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# EDITED TRANSCRIPT

SFM - Sprouts Farmers Market Inc at ICR Conference

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## 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*

## CONFERENCE CALL PARTICIPANTS

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

## PRESENTATION

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

Thank you, everybody, for joining us today. I'm Bill Kirk, the U.S. food retail analyst at RBC. Today with me, I have Sprouts Farmers Market's Amin Maredia, CEO; and Brad Lukow, the Chief Financial Officer. Before we get into the thick of it, you guys preannounced yesterday after the close. So maybe if you want to take a couple of minutes to talk about the quarter and highlight anything from that preannouncement for the folks.

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

Yes. For those of who we met and I have called, we announced a 4.6% comp for the fourth quarter and guided on EPS slightly above the top end of our range for the full year. And so business continues to operate well. Always remind people, our 4.6% comp, we have about 125 to 150 basis points of cannibalization. So in a near to -- a flat deflationary environment, the 6 (sic) [4.6%] comp in food retail is probably pretty good.

And so we're pretty excited with what the consumer's doing. Our product, our merchandising, our innovation is the best that I've seen since I've been at the company. And so we're very excited as we charge into 2018, and we'll talk about some of the other things that we're focused on where we try to focus on the vital SKU and try to get them right. And we'll talk about combination of innovation and infrastructure, where Brad will talk a little bit about that if we get a chance.

## QUESTIONS AND ANSWERS

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

Sure. And people look a lot, as a barometer for competition, they look toward gross margin percentage. How did that hold up in the fourth quarter results that you've preannounced?

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

Yes, obviously, we didn't announce gross margins in our prerelease. But we tried to give you the idea that gross margin was good with the guide on the EPS. So we're very pleased with where the overall business. Business was very good during the holidays. And so we're pretty excited with what the team delivered in the holiday season.

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

Excellent. And the other recent announcement is the press release this morning with the expanded partnership with Instacart. What's behind that partnership? And maybe what are the implications for your relationship with Amazon Prime Now?



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

So from a -- for what's behind the relationship, just to kind of set the stage is, as we've learned a lot about e-commerce and the home delivery business in grocery, one of the key interesting things that for Sprouts and retailers, who were further spread apart as opposed to maybe conventionals who have a concentration of stores every 2, 3 miles apart, we've seen that as a very positive, productive activity for us because it's expanded customer and transaction count, and it's a profitable business for us. So we don't think of it as a burden of home delivery. We think of it as an opportunity. So our spacing as a healthy food retailer or a specialty store, somebody -- some people might put us in the specialty category, is actually beneficial. And so that's one thing. It's a trade area expansion because as many of you know, most people shop grocery 5 to 7 minutes from where they live. This allows us to capture customers outside that 7-minute trade area, so that's great. Second is we think of home delivery as, we want to be where the customer wants us to be. So we want to be channel agnostic. So it would be through both our own website over time as well as third-party partnerships. And at the end of the day, our focus is on the customer, and how can we execute well and be where the customer wants us to be.

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

Sure. And is it fair to characterize that expanded Instacart partnership is in addition to the Amazon partnership?

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

Yes. I can't comment on the Amazon partnership right now. But our initial rollouts for Instacart will be in addition to the 8 cities we're already in today. So we weren't in our home market of Phoenix. So we'll be starting in Phoenix and then continue to roll out as the months come.

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

Okay, excellent. And then taking a step back and may be looking a bit broader. 2017 had a lot of big scary headlines, right? It was Amazon, Whole Foods. It was all the -- it was Lidl. How did or did not the grocery industry change during that year? And how do you kind of expect it to continue to evolve in 2018?

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

Yes. No, that's a good question. It was definitely a lot of headlines in 2017. In terms of how the industry has evolved over the last 2, 3, 4 years is, I think more than ever in food retail, customers are looking for great products, healthy products, more and more so, and then great experiences. So I would characterize it as I think somebody put a note out not long ago that the strong are getting stronger. And so I think that continues. I think the -- over the -- there's almost 30,000 conventional retailers -- food retail stores in the country, not retailers, food stores in the country. I think there'll continue to be shake out of the weaker players in the space, which will bring share to market. In terms of Sprouts, positioning-wise being authentic in health and value both, positions us really well foundationally. As I mentioned, our product innovation and our merchandising is as strong as ever, and we've evidenced -- seen the sales get -- continue to get stronger over the last several quarters. And I think for 2018, to your '18 question, we're really laser focused on experience, both in-store and out of store. And so we've, over the last 2 years, have spent incredible dollars on training and paying benefits to get consistency in our stores. And now we want to bring even more experiences inside the stores, what we're focused on; and second, outside the store. During this quarter, we'll be launching our new mobile social web platform, which will be focused on health, because not many food retailers can stand on that basis and really focus on health, on knowledge and on convenience for the customer. We'll be enrolled -- it'll be in phased rollouts to bring experiences outside the store initially and then more experiences inside the store. So that's what we're really focused on, is one, experience, continuing our growth and then infrastructure, which I'll have Brad talk to in a -- maybe a few couple of minutes from now.



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

Okay. So some of your competitors have tried to emulate some of the things you do well. Some have gone with a smaller format or tried to introduce some more produce-heavy assortment, I'm kind of referring to Kroger Main & Vine or Whole Foods 365. Both have had some closures: (inaudible) Main & Vine, closed. Whole Foods 365 closing a store. Why do you think they struggled to try to bring their proposition toward yours?

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

Yes. I think that from a category standpoint, we've got the value retailers, conventionals and then everybody else. And in the everybody else, every format you walk in and it always looks like it's easy to emulate or copy. We can all walk into Chick-fil-A right now and go, how hard is this? But it is, right? And it's really something we've built over 20 years that's special. And it starts with the authenticity of the healthy products, your assortment, merchandising, the partnerships and the relationships, the deep relationships. There is so much noise in the industry about pricing and pressing vendors. That's not an issue for us because we execute -- I think our team executes as one of the best execution for our partners, for our vendors, and I hear that all the time. It's the #1 compliment I get from the vendors. Our store size and placement of our stores spread out nicely, 30,000 square-foot convenience box that you can do a full shop at. Approachable and knowledgeable service. I could go on and on and on. And then once you put it all together, that's what makes Sprouts, Sprouts. And in any market beside my -- outside of days like this, I will always have my -- a uniform, right? It's the same pants and the black Sprouts shirt. And no matter what airport I'm at, I hear 2 things, is people saying, one, I love Sprouts; and two, your employees are so nice and helpful. And that's not -- it's not something we preach to our customers. That's what they tell us. And that's not something you build overnight. So I think it's all those pieces and the confluence of health, the deep selection and service, the assortment and the value proposition is all nicely packaged, and that's where the trends are today. So we're just blessed with having this format.

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

And in the recent results, I think you commented there wasn't much inflation. So what is your expectation for inflation going forward? And do you think -- maybe this is for Brad. Do you think retailers can get it to the shelf?

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

Yes, I think our expectation is the full year comes in slightly deflationary. Q3 was pretty much flat. Q4 was pretty much flat. We had very slight deflation across produce. We had some slight inflation across protein categories. And our look forward into the first quarter, it's going to be a continued, fairly benign environment. I would say from a retail pricing perspective over the last 6 months, I would characterize it as being very consistent. I think retailers have taken the opportunity where there's been a slight inflation to pass cost increases along at shelf. We're always a fast follower, and we're generally not leading with that. We're very consistent and strategic around our price gaps and our positioning across our 26 price zones. And we'll continue to ensure that we are priced properly.

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

And where you overlap with Whole Foods in some of those price zones, what have you seen from them in regards to produce about price or even about a change of maybe to their assortment in produce?

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

Yes, I think we monitor every single competitor extremely closely, market by market. And all I'll say is that we've continued to execute our strategy around everything we do, including pricing. And as evidenced by our last 2 quarters in a row at 4.6% comp, I think it speaks for itself in terms of the relevance with our consumer set. And we continue to see accelerated strong traffic into our stores.



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

And there's some initiatives behind traffic. Deli rolling out deli services into the stores is one of them. I'd imagine if it's drawing a lunch-time-type purchase, it might have smaller ticket. But what's it done for transaction comp in those stores where it's deployed?

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

It absolutely drives increased traffic, the frequency, the 12 o'clock, 5 o'clock crowd area into the store. Our customer base is now seeing us as much more relevant into that expanded deli category, as the consumer trends continue to focus around healthy eating but make it easy for me and create value. And so we're happy to see that we're not seeing a big increase in overall systemwide ticket because it's -- the natural growth that we're seeing in average basket, particularly in our private-label area of the business, is being somewhat offset by the accelerated traffic that we're seeing in our stores that have the full deli offering.

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

And I'm glad you brought up private label. Where do you kind of stand with potential categories where it could be deployed versus where you are today? What are some of those categories? And what does private label do to comparable store sales versus profitability?

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

Yes. Private label for Sprouts has been a great journey. We're -- this year, we'll be over \$0.5 billion in sales in the private label. It will be over 12% of our business now. And it's a 30% sales growth year-over-year for us. It has been for the last few years. But for Sprouts, what's exciting about private label is that we've taken a very differentiated approach to private label. It's been -- historically, it's been healthy food. And today, over the last year or 2, we've taken -- the last year or so, we've taken this added emphasis on health and taste. And so that's taken us in a very different direction on creating really unique products. And so our approach is attribute-driven products. It can be raw foods. It can be vegan, a new twist on taste trends, whether it's Asian or some European or something that's really unique in the marketplace. So that program really started to resonate and been a complement for us in depth of assortment. And our baskets are meaningfully higher and much more profitable when private label. So we'll continue to grow that program. But we have a very clear three-pronged strategy to continue to work with our major vendor partners, work with emerging brands and work private label. And it's a collective and comprehensive set of health and selection for the customer of depth of assortment that we think about. And categories like private label's growing great across the store in every department. So we have more opportunities in certain areas than others, and we're going to continue to deepen that. And I think in the midterm, we'll be in the mid to high teens in that area.

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

So those are some of the strategies that are visible for us to see as we go into your store. But some of the things that are a bit harder to see would be some new initiatives around shrink management and promotional management. What do those programs entail? Maybe what's the size of that opportunity relative to some of the other initiatives we talked about? And is there some sort of big capital investment required to begin those procedures?

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

Yes. I would say Sprouts has really been quite focused on implementing software solutions to add efficiency across the organization to enable us to scale and scale very profitably. And it's one of the reasons why about a year ago, we came out and said, look, from a new store growth perspective, we feel very comfortable that we can execute flawlessly, opening approximately 30 stores a year in the context of all of the opportunities that we have to implement all these systems. So from a system standpoint, really started middle of 2016 where we put in labor scheduling in the non-production department. You saw that over the last number of quarters that we're starting to get some real traction from an efficiency and sales per labor hour productivity perspective, having the staff team members in the store at the right hours when the customers want the service



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in the store. And we've seen our customer service scores increase. Really for 2018, the focus from an efficiency standpoint is implementing a system across all our fresh categories. Everything in terms of how we order product in the past and up to today, it's all manual in nature. We're putting in a best-in-class, cloud-based solution. We'll be rolling that out across the system in 2018 with integrated demand forecasting. So inevitably, when you have a manual system, you've got half of your stores ordering too little, half ordering too much. You're leaving sales on the table in the stores in half of the stores; and the others, you're shrinking out too much. So we see this, and a number of us across the executive team have implemented this type of solution in past lives, and we really understand the size of the opportunity. And so that is going to be a focus, and that will be integrated with labor scheduling, production planning. When you think about a lot about of the product that we produce in-house that's in the deli area, the service case, we've now have developed engineered labor standards that is integrated with our demand forecast throughout the day so that we're producing throughout the day rather than just at the beginning of the day or a couple of times during the day. So the product is going to be fresher. The product is going to be full in the case throughout the day to meet the demand of the sales. And that, of course, drives your labor scheduling, and it's all a nice fit. So that's a big initiative for us. It'll take us the bulk of 2018 to roll it out by department, and we'll start to see some of the benefits in the back half of the year, but really looking for run rate savings in 2019. But we then have the luxury of determining how much of that just drops to the bottom line versus strategic investments, market by market, maintaining our competitive position. Again for us, that's tailwinds. Most of our competitors have implemented these types of solutions years ago. So we're pretty optimistic based on the historical experience that we've had with -- to date on labor scheduling.

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

Excellent. See what the time says. We're plenty. Good. So the -- maybe switching toward real estate strategy. You've entered some new markets, going up from Florida, pretty much all the way toward Pennsylvania. How do you think about new and existing markets in terms of expansion for new units? And how do you think about the 10% growth rate? Why is that the right number for new units per year right now versus others, who have taken it down pretty dramatically?

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

Yes, just starting at the top. We've done this for a few years now. But we always are looking out 5 to 10 years to see where's the economy growing? Where's the population growth of the country? Where are the job creation? Where is the education? People, where are they moving -- educated people moving? So we're taking a very long view when we decide new markets. And because there's so many potential places for Sprouts to go, being only in 15 states today, and sort of pulling that into the near term, we're looking at a combination of near-term education levels, income levels, job growth, so all the basic demographics of a wide swath of middle income and upper middle income. Also competition, the level of how strong is the specialty competition. How strong is the conventional competition in the market? And after taking all of that into account, as we've come to the East Coast with -- and the Southeast, expanded to Florida and have been a very productive market, we'll continue to grow here. We see -- we announced the Mid-Atlantic a couple of months ago. We're very excited about the Mid-Atlantic. We think for -- it's right for a format like Sprouts. The competition level there is not as robust as maybe in some other parts of the country, so we're excited to get up there in 2018. And then in terms of the 10% growth rate, we were growing 12% to 14%, a little bit faster. And because we're expanding into new markets, we found ourselves stretched and decided to slow down growth even though Jim, our President, always reminds me 10% growth rate's not the slowest growth rate in this industry. He reminds me almost every other day. But nonetheless, it also allows us to focus on the projects that Brad talked about. Because when we looked at the share of dollars that are available there in these projects from a profitability standpoint, that's meaningful to the EBITDA of this company. And so we feel good. And it's -- with 15 states, going to 18 states in the next 12 to 18 months, it gives a very good balance of that 70-30 mix that we think about. And it gives us a lot of leverage. If you do math, it's less than 2 a state. So there's a lot of brokers and a lot of landlords fighting to get Sprouts in their centers today because of the traffic we drive to the centers. So certainly, the leverage is on our side in being able to be very selective in the real estate.

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

With others having slowed their growth rate more dramatically, are you seeing less competition for sites? Has that really changed?



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

I think it's -- there's a duality, is there's always competition for great sites, right? And there's a number of formats in the 25,000 to 30,000 square-foot box. So I wouldn't say that there's -- but by having so many markets to choose from, it does open that up, that flexibility up. So you can always get an average site. But that's not in the program, okay? So I don't think that the demand is meaningfully reduced for great sites. And as we've upped our bar on site selection, I think it feels neutral because we've upped our bar in the demographic and the density in the -- because we frankly want higher sales volumes. And so as we moved our bar up, it feels a little bit more neutral in terms of competition.

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

And everybody's trying to figure out what Whole Foods is up to. Have you seen any change from them in terms of where they show up at different locations? Or what they're thinking on real estate?

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

Been pretty quiet when we're out in the markets on what's happening there. I know that they've, I think, formally announced what they're doing on 365 going forward. But there's probably a little bit more activity when they were expanding the 365 format. But today, it's been relatively quiet, certainly in the trade areas that we're interested in.

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

Okay, on the back end maybe on the gross margin line. Some of the large food retailers have done well in that line, and they've credited maybe pushing more aggressively against their suppliers to help on that line. Is that an item that's unique to may be Kroger's scale or Walmart's scale? Was that an opportunity that you at Sprouts would have as well?

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

Yes. Our approach to business with vendors, it's very different. It's -- we never start with what's the cost? We start with, what's the sales growth plan for next year? And when you get the right sales growth plan, the cost of margin solves itself. And when you execute against that sales growth plan, when you pick up the phone, and Jim's probably one of the best in the industry, he gets what he wants in price. So our mentality and approach is just different. And a lot of our vendors in the natural and organic space operates differently than some of the large CPG companies. So our approach has always been very relational. And it's just so much cleaner way to do business. And we, Jim and I, talk about this all the time. We don't think we have, outside of some vertical integration in a couple of areas, a scale that's at an advantage to anybody else in terms of price. Bottom line is when you execute and are growing somebody's sales at 15%, 20%, you can ask for a lot, and they'll give it.

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

I think back in December, Amin, you had mentioned that tax reform you thought could be split between shareholders, customers and employees. Now that the legislation's passed, is that still your expectation? Have you seen anybody do anything conclusively with what they believe that they're savings to be?

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

I don't think we've seen much yet. It's still early days. But the way we think about it, fundamentally from a strategic standpoint, we haven't -- we are not altering our course. We have been focusing on the key strategic platforms of the company. When you think about the service level that we provide in our stores, it's critical for us to make sure that we continue to invest in team members. So starting in -- back in 2016, we communicated to the market, and we stepped up our game, made strategic incremental investments in wages in key markets and in key positions in the store



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that is service oriented. We've also stepped up our game in training. And at the end of the day, we're obviously always assessing market by market. But we do not see any step-change requirement in that regard. And with regards to capital, again, we've talked about strategically the number of stores that we're going to open per year and the systems that we're implementing. So really no change from a strategic focus standpoint. And I think we've made it very clear to the markets and very transparent that we're very much a shareholder-friendly company. We have a real capital-efficient model that generates 35%, 40% cash-on-cash returns, very strong model that allows us to generate excess free cash flow that we'll continue to return to shareholders in the form of a -- the buyback program.

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

The only one thing I would add to that is, to the extent that others do announce anything, I think there are 2 elements: One is some people might just be behind, right? So this affords them an opportunity to catch up, so that would impact us. And then it also depends on who's making that announcement, right, whether it's price or wage and benefits. So Brad talked about we feel like we're really well positioned. And we try to be very data-driven as a company. When somebody does make an announcement, the first question is, if it's price related, is it our customer? The second is, where is it, right? So being very focused on not broad brushing and chasing and reacting. We've got our processes and systems nailed down to what I think is a science on both pricing and deliberate investment in wages, benefits, other benefits that you can provide for a brand like ours, positions in the store. And over the last 2 years, we've made meaningful changes in certain positions that are super important to us to bring our turnover down deliberately. And we've done that. And that's why when you hear the confidence here, it's because we are seeing the fruit -- the rewards of all the labor we've put in into this work.

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

And I guess that's a pretty good place to stop. Looks like we're about out of time. Thank you, guys, for joining us here today. I believe you go to breakout in -- within the hour, so more questions then.

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

Great. Thank you.

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