conservative as your first half or first quarter guidance?

John Schaefer:

I don't know that we've changed—I mean our outlook has always been conservative for the year. How it breaks out quarter-to-quarter is really a factor of what was going on in each of those quarters individually and as you get to the back half of the year other than that little run up to the Presidential election which then dropped right off the cliff in the fourth quarter. The second half of the year didn't really have any events that really were impactful. It had some conservatism, there was some hesitation as you'll recall during the preholiday period. All those things present a relatively easier compare in the second half of the year. So we still look at it conservatively and I still think that that's our opinion as we sit here today.

Daniel Hofkin:

Okay. And then just touching on the store model and obviously it sounds like 2016 class continued to perform well. You've talked about the new stores doing kind of low double-digit, EBITDA margins four-wall and 20% plus ROIs pre-tax. How does this new operating environment—assuming this is the new normal and next year maybe we're growing a little bit off of it—but how does this new environment affect those metrics for margin and ROIs here at the store level?

John Schaefer:

They don't. I mean we look at a new—if we went into a market two years ago and thought it was a $10 million market, we'd put a store there. If we go into a market this year now and we don't think it's a $10 million market in these environmental conditions, we're not going there. If it's a 50,000 square feet store and we don't think there's going to be $5 million in that market, we don't go there.

I mean keep in mind we have hundreds of locations to choose from and we literally have a list of locations that our real estate folks are looking at constantly and it's in the—it's 80 or 90 stores that we're looking at and we're picking 12. So we look at today's environment, we look at the impact of what's going on today and then we look at that market in relation to what's going on today.

So while there is—if you look at 90 stores two years ago or in 2013 there were probably 50 that were slam dunks, maybe those 90 stores today only represent 30 that are slam dunks but we're only doing 12. So I don't think—I mean our metrics do not change. If they don't get double-digit four-wall EBITDA and 20% ROIs in year one, we don't go there.

Daniel Hofkin:

Okay, that's helpful. Thanks, best of luck.

Operator:

Thank you. Our next question comes from Stephen Tanal with Goldman Sachs. Please proceed.

Stephen Tanal:

Hi guys, thanks for taking my question. So just—I'm still struggling though with this 1Q guide, right. The hunting and shooting category compared it doesn't look particularly tough and the NICS data that came out in February is down less than what we just saw yet the comp guidance obviously is assuming things get worse. How would you sort of color that to help me think about that?

John Schaefer:

Well if I'm not mistaking, the February NICS data was down 12%. So I would have to say it is in line with the NICS data that we have seen. So we're sitting seven weeks into our quarter so we're—and we're halfway through. So I mean I don't know what else to add to that, but that's what we're seeing.

Stephen Tanal:

Got it, okay. I'm looking ex-permits and I think ex-permits you averaged out to something down 8-ish or so in 4Q and down 7% in February. But anyway, I guess without the permit—fair enough. So that helps. I think in the past periods that were a little bit challenging, you were able to sort of talk to the mom-and-pops and what was going on there. I think clearly there's a bit of a inventory build and you made some comments there. But if you could just share anything with respect to kind of your local competition, your through competitive set, how are they faring and how do you see that shaking out as you get through this year?

Kevan Talbot:

We're planning for it to be consistent with what we've seen in the past and you've indicated that in run-ups the mom-and-pops have build up their inventory and then have—it's created a more of a promotional environment which is what we've anticipated for 2017.

As John's indicated, our inventory levels are below last year on a per store basis. We feel like that that provides us flexibility to take advantage of some opportunistic buys and that will allow us to compete better in this promotional environment.

So that's how we're looking at these things, but yes it's no different. We've heard the same things and it happens every time if there's a run-up the mom-and-pops stock up on inventory and that creates a little bit of over inventory that creates a more promotional environment.

Stephen Tanal:

Got it. But no real signs of stress in that cohort that you could tell, share loss, that kind of thing or?

Kevan Talbot:

Nothing we've seen yet. We'll continue to monitor that as we go through this year.

Stephen Tanal:

Got it. And just lastly I wonder if you wouldn't sort of venture a guess on Gander here. Obviously the stalking horse bid deadline was today for that bankruptcy process. Not too many strategics out there that would seem to participate and I think a pretty big inventory number there and some chatter that maybe

Hilco is interested. Any sense or do you think this goes dark? I mean this is the third time they have filed now. Any view that you might care to share?

John Schaefer:

Steve, being from the Midwest I love Gander. I'm sorry to see that it's entered Chapter 11 once again, but frankly I've been in like one store in the last three years so I don't know that—I know what their struggles are or what their inventory looks like on an individual store-by-store basis. So I look at it from a more macro standpoint that the Midwest is now a big opportunity for us.

Stephen Tanal:

Fair enough. All right, thanks a lot guys.

Operator:

Thank you. Our next question comes from Peter Keith with Piper Jaffray. Please proceed.

Peter Keith:

Hi, good afternoon. Thanks for taking my question. First off, I just wanted to think about the results that you reported the last two quarters relative to the NICS data and I guess what's kind of an interesting coincidence if we look at Q3 I think you said your states on a NICS basis were up 17 and you comped positive two, and then (inaudible) your NICS data was down 17 and you're comping down five. My direct question would be, why is it when the NICS data seems pretty strong, yet your comps increased at a lower rate than when the reverse happens and the NICS data declining?

Kevan Talbot:

I think as you look at the NICS data and you analyze the data, particularly the last two quarters, you've got to take into account the State of California. California had some change with respect to their firearms laws and there was some MSR only, some tactical only gun shops in California that with those changes in firearms laws within that state basically had to liquidate their inventory.

And so if you break out the State of California I think you will see a much closer comparison with our results versus the states that we're in obviously because we're not a tactical only shop. We do sell hunting and other use products. John referenced one of those statistics. We saw great results in those categories in the fourth quarter. It's the personal protection that was up significantly in the prior year so the use categories performed very well for us in the fourth quarter. So I'm not looking at the same numbers that you're looking at; I would speculate that it's the State of California.

Peter Keith:

Okay. Thanks Kevan. And then, Kevan, maybe another direct question for you just in regard to the covenants. So you had mentioned your debt to EBITDA ratio right now at about 3.5, you're a full turn above the covenant ratio. I'm just looking at the filings and looked like your covenant ratio does step down by a full turn over the next 12 months and you're guiding for lower EBITDA. Do you guys get pretty close to that covenant level 12 months from now, and if so, are you thinking about that in terms of your capital allocation?

Kevan Talbot:

Just a couple of quick points of clarification. Our covenant currently is 3.5 on the leverage ratio, our actual results are less than 2.4. Our covenant does step down by the end of next year but it steps down to—I believe it's 2.85, going off top of my head. As we have modeled and projected we've done some various scenario analysis that we believe that we still have plenty of cushion based upon these results and it would have to decline—the mark would have to decline fairly significantly over where we're currently projecting which as we've indicated we feel is very conservative and we would still be in compliance.

Peter Keith:

Okay. Thank you very much guys. Good luck.

Kevan Talbot:

Thank you.

Operator:

There are no further questions. I would like to turn the floor back over to Management for closing comments.

John Schaefer:

Thanks everyone for joining us today and have a great rest of your week. Thank you very much.

Operator:

This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.