

HF Foods Group 3Q23 Earnings Call

Anna Kate Heller, ICR

Hello, everyone.

Good afternoon and welcome to HF Foods Group's third quarter 2023 earnings conference call. Joining me on today's call are Peter Zhang, HF Foods' Chief Executive Officer, Felix Lin, the Company's Chief Operating Officer, and Carlos Rodriguez, Chief Financial Officer. In a moment, we'll hear their prepared remarks.

By now, everyone should have access to the earnings release for the period ended September 30, 2023 that went out Thursday, November 9 at approximately 4:15 PM Eastern time. The press release is accessible on the Company's website at investors.hffoodsgroup.com.

Before we begin, let me remind everyone that today's discussion contains forward-looking statements based on the environment as the company currently sees it, and as such, does include risks and uncertainties. If you refer to HF Foods' earnings release, as well as the Company's most recent SEC filings, you will see a discussion of factors that could cause the Company's actual results to differ materially as a result of these forward-looking statements. Please remember the Company undertakes no obligation to update or revise these forward-looking statements in the future.

In these remarks, the Company will make a number of references to non-GAAP financial measures. We believe that these measures provide investors with useful perspective on the underlying growth trends of the business and have included in the earnings release a full reconciliation of non-GAAP financial measures to the most comparable GAAP measures.

Now, I will turn the call over to Peter.

Peter Zhang, CEO

Hello, everyone. I am excited to be speaking to you on our first HF Foods Group earnings call. I will start by providing an overview of HF Foods' business model. Then Felix will talk to you about our competitive advantages and our transformational plan, and Carlos will review our third quarter financial results and discuss key opportunities for growth.

HF Foods was founded in 1997, and the company merged with B&R Global in 2019 to form a leading national player in the Asian foodservice distribution market. Our mission is to help local and regional Asian business owners fulfill their dreams by partnering with domestic and international suppliers, to bring the most variety, high-quality selection of Asian ingredients, that creates a one-stop shop for our customer's needs.

With a history of strategic acquisitions, today we are a leading food distributor for Asian restaurants in the country with a widespread distribution network that covers 95% of the United States. 98% of our customers are independent restaurants, and our unique competitive advantage in this niche sector is our ability to foster deep, long-term relationships with our diversified customer and supplier base.

Our diverse management team and workforce relates to the Asian community and has the unique ability to understand their languages and defined cultural needs. This allows us to provide a selection and offer solutions that are fitted to each customer.

Now over to you, Felix.

Felix Lin, COO

Thanks, Peter.

I will first spend a few minutes on the Asian restaurant market and our competitive advantages, and then will share some details of our operational transformation plan.

HF Foods' offering is critical and highly difficult for a competitor to replicate at scale. In the U.S. today, there are about 94 thousand Asian restaurants. These are largely small, mom and pop businesses, and our customers rely on our large scale and distribution capabilities to provide affordable, consistently high quality food. Our offerings include products from all key categories including frozen seafood, Asian specialty, meat & poultry, fresh produce, packaging, and commodity. Asian specialty includes, for example, specialty Asian noodles, vegetables, and spices, and commodity includes products like rice, rice flour, cooking oil, and sugar. Each individual category makes up between 6% and 31% of net revenue, so we are well-diversified in our product offerings. In addition to the cultural understanding and ease of communication that we offer to restaurant owners, our infrastructure is deeply established and uniquely able to serve them. We are a true "one stop shop" and have region-specific brands and operations,

supported by our extensive distribution network and multi-lingual sales force. The Asian foodservice market is projected to grow over the next five years, and I am confident that we are well positioned to capitalize on this growth in the near and long term.

Regarding our competitors – the Asian foodservice distribution industry is made up of fragmented, regional players. HF Foods is one of the only service providers in the industry with national reach, and we offer a complete package that our competitors cannot. Our deep cultural connection makes our customers sticky and ingrains HF Foods in local communities. Small, regional players lack the national reach, extensive product offering, and strong supplier relationships that we have. Our focus on independent Asian restaurants who are frequently underserved by other large food distributors and our strong, tenured relationships with customers nationally allow for an effective word-of-mouth referral system and offers an integrated value proposition. The fact that 98% of our customers are independent restaurants presents a promising opportunity for us on the margin side, as independent restaurants offer a pathway to achieving significantly higher profitability when compared to large chains.

Another lever is our strategy of engaging in spot transactions. By conducting transactions at the current market rate, we position ourselves to capitalize on immediate opportunities, respond swiftly to market dynamics, and effectively manage risk associated with price fluctuations to maintain a competitive edge.

Before I get into the details of our transformation plan, I want to highlight a few key accomplishments of our transformation plan in 2023.

First, note that historically, most of our procurement activities have been conducted at the local distribution center level, independent of aggregated purchase volume. However, we successfully piloted a centralized purchasing program for our seafood acquisitions in order to fully harness our collective purchasing power, a standard practice throughout the industry. We have already seen significant margin gains on certain SKUs as a result. We also made the decision to divest our poultry processing businesses, which we completed this year, as part of our commitment to refocusing on our core business and exiting low-margin businesses.

We have spent a lot of time over the last year meticulously analyzing the ways we can improve every aspect of our operations, and I am excited to discuss with you today the details of our operational transformation plan that we will continue to update you on in the coming quarters.

To achieve our growth targets and ensure our business is primed for success, we've developed a comprehensive operational transformation plan that we have already begun implementing. Our transformation program is focused on 4 key areas:

1. Centralized purchasing,
2. Fleet and Transportation,
3. Digital Transformation, and
4. Facility Upgrades.

All of these key focus areas will have significant growth or cost reduction impact to our business for years to come.

Starting with centralized purchasing, we are formalizing national category purchases, welcoming new vendors into our ecosystem. This will allow us to maximize purchasing synergies from the acquisitions we have made. We aim to deliver savings primarily in key categories such as seafood, meat and poultry and fresh produce, a testament to our commitment to financial prudence and value maximization.

We are also making substantial improvements to our transportation system, as we are establishing a national fleet maintenance program. We're defining and finalizing new truck specifications and initiating a replacement program for 50% of our existing fleet over the next several years, and we're implementing a national fuel savings program to maximize efficiency in 2024. Our current inbound logistics operations is highly fragmented and we are working to consolidate our domestic inbound freight management by partnering with strategic, integrated third-party providers. This initiative aims to establish a unified approach, further optimizing and fortifying our supply chain and total cost structure.

As for digital transformation, we are piloting and implementing a modern ERP solution across all of our sites to complement our recent go-live with Workday, which Carlos will

discuss in more detail. These upgrades will enhance our operational efficiency and responsiveness, setting the stage for streamlined processes and greater data driven decision-making.

Finally, we've recently kicked off a network and facility study to optimize our distribution network, with the goal of reorganizing and upgrading our facilities and distribution centers. We are working to streamline costs more efficiently, and to capitalize on cross-selling opportunities. We are converting our distribution centers to maximize usage most efficiently, and to allow them to serve as full broadline facilities that supply the products that are strongest in demand in the area. For example, some customers are primarily seafood-only customers because the distribution center in their area does not provide an opportunity for them to purchase Asian specialty items from us, and vice versa. With these changes, they will be able to buy both. These improvements will help us to optimize operations as well as increase wallet share with existing customers through cross-selling as well as more easily serve new customers. This will also provide the opportunity to expand our presence geographically, in order to capitalize on the significant white space for growth.

These initiatives collectively form the roadmap of our transformation plan, which we are fully committed to executing diligently, setting the stage for sustainable long term growth and delivering value to shareholders.

Carlos?

Carlos Rodriguez, CFO

Thanks, Felix.

Before I discuss our third quarter results, I'd like to emphasize some key achievements in 2023. In addition to clearing our various compliance hurdles, we've professionalized our workforce, gone live with Workday financials and human capital management applications, and enhanced our finance team's capabilities while streamlining our financial reporting and accounting systems. With these accomplishments, we now have the corporate infrastructure in place to set the stage for efficiencies and success.

I'll now talk about our results for our third quarter ended September 30th, 2023, versus the same period in 2022, and then I will talk about additional opportunities for growth.

Net revenue for the third quarter decreased 6.4% to \$281.5 million, from \$300.7 million in the prior year quarter. The decrease in net revenue was primarily attributable to declines in the Meat and Poultry and Seafood product categories, driven by deflationary pricing of poultry and shrimp.

Gross profit decreased by 1.1% to \$50.9 million for the quarter, compared to \$51.5 million in the prior year quarter. Gross profit margins increased approximately 100 basis points to 18.1%. Gross profit margin expansion was primarily the result of a mix shift of higher gross margin shrimp and other frozen food sales that were realized in part by our pilot centralized purchasing program in addition to the impact of exiting HF Foods Industrial, or HFFI, one of our lower margin poultry processing businesses, partially offset by the deflationary pressure in Meat and Poultry, which dropped from the height of 2022. During 2022, we benefited from the significant inflation experienced in poultry pricing, which created a tough year-over-year compare.

Distribution, selling, and administrative expenses decreased approximately 9.8% to \$48.8 million for the third quarter of 2023 from \$54.6 million for the third quarter of 2022. The reduced expenses were due primarily to lower professional fees, partially offset by higher payroll and related labor costs.

Operating income for the third quarter of 2023 was \$2.1 million compared to a loss of \$3.1 million for the third quarter of 2022. The increase was driven by the lower distribution, selling, and administrative expenses.

Total interest expense increased to \$2.7 million for the third quarter compared to \$2.3 million in the prior year quarter.

Net income increased to \$2.0 million, for the third quarter, compared to net loss of \$3.9 million for the prior year quarter. Improved net income was driven by lower distribution, selling and administrative costs, and the \$1.7 million change in the fair value of interest rate swaps, partially offset by increased interest expense.

Adjusted EBITDA increased approximately 150% to \$10 million for the third quarter, compared to \$4.0 million for the prior year quarter.

Turning to the balance sheet and an update on our liquidity:

At the end of the third quarter, we had available capacity of \$48.6 million in additional funds through our line of credit. We feel very comfortable with our current liquidity.

Shifting gears to our M&A growth strategy: Our M&A playbook has allowed us to identify opportunities with significant synergies and expand geographically, increase distribution capabilities, and increase our product selection. We recently acquired Great Wall Group and Sealand Food in 2022, both of which were leaders in the Asian foodservice frozen seafood market and we are realizing the purchasing synergies in 2023 from those acquisitions. We see substantial opportunity for continued strategic M&A, and our strong track record as an acquirer of choice for most Asian food distributors means that most of our targets come to us first to initiate the conversation. Our industry relationships run deep across the U.S., and we have opportunities for touch points with tangible targets in the sector.

Let me leave you with a few key reasons we believe we are well-positioned for long term growth:

1. We are a leading, scaled, nationwide operator serving the Asian foodservice market. We offer restaurant owners a one-stop-shop for both a friendly cultural connection and the national scale in order to help them reliably serve customers the products they love at an affordable price.
2. Favorable market trends and demographics indicate that demand for Asian food will continue to grow at a robust pace, and we have the infrastructure and industry knowledge and experience in place to capitalize on this growth.
3. Our positioning and scale in our niche sector is very difficult to replicate. Our deep understanding of Chinese language and cultural background, as well as the long-term relationships we have formed with customers make it extremely hard for large national players to enter the space. At the management level, our diverse best in-class team is professional, highly experienced, motivated, and culturally connected to the mission of HF Foods.

To sum it up, we have an attractive long-term financial profile with a margin expansion and revenue growth strategy that we are laser focused on executing. We are pleased with the progress we have made so far and look forward to our financial metrics continuing to reflect the success of our transformational initiatives in upcoming quarters.

I would now like to turn the call over to Peter for closing remarks.

Peter Zhang, CEO

Thank you, Carlos. We have a very strong value offer as a leader in Asian food distribution and have transformed the market in which we operate by serving as a trusted partner to thousands of restaurants across the United States. We are focused on executing our transformation plan to improve operations and expand margins as we continue to pursue growth. We have created ourselves as a critical partner in providing high-quality specialty products, necessary to delivering authentic experiences, and have been able to build HF Foods into an enterprise, that generates over \$1.1 billion of net revenue annually, thanks to our deep understanding of customer needs their loyalty in return. And our journey is just getting started.

We look forward to speaking with you again on our fourth quarter earnings call and updating you on the progress of our operational transformation plan. Thank you everyone and have a great day.