THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

SFM - Q2 2017 Sprouts Farmers Market Inc Earnings Call

EVENT DATE/TIME: AUGUST 03, 2017 / 2:00PM 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

Andrew Paul Wolf *Loop Capital Markets LLC, Research Division - MD*

Charles Edward Cerankosky *Northcoast Research Partners, LLC - MD, Equity Research Analyst & Principal*

John Edward 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*

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 - Research Analyst*

Scott Andrew Mushkin *Wolfe Research, LLC - MD and Senior Retail & 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*

William Joseph Kirk *RBC Capital Markets, LLC, Research Division - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Sprouts Farmers Market Second Quarter 2017 Earnings Conference Call. (Operator Instructions) And as a reminder, this conference call is being recorded. I would now like to introduce your host for today's conference, Ms. Susannah Livingston. Ma'am, you may begin.

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 second 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 second 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 openings 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 a reconciliation of our non-GAAP measures to the GAAP figures, please see the tables in our earnings release.

For the second quarter ended July 2, 2017, diluted earnings per share of $0.29 increased 16% from diluted earnings per share of $0.25 in the same period in 2016.

With that, 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. On behalf of our 28,000 team members at Sprouts, Jim, Brad and I are excited to share with you today about the continued momentum that is building in the Sprouts business. Our team's relenting focus on executing our strategic direction, while managing through the near-term competitive environment, has positioned us to increase our top line and bottom line guidance today. While many of you have known Sprouts only since 2013 when we became a public company, this summer marks our 15th year in business. Our passion for providing fresh, natural and organic items at affordable prices for our customers remains just as strong today as it did in 2002. We also remain focused on delivering an exceptional customer experience every day in our stores while strategically building for tomorrow.

For the second quarter, sales rose to $1.2 billion or a 15% increase over last year, driven by strong new store productivity in the low 80s and comparable store sales growth of 1.4%. Sales continue to be bolstered by the strengthening in our non-perishables departments and strong execution of many of our strategic initiatives we have shared on past calls, including private label growth, enhanced meat and seafood offerings and momentum in the deli department. New store productivity has been strengthened by the various strategic initiatives we have implemented over the last several years, which has created a fuller shopping experience for our customers and further strengthening our fresh and healthy business model going forward.

Cost deflation improved throughout the quarter, ending the quarter modestly inflationary, as deflation eased in several fresh categories. The industry's promotional environment remained competitive, with continued investments in retail price similar to the prior quarter. Sprouts continues to maintain our pricing strategies and our Healthy Living for Less promise to our customers.

Excluding the Fourth of July holiday shift, traffic was slightly positive for the quarter. In addition to the holiday shift, traffic was impacted in certain fresh categories that were plentiful in 2016 but impacted by weather-driven gaps this year. We are pleased to see traffic improve in the back half of the quarter as well as a sequential quarter-over-quarter improvement on a 2 year-stack basis in Q2. The traffic momentum since the back half of second quarter has continued to build into the third quarter.

Shifting to new store growth, in the second quarter, we opened 13 new stores, including our third and fourth store in the Florida market. We have opened 5 additional stores in the third quarter-to-date for a total of 279 stores today. Our pipeline remains strong, with 6 more stores scheduled to open this year and 56 sites -- approved sites and 42 signed leases for the coming years.

Let me now turn to our strategic priorities. Our strategic investments and innovative product offerings continues to gain traction. Our private-label program continues to grow, with more than 2,300 product offerings in the store. This increasing penetration in the grocery aisles helps differentiate Sprouts and drives customer loyalty and repeat trips, as customers seek out their favorite Sprouts brand products.

The enhanced deli program is now in more than 120 stores and is driving more lunchtime and dinnertime traffic. I'm very pleased with our fresh team's progress in this department. Data is showing that more and more customers are viewing Sprouts deli, as well as the Sprouts meat and seafood department, as their primary destination for these items. This is reflective of the product innovation, quality as well as the team member training and great customer service in these departments.

We continue to accelerate our engagement with our customers in more meaningful ways outside the store, leveraging strategies that build our brand and credibility in the healthy living space. We are making significant investments in the Sprouts digital experience to ensure our customers have access to what they need, when they need it, on the platform of their choice. We know our customers want more relevant content and personalization, and we are engaging with them in new and exciting ways, including personalized mobile coupons through the Sprouts app and other channels.

Our partnership with Amazon Prime Now continues to grow, as we will be delivering Sprouts products through the Prime Now service to over 20 locations across many of our major markets by year-end. We launched the service in the Atlanta metro area just last week. As change continues in the grocery industry, we remain confident in our ability to bring the Sprouts experience to our customers, both in the store and out of the store.

Lastly, our investments in infrastructure to drive productivity in the stores, manage our operational cost and support our long-term growth, remain on target. Our labor management system, once fully rolled out, will improve our store productivity, ensure we are delivering a great Sprouts customer experience to our guests and help manage shrink. Our rollout of the labor management system in our non-perishables department and the front end has started to see early benefits. Additionally, our business intelligence team continues to automate data and drive further analytics, enabling our merchants to enhance business decisions and to refine our promotional programs.

Before I hand it over to Brad, I want to say I'm thankful for the incredible hard work and energy demonstrated by the entire Sprouts team, both at the office and the stores each and every day. For 15 years, our customers have continued to give us [input into] our business, and we are more than ever committed to investing in and executing against our strategic priorities that are driving innovation for our customers today and strengthening our healthy living model for tomorrow. It is also exciting to see the momentum building from our product innovation into our top line sales and benefits to the middle of the P&L from our investments in training, infrastructure and technology.

With that, 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 second quarter and then review our guidance for 2017.

As Amin mentioned, for the second quarter, sales were up 15%, with comp sales growth of 1.4%. Modest inflation was mainly driven by fresh categories in the back half of the quarter.

In the second quarter, gross profit increased by 12% to $342 million and our gross margin rate decreased 70 basis points to 28.9% compared to the same period last year. The majority of this decrease was due to modest cost inflation, coupled with the ongoing competitive promotional environment negatively impacting margins. In addition, occupancy expense deleveraged due to an increase in average square footage growth in our new stores, higher rents and the associated deleverage from lower comps.

For the second quarter, direct store expense increased 14% to $236 million, a decrease of 20 basis points, to 19.9% of sales compared to last year. As wages and medical costs continue to rise, driving productivity in the stores remains a strategic focus. Leveraging our new labor management system in our non-production departments improved store labor productivity this quarter. As well, we remain focused on improving other operational efficiencies in the store which have led to additional cost savings this quarter. These efficiencies were partially offset by higher benefit costs due to increased enrollment compared to last year.

SG&A increased 24% to $38 million for the quarter, an increase of 20 basis points, to 3.2% of sales compared to the same period last year. This primarily reflects higher compensation expenses, an increase in advertising and regional expenses and an increase in other corporate costs versus the prior year.

EBITDA for the second quarter increased 4% to $87 million, a decrease of 70 basis points, to 7.4% of sales compared to the same period last year. This decrease in margin was primarily driven by lower gross profit margins due to cost inflation, coupled with the ongoing competitive environment.

Net income for the second quarter was $41 million, an increase of 10% from the same period in 2016.

Diluted earnings per share was $0.29 for the quarter, an increase of $0.04 from the same period last year.

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 30% for the second quarter and impacted EPS by $0.03.

Shifting to the balance sheet and liquidity. We continue to generate solid operating cash flows from operations, up 22% year-to-date to $180 million. We also invested $113 million in capital expenditures, net of landlord reimbursement, primarily for new stores.

During the quarter, we repurchased approximately 1.8 million shares for $40 million. We ended the quarter with $15 million in cash and cash equivalents, $310 million borrowed on our $450 million revolving credit facility and $210 million available under our current share repurchase authorization. Subsequent to the end of the quarter and through July 31, we've repurchased an additional 700,000 shares of common stock for $16 million. Year-to-date through July 31, we have repurchased 6.6 million shares of common stock for a total investment of $136 million.

We ended the quarter at 1.5x net debt-to-EBITDA and plan to remain in the 1.2x to 1.5x range for the near term, allowing us to self-fund our unit growth through cash generation and to enhance shareholder returns through our ongoing share repurchase program.

Let me turn to 2017 guidance at this time. Net sales growth is expected to be in the range of 13% to 14%, an increase from last quarter, attributed to improved trends in the business. As well, we are increasing our full year comp sales growth range to 1.5% to 2%. This reflects the continued strong momentum in comps since Q4 2016 and the strong start to our third quarter. Lastly, we are increasing our diluted earnings per share to the range of $0.88 to $0.92, which equates to EPS growth of between 6% and 11%. This includes a lower estimated effective tax rate of approximately 33% for the quarter. The lower effective tax rate, again, is due to the change in the accounting standard related to the recognition of the excess tax benefits for stock-based compensation.

Now consistent with our previous guidance back in May, we plan to open 32 new stores. CapEx will be in the range of $155 million to $165 million, net of landlord reimbursements.

A few additional items to note for the 2017 guidance. We expect deflation to be flat to slightly negative for the full year, a slight improvement from what we believed on our last call, mainly attributed to reflation in fresh categories.

And as it relates to margins, we will continue to make price investments as necessary to drive traffic and to maintain our competitive position. Many of our strategic initiatives continue to enhance margins, and we will be cycling easier compares in the back half. As a result, we now expect gross margins to end the year below 2016 by approximately 40 to 50 basis points, most of which relates to our first half performance.

And on the direct store expense line, due to labor productivity gains and continued momentum in the business, we expect DSEs to delever slightly less than originally thought.

On the SG&A line, we continue to expect to be relatively flat to slight deleverage as a percent of sales, mainly attributed to our expected comp sales growth. Based on the cadence of SG&A in the back half of 2016, we would expect deleverage in the third quarter of this year, largely offset with leverage in the fourth quarter.

Below the EBIT line, we expect interest expense to be approximately $20 million, including interest related to financing and capital leases.

In conclusion, despite the difficult competitive environment, we are pleased with our financial performance, strong free cash flow generation and healthy new store productivity, setting us up well for continued growth and long-term shareholder value.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Karen Short with Barclays.

Karen Fiona Short - *Barclays PLC, Research Division - Research Analyst*

Just to clarify on guidance. So you've given us what your new expectations are for inflation or the slightly negative -- flat to slightly negative in terms of deflation, inflation for the year. But I guess your comps -- raised comp guidance doesn't necessarily reflect that magnitude of an increase. So maybe a little color there. And then I guess on guidance, what I'm a little confused by is -- and I'm talking about EBIT more than EPS, because there's too many moving parts, with tax rate and interest and things -- but you have a really easy comparison in the second half and -- in terms of comparison to last year and yet you're really only looking for, at best, a slightly positive growth rate. Or well, at best, a slightly positive earnings growth rate, but still down EBIT for the second half of the year. And I guess I'm still -- I'm a little confused about that, given the momentum that you have in the business. Is that purely a function of gross margin investments that are required?

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

Karen, it's Brad. Let me start with the deflation question. So our previous guidance had us roughly at minus 1.5 deflation for the full year, as our previous range was minus 1 to minus 2. Now we're looking at, based on what's happened in the second quarter and visibility into the third quarter, of being flat to slightly negative. And in terms of how that translates into our comp increase, we're now looking -- we've raised effectively midpoint to midpoint 75 to 80 basis points of our comp. And in the context of what that means for the back half, we're looking at almost a 3% comp. And so from our perspective, that lines up pretty closely. And with regards to the competitive landscape, we've really taken into account what's happening from a promotional point of view, looking at price investments that we'll continue to make, but also the fact that we're now seeing some strong productivity improvements that will continue through the back half, as well as the strategic initiatives that are driving higher-margin categories. So all that taken together, I think we're feeling very strong in terms of the trends that we're seeing to date through the third quarter, and that's how we're looking at balancing it out.

Operator

And our next question comes from the line of Kelly Bania with BMO Capital Markets.

Kelly Ann Bania - *BMO Capital Markets Equity Research - Director and Equity Analyst*

Just wanted to ask a question about inflation, deflation and making that transition. Are you seeing prices being passed through, it sounds like mostly in some of the fresh categories, in a similar time frame that you would expect historically? Or is it in those categories where you're seeing still some of the competitive pricing? Just any elaboration on those topics.

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

Kelly, I'll start broadly and then have Jim add. I think, broadly speaking, across the board, what we're starting to see with a little bit of reflation in the fresh categories is retailers are starting to inch up in everyday retail, however, it remains highly promotional on front page ad and in-store promotions. We've also seen in-store promotions continued to tick along. So I would describe the overall competitive environment to be relatively neutral for the last 6 to 9 months. It's feeling like people in certain pockets of the country are pulling up. Now we've all certainly seen the headlines of Lidl and Walmart in certain pockets of the country, and that doesn't really impact Sprouts. That's a discounter model that historically has not been our shopper. So that's sort of broad. I'll let Jim jump in if he wants to add any color about particular departments.

James L. Nielsen - *Sprouts Farmers Market, Inc. - President and COO*

Yes, I mean, Kelly, the only thing that I would add is in the non-perishable departments we haven't seen much inflation, so the shelf pricing has been very stable. As it relates to the fresh pricing, there's been a little bit of a lag, 1, 2 weeks, so there's been a small, short squeeze that we've had. But in general, as we look at all of our pricing data, most retailers are passing through the increases in cost at the shelf.

Kelly Ann Bania - *BMO Capital Markets Equity Research - Director and Equity Analyst*

Okay. That's helpful. And then I guess just wanted to follow up on the Amazon Prime Now partnership. It sounds like it's expanding to 20 stores. Just longer term, I mean, do you envision continuing to grow that? Are you looking at any other options, maybe diversifying some of your options on delivery? Any comments there?

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

Yes, so I'll start by saying Amazon has been a fantastic partner. We've learned a lot together about the business, and it's a great way for Sprouts to engage with our customers and bringing them fresh, healthy products to their doorsteps. And our focus is really to be convenient for our customers and engage with them wherever they want to be. And so we'll continue to learn. And we want to be thinking about being channel-agnostic. And to the extent that our customers want us to be in other places, we'll look at that. So that's really how we're thinking about this. And I would end by saying is we're very, very confident in our ability to continue to engage with our customers inside and outside the store. And today, we're continuing to develop our partnership with Amazon and we'll continue to actively have that dialogue with their senior team and move forward from there.

Operator

And our next question comes from the line of Scott Mushkin with Wolfe Research.

Scott Andrew Mushkin - *Wolfe Research, LLC - MD and Senior Retail & Staples Analyst*

Got a 2-part question. So I want to get back to Karen Short's original question on guidance, because I'm kind of with her a little bit on trying to understand things a little bit better on what the message is. Because collectively, I think most analysts are going to have to cut their back half, given the strength of the second quarter. So I guess I'm just trying to understand a little bit why that would be the case. And then on my longer-term question, kind of dovetailing to my next thought, is that we're -- obviously, in the last couple of years, we haven't had big EBITDA growth rate here. And in looking at the environment as we look out to next year and the year after and the year after, how do we get back to double-digit EBITDA growth? That was the 2-part question.

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

Yes, thanks, Scott. Those are 2 great questions. I think as Brad mentioned, the back half of the year, we're assuming nearly a 3% comp. And when we look at in the trajectory, if you think at the low point in the fourth quarter, we were at 0.7% comped; then first quarter, 1.1%; second quarter here, 1.4% today. And when we look at the momentum building into the business, we -- and the competitive environment and not knowing who may get more competitive or less competitive any given month, we wanted to be prudent. And so we looked at our 2-year stack, we always take a look at that, that we felt that a 3, and that would basically equate to roughly a close to a 4, 2-year stack was prudent. And if the momentum continues to build, you could see upside there. But we wanted to make sure that we were prudent about that.

THOMSON REUTERS

And then I think on the longer-term question around margin, I think, as we all know, the last 2 years, the pressure on margin, overall operating margin, has been a large function of deflation and people getting more competitive trying to keep sales up. And as we all know, and we saw this at Sprouts in 2013 and '14, that leverage is heaven and moves quickly and deleverage also moves quickly. So as we were starting to turn the corner, we're pretty confident that leverage is falling. At the same -- we think it will follow, at the same time, the initiatives that we have going on, both on the product side as well as the middle of the P&L, are going to give us additional dollars to either enhance margins to shareholders or reinvest in price if necessary. And those are, particularly when we think about deli and private label and what we're doing in meat and seafood, those are all additive overall to the GP dollars and GP percentage and then as well as the work that Dan Sanders and Brad and others have been leading in driving productivity in the middle of the P&L on the non-perishables and the front end, seeing that discipline. It's fantastic to see not only starting to see leverage in the middle of the P&L in those areas, but also seeing better customer service at the same time, which we think is super important. And as we move forward, we'll continue to accelerate our investment into the perishable departments, which really ties in automated ordering -- first understanding production planning to automated ordering to shrink and being -- and producing the right amount and being there for the customer to serve the customer. So all of those components are being actively worked right now. All of us know that fresh item management takes a little bit of time to roll out, but we're actively engaged in that project and pretty excited about how it impacts service and -- positively impacts service and can be an enhancer to margin. So long-winded answer, but we've got some good initiatives to drive margins and drive top line -- drive top line sales as well as areas to offset any margin pressure that we could see in the future.

James L. Nielsen - *Sprouts Farmers Market, Inc. - President and COO*

Scott, the only thing that I would add is that just think of the new market maturity. So as we mature in those markets, we, obviously, we're improving on the bottom line. And the site selection over the course of the last 2 years, you've seen the new store productivity is continuing to improve. And so that new market maturity will accelerate as we move forward.

Operator

Our next question comes from the line of Rupesh Parikh with Oppenheimer.

Rupesh Dhinoj Parikh - *Oppenheimer & Co. Inc., Research Division - Director and Senior Analyst*

So first, just going to the comp performance during the quarter. Is there any way to quantify the -- or I guess the headwind from the Fourth of July shift and the availability comparison?

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

Well, I think as Amin mentioned, there was a negative impact. It was modest. Again, when we look at traffic, it was largely a traffic impact in the second quarter that put us just slightly negative. And taking into account that shift, we would've been positive on traffic. And importantly, we're seeing very strong uptick in traffic through the third quarter to date and feel really, really good about that.

Rupesh Dhinoj Parikh - *Oppenheimer & Co. Inc., Research Division - Director and Senior Analyst*

Okay, great. And then on the gross margin guidance, it sounds like the commentary so far suggests that the promotional environment has been consistent with your expectations. So I'm still unclear in terms of what the key drivers of that guidance reduction is if the promotional environment has been fairly consistent with your expectations.

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

So Rupesh, let me just be clear with regards to our articulated range of down 40 to 50 basis points, that is almost entirely based on the first half performance. As you know, we're sequencing easier compares, certainly, sequentially. We had a significant drop last year from Q2 to Q3 due to the very heightened promotional environment. And so we've taken that into account. And it implies that we're basically flattish on gross margin for the back half of the year. And that's how you get to minus 40 to 50 for the full year.

Rupesh Dhinoj Parikh - *Oppenheimer & Co. Inc., Research Division - Director and Senior Analyst*

So is it then fair to say then that first half gross margin performance may have been below your prior expectations?

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

Slightly below.

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

Slightly below.

Operator

And our next question comes from the line of Shane Higgins with Deutsche Bank.

Shane Paul Higgins - *Deutsche Bank AG, Research Division - Research Analyst*

Just on the DSE dollar growth, it did slow pretty sharply sequentially, about 400 basis points versus the first quarter. Can you guys just walk us through some of the factors behind that slowing growth rate? And I think in your prepared remarks, you guys mentioned some of the labor productivity efforts that you have. And if you guys could just flesh that out a little bit and kind of how we should think about that year-over-year growth rate in the back half of the year.

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

Sure, Shane. It's Brad. Again, as we talked about, last year, middle of last year, we introduced labor scheduling into our non-production departments. And it takes some time to get that integrated into the business. And what we're starting to see, what we saw clearly in the second quarter, was some very favorable year-over-year sales per labor hour productivity improvements, which just reinforces what our initial expectations were in terms of we knew, putting these technologies in, were going to drive significant productivity enhancements. And we're only in the early stages, that was just for the non-production departments. We're now actively involved in rolling that out through the balance of the store. And so when we look at first quarter, we were down about 75 basis points in DSE. Now up about 20 basis points favorable. The lion's share of that relates to this labor productivity improvement. But also, we've got a lot of good work going on in the building with regards to goods not for resale and really driving out costs, operating, supplies expense, et cetera, et cetera. So we are starting to get some tailwinds, and again, it's early days. So when we look at the back half of the year with regards to DSE, we have an easier compare. In the third quarter, it should be flattish and then just slightly negative in the fourth quarter. Overall, for the full year, just slightly negative, but better than our initial beginning-of-year expectations.

Shane Paul Higgins - *Deutsche Bank AG, Research Division - Research Analyst*

And do you guys expect, anticipate, that as you continue to roll out some of these systems that the -- 2018, you'll actually get even additional leverage potentially on DSE?

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

Absolutely. I mean, we're really in the early days. So we've got our plans and programs in place and that would be our expectation for 2018.

Operator

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

Andrew Paul Wolf - *Loop Capital Markets LLC, Research Division - MD*

I just wanted to ask about new store productivity, which seemed to be pretty solid. But maybe I missed it if you didn't give out the metric. And is there any variation -- I don't know if you're going to be specific, but could you tell us if there's much variation by geographies between some of your newer geographies and existing markets?

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

Sure, I'll do those in sequence. We've historically always assumed -- our core model assumes new store productivity in the mid-70s, and the past 2 years, we've been around 80%. And in the past couple of quarters, we've been above 80%. And so the recent quarters improved -- significant improvements have really been aided by 2 things. One is our 2016 and '17 vintages are a little bit heavy -- or 2015 and '16 vintages were a little bit heavier in existing markets, which drove higher cannibalization, but also drove higher new store productivity. And in 2016, we took on a few more Haggen stores in California. So that was part of it. The additional piece, which we're pretty excited about that's driving higher new store productivity, which is particularly helping the newer markets is one, we're continuing to refine our site collection process. Second, we've significantly improved our new and existing market launches. And the social media and the grassroots marketing in Newark, our marketing team's done a fantastic job of defining a playbook there. And third, which is long term, we think it will be incredibly beneficial as our strategic initiatives, particularly things we're doing in deli and meat and seafood, are leading to higher volumes in these areas. So our mix is actually improving. So our overall sales are improving and our mix to some of the higher-margin departments are improving. So we're pretty excited about that. And the customers are really engaging well with a fuller shop. And so we think that these initiatives, as we always thought, would continue to pay dividends, not only in the midterm, but also the long term as we enter new markets.

James L. Nielsen - *Sprouts Farmers Market, Inc. - President and COO*

Andrew, the only thing that I would add is -- the last piece of that is the operational consistency. We've learned a lot from Atlanta, and Dan Sanders and the operations team put together a really solid plan for all new markets. So not only opening them well with the support of the marketing team and the strong brand, but we're driving consistent operations post open.

Andrew Paul Wolf - *Loop Capital Markets LLC, Research Division - MD*

And I think you guys referenced site selection. Is there actually like new methods being employed that are maybe using digital tracking and things like that, that are perhaps improving your hit rate or are you likely (inaudible)?

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

Sure. We've expanded our team. There are a couple of things going on. As we've expanded our team there, we've got much deeper and more precise analytics around our core customers today. And obviously, now having 200 -- nearly 280 stores to look at analytics from, it's really improved the process and has given us much greater confidence in estimating new store sales in that curve as well as cannibalization. In fact, in the last 6 months, the cannibalization number that we estimate is coming right square, very, very close to what we expect when we approved the sites. So that's fantastic for us, to be able to narrow that down and understand the economics net of cannibalization for the new stores. So that's been incredibly helpful. And I think that the real estate availability, it's no surprise to anybody that portions of retail are continuing to struggle and we're starting to see the waves of real estate availability kick up, and we're starting to be tougher on rents with -- in negotiations, because we have so many opportunities for opening 30 stores in 15, 16 states, it gives us much more flexibility in positioning ourselves for -- with the landlords.

Andrew Paul Wolf - *Loop Capital Markets LLC, Research Division - MD*

And if you'd allow me to follow up on the gross margin. It sounds -- I'm going to distill it to my understanding, is that it sounds like it's much more the promotional environment than pricing. But at the end of the day, it's sort of like what's the difference. So in any case, I just want to check if that is what's going on. Prices are creeping up on the shelf, but yet there's a lot of promotionality out there that's hindering price realization for the retailers. And I just wanted to check that, my understanding versus what you're trying to tell us. And second, I wonder if you would be willing to speak to regionality, because I think earlier, you kind of said what's going on with Walmart and Lidl and ALDI is sort of not exactly in your orbit. So it would sound like that may not be as big an issue as maybe what's going on in the western part of the country.

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

Yes, so take that in order. On the first point around gross margin, you heard that clear, you described that well in terms of it's heavy ad and in-store promotions. We do see -- this is something historically we've seen as reflation occurs and people are starting to feel better about their comps, as Jim mentioned a couple of minutes ago, is we tend to see a short squeeze in the near term and then it loosens back up. That's what we've seen in historical cycles, the last 2 deep cycles that we went through. And we don't have any reason to believe that this one would be materially different, because competitive intrusions also getting lighter out there. Certainly, in our core business model, it is with some of the specialty slowing down growth.

And then your second question in terms of regionality, I think we're quite protective of sharing too much there and signaling to competition, but I think Jim's comment about our operations are stronger, our new market rollouts are stronger, our product sets going into the value proposition for the customer are stronger than ever. All of those things are boding really well, with Jim's comment about accelerating that maturity curve in new markets. So we do believe that, over time, we could see the delta between existing markets and new markets, which was quite wide years ago, will continue to narrow because of the brand and the value proposition and the consistency in which we're delivering in these new markets.

Operator

And our next question comes from the line of Robbie Ohmes with Bank of America Merrill Lynch.

Robert Frederick Ohmes - *BofA Merrill Lynch, Research Division - MD*

I'll just do a simple pure one. I was hoping you could clarify a little more as you talk about getting back to almost 3% IDs for the back half. I think you mentioned inflation coming back in, but how much of it is traffic coming back? What's the assumption on the traffic build in getting back to 3%? And then as you think about being above that 3%, scenarios where you get above that, is it more likely to be traffic? Or is it there are signs you're seeing that as you get to the fourth quarter, you can really see much stronger inflation back in your assortment?

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

Yes, I think as far as the traffic, we've continued to see traffic accelerate quite well. And as you know, historically, generally of our equation, 30% to 50% of our comps have been traffic, depending on the year, has been ranging in that range. And then the other element around the 3% is remember, as Brad mentioned, is we still expect the back half to be relatively flat in terms of deflation. So I think Karen asked a question earlier, and maybe you're perhaps asking the same one, is does 3% feel soft? I think it's important to remember that 3% in a near 0 deflation or even a slightly -- near flat or slightly deflationary environment for the back half of the year is -- or slightly inflationary environment in the back half of the year, we still think is a very good number to walk in with at this point in time. But traffic certainly has taken a nice uptick, and we're pretty excited about that.

Robert Frederick Ohmes - *BofA Merrill Lynch, Research Division - MD*

And just a quick follow-up. The productivity initiatives sound great. Any commentary just on the wage environment? And are you seeing pressures there?

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

Yes, I think generally, we've been ahead of wages in most of our markets, and it's the same markets where -- we're not seeing any huge pressure, we did see a wave last year and coming into early this year, but I think things have settled down. And I think more importantly, our HR team has done a great job of staying ahead of the curve, in markets like NorCal, where cost of living is just exploding. But overall in the network, wage inflation has been in check, there's just a couple of small pockets in the country where we've had to make sure that we're ahead of competition to attract the talent. And in fact, I'll go ahead and take the opportunity to talk about that is as we've expanded our training program, we've continued to see both store management-level and staff-level turnover continue to come down at a fairly rapid pace. In most environments, having a 5%, 7% improvement in turnover is big. But we're starting to see well into the double digits, 10%, 20% improvements in management and at the staff level, which we're really excited about to -- which really is going to help us build the power of this brand as we go forward.

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

Just a little bit more context in terms of what we're doing on the labor productivity side. I mean, first -- or the second quarter this year, we saw very nice productivity enhancements that slightly more than offset all of the wage cost increase. So it's early days, and we would expect going forward that we'll continue to see the benefit of those labor and technology initiatives in the business.

Operator

And our next question comes from the line of Stephen Tanal with Goldman Sachs.

Stephen Vartan Tanal - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

I wondered if we can just spend a second on the Amazon Prime arrangement. And I'd love to know how the stores are comping versus the rest of the chain and how you think about that rollout longer term. How many stores do you hope to get delivery in, I guess, whether or not with Amazon Prime, over time? How would you frame all that?

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

Yes, so I think it's been a slow start and a fast ramp. We're continuing to ramp faster now, and I think we'll see that continue into 2018. And we wanted to make sure we worked through all the operational kinks and the efficiency kinks and particularly the customer service element of it, which is super important to both Sprouts and Amazon. And as we've done that, we'll accelerate that. Ultimately, it depends by market, of how many stores you need to serve the majority of the customers in that market. But we think that we certainly -- we think that, that number could be somewhere in the 1/3 to 40% range, maybe to half of the stores. But the key point there is it helps us extend our trade area. That 7- to 10-minute trade, driving trade area generally thought of as specialty retailers, really helps us extend that trade area in our network. So we don't think -- today, we certainly don't think we would need more than 30%, 40% of the network. Now in the future, to the extent that home delivery or click-and-collect continues to be more desired, more and more desired by customers, you might just add more stores simply for efficiency reasons. Because at that point, you would have the ability -- it would actually add network efficiency. So in short, it's probably 30%, 40% of the stores over time and you'll see us accelerate in 2018.

Stephen Vartan Tanal - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Got it. And any color on sort of the comp differences, is that contributing meaningfully to the stores that have it already?

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

It's very productive, so I'll leave it at that.

Stephen Vartan Tanal - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Fair enough. And just lastly for me. A lot of talk about kind of the traffic and ticket. I wondered if you can quantify it, as you guys usually do, maybe adjusted for the shift of Fourth of July and also on an adjusted basis, just as we think about the acceleration that's ensued?

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

Yes, so I would say it's slightly less than the 40% mix that we would normally see, primarily driven -- and Jim can add color on this, but it was primarily driven by availability in produce. And certain meat categories had also run up significantly. And when that happens, the ability to promote heavy is more difficult. You can certainly do it, but it doesn't bode as well on margins and doesn't give you the same traffic lift, has been our historical experience. So we did have a couple of headwinds in those 2 departments during the quarter which impacted traffic. But the key takeaway there is that, produce is -- it's a very strong summer season and so it's in full swing now and we're certainly seeing the impact of traffic there. And certain categories in meat have come back down after the July 4th holiday season. And we've seen a meaningful improvement in traffic over the past few weeks.

Operator

(Operator Instructions) And our next question comes from the line of Vincent Sinisi with Morgan Stanley.

Vincent J. Sinisi - *Morgan Stanley, Research Division - VP*

So I will limit to one question. Just in terms of the online initiatives. Obviously, it's still early, but like you guys had said, you're drawing in from a bit wider trade area. I'm just wondering, both in terms of the personalized mobile as well as the Amazon Prime Now, like how much are you doing yourselves in terms of advertising that? And then also with what you're starting to see from both of those things, how does that factor or is it starting to factor in, maybe kind of down the road, how you think about store densities?

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

Sure. So I think as far as marketing, those 2, we have -- the marketing team has 2 separate teams working on how we market to the channel. So both the in-store and out-of-store channel. So that keeps the teams very focused. And it's interesting, because we'll try different approaches on one versus the other because the customer behavior is different. So we're learning a lot from that and deploying our learnings to market to them differently. And we recently, as I stated in my remarks, not long ago started to push more personalized coupons and personalized offers and personalized education to our growing [KCIDs] as we have about 3.5 million customers who walk into our stores, slightly less than that, every week. And we have now 850,000 customer IDs. And we see many of our customers, we're seeing an acceleration in engagement with Sprouts in online and mobile there and how they're interacting. And one data point I would share there is we've seen our mobile coupon activity tick up quite a bit over the last few months as that platform gets more robust. And we're actually working on a new platform right now which we'll be rolling out next year that we're pretty excited about that will -- early next year, which will further enhance that customer engagement and customer connectedness on the Sprouts side, mobile web and -- mobile and web both.

Vincent J. Sinisi - *Morgan Stanley, Research Division - VP*

Okay, that's helpful. And I guess maybe just on -- just the other part of the question, just on kind of what you are maybe starting to think about or starting to see from a density standpoint?

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

Yes, I think from a density standpoint, it's been interesting is if you look at our most mature markets, we have market shares that are upwards -- percentages well above what we ever thought of as a specialty competition. So in terms of how many stores Sprouts can open in a market, our view has just become that number just keeps going up over time. And I think the key there is we're operating as a convenient, healthy grocery store. And it's a fuller shop. And as we continue to do that to meet our customer demand, the ability for Sprouts to open more store has just become more and more evident. And the leverage that we see in our mature markets when we open more stores has been incredible. So the shift to e-commerce, I believe, over a 5-, 10-year period will certainly, we'll be smarter about placement of stores. But at this stage, we don't think that we would have a smaller network of stores than the 1,200-plus stores that we always thought of, sitting here today.

Operator

And our next question comes from the line of Bill Kirk with RBC Capital Markets.

William Joseph Kirk - *RBC Capital Markets, LLC, Research Division - Analyst*

It looks like ALDI is looking at Arizona, with plans for a distribution center. So what would you expect from them, maybe in terms of timing and size of entry versus what you've seen from them in Southern California?

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

Yes, I know they've built the -- Arizona is a distribution facility, and a lot of it is to allow for easier distribution into California. We've not seen them expand materially in the Arizona market. With that said, I think the ALDI shopping experience, the products they carry, the products, the service, the go-to-market approach of what they sell is quite different from Sprouts. So the discounters, Jim and I had a chance to visit Lidl stores last week, and our overarching theme of the discounter business and its impact on Sprouts has been minimal in the past, and we would expect it to be similar, based on what we see today and how we see those stores, what they're selling, how they're selling and what customers they're drawing. So -- but obviously, anyone who sells grocery is a competitor and we keep a close tab on how any new openings, from even discounters, could be impacting our business.

James L. Nielsen - *Sprouts Farmers Market, Inc. - President and COO*

Bill, the only thing that I would add is if you recall, we had -- and we called it out about a year ago, 17 ALDIs open up within roughly 3 miles in Southern California. And outside of that early grand opening period, we fared extremely well. And I think that speaks to the brand, the brand strength in California. So we're extremely confident in the brand strength here in Arizona. And I would assume that, that would follow the same type of cadence as we move into this marketplace.

Operator

And our next question comes from the line of John Heinbockel with Guggenheim Securities.

John Edward Heinbockel - *Guggenheim Securities, LLC, Research Division - Analyst*

So Amin, a 2-part question here. When you think about the work you've done on labor productivity in-store, to what degree has that brought down the comp required to leverage? Has it dropped to 2% sustainably? And then kind of as a follow on that, when you think about how you want to run the business long term, is there an opportunity and elasticity, where you could or should run the business for a flat EBITDA margin over the next 3 to 5 years and drive more for share, given how modest your share is today?

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

Yes, so I think the key thing on the productivity, as Brad alluded to, all of these systems are at the first instance intended to drive effectiveness and customer service. And the resulting benefit has been productivity. And so we're continuing to -- we're starting to see the productivity in the non-perishable departments, but we think that the greater benefits, frankly, sit in the perishable departments, because the impact, in a significant way, what you need to produce, when you need to produce it, when you need to be there for the customer, in the first instance. The second is inventory management, which in fresh can have a meaningful benefit to shrink. And third is just customer engagement and allowing those teams to be more -- to be there when the customers are shopping those items in the store. So the customer service improvement would be better. So that's -- we think that over the next 2 to 3 years, that productivity will continue to strengthen. But our focus is, we will not take productivity at the hest of customer service. We watch those customer service scores very carefully when we roll out these new systems. And we do them systematically market-by-market and not roll out fast to make sure we fully understand any impact we may be having. Hopefully, a positive impact on service is what we're looking for, and we've seen that so far.

And I think on the second part of your question was -- maybe, John, can you just repeat that if you're still on the line? I think the second part of your question was around EBITDA margin of the businesses. I think the key for us is driving our product innovation initiatives and our out-of-store engagement initiatives have continued to focus on driving sales. And second, sales as well as margins, because of some of these initiatives are higher-margin departments, and they do have more production, but they are higher contribution departments as a whole. And second, the productivity that we just spoke to will continue to give us basis points. And I think we'll just be smart businessmen and women here. And to the extent that we need to reinvest it to be competitive and drive the business, we will. And to the extent that it's margin-accretive, then we'll take it to margin. But there's no shift in this company of being a sales-minded company. We're very much interested in gross margin dollars over gross margin percentages.

Operator

And our next question comes from the line of Ryan Domyancic with William Blair.

Ryan John Domyancic - *William Blair & Company L.L.C., Research Division - Research Analyst*

So back to traffic, do you think the biggest headwind to traffic continues to be the loss of some value customers in this competitive environment? Or over the past year, has it shifted to something else, like more competitive openings, more e-commerce or an overall softer consumer environment?

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

So I think for Sprouts, it's been -- the drivers are cannibalization first, which is working its way down. We were above 150 -- 150 basis points for several quarters. And now that number is continuing to come down towards the 125 basis point mark in the back half of this year and going into '18. The second was we were seeing an uptick in competitive intrusion over the last couple of years. And that started to flatten out, and as I mentioned, is the one that we watch the most and we see the impact from -- the greatest, were the specialty. And good news there is the specialty space is settling down in terms of growth. And then I think the third element is certainly competitive, and we've always -- particularly, in our core traffic driver departments, we've always remained true and competitive in that area, not to lose traffic. I think the second quarter traffic commentary around having availability in certain -- gaps in certain produce and then also inflation in meat impacted traffic. But what I would stress is, is that we're back to our normal environment, and accelerating environment, and feel very positive about where traffic is headed as we sit here today.

Operator

And our next question comes from the line of Chuck Cerankosky with Northcoast Research.

Charles Edward Cerankosky - *Northcoast Research Partners, LLC - MD, Equity Research Analyst & Principal*

Amin, I'd like to go back to something mentioned early in the call about how sales were helped by the non-perishable departments. Can you talk a little bit about what's driving that and how it's affecting basket size?

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

Yes, I'll start and then I'll let Jim jump in. I think the non-perishable departments is really driven by the, at the highest level, the authenticity and the desire of more and more people to eat healthy, fresh, natural and organic, and Sprouts provides a convenient format with a very focused -- convenient and value-driven format with a focus on those who desire and want to eat healthier. And the non-perishable department is no different. We can see it in the data, that the categories are continuing to grow 8% to 10% from the public data. And Sprouts continues to lead in that space. And so -- and we also have certain departments which are heavy customer service oriented. An example would be our vitamins and HBA department. And those departments have continued to see the benefit as more people are looking for supplementary additions to their nutrition. That business has been quite strong for us for many years and it continues to build. So those would be the headlines. I don't know, Jim, if you want to add anything else.

James L. Nielsen - *Sprouts Farmers Market, Inc. - President and COO*

Yes, Amin, the only thing that I would add is we have a fantastic team in here in the office that we've assembled. So they put together on-trend products, category review process is extremely thorough. So we think we're always well-positioned. Promos are relevant, every time we go out, so we've got great partnerships with our vendors, which has continued to create tailwinds for us as we go to product development, promo development. And lastly on the non-perishable side, we really haven't talked about it today, but the private label continues to accelerate. Top line accelerated from Q1 to Q2, comps accelerated from Q1 to Q2. And the basket on that, as you kind of referred, is more than by 2x that or it's 1x that of a non-private label basket, and also generating better gross margins. So extremely pleased with what we're delivering on the non-perishable side. I've got to give the team a lot of credit here, in the office as well as the store, in terms of engagement and execution.

Operator

And our next question comes from the line of Ken Goldman with JPMorgan.

Kenneth B. Goldman - *JP Morgan Chase & Co, Research Division - Senior Analyst*

I wanted to dig in a little bit more on the inflation question. I'm a little confused. First, I think you said that you ended the quarter with slight inflation, but it was deflation for the entire quarter overall. I was just curious, and I missed the beginning of the call, forgive me if you addressed this, but perishables, fruits and vegetables, should've have been pretty inflationary. Some of your competitors recently reported and they have much less exposure to perishables than you do, and they had either inflation or flat numbers. So I'm just wondering, am I missing something? I'm trying to figure out kind of what was deflationary that was holding you back this quarter? And then my follow-up to that would be what is your outlook for produce in the third quarter? Because I see it pulling back a little bit, at least in the basic numbers that we see. But it's always hard to tell from our angle what the right numbers would be.

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

Okay. Ken, it's Brad, I will start and then Jim can provide some additional color. But just to be clear, in the second quarter, we were slightly inflationary overall. So if you look at the first half of the year from a total cost inflation, deflation perspective, we were about minus 1%. What we're now seeing and our projection for the full year is to be flat to slightly deflationary overall. And I'll let Jim add some color.

James L. Nielsen - *Sprouts Farmers Market, Inc. - President and COO*

Yes, so Ken, as we moved through the quarter and accelerated, and let's just step back for a second. Just because things become inflationary, doesn't mean you pass it through to retail, because you saw big jumps in there. So now Q2, slightly inflationary. The California share crop was a little bit tight. As we move Northwest, it's been extremely robust. And as Amin mentioned earlier in his comments, poultry and beef in the back half of the quarter did provide some headwinds in terms of inflation. As we look to the back half of the year, just a little color, we would expect beef to be -- or poultry and beef to be slightly inflationary, offset by produce being flat to potentially slightly deflationary, with what we're seeing with some of the early crop estimates and what we've seen here early in the second quarter. So overall, it rolls up to the 0 to -- or excuse me, the third quarter, rolls up to 0 to negative 1.

Kenneth B. Goldman - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Okay. And in terms of fruits and veggies, just a little bit, I know we're running a little long here, but just in terms of the California crop, any comments on how, I know we had a little bit of flooding maybe a few months ago, has that calmed down at all? What do you think in general terms of your outlook there? And I know it's so hard to see more than a few weeks out.

James L. Nielsen - *Sprouts Farmers Market, Inc. - President and COO*

Yes, so I mean, I was -- I'll speak to the third quarter so we're not looking back. I mean, looking back, some of the inflation was California cherries, stone fruits and melons. As we look forward, we're looking to, again, flat to slight deflationary produce, robust Northwest cherries, grapes, apples look good. Still running into some of the few headwinds with stone fruit in the first part of the quarter, but veggies stabilized. We're not seeing those -- the variability that we did earlier. We're starting to see some consistent cost, not with a high level of variability.

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

All right, good. I know that we've run a little bit long and we have a couple more questions and we'll follow up in a few minutes with the analysts. So we apologize for running long. But I really appreciate everybody's time on the call. And hopefully, you can hear from this team that we're pretty excited about where we're headed in terms of product and innovation at the company, as well as how the business is, how the overall industry is starting to see a positive turn. So we're pretty excited as we go into the back half of the year and look forward to talking to many of you and seeing you on the road. Thank you.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program and you may all disconnect. Everyone, have a great day.