THOMSON REUTERS

FINAL TRANSCRIPT

Q1 2017 Sprouts Farmers Market Inc Earnings Call

EVENT DATE/TIME: 05/04/2017 10:00 AM GMT

CORPORATE PARTICIPANTS

Amin N. Maredia *Sprouts Farmers Market, Inc. - CEO and Director*
Bradley S. Lukow *Sprouts Farmers Market, Inc. - CFO, Principal Accounting Officer and Treasurer*
James L. Nielsen *Sprouts Farmers Market, Inc. - President and COO*
Susannah Livingston *Sprouts Farmers Market, Inc. - VP of IR & Treasury*

CONFERENCE CALL PARTICIPANTS

Alvin C Concepcion *Citigroup Inc, Research Division - VP and Senior Analyst*
Charles Edward Cerankosky *Northcoast Research Partners, LLC - Principal, MD and Equity Research Analyst*
Christopher Mandeville *Jefferies LLC, Research Division - Equity Analyst*
David Glenn Magee *SunTrust Robinson Humphrey, Inc., Research Division - MD*
Edward Joseph Kelly *Crédit Suisse AG, Research Division - Senior Analyst*
John Heinbockel *Guggenheim Securities, LLC, Research Division - Analyst*
Karen Fiona Short *Barclays PLC, Research Division - Research Analyst*
Kelly Ann Bania *BMO Capital Markets Equity Research - Director and Equity Analyst*
Kenneth B. Goldman *JP Morgan Chase & Co, Research Division - Senior Analyst*
Mark David Carden *UBS Investment Bank, Research Division - Associate Director and Associate Analyst*
Robert Frederick Ohmes *BofA Merrill Lynch, Research Division - MD*
Rupesh Dhinoj Parikh *Oppenheimer & Co. Inc., Research Division - Director and Senior Analyst*
Ryan John Domyancic *William Blair & Company L.L.C., Research Division - Analyst*
Scott Andrew Mushkin *Wolfe Research, LLC - MD, and Senior Retail and Staples Analyst*
Shane Paul Higgins *Deutsche Bank AG, Research Division - Research Analyst*
Stephen Vartan Tanal *Goldman Sachs Group Inc., Research Division - Equity Analyst*
Vincent J. Sinisi *Morgan Stanley, Research Division - VP*
Zachary Robert Fadem *Wells Fargo Securities, LLC, Research Division - Senior Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Sprouts Farmers Market First Quarter 2017 Earnings Conference Call. (Operator Instructions) As a reminder, today's conference call is being recorded.

I would now like to turn the conference over to Susannah Livingston. Please go ahead.

Susannah Livingston ***Sprouts Farmers Market, Inc. - VP of IR & Treasury***

Thank you, and good morning, everyone. We are pleased you have taken the time to join Sprouts on our first quarter 2017 earnings call. Amin Maredia, Chief Executive Officer; Jim Nielsen, President and Chief Operating Officer; and Brad Lukow, Chief Financial Officer, are also on the call with me today.

The earnings release announcing our first quarter 2017 results, our 10-Q and the webcast of this call can be accessed through the Investor Relations section of our website at sprouts.com.

During this call, management may make certain forward-looking statements including statements regarding our future performance and growth, product expansion, new store opening and 2017 expectations and guidance. These statements involve a number of risks and uncertainties that could cause actual results to differ materially from those described in the forward-looking statements. For more information, please refer to the risk factors discussed in our filings with the Securities and Exchange Commission, along with the commentary on forward-looking statements at the end of our earnings release issued today.

In addition, our remarks today include references to non-GAAP measures. For reconciliation of non-GAAP measures to the GAAP figures, please see the tables in our earnings release.

For the first quarter ended April 2, 2017, diluted earnings per share of $0.33 increased 10% from diluted earnings per share of $0.30 in the same period in 2016.

With that, now let me hand it over to Amin.

Amin N. Maredia *Sprouts Farmers Market, Inc. - CEO and Director*

Thank you, Susannah. Good morning, everyone, and thanks for joining our call today. Sprout's model of fresh, natural and organic products at prices the everyday shopper can afford, continues to resonate with our customers evidenced by another quarter of positive comp sales and traffic. This is a remarkable accomplishment on the part of our 25,000 team members across the country, considering the ongoing and deep deflationary pressures during the first quarter. We remain focused on delivering innovative products, connecting with our customers both in and out of the store and systems and our team members for scale and long-term growth. This focus continues to produce exceptional customer engagement and service scores, strong operations and solid financial results.

For the first quarter, sales rose to $1.1 billion or a 14% growth, driven by comp sales growth of 1.1% as well as strong new store productivity in the low 80s. While cost deflation of 3% was the highest we have experienced as a public company, we saw modest improvements throughout the first quarter as produce deflation eased towards the end of the quarter.

Sales continued to be bolstered by strong private label sales, which are growing well north of the company average, and continued strength in our nonperishable departments. On the perishable side, despite the deflation, we continue to see strong tonnage growth, which was the strongest increase we have seen since Q4 of 2015. And our fresh team continues to make solid progress in our expanded deli department.

Our focus on the customer is driving positive traffic, which was 0.6% for the first quarter, sequentially increasing since the third quarter of 2016. Cannibalization continues to impact our traffic and is running above the upper end of our customary range. However, we expect that to improve throughout 2017.

The competitive promotion environment was at similar levels to the prior quarter. We are maintaining our competitive position by remaining focus on the customer, offering knowledgeable customer service and fresh healthy products at affordable prices.

Shifting to new store growth. In the first quarter, we opened 8 stores, including our first stores in Florida and North Carolina, which brings our presence to 15 states coast-to-coast. Our 2016 and 2017 vintages continue to open above our expectations. In part, this has been driven by our increased brand awareness activities centered around the communities in which we operate and focused on building our brand affinity and awareness as we enter new and emerging markets. Our pipeline remains strong with 63 approved sites and 43 signed leases for the coming years.

We also opened our new Atlanta produce distribution center in December of 2016. The D.C. is proving to be a tremendous benefit to all of our stores in the Southeast. Most notably, it provides customers fresher and more local produce and allows us to expand our produce vendor relationships.

Let me now turn to our strategic priorities for 2017 focused on sales growth and investments and infrastructure. First, we continue to advance our product offerings centered on health, taste and value to meet our customers' needs. Our private label program continues to be a major focus for new offerings in the store, focused on taste and differentiation of products in key categories. We now offer more than 2,100 private label items across the store, driving 11% of our total revenues. By the end of 2017, we expect our private label program to exceed $500 million in sales. In addition, we continue to work closely with our vendor partners as we jointly focus on new product innovation.

We are well on track to achieve our goal of launching the enhanced deli program in 50 new and existing stores this year, with nearly half implemented in the first quarter. This includes a full service case of freshly prepared protein and sides, a salad bar, fresh juices and soup stations. We continue to drive further innovation in our ready-to-eat offerings and deli to provide a convenient shopping experience for our customers and remain excited about new items going into the stores over the next few months. We are also improving the ingredient standards in our grab-and-go items, always remaining rooted in freshness and quality. We also continue to enhance our meat and seafood department through service, product enhancements and merchandising based on consumer trends and shopping preferences.

Second, we continue to accelerate customer engagement and content across print, digital and in-store to enhance the Sprouts experience and drive increased loyalty with our brand. Our mobile app continues to gain traction, and this year we are focused on improving the user experience. We have begun to leverage affinity-level capabilities to enhance customer offers and loyalty, and look forward to continue to leverage data from mobile customer interaction for increased personalization in the future.

We recognize that the landscape for grocery shopping continues to evolve, and therefore, have expanded our Amazon Prime Now partnership currently in 10 stores with at least 10 more stores to come as the year progresses. By year-end, we plan to be in many of our major markets, allowing Sprouts products to be delivered directly to our customers' doorsteps.

Lastly, we are investing in infrastructure to support our store growth and drive productivity improvements. Our technology projects are progressing as planned, focused on driving efficiencies both at the store level and the support office. All of this is key for scale and will enhance the experience of our team members and customers alike, driving retention and improving service in the store.

The team members' training established last year continues to improve our team members' professional growth and strengthen our operational performance scores in the store, creating a team with deep and operational readiness for a continued growth across the country.

Before I hand it over to Brad, I want to say that I'm deeply grateful for the passion and performance that our teams delivered against this dynamic environment during the quarter. We remain confident in our business model and we continue to focus on our customers, our team members and our model of health and value.

Let me turn the call over to Brad to speak about our financial results and 2017 guidance.

Bradley S. Lukow ***Sprouts Farmers Market, Inc. - CFO, Principal Accounting Officer and Treasurer***

Thank you, Amin. I'll begin by discussing some of the business drivers for the first quarter, and then review our guidance for 2017. As Amin mentioned, for the first quarter, sales were up 14% with comp sales growth of 1.1%. Deflation of 3% reached its highest levels since we've been a public company, mainly driven by deepening produce deflation during January and to a lesser extent in the back half of the quarter. By the end of the quarter, many of our categories entered a neutral or slightly positive territory with regards to inflation.

For the first quarter, gross profit increased by 10% to $337 million and our gross margin rate decreased 110 basis points to 29.8% compared to the same period in 2016. The majority of this decrease in margin is from cycling higher margins in 2016 when we experienced deflation without the corresponding promotional environment. In addition, occupancy expense deleveraged due to an increase in average square footage growth in our new stores and higher rent expense, partially attributed to higher real estate taxes.

For the first quarter, direct store expense increased 18% to $229 million, an increase of 75 basis points to 20.3% of sales compared to the same period last year. The increase was primarily due to higher payroll and benefit costs, in part due to deleverage of fixed expenses associated with lower comp sales growth and an increase in depreciation expense from higher unit growth in 2016.

SG&A increased 4% to $32 million for the quarter, a decrease of 30 basis points to 2.8% of sales compared to the same period last year. This primarily reflects timing of our investments associated with our strategic initiatives as well as lowered net marketing and stock-based compensation expenses as compared to the prior year.

EBITDA for the first quarter totaled $95 million, a decrease of 2% when compared to the same period last year. This reduction was primarily driven by lower gross profit margins and increased labor cost.

Net income for the first quarter was $46 million, flat from the same period in 2016. Diluted earnings per share was $0.33 for the quarter, an increase of $0.03 from the same period in 2016. The recognition of excess tax benefits related to the exercise of stock options, now reflected in the income tax provision, lowered our effective tax rate to approximately 32% for the quarter.

Shifting to balance sheet and liquidity. We continue to generate solid operating cash flows from operations, up 17% in the first quarter to $115 million. We also invested $57 million in CapEx, net of landlord reimbursement, primarily for new stores.

During the quarter, we repurchased approximately 4.1 million shares for $80 million, fully utilizing our prior $250 million authorization. We ended the quarter with $21 million in cash and cash equivalents and $285 million borrowed on our $450 million revolving credit facility. On February 23, our board approved a new share repurchase authorization for $250 million to be used through the end of December 2018.

Looking forward, our expectation is for our net debt to EBITDA to be in the range of 1.2 to 1.5x. We believe this range provides an optimal leverage for Sprouts, and combined with our strong operating cash flows, positions us well to self-fund our growth and enhance shareholder returns through our ongoing share repurchase program.

Now let me turn to 2017 guidance. We now expect net sales growth of approximately 12.5% to 13.5%. We are increasing our full year comp sales growth to be in the range of 0.5% to 1.5%. This reflects the ongoing competitive environment that remains at similar levels to the first quarter as well as easier compares in the back half of the year. Our expectation is that Q2 comps will track at similar levels to the first quarter.

Diluted earnings per share are in the range of $0.87 to $0.91 resulting in EPS growth of 5% to 10%. This includes an estimated effective tax rate of approximately 35% for 2017. The lower effective tax rate is due to the change in accounting standard related to the recognition of excess tax benefits for stock-based compensation reflected in the income tax provision for the year.

Consistent with our previous guidance back in February, we plan to open 32 new stores, including stores opened in 2 new states, Florida and North Carolina. And CapEx will be in the range of $155 million to $165 million, net of landlord reimbursements.

A few additional items to note on the 2017 guidance. We expect 2017 to be in the 1% to 2% deflationary range, a slight improvement from what we believed at year-end, mainly attributed to produce. We anticipate that deflation will progressively improve throughout the year with the expectation that we will cycle deflation in most all categories as we enter the third quarter.

As it relates to margins, we continue to make price investments as necessary to drive traffic and to maintain our competitive position. We continue to expect gross margins to be lower than the prior year in the first half of 2017 as we cycle the higher gross margins in 2016. For the full year, we would expect gross margins to be slightly below 2016 levels.

On the direct store expense line, we continue to expect to delever DSE as a percent of sales, primarily due to higher wage costs and deleverage from our expected comp sales growth. On the SG&A line, we expect to be relatively flat to slightly leveraged as a percent of sales, mainly attributed to our expected comp sales growth. Below the EBIT line, we expect interest expense to be approximately $20 million including interest related to financing and capital leases.

In conclusion, we are pleased with our financial and operating performance for the first quarter. We remain confident in our business model, our strong free cash flow generation and our strategic priorities to position Sprouts for growth, while driving long-term shareholder value.

With that, we'd like to open up the call for questions. Operator?
