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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Sprouts Farmers Market First Quarter 2018 Earnings Conference Call. (Operator Instructions) As a reminder, this conference call is being recorded.

I would now like to introduce your host for today's conference, Ms. Susannah Livingston. Ms. Livingston, you may begin your conference.

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 2018 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 2018 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 2018 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 SEC filings 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.

With that, let me hand it over to Amin.

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

Thank you, Susannah. Good morning, everyone, and thanks for joining our call today. Sprouts' fundamentals continue to show strength as demonstrated by our first quarter results and good progress on the strategic initiatives. For the first quarter, sales increased by 14%. New store productivity was in the low 80s, above our historical average and we grew EBITDA by 12%, all resulting in solid cash flow generation. Despite tightness in produce supply and slight deflation, we achieved EPS of $0.50, which beat our internal expectations for the quarter, driven by higher gross margin and labor productivity improvements. For the first quarter, sales rose to $1.3 billion with strong performance in new stores, a comp of 2.7% and continued positive traffic.

Our private label initiative, optimizing our promotions with BI tools and products that are more relevant to our customers are driving comps and adding to the full shopping experience that our customers embrace at Sprouts. Comps were impacted by a slight deflationary environment, calendar shift from the nearest holiday and tightness in key produce categories early in the quarter, which limited our ability to promote during the quarter. Despite the CPI reporting inflation for the quarter, we experienced slight deflation due to the mix of our basket.

The overall promotional environment remains competitive, and we continue to maintain our pricing strategies across all departments and geographies and our healthy living promise to our customers.

Shifting to new store growth. In the first quarter, we opened 9 new stores, including our first new store in Maryland, which brings our presence to 16 states coast-to-coast. Our pipeline remains strong with 47 approved sites and 40 signed leases for the coming years. We look forward to opening our first store in the state of South Carolina next month as well as the opening of our 300th store.

Our recent vintages continue to open very strong, both in new and existing markets, and our new store productivity continues to run above our historical averages. This is a direct result of our brand strength that continues to resonate across the country, driven by improved execution of store openings in new markets as well as improvements over the last 2 years in our site-selection process.

Now let me provide a brief update on our 2018 strategic priorities. This is a dynamic time for the grocery industry and while we continue to remain nimble and adapt to the changing environment, our focus remains on our strategic priorities including authentic and unique -- healthy product offerings, improving customer experiences in and out of store, investing in our team members' developments, and investments in technology to drive efficiency and lower our cost structure.

First, on the product innovation front. Our private label continues to drive success in many of our categories with comps continuing to exceed the company average. An increased number of private label baskets as well as more private label items in these baskets has propelled our penetration to more than 12%, a 100 basis point improvement over the same period last year. Our private label focus remains on better-for-you ingredients, on-trend and unique products, taste and value. We are already on our way to launching more than 200 new items this year. We also continue to innovate in Deli, Meat and Seafood. We are evolving as a destination for ready-to-eat and ready-to-cook items, which are resonating well with our customers. We continue to introduce new products, thoughtful and simple to meet today's customers' preferences. Our focus remains on making the shopping experience in deli and meat and seafood areas exciting and easy for our customers.

Second, we continue to enhance our capabilities to connect with and engage customers across all touchpoints. In February, we launched our new sprouts.com website and mobile app. In store, our team members are passionate about inspiring, educating and empowering every customer to eat healthier and live a better life, and we wanted to bring these experiences to our customers on our digital platform. Our new Sprouts.com and mobile app allows our customers to explore staple, trending and unique products and add them to their shopping list, deliver valuable savings through mobile coupons, new continuity offers and geo-targeted weekly circulars to ensure we deliver value for our guests every time they shop. We look forward to building additional personalized features that are meaningful to our customers and empowering them on their health journey.

On the home delivery front, we began our Instacart same-day delivery -- home delivery partnership at the beginning of the year. The Sprouts brand and the service resonating extremely well with our customers, and we continue to see week-over-week growth in the business work. With great customer response and strong execution, we're continuing to expand to all of our major markets and now in the early efforts of increasing awareness and marketing. As of May 1, we also discontinued our Amazon Prime Now home delivery partnership out of our existing 15 stores. The transition will impact comps for the next several quarters, but we remain very confident about growing our home delivery business as it brings a unique health and value proposition to our customers.

Third, we are continuing to focus on our team member development, which is allowing us to provide great service in-store and build our bench for future growth. As we mentioned on our last call, the Tax Cuts and Jobs Act was a catalyst, which allowed us to invest an additional $10 million or $0.06 in our team members in 2018. These strategic investments focus on wages, health benefits and training. We have seen for the past 2 years that our thoughtful approach to team member investments have resulted in improved customer satisfaction scores, better operations, including in-stock position and significant improvement in team member retention. We look forward to the incremental investments further strengthening our team, our brand and our culture.

Lastly, we're investing in systems to support our growth and gain operating efficiencies. We have begun implementation of our Fresh Item Management Technology to reduce operating complexity, drive better in-stock position, reduce shrink and integrate our production needs with our labor management system. We began testing the software in one department with early success and are currently expanding work into other departments. We'll remain on track with the rollout to the other departments and as the year progresses, we expect to gain efficiencies beginning in 2019.

Before I close, I'am proud to speak about one of the sustainability successes we achieved in the first quarter. More than 80 Sprouts stores received a grocery stewardship certification, which recognizes our commitment to operational practices to reduce our stores' environmental impact and save resources. It measures cost savings through operational sustainability efforts, revenue-generating sustainability opportunities and employee engagement strategies as well as metrics on waste, water, energy and other conservation initiatives. We continue to move forward towards our Zerowaste goal by 2020.

In summary, our strategic initiatives are progressing very well and will further strengthen our business model, and our results today provide evidence that we have a strengthening business model, which continues to deliver double-digit sales and earnings per share growth - further supporting our confidence in delivering long-term success.

With that, let me turn the call over to Brad to cover our financial results and 2018 guidance.

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

Thank you, Amin. I'll begin by discussing some of the business drivers for the first quarter and then review our guidance for 2018. For the first quarter, sales were $1.3 billion, up 14% over the prior year, driven by strong new store productivity in the low-eighties and comp sales growth of 2.7%. As Amin stated, private label, promo optimization and product innovation continue to drive comps. Contrary to our original expectations, we experienced slight deflation, which negatively impacted our first quarter comps. In addition, the shift in the New Year's holiday impacted Q1 comps by approximately 25 basis points. And as Amin mentioned, we experienced a tight produce supply early in the quarter. Despite these challenges, we delivered strong earnings growth, mainly driven by an improvement in merchandise margins, solid new store and labor productivity, helping to partially offset our strategic investments.

For the first quarter, gross profit increased by 15% to $387 million and our gross margin rate increased approximately 25 basis points to 30.1%, compared to the same period last year. The majority of this leverage was due to improved merchandise margins. While our ability to promote produce was limited and negatively impacted our comps for the quarter, it did result in a favorable gross margin mix.

Direct store expense increased 15% to $263 million, an increase of 10 basis points to 20.4% of sales compared to the same period last year. This deleverage is primarily driven by the holiday shift -- holiday pay related to the calendar shift in New Year's as well as increased benefit costs and depreciation. This was partially offset by our continued improvement in labor productivity and operating efficiencies in the stores.

SG&A increased 29% to $41 million for the quarter, an increase of 40 basis points to 3.2% of sales, compared to the same period last year. This deleverage primarily reflects cycling lower stock base compensation and bonus expense in the prior year, and costs associated with our strategic technology investments. These investments pertain to the fresh item management system and costs associated with the improved website and mobile app that we released in the first quarter, which will enable future operational savings and sales growth.

EBITDA for the first quarter increased 12% to $107 million, a decrease of 10 basis points to 8.3% of sales when compared to the same period last year. The decrease in margin was mainly driven by the holiday shifts, increased operating costs from the timing of our strategic initiatives, partially offset by improved gross margins.

Net income for the first quarter was $67 million and diluted earnings per share was $0.50, an increase of $0.17 or 52% over the same period last year. The exercise of expiring pre-IPO options reduced our effective tax rate in the first quarter of both 2018 and 2017, resulting in a benefit to earnings per share of $0.08 and $0.03 respectively. The improvement of reported earnings per share is primarily due to higher sales and margins, a lower effective tax rate and fewer shares outstanding due to our share repurchase program.

Shifting to the balance sheet and liquidity - as reported in the first quarter, we amended and restated our credit agreement. Our total commitments increased to $700 million from $450 million, and we extended the maturity through March 2023. This expanded facility provides us with greater financial flexibility to execute on our capital allocation strategy.

We continued to utilize our solid operating cash flows, $104 million in the first quarter to support our unit growth and sales initiatives. We invested $38 million in capital expenditures,net of landlord reimbursement, primarily for new stores. During the first quarter, we repurchased 3.3 million shares for $83 million. We ended the quarter with $21 million in cash and cash equivalents, $368 million borrowed on our $700 million revolving credit facility, $394 million available under our current share repurchase authorizations and 1.4 times net debt to EBITDA.

Now let me turn to 2018 guidance. Due to lower inflation than originally anticipated and the transition of our home delivery model, we are lowering our comp and sales guidance for the year. We are maintaining all other guidance, including EPS based on solid first quarter earnings performance. Net sales is expected to be between 10.5% and 11.5%, and we expect full- year comp sales growth to be in the range of 1.5% to 2.5%.

In addition, we are maintaining our guidance for the following: Our effective tax rate will be between 19% and 20% for the full year; diluted earnings per share will be in the range of $1.22 to $1.28, resulting in EPS growth of 21% to 27% for the full year; Capex of approximately $165 million to $170 million, net of landlord reimbursement; and approximately 30 new stores for the year.

A few additional items of note on the full- year 2018 guidance. Our original guidance contemplated an inflationary environment, and we now expect inflation to remain flat for the year. Currently, in the second quarter, we continue to experience some cost deflation in certain categories. As it relates to margins, we still expect gross margins to deleverage slightly year-over-year, primarily related to deleverage inoccupancy.

In regards to DSE, the investments in our team members from tax reform savings will account for approximately 20 basis points and commences in the second quarter. The remaining DSE [deleveragee] is due to investments, predominantly training, to support our system implementations.

Our team member investments from tax reform savings as well as costs associated with the training component for the new systems will step up in the second quarter of 2018, resulting in the highest amount of deleverage during this period. We still expect DSE deleverage to be between 20 and 40 basis points for the full year.

Due to the timing of our strategic investments as compared to the prior year, SG&A deleveraged more in the first quarter. We continue to expect only slight deleverage in SG&A for the full year.

Below the EBIT line, we still expect interest expense to be approximately $27 million, including interest related to financing and capital leases.

With regards to our tax rate, most of the pre-IPO options have been exercised in the first quarter of 2018. As a result, we expect our effective tax rate to be in the range of 24% to 25% for the remaining quarters.

And as for capital structure, our capital allocation priorities remain unchanged: first, unit growth; second, investments in the business; and third, returning capital to shareholders. As for share repurchases, we expect to maintain a net-debt-to-EBITDA ratio of approximately [1.4x] to 1.7x (corrected by company after the call).

In conclusion, we remain confident in our business model and based on our continued strong EBITDA growth, our solid free cash flow generation and healthy new store productivity, that will continue to drive long-term shareholder value creation.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Kelly Bania of BMO Capital.

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

Was wondering if you could just talk a little bit about the produce, the tightness in the produce supply and it sounded like that maybe got better in the back half of the quarter, and just curious if you can explain how that's maybe impacting traffic and your ability to promote your key produce category.

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

Kelly, it's Jim. As relates to traffic, we were positive for the quarter, but we did see some tightness in the first half of the quarter related to produce on the import side of the business. And if you look at last year, obviously, we had much better supply the first part of the quarter on the import side. As the quarter progressed, we saw the import improve, and as products moved up into the northern hemisphere and into California, we saw some deflation, which negatively impacted us on the sales side. In the first half, we were negatively impacted from the ability to promote as relates to supply.

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

Got it. And can you just maybe help us understand the lower inflation outlook, just lower inflation overall? Which category is that really stemming from? Is that produce? Is there other categories in the store? I thought maybe produce would have been inflationary for the quarter, but maybe it's now deflationary. Maybe you can just help us understand that a little bit more?

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

Yes. Kelly, this is Amin. I'll start and Jim can add. It is, we -- as Jim mentioned, we saw beginning of the quarter is relatively mute to slight inflation in produce, but as the quarter progressed, we saw quite a bit of deflation as we moved to the hemisphere, and we're continuing to see deflation today and expect it to settle down as we get into the early summer months and summer months. So most of the deflation that we're seeing is coming out of produce. There's some in meat, but it's primarily in produce.

Operator

Our next question comes from Vincent Sinisi of Morgan Stanley.

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

I wanted to ask on the digital front. No -- a few months in now, of course, with Instacart and you mentioned the 15 stores that have previously been with Amazon no longer. Can you just maybe give a little bit of color on kind of the impact that you're expecting from that specifically? Like, are those 15 stores already now switched over to Instacart? And maybe just any initial color that you're seeing within the data would be helpful.

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

Yes, Vincent, good question. As you know, we started our beginning of our Instacart partnership at the beginning of the year. For the quarter, there were only about 12 or 13 stores that were on Instacart and they have a very different gravity model. So what we would expect is we've continued to ramp and as we've seen great response and operational execution, we ramped up the partnership fairly quickly and as we continue to see strong operations, we'll increase -- now we're starting to increase our marketing efforts around it. We want it to be very methodical and ensure that we had exceptional customer service before we expanded our marketing efforts. So as we go through the year, we remain really confident in how the brand is responding and the week-over-week sales growth we're seeing in the business. So we were in our former relationship for about 18 months, so anytime you switchover, there's always going to be timing differences to grow the business. But we're very confident that throughout this year, we'll grow this business in a similar fashion, if not better than what we have with our previous relationship in the markets that we operated in. Sorry, I was just going to say, it is -- so it will impact -- specific to your question, it is -- it will impact or slight impact to our comps for the next several quarters, but we would expect it to normalize as we go towards the end of the year.

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

And then the only thing I would add is we only had 16 stores for the full quarter, and what we did see in those 16 stores, since we have good line of sight of those, we saw good growth, accelerating growth throughout the quarter. So we're able to really view that and look at the back half of the year with the implied growth we've had in the stores with the longest runway and get really comfortable with the back half of the year numbers from the home delivery front.

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

Okay, and if I could just slide one fast. I know you guys have said in the past that with the online orders, the majority of them were coming in from kind of beyond that 5- to 7-minute drive time. Is that still the case today?

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

Yes. We're doing some insights with our new partnership. It looks like it's early days. We've been in for 12 weeks so we're actually in the middle of understanding that, but I think the expansion of the trade area, given the number of units that we have in the market, still applies and the key for us is to make sure we have enough stores to be able to service this model as Instacart has a different Gravity model. So we feel pretty good that we can expand our trade areas to capture that outside of 5, 7-minute sales.

Operator

Our next question comes from Mark Carden of UBS.

Mark David Carden - *UBS Investment Bank, Research Division - Associate Director and Associate Analyst*

I wanted to dig into gross margin a little bit. What were the primary drivers in the merch margin improvement? Was it related mainly to mix, deflation or something else? And if you found competitors to be ramping up their price investments more or less than you initially expected following tax reform?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

Thanks, Mark. It's Brad. As we pointed out, because we had some supply tightness on the produce side in the first half of the quarter, it limited our ability to promote in the produce category. And as a result, we saw a more favorable product mix, category mix within our business that drove the improvement year-over-year on merch margin. From a competitive standpoint, we continue to see a competitive environment similar to the fourth quarter. You see some spikes in certain categories in certain weeks, but overall, I would say it's a consistently competitive environment.

Mark David Carden - *UBS Investment Bank, Research Division - Associate Director and Associate Analyst*

Great. And then as a follow-up, a few quarters ago, you mentioned that you're considering adding a click-and-collect option to supplement your online offering. Is this still in the works for you guys? And if so, do you have any update on any rollouts on those tests?

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

We wanted to really get our home delivery. We think we can expand our gravity model and drive incrementality through home delivery. So we're really focused on that to make sure we get that service right, marketed right and customer experience right. We'll certainly look at other types of tests, including click and collect, as we sort of move forward and see how that's adding value to our customer. And so we don't have a rollout plan for click or collect, or others at this point. But we're going to look at it once we get really our -- I would say, our home delivery homed in, and feel good about maximizing that potential because we actually see more incrementality from there. We do know from research that home click-and-collect for the most part creates cannibalization from in-store and because we're a small box, we're already convenient to come in and out quickly. So that's why we've prioritized home delivery.

Operator

Our next question comes from Ken Goldman of JPMorgan.

Thomas Hinsdale Palmer - *JP Morgan Chase & Co, Research Division - Analyst*

It's Tom Palmer on for Ken. I wanted to clarify what has changed in your same-store sales outlook. You issued guidance in late February. You cited New Year's Eve shifts and produce availability earlier in the quarter. I would've thought those items were known when you issued guidance. So could maybe you just quantify how much of the reduction is related to those items versus like the Amazon and inflation ones that you mentioned as well?

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

Yes. I think the items you just mentioned a minute ago were first quarter drivers. So when we think about the full year, the change in guidance for the full year, it's primarily driven out of our expectation at the beginning of the year of an inflationary environment to now a more near-flat environment, is the primary driver and then a secondary driver is transitioning to partnership. As you can imagine, we were in the Amazon partnership for over 18 months, and we continue to build that business over time. So as we reramp this new partnership, we'll have transitional impact that will last for the next several quarters and then will fall away.

Thomas Hinsdale Palmer - *JP Morgan Chase & Co, Research Division - Analyst*

Okay. And I just wanted to quickly follow up on the pricing question from earlier. You indicated last quarter that your earnings guidance factored in need to make price investments to respond to the actions of others, but that you did not necessarily have then current plans to cut pricing. Has there been any change in this outlook?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

Yes. It's Brad. As we set out in February and again today, our EPS guidance range for the year does contemplate, should we need to make incremental price investments. We remain diligent and focused in our consistent approach to look at our competitive pricing position market by market, week by week, and we feel very good about our competitive positioning.

Operator

Our next question comes from Karen Short of Barclays.

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

Just a clarification and then another question. So I guess back to the comp guide down, I'm still a little confused because I would have assumed in February, when you gave your full year guidance that you would have known that you would be transitioning the Amazon partnership or is that not the case?

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

Karen, for the contract, I won't get into the details. We considered it in our guidance and as we look at the information we know today and how we're ramping up versus the timing of the wind-down, it's causing a slightly higher impact on that transition than we'd have originally expected. But I think the primary driver, Karen, really is our expectation of the inflationary environment to what Jim alluded to earlier is the deflationary environment we're seeing in produce today, we would expect that to settle down over the course of the summer. But certainly, it's something that we don't see a flip back to an inflationary environment or a highly inflationary environment for the full year. We do expect the back half of the year to be more muted or perhaps even slightly inflationary. We'll see how the summer proceeds, but we don't see ourselves getting into the inflationary environment that we expected in February.

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

Okay. And just to clarify, the deflation, is it cost? It's not a retail deflationary environment in produce because of competitive challenges?

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

Correct.

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

Okay. And then I just wanted to switch gears for a bit, I guess the full year comp overall in terms of the guidance. So I mean, I understand inflation may be less of a headwind as we get it into the second, third, fourth quarter, but when I look at what your comp would need to be and specifically more the third and fourth quarter to get to the full year, you really have to look at a pretty meaningful acceleration in the 2-year. So I guess maybe just help me get comfortable with that a little bit. I mean, I know I can look at the 3-year, and it's not as tough on the 3-year, but it is pretty tough on the 2-year. So maybe just talk to that a little bit.

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

Sure, Karen. It's Brad. The acceleration in the 2-year in the back half is really related to 2016 back half or the front half of 2016 was about a 4.5 comp and it dropped to 1% in the back half. So specifically, on the 2-year, it's a much easier compare against 2016.

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

Right, but I'm talking about the 2-year. You're saying the 3-year is easier. I'm talking about the 2-year.

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

I'm talking the 2-year from '16 to '18.

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

And Karen, the only thing I would add is that we did have a small shift this year in terms of our remodels and sales initiatives, the timing so they're more back-half loaded so we get the tailwind from that. And as we talked about, we're going to move to a flat state, potentially slightly inflationary in the back half and then the acceleration at home delivery gives you that -- that stack goes up and that growth in 2-year stack.

Operator

Our next question comes from Ben Bienvenu of Stephens Inc.

Benjamin Shelton Bienvenu - *Stephens Inc., Research Division - Research Analyst*

I just want to ask about the implied margin guidance in light of the more muted expectation for same-store sales going forward. It sounds like maybe gross margins are going to be a little bit better than you would have thought going forward versus your prior expectations. You executed nicely on direct store expenses, but at a lower sales rate. Just help us understand about the inherent deleverage there, and what you need to do from an execution standpoint in order to hit your maintained earnings guidance range.

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

Yes, with regards to gross margin, obviously, we exceeded our expectations in the first quarter, with a more favorable product mix because of the lack of availability on produce earlier in the quarter. And our expectations for the balance of the year on gross margin are consistent with our original guidance and our original guidance was in expectation of only slight deleverage, which is primarily driven by the occupancy deleverage for the year. With regards to DSE, as we set out at the beginning of the year and maintain today, we're looking at 20 to 40 basis points of deleverage for the full year and half of that is related to the team member investment from tax savings, which is about $10 million spread over Q2 to Q4. And the balance of that, much of which will be experienced in the second quarter, relates to the operating expenses associated with training specifically with regards to system implementation like fresh item management that's going to drive operational efficiencies once fully implemented in the early part of 2019.

Benjamin Shelton Bienvenu - *Stephens Inc., Research Division - Research Analyst*

Okay, great. And then it sounds like, I appreciate the clarification on your backdrop for deflation versus inflation, and now expectations of cost deflation. Do you think with where we are in the broader grocery landscape that if we see broader-based moderating inflation or even essentially flat or deflationary environment on a broad base basket, that the instinct to get more promotional will return? Or have we learned our lesson in the most recent cycle and that's perhaps not prudent? Just your thoughts broadly on the posture in the market from a competitive standpoint.

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

Yes, it's a good question. As we said, we've been seeing deflation in produce over the last couple of months. We think that's going to moderate as we -- based on the crops that we see sort of into the summer. I think that this environment's a little bit different than 2016 where we had a sustained inflation for a long period of time and you had a multiple retailers with negative comps and perhaps even negative traffic driven by that sustained environment. This environment feels pretty different so while people remain competitive, I think people -- what we sense is from what we're seeing certainly is it'll be -- it'll remain competitive, yet a little more rational than what we saw back in '16 and we don't see the deflationary environment sustain because it's limited to a couple of categories.

Operator

Our next question comes from Renato Basanta of Susquehanna.

Renato Basanta - *Susquehanna Financial Group, LLLP, Research Division - Associate*

Just quickly wanted to touch on occupancy. It's a bit of a headwind this year, but how should we think about it next year and beyond? Presumably more attractive real estate could be available given the retail landscape, maybe pressure on rents ease. Do you expect that to sort of turn in your favor?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

Yes, it's Brad. Part of the reason for the deleverage, again, this year is related to the fact that all of our new stores that we're opening are 30,000 square feet whereas if you look at our total network of stores, the average is slightly below 28,000. And so once we get into 2019, we would expect that to be more muted. We do see pockets of the U.S. where we're opening stores, where there's a tighter supply on construction and drives a little bit higher occupancy cost. But I think, by and large, we'll see a muted impact on overall leverage, deleverage in occupancy in 2019.

Renato Basanta - *Susquehanna Financial Group, LLLP, Research Division - Associate*

Okay, that's helpful. And then just a quick follow-up. You're obviously investing in team members, salary, training, promotions. Are there any metrics that you can maybe share with us regarding how those investments are paying off, maybe employee turnover, service level metrics, et cetera? And then maybe just touch on how that relates to your store expansion strategy, and how those investments might be contributing to new store performance?

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

Yes, great question. This is an area we're actually quite excited about. We continue to see improvement in execution in the stores and from a metrics perspective, our customers' service scores continue to improve. The ones that's amazed us is, as we've continued to invest in team members is our retention, even in a tight unemployment market, our retention has really taken a step-change. And so we're really excited about that because as we grow, having team members with -- trained and experience, continues to resonate and then our overall team member engagement score, which we measure, we do an annual pretty in-depth survey, that's continuing to move up. And we just came out of a Store Manager Summit last month and it was our third all-store manager summit that we've done at the company, and I've never seen sort of the engagement and motivation and people being behind the brand and the culture, and what we're doing at the company and the difference that they're making in our customers' lives every day in healthy food has never been higher. So we're really excited about how that then translates into better operations, consistency, especially for a growing retailer like Sprouts.

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

The only thing I'd add to is our -- we're 100% staffed and our ability now to attract new talent as we continue to enrich our pay-and-benefit plan as well as training, is really helping us in a really tight unemployment market. So that's been a huge benefit to us.

Operator

(Operator Instructions) And our next question comes from John Heinbockel of Guggenheim.

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

So, Amin, if you think about the -- you guys have always had this transition, right? Acquire customers, trial, then they buy more and become loyal. Where is that trajectory today, if you can track it versus a year ago or 2 or 3 years? The same trajectory, is it faster, slower? Where does that stand?

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

Good question, John. What's amazing is even as our new store productivity has continued to improve, we had thought a year or 2 ago, that perhaps with higher new store productivity, our comps in the second, third, fourth year might flatten a little bit, but they haven't. They remain on the same trajectory in the second, third, fourth year and the benefit that it has to comps. So we're pretty excited about that step-change in our model and as we continue to see the impact that private label, deli, meat and seafood is having to our new store productivity and the fact that the overall business is resonating more and more to customers and we're doing some interesting test to merchandise better in the form and flow and function of the store, and those stores are doing extremely well. So in our new stores, in both existing and new markets, particularly new markets, we've seen continued step-change of new store productivity. So very bullish on that front.

Operator

Our next question comes from Chuck Grom of Gordon Haskett.

Charles P. Grom - *Gordon Haskett Research Advisors - MD & Senior Analyst of Retail*

It's sounds like about 3 quarters or so, the change in the comp guide from earlier this year is from your inflation expectation with the balance, the switch away from Amazon. I guess one, is my math right? And then two, curious why the Instacart partnership would not only help offset that, but why wouldn't that be a tailwind? And I guess, could you discuss the number of markets that you expect Instacart to be in as 2018 progresses?

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

Yes. One thing is, is even though we were only in 17 stores and then 15 in final before we transitioned, we covered most of our major markets. So in terms of the Instacart partnership, we wanted to make sure because we were switching to a different platform, what was most important to us was getting customer experience right and we're -- and operations right. And we've been very happy. So as Jim stated, that for the full quarter, we only had 16 stores, but we've really meaningfully accelerated that and as we do that throughout the year and now, are starting to -- just starting to increase our marketing efforts. We did not want to push marketing efforts, and as well as awareness with the customer hard until we were sure that our operational and customers service scores were nailed down. And we're only 14 weeks into the partnership. So we're pretty positive on that front. I don't know if you want to add anything here, Brad.

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

Yes, I think the split is roughly 3 quarters, 1 quarter. Again, as Amin said, there's a ramp period. We certainly built the Amazon business over a 2-year period, and we'll do the same and feel very comfortable that we'll do so, but when you turn off one system, you obviously have some transition headwinds. But we're feeling very confident and feel really good about the business model and how the customers are responding to it.

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

So we feel good that, it's not going to take us 2 years to build to the same level that, that we had the other partnership in because of our muscle memory and how the brand is resonating with our customers looking for health and value online.

Charles P. Grom - *Gordon Haskett Research Advisors - MD & Senior Analyst of Retail*

And just to follow-up on that. Do you think your guidance is somewhat conservative in that effect that you're not picking in much of a lift, but in theory, if it does take off, there could be some upside?

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

Yes. Because it's early, you always don't want to be overly bullish on it. So I think as our awareness and marketing campaigns take off, if we were seeing increased momentum, we'll share that with you on future calls.

Operator

Our next question comes from Scott Mushkin of Wolfe Research.

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

It's really more of a taking a step back and taking stock question. If I look at you guys, and you're in stores a lot, I'd say compared to when you went public, you're much better operators. I think the stores are really operating well. And I'll also say one of the things that doesn't get talked about is your merchandising. And then, of course, we're in a better economy, but back then, when we talked about 4 to 6 comp, half through traffic, half through inflation, but also kind of a -- the new store maturation. And I guess when I'm sitting back and trying to understand, given that I think you actually are a much better company today than you were back then. What's changed? Why is comps so low? And the retail price is not just about the cost of the good, it's also about what's going on with your labor cost, what's going on with your shipping costs, what's going on with delivery. And so usually, that retail price in an economy like this would be growing and if your cost of goods were falling, you could actually see a nice widening out of your margin and your comps should stay real strong. So I'm just trying to get my arms around. I know it's a long question, but maybe you can comment on it.

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

Yes, Scott. No, that's a great question and if you really step back and we've done this analysis, I think the 2 biggest drivers are one, is inflation/deflation. And if you recall, when we first went public, and then back into '14, '15, we were running 3-plus inflation. And so when you go from 3-plus inflation to deflation, that's a pretty big swing. So I think that's one of the biggest deltas. I think the second part around the business is our East Coast business continues to accelerate and we're seeing good -- all of our new vintages are continuing to see acceleration in the business. And in our more mature markets, it's really the tailwinds of some of the initiatives that were driving some of the early success, while we still continue to have an issue that's like private label, meat and seafood and deli. Those tailwinds are just different today than they would have been when we were just coming up with some big initiatives in the overall environment. So -- and then as you know, competition and margins, obviously, weigh in. So we've always, even today, we think of this as a -- in a flat inflation-deflation environment, a 2.5, 3 comp business and if you're in a deflationary environment, then you're going to come off of that. So it's -- the biggest punchline here is inflation, deflation.

Operator

Our next question comes Edward Kelly of Wells Fargo.

Edward Joseph Kelly - *Wells Fargo Securities, LLC, Research Division - Senior Analyst*

I just wanted to ask a question on produce. And what I'm hoping you could help us understand is the optimal environment from a produce standpoint for you. You talked about earlier in the quarter, tightness [in supply] that obviously hinders you to some extent from driving traffic. Supply has gotten better, but now, we have deflation in the category associated with that, and that's not good either. So I'm just trying to understand what you would see as the most optimal environment there. And then just kind of a follow-up to Scott's question, is there -- how are you now thinking about growth of the business over time? You did slow or pull back on growth to some extent, but you seem to be having a lot of success on the East Coast. Just wondering how we should be thinking about unit growth going forward.

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

Yes. I think I'll start and then let Jim add, and I'll do it in reverse order so Jim can add to the inflation, deflation. As far as growth is concerned, what we've seen is when we went to about a 30-store growth and a more balanced growth in existing markets and new markets, we're really seeing really great, one, ability to pick better sites and be more selective, frankly, in walking away from sites when the economics are not strong. Second, is our training and our new store and our operations are starting off much stronger in the new markets. As well as we're -- feel like we're starting to hit near that tipping point where our brand is leading us, now being in 16 states and in 18, 19 states by the end of the year. We're starting to tip a point where more and more people already know Sprouts when we go into a new market, but they've been into a Sprouts somewhere else during their travels, and that's resonating also as we're going to new markets. So I think that's helping our new store productivity. So all of those pieces, we feel really good about, but we've learned that having that 30 stores seems to be very manageable and very strong on operations. So we like that place. In terms of inflation/deflation, I'll start and then let Jim jump in. Optimum what's for us is this slight inflation or flat to even slight deflation. What tends to happen from time to time is, particularly in winter months, but it can happen at other times of the year is when you get a deep deflation on a particular item or category that hinders us from -- it just hinders sales, right, because you have a lower cost and lower retail, and when you have significant inflation on items for Sprouts, it hinders our ability to promote because when you tend to have tightness and significant inflation, lot of times, the quality of the product is not great. And we, as a company, don't like promoting items, even if it's peak season if the quality is not great. So meaningful inflation actually hurts us. So narrow bands are ideal for us on items and categories.

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

Yes, Amin, just to follow-up. I mean, 0 to 2 would obviously be ideal, but being consistent against all major categories and key items, as everybody looks at CPI, that's a mix of all baskets. We just like that level of consistency across major categories and items, which would imply, obviously, consistent supply and rational pricing in the competitive environment.

Operator

Our next question comes from Judah Frommer of Crédit Suisse.

Judah C. Frommer - *Crédit Suisse AG, Research Division - Research Analyst*

Just another one on the produce tightness. Sorry to beat this one to death. But if you had your druthers in the quarter, do you think you would have promoted more heavily on produce? And do you feel like maybe you lost some traffic because of that? And kind of connected to that, what did you see in other channels conventional, Walmart, Whole Foods? Did they have the same tightness? Did they promote more heavily than you're perhaps able to?

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

As we've mentioned in the call, the only change in the promotional activity and as we referred in Q4 was in the uptick in protein. So we didn't see -- others promoting tightness in markets make it very difficult to promote aggressively in that first 6 weeks. So we didn't see in our competitors, but as the market did free up and we moved into Mexico and to Southern California and supply became more abundant, we saw others jump on board and promote on the back half of the quarter.

Operator

Our next question comes from Paul Trussell of Deutsche Bank.

Paul Trussell - *Deutsche Bank AG, Research Division - Research Analyst*

I apologize if I missed it, but I wanted to inquire about category color. Specifically, how did produce perform in 1Q? Then curious on other areas of the store, deli, nonperishable departments, et cetera. And also, are you able to discuss traffic and overall comp trends quarter-to-date?

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

Yes. So as you know, we don't give department-specific comps. I think the overall theme, I'd say, is 3 things is during the first quarter, because of the tightness -- early in the quarter particularly, because of the tightness in the supply in the produce market, it impacted our traffic somewhat as well as our ability to promote in that area, so certainly impacted comps there. We're seeing really good -- second, we're seeing really good traction in -- overall in our nonperishables department, including private label. And third, our initiatives in deli and meat and seafood continue to resonate well. We're excited about how that continues to evolve as we go through the year. There's some more work we're doing in those departments based on what we've learned about the consumer. So that's all -- those initiatives are on positive traction. So that's how I would characterize it. The only headwind was produce as we talk about.

Operator

Our next question comes from Rupesh Parikh of Oppenheimer.

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

I had a question on Instacart versus Amazon Prime Now. As Amazon Prime Now clearly is free for Amazon Prime members, so I was just curious, how are you guys thinking about maybe the potential consumer resistance in paying delivery free under Instacart versus what you previously had in the Amazon Prime now?

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

Yes, based on what we've seen early on here as the business has been building, is clearly, the higher it is, the more resistance you're going to get from a customer. But to date, based on the sales that we're seeing in the markets that we've launched in and have been operating in for 10, 12 weeks without much marketing, we're pretty positive around how this sort of business builds out. And we're continuing to always test different approaches, but I think one of the big differences is even if the customer is paying -- paying a fee, they're getting a great value with almost all of our pricing in store being the same pricing online. So I think the customer really appreciates the consistency of being able to walk in the store or online, having majority of our promotions being there online. So the total value of the basket seems to be resonating. And of course, the price elasticity for the online customer is a little bit different than what you might be in the value customer coming to the store.

Operator

Our next question comes from Robbie Ohmes.

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

Just I know you don't like to give too much quarterly guidance, but can you just -- the street got a little high on the comp expectation for the -- first quarter there got well above your annual comp guidance. For the second quarter, can you maybe help us think about Easter shift? How much we should think about deflation pressuring 2Q? And how much Amazon -- maybe just a little bit of guidance on where -- how we should be thinking about what we should factor into our thinking on the comp for the second quarter.

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

Yes, Robbie, it's Brad. I would say, what we're seeing to-date in the second quarter is continued deflation in certain categories, including produce, which will weigh on comps in the second quarter. And obviously, we just ended the APN service out of our 15 stores, so the impact of that on the business as we ramp Instacart will be more felt in the second and third quarters. And beyond that, we'll start ramping up and as Amin pointed out, doing a lot more from a promotional and advertising and awareness perspective. So for, I'd say that those are the 2 key elements that will impact the 2Q comps.

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

Be reasonable to think 2Q would be lower than 1Q?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

I'm not giving specific, but the fact that we have a new item in the second quarter being the transition of APN out and Instacart ramping up, that was not existing in the first quarter. So I think that would be a fair statement.

Operator

Our next question comes from Alvin Concepcion of Citi.

Garrett Klumpar

It's actually Garret on for Alvin. I'm actually sitting (inaudible) So just wanted to see how you're thinking about the balance of comp first margin. Looks like the scale pipped towards the profitability side of the equation in 1Q because of the tight produce issue. So is that something we should also expect in 2Q and 3Q, maybe before reversing out as the year progresses, since you're calling for kind of slight gross margin deleverage for the year?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

Yes, I think in the second quarter, we'd be more looking at roughly flat overall total gross margin rate from a year-over-year perspective.

Garrett Klumpar

Okay. And then should we expect that to reverse out in 3Q and 4Q, as you know, the comp headwind kind of mitigates a little bit?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

Yes, I don't think you're going to see very much in the way of movement, plus or minus. We still anticipate the full year to be only slightly deflationary from a total gross margin rate point of view.

Operator

I would now like to turn the conference back to Amin Maredia.

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

We really appreciate everybody joining the call today, and we look forward to seeing you in person in meetings over the next couple of months. 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.