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SFM - Sprouts Farmers Market Inc at Jefferies Consumer Conference

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CORPORATE PARTICIPANTS

Brad Lukow *Sprouts Farmers Market, Inc. - CFO*

CONFERENCE CALL PARTICIPANTS

Mark Wiltamuth *Jefferies LLC - Analyst*

PRESENTATION

Mark Wiltamuth - *Jefferies LLC - Analyst*

Okay. Welcome back, I am Mark Wiltamuth, the food and drug retail analyst. Next up we have Sprouts Farmers Market. We have got Brad Lukow, the new CFO, and also Susannah Livingston from Investor Relations. We are going to do all Q&A format and no slides, so you can also chime in with your questions along the way. But why don't we start with an introduction of Brad. Brad is the new Sprouts' CFO.

You were at 99 Cents Only briefly, but most of your career, 20 years plus at Shoppers Drug Mart in Canada, the leading drugstore operator up there. I covered you for six years while you're at Shoppers Drug Mart as CFO. Are there any parallels between the two initiatives you had at Shoppers Drug Mart that might carry over here? I know there was an error there. There is a unit growth there at Shoppers Drug Mart, but also you went through an era of working with suppliers to bring down costs or any supply chain things you could work to kind of factor into the Sprouts story and then maybe give us an update on what you have been working on since your first three months here on the job?

Brad Lukow - *Sprouts Farmers Market, Inc. - CFO*

Well, first of all, thank you very much. It's like a bit of a homecoming, seeing you again, so that's a pleasure. It is a long first question. I could probably go for 25 minutes on a loan, but look, we are excited to be here. I am excited about the opportunity at Sprouts and the runway that we have in front of us, and there's a lot of parallels, as you suggest, to Shoppers. I was there for 20 years and saw revenues grow from less than \$3 billion to \$12 billion, and it was the same type of story. There was a huge greenfield expansion opportunity.

But when I think about parallels and what I like about Sprouts, it's the power of the brand. So like my previous experience in Canada, our brand resonates with a broad demographic, and we are seeing that from coast to coast in the US.

We also have a tremendous runway of opportunity in front of us in terms of store growth. We will open 36 stores this year, and we see on an ongoing basis 14% square footage growth.

And the other element that I like about the Sprouts brand is that consumers in the broad demographic are coming to our stores because they are interested in health and wellness and nutrition, and our positioning healthy living for less really resonates across the country.

The other element I would say is similar to my experience is a relentless intense focus on the customer and delivering value add to that customer day in, day out. You see that in the deli initiative that we've started to roll out this year, and it is providing more value and opportunities to grow share of wallet with that customer.

From a cost and infrastructure perspective, I think that is where the opportunity lies. Because the Company is relatively young from a growth standpoint, it was important that we recognize that to sustain the unit volume growth that we are talking about, we really need to invest in infrastructure. And so as we called out late last year and through our first quarter this year, the Company's making incremental investments to enable us to sustain that unit volume growth. So we've implemented a number of infrastructure projects, including labor scheduling, where we are implementing a business intelligence team. We have a data warehouse in process in place right now, but we are really on the ground floor.

So I think unit growth opportunity from a supply chain standpoint, as you know, we self distribute produce only. We want to control the quality and freshness and have decentralized buyers at those distribution centers so that is a core of our business and we want to continue to leverage



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that. From a cost standpoint and as we expand across the country, we are opening another distribution center for produce in Atlanta late this year, and that will facilitate our growth up and down the East Coast.

Mark Wiltamuth - Jefferies LLC - Analyst

Is there anything about the supply chain that is kind of unique to you that gives you a buying advantage over the other grocers?

Brad Lukow - Sprouts Farmers Market, Inc. - CFO

Yes, I would say what's a little bit unique about Sprouts is our -- to my point on decentralized buying, but we have very close relationships with the individual growers. And I think it's a key advantage for us also because we move such tremendous volume of produce that we are generally the first to get the call when a grower needs to move volume, because they know we can move it quickly. And we are very nimble with regards to promotional activity. We generally can move very quickly to put a product that becomes available from an opportunistic standpoint and put it on local ad and just a certain market, one or two or three markets.

So I think we will stick close to our roots in terms of that key advantage of having that great relationship with the growers, and we will expand that across the country.

Mark Wiltamuth - Jefferies LLC - Analyst

How about -- maybe we will talk a little bit about pricing competitiveness. You have always tried to keep a gap relative to the peers out there to showcase the produce at a value for the consumer. What is your reaction as others come down? Whole Foods has announced they are trying to bring down price. They are clearly far away from you on pricing, but Kroger has been strategically cutting in produce and other conventionals also kind of looking at that segment of the store. Do you try to maintain a gap versus the peers, or how do you approach price relative to the conventionals?

Brad Lukow - Sprouts Farmers Market, Inc. - CFO

Yes, so I think we have always maintained a price gap in produce that has been 20% to 25%, and that is market by market. We have a pretty rigorous process and have had that for a number of years, where we are monitoring on a weekly basis our total basket in fresh relative to our key competitors. And going into every year, we just assume it's going to get tougher, that the marketplace will continue to get more competitive. That is why we have to continue to do two things: one, leverage cost by investing in infrastructure on those few projects that I alluded to earlier, but also how do we drive stickiness with the customer by delivering more value add. And that is whether it's in the meat and seafood case, whether it's in the deli initiative that we are implementing this year, we are really focusing on how do we drive engagement and loyalty with that customer and the infrastructure investments that we are making are -- will certainly add efficiency. But we are looking to reinvest that in price, and we will continue to do that on an ongoing basis.

Mark Wiltamuth - Jefferies LLC - Analyst

Okay. Talk a little bit about inflation/deflation. That's the top topic on all growth REIT questions we've been getting. So we've seen just in the last quarter out of some of the conventionals, Kroger indicated they saw a 400 basis point decline sequentially in the inflation they saw in produce, so things dropping off there. Talk about what you're saying in the produce side of things and maybe inflation/deflation generally right now.

Brad Lukow - Sprouts Farmers Market, Inc. - CFO

Sure and it's really my favorite topic. It's the nature of the beast. It is -- you deal with inflation/deflation day in, day out, and you can't control mother nature.



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As we saw in the first quarter of this year, we had negligible inflation. I think total store was maybe 50 basis points of inflation, but we've seen pretty significant deflation in the protein category since last August. It's double-digit. We've seen a continuation of that into the second quarter. We don't lap that until August. But as you saw in the first-quarter results, there is a positive on deflation in that area and that we saw margin expansion, and that's on the cost side of the business. You also have to look at what's happening from a retail standpoint, and we are responsive to any moves on the retail pricing side. Obviously a number of people saw a margin expansion in the first quarter. We've seen a little bit of a step up. Nothing significant, but a little bit of a step up in sort of add pricing in protein, whereas we have a sustained period of deflation, eventually somebody uses that opportunity to promote on the front page, and we do that as well.

In terms of produce, last year when the Port of LA Long Beach opened up, it flooded the market with products, and it gave us tremendous opportunity because of the strength of the produce area and the mix of our business to promote, and the availability was plentiful. What we saw in the second quarter of last year is pretty significant deflation throughout the second quarter in produce, but that can move on you very quickly, and we are seeing a little bit of deflation actually in the last six weeks of this current quarter in produce. And just looking at what happened in the first quarter, we started out slightly inflationary, and then that inflation really tapered off at the end of the first quarter and has actually turned slightly deflationary in this Q. I would say for Q2, we are probably going to be around flat, probably zero on inflation from a total store standpoint.

Mark Wiltamuth - Jefferies LLC - Analyst

Okay. What is the environment you like to see best for produce? You like plentiful supplies, relatively low prices. You want to promote, so what's the ideal environment for you?

Brad Lukow - Sprouts Farmers Market, Inc. - CFO

Yes, slightly inflationary is a good environment for us. But, as you know, we can't control it. One of the things that we are recognized for is the breadth of offering. So if something happens where availabilities are short on certain items, we can move and promote other categories. But you are really beholden to the weather, and we just deal with that day in, day out.

Mark Wiltamuth - Jefferies LLC - Analyst

Let's talk about that new deli offering you have. How many stores are you in now? What do you think it does to comps when it goes in there?

Brad Lukow - Sprouts Farmers Market, Inc. - CFO

Sure. We are excited about the deli offering. We started it late last year. In the first quarter of this year, we did 24 stores. It was evenly split between existing and new stores, and this is why we are doing it. It really came out of the consumer research. Our customers were saying they wanted more in that deli space. And if you look at the offering, not all stores will have the full complements. It really depends on the traffic and the daytime traffic that we see at the noon hour, 5:00, and the offering includes deli expanded service case where we have fresh prepared product in-store. We also have the salad bar, the sandwich bar, coffee and juice. We have recently upgraded and expanded our HMR offering through new formulations, ingredients, packaging.

So when I think about the network, at this point likely the legacy stores we are talking roughly 50% of those stores would get some element of that expanded deli offering, depending again on the specific demographics of the area of the store in traffic counts. But if you look at the customer, part of this you just have to do it to be in the game because the changing needs of our consumers who want the alternatives to be able to come in and out with a quality, fresh product. You just need to do this to be in the game.

So, number one, we have to execute on it. Number two, it's great when you can do it, and you are seeing very nice sales lifts, which it's early days, but we are seeing pretty good sales lift, which allows us to conclude that the financial returns are quite attractive.

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So this will be an area market we will continue to execute over the next couple of years, again to retrofit existing stores, and likely 70% of the new stores that we open will again have that offering.

Mark Wiltamuth - Jefferies LLC - Analyst

And is prepared foods a big part of that? You mentioned salad bar and sandwiches, but are you raising the game in prepared foods as well?

Brad Lukow - Sprouts Farmers Market, Inc. - CFO

We are, if you look at the service case. We have a lot of offerings like chili lime chicken, applewood barbecue chicken, prepared salads. And I can say I've been living off of this for the last few months as recently moving to Phoenix. So this has been a great opportunity for me to task to trial the product in its incredible quality. One of my favorite items, by the way, is the brussels sprout. They are fantastic. And that is consistent with the feedback that we've been getting from our customers. So we are excited about it.

Mark Wiltamuth - Jefferies LLC - Analyst

Maybe you can talk about performance of your newer tranches of stores. How are those doing in the market today and then maybe talk about cannibalization prospects as well?

Brad Lukow - Sprouts Farmers Market, Inc. - CFO

Sure. So one of the things that I quickly discovered after coming to Sprouts is the tremendous efficiency and capital efficiency of our new store program, and the financial returns are quite attractive. When you are looking at 35% to 45% cash on cash returns, clearly the Company continues to throw off a significant excess free cash flow, and it's a balance between existing markets and new markets. Again, about 70% of our new stores will go into existing markets. Existing markets mature within a couple of years in terms of sales performance. It takes longer obviously in new markets where your brand awareness isn't as high, but we are still seeing really terrific returns. And so we are excited about the opportunity that's in front of us in terms of net new markets to expand into markets.

Mark Wiltamuth - Jefferies LLC - Analyst

And that push to the Atlanta DC, is that going to help with the onward march to the East Coast?

Brad Lukow - Sprouts Farmers Market, Inc. - CFO

It absolutely will, and we will be opening that DC late this year, and that will help really in terms of the freshness of the product. So we operate in a number of states on the East Coast today, but we service it out of Texas. So the opportunity for us is greater freshness and cost of product. And it also -- initiative we've been looking at and doing more of is the local product. And so when we think about our expansion on the East Coast, it will be a continuation of engaging with the local community in terms of growers and grocery producers to really leverage the local product and formulations that are important for our customers.

Mark Wiltamuth - Jefferies LLC - Analyst

What are you seeing as you're looking at real estate availability for your size box? That is 20,000 to 30,000. Hopefully just working on the 365 stores, we've got the hard discounters, Aldi and Lidl looking at boxes in that size range, and they are going to be expanding. What is the real estate availability right now, and how are lease rates versus what they were maybe a year or two ago?

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Brad Lukow - *Sprouts Farmers Market, Inc. - CFO*

We are highly attractive from a landlord perspective, and coming out of the recent conference in Las Vegas, we are deepening our relationships with the landlords. They are coming to us because they like the strength of our brand and the traffic that we draw to their centers.

So, as you've seen, while you could have some tightness in rents in certain markets, it is not widespread. If you look at NorCal, clearly where the cost of living has been skyrocketing from a rents perspective and you see ads everywhere for companies hiring, rents are higher there, but retail are higher there as well. But, again, you see a number of retailers in that size footprint that are shuttering stores, and we have -- we are going to be opening a number of stores that we pick up from Hagen last year, and we see other retailers are shuttering stores that we've had a number of opportunities come to us where we can be highly selective in that opportunity. So it will always be a tough work, but it's the strength of the brand and the relationships that we have deepened with our landlords that we are feeling that we are in a good space.

QUESTIONS AND ANSWERS

Mark Wiltamuth - *Jefferies LLC - Analyst*

Let's pause and maybe take a question from the crowd here. Anybody with a question for Sprouts? Okay. Why don't we move forward and look at your e-commerce strategy and your relationship with Amazon? Can you talk about that a little bit?

Brad Lukow - *Sprouts Farmers Market, Inc. - CFO*

Sure. So we are in the early stages in a partnership with Amazon. Again, we are trying to really learn from what we are doing now with the home delivery model, partnering with them in six cities in four markets, and while it is early days, we have seen good engagement from consumers. Amazon brings the strength of their volume of consumers to their site, but it's really the strength of the Sprouts brand that is resonating and why it is actually a symbiotic relationship. They bring the traffic, we bring the brand. We've seen, again, early days, and it's not -- it's only a handful of stores. But early days is attractive sales lifts that we are seeing and average baskets that are higher than in store.

So it's an area where the market is moving in this direction, and while grocery has traditionally and continues to lag online buying in general, it's an area that we are convinced will continue to grow over time. We will experiment with different models, whether it could be a combination of a click and collect, as well as home delivery. Again, home delivery, the economics work in urban setting. It becomes rather challenging from a cost of delivery perspective in more suburban settings, and we are more of a suburban footprint in terms of our store network. But that is where click and collect can work as well.

So we will continue to experiment with this, Mark, and it could be some combination. We have a lot of opportunities, a lot of alternatives that we could look to execute on.

Mark Wiltamuth - *Jefferies LLC - Analyst*

And what is the cost for consumer looking at doing an Amazon purchase of a Sprouts item, and what kind of delivery fee is layered on top and maybe walk through the economics for consumer?

Brad Lukow - *Sprouts Farmers Market, Inc. - CFO*

I think at this early stage, I am not going to get into a lot of detail on that, but essentially it's an Amazon Prime now customer. So they pay their \$99 a year, and they get free delivery within the two hours.



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Mark Wiltamuth - Jefferies LLC - Analyst

Okay.

Brad Lukow - Sprouts Farmers Market, Inc. - CFO

So it's attractive.

Mark Wiltamuth - Jefferies LLC - Analyst

Okay. And talk maybe about the new business intelligence group. What you doing there internally? What is that group going to be focused on? Do you have any real data on customer purchases you can analyze, and maybe talk about that a little bit?

Brad Lukow - Sprouts Farmers Market, Inc. - CFO

So the exciting thing is that we are literally on the ground floor on business intelligence. So my background, I've got a lot of history in leveraging the data from loyalty programs back at Shoppers. So it's quite exciting. The good news is that we have the 1010Data warehouse in place. We are on the ground floor of leveraging that data to understand consumer spend and even -- we are just on the ground floor of basic basket analysis and cross-promotional opportunities. We will be looking at promotional effectiveness.

So, lots of encouraging opportunities over the next year. It's really going to take us a year to get orders of magnitude of data that we can execute on. But we've got the team in place, we have the leadership, we hired the team, and we are starting to look at early when -- late this year into next year.

Mark Wiltamuth - Jefferies LLC - Analyst

But, transactionally, you could look at maybe some credit card data. What are the things you are chewing on with that?

Brad Lukow - Sprouts Farmers Market, Inc. - CFO

Yes, so credit card data we have, but we want to understand consumer buying patterns and what individual customization of offers we can provide. And that really leverages our recently implemented digital app, the Sprouts app that we soft launched in April, and we already have over 400,000 unique IDs. What's different about this is the customer will self select, whether they are vegan, whatever, they're interested in from a product standpoint. We will provide truly customized offers based on their household spending. And we will also use that app as an opportunity to showcase new products, whether it be private-label or other. So I think we are excited about the use of this app going forward.

Mark Wiltamuth - Jefferies LLC - Analyst

So it sounds like it will be an opt-in digital solution rather than card-based loyalty card.

Brad Lukow - Sprouts Farmers Market, Inc. - CFO

That's exactly right. It is ease-of-use. A barcode comes up on your phone, so it is -- we have made it easy to use at the front end, check out. We push out unique customized offers, and they can be added to their shopping basket, and it's an easy transaction at the POS.



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Mark Wiltamuth - Jefferies LLC - Analyst

And at 400,000 IDs, are there certain markets that are doing that, or is it more nationally available now?

Brad Lukow - Sprouts Farmers Market, Inc. - CFO

Well, I think that it would be reflective of our store base in terms of where we are seeing the growth, but it's early days. But we are encouraged by the level of engagement that we are seeing from consumers.

Mark Wiltamuth - Jefferies LLC - Analyst

Okay. Are there any teasers to get people to sign up? They get some discount if they first sign up for the app?

Brad Lukow - Sprouts Farmers Market, Inc. - CFO

No, they are just excited about the opportunity.

Mark Wiltamuth - Jefferies LLC - Analyst

Okay. Any other questions for Sprouts from the audience?

What if you spent a little time on store supply/demand in the sector? We've been watching retailer on retailer collisions, and you are also hearing some of the retailers talking about cannibalization. What is your thought on -- the industry has good demand growth. Because I went to [XOS], they are talking about 11% industry demand growth, but yet there are still a lot of stores opening up in the sector. Do you think we are at a point where we are having too many openings of national organic retail stores right now?

Brad Lukow - Sprouts Farmers Market, Inc. - CFO

No, we think it's actually a positive for the industry and for everyone that you've got the tailwinds, you've got consumers across America that are interested in eating healthier, concerned about source of food. And while there has not been a material step up in new store openings, when we do see competitive openings within a few miles of our stores, what we are encouraged by is that you always get hit a little bit on grand opening. But we bounce right back, and again it really goes back to the power of the brand, that value offering that we have.

Mark Wiltamuth - Jefferies LLC - Analyst

And you still are targeting -- taking share from conventional grocers more so than nipping away at the other natural/organic players. Is that fair?

Brad Lukow - Sprouts Farmers Market, Inc. - CFO

I think based on our consumer research, the bulk of our new customers are coming from conventional retailers. But again, I think the days of one-stop shop are behind us. Consumers stop two, three different stores. Customers are just shopping differently.

Mark Wiltamuth - Jefferies LLC - Analyst

Okay. Any other questions? With that, I think we will wrap it up there. Very good. Thank you very much.



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Brad Lukow - *Sprouts Farmers Market, Inc. - CFO*

Thanks very much.

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