

THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

SFM - Sprouts Farmers Market Inc at Oppenheimer Consumer Conference

EVENT DATE/TIME: JUNE 19, 2018 / 2:15PM GMT



JUNE 19, 2018 / 2:15PM, SFM - Sprouts Farmers Market Inc at Oppenheimer Consumer Conference

CORPORATE PARTICIPANTS

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

CONFERENCE CALL PARTICIPANTS

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

PRESENTATION

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

Thank you for attending Oppenheimer's 18th Annual Consumer Conference here in Boston. My name is Rupesh Parikh. I'm the senior food, grocery and consumer products analyst at Oppenheimer. I'm very pleased to introduce our next presenting company, Sprouts Farmers Market. This is the first time the company is attending our Consumer Conference, so we're very excited to have them here today. Joining us from Sprouts is Brad Lukow, CFO; and in the audience, Susannah Livingston, Vice President of Investor Relations and Treasury.

For those of you who are not as familiar with Sprouts Farmers Market, the company is a leading natural organic retailer, with about 300 stores in the U.S., with a larger concentration in California, Arizona, Texas and Colorado. They are slowly inching their way up the East Coast, with a plan of opening later this year in Philadelphia. Sprouts is one of the few growth stories left in grocery retail, with plans that include roughly 10% annual unit growth. We view the recent pullback in shares as an attractive entry point for longer-term investors.

So before we begin, I'll just mention that today's format will be a fireside chat. So I'll go through some questions I prepared. And then if time allows, we'll open it up to the audience for Q&A. So let's begin.

QUESTIONS AND ANSWERS

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

So I'd like to start at a high level and talk about the natural organic category overall. So as you look at the broader category, what type of growth rates are you seeing currently? And within your store, what are some of the hotter trends right now?

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

Yes, the SPINS syndicated data is projecting or forecasting growth of 6% to 8% over the next 3 years through 2020. More consumers are interested in natural, organic, eating healthier. And obviously, with Sprouts rooted in health and natural and organic and value, that plays right to the middle of our plate. Some of the trends that we're seeing both in perishable and nonperishable in the prepared foods area, we're doing a lot of work in early days of introducing some exciting new products. We're ready to eat in-store, ready to heat or ready to cook, where we're doing all the work for the consumers, so things like marinated salmon with the vegetables already chopped up, ready to go. We call them one-pan meals. In 7 to 10 minutes, 11 minutes, you're having a great meal for your family. So that's the trend, and we've been spending a lot of time on our initiatives in the deli and meat and seafood area of the store, which is resonating more and more with our consumers. Private label has also been a really interesting trend for us, and we've been really pushing in that regard in terms of the product, the attributes, the taste, the value, which is resonating with our consumer. We've got a long way to go there.



JUNE 19, 2018 / 2:15PM, SFM - Sprouts Farmers Market Inc at Oppenheimer Consumer Conference

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

Okay, great. And then as you look at your consumer right now, how do you feel about the health of your consumer currently? And with the continued improvement in economy, are you seeing any incremental positive changes, whether trade-up to more expensive products or other favorable changes on the mix side lately?

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

Yes, I think if you look at consumer confidence is at a 17-year high. So I think the consumer's feeling good. Also, if you look at the tax reform, it's putting more dollars in the jeans of the consumer, and so that's helping as well. One thing that I don't think will change, though, notwithstanding those positives and record-low unemployment, consumers still want value. We see that as an ongoing trend, and again, playing to the core value of Sprouts, where we offer that deep value across the entire store. So I think while the consumer's in a good space, the ongoing focus is on value.

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

And now on to competition. So clearly, a very dynamic grocery backdrop today. So curious what you're seeing out there right now from both competitor openings in your market and also on the price competition side.

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

Yes, I think if you look across the sector, and again, our core competition is the conventional grocery retailer. We know that 60% of our customers come from the conventional supermarkets, where we open up the store. And most of the conventionals have scaled back new store openings. For the most part, most of the new store openings across the U.S. would be limited to the European deep discounters, the ALDIs and Lidl's of the world. And we know that our core customer is very different than an ALDI customer and a Lidl customer. And Sprouts plays to a broad demographic of middle America and we target median household income, higher level of bachelor degree, et cetera. And so I think when we look at who's opening stores, it's really not in the mainstream in terms of who our competitor set are. I'd say there's a lot more headlines and companies doing some work on the e-commerce side, which we have also been engaged in recently.

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

And on the price competition front, are you seeing anything new out there?

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

Yes, I'd say from an overall perspective, it remains a very competitive marketplace. Front page ad, it seems to be where we see the competition playing out. It's -- while it hasn't stepped up, it's been pretty competitive. Where we've seen a little bit of a difference over the last 9 months or so, we're seeing some shelf prices edge up, as you see some cost increases across the store. There seems to be more of a willingness to pass some of that along, while still maintaining pretty competitive pricing on the front page.

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

And then as you look at your Sprout stores on a close proximity to Whole Foods, have you guys seen any quantifiable difference in performance?

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

Yes, we look at -- obviously, since the June 16, 2017 announcement at 6:02 a.m., we've been monitoring with precision the -- any impact on stores. We measure 3-minute, 5-minute, 10-minute-drive time away from a Whole Foods. Keep in mind that on average, 70% of your sales come from



JUNE 19, 2018 / 2:15PM, SFM - Sprouts Farmers Market Inc at Oppenheimer Consumer Conference

within a 7-minute drive time. And so when we monitor, whether it's traffic, sales, tonnage of the stores that are within a drive time of a Whole Foods versus our anchor set of stores that are not, we cannot detect any perceptible change in the performance.

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

And as you look forward, obviously, Amazon Prime Now recently rolled out to more of the locations. The Amazon Prime discounts in Florida now, they seem to be more aggressive in rolling those out. How do you feel about Sprouts' valuable proposition versus some of these new efforts by Whole Foods, Amazon?

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

Yes, so just to reiterate what our pricing model is, we're value across the store. We lead in produce. We're meaningfully greater value, lower prices in our produce area of the business, which is fundamentally a difference from a conventional supermarket, for produce, for us, represents roughly 24% of our business, whereas a conventional supermarket would be 8% to 10%. So we have a very disciplined pricing strategy that we follow through roughly 30 price zones across all the markets that we operate in. And we're always price-checking against the best conventional retailer market-by-market, not against Whole Foods. I will say, though, we obviously watch what they're doing, and in some cases, have made some small adjustments last year to maintain the spread that we had in key items. But when we look at the overall basket between a Sprouts and a Whole Foods, it's still meaningfully greater value for the Sprouts customer. And then I would add, in terms of where we locate our stores, it's closer to where the customers live. We tend to be more neighborhood-y, whereas a Whole Foods, in many instances, are more of a destination shop. So we cut them off from the perspective of drive time from where the customers live and where they want to shop. And so even though there's been some ongoing noise in the marketplace around price reductions and now the Prime membership, we still believe, based on the data, fundamentally, it's a greater value, and we're more convenient for our core customer, which is again the broad demographic of the U.S.

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

Okay. And switching gears to another hot topic out there, e-commerce, can you remind us how you think about the ramp in the number of stores participating at Instacart over time?

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

Yes, so how we go-to-market with our home delivery, which again, put in context for everyone here, in the U.S., home delivery for food represents only 2.5% of the \$850 billion industry, and fresh food is less than 1%, but that is the backdrop. We have switched partners earlier this year from Prime to Instacart, and the fulfillment model is fundamentally different. If we look at the geographic coverage with Prime, we were covering all of our major markets within 15 stores. So 15 stores with a pick, pack and deliver. With Instacart, we're now hitting almost all of those same markets with a couple of exceptions at this point, and fulfillment is being done in well over 100 stores. So the distribution of that business is far more attractive from our point of view, less disruption for the in-store customer, less drive time to get to that consumer, so a better economic model. And so by the time we get through Q4 of this year, we'll be in all of our major markets, and we're seeing a tremendous pickup in growth in the home delivery business.

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

So it's only been a short period of time. Would you say, at this point, Instacart's ahead of your expectations? Or just how is Instacart progressing versus where you thought it would be at this point?



JUNE 19, 2018 / 2:15PM, SFM - Sprouts Farmers Market Inc at Oppenheimer Consumer Conference

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

Yes, the Instacart business has grown at a faster pace than we had expected. We were very intentional and deliberate around rolling out the home delivery service across well over 100 stores because our core focus was to make sure we weren't going to disappoint the customer. The first time you order online, and you get a rotten apple or a tomato that you wouldn't have selected yourself, you lose that customer. And one of the things that we benefited working with Amazon over the last 2.5 years is how they'd perfect the operational execution at the store level. And the fact that we skewed to fresh and 24% of our business being produce, meaning, that we turn that inventory over 2.5 days, we're guaranteed fresh for our customers. So we were very intentional to roll that service out across the network slowly to make sure the operational execution was there. And in the absence -- we did not want to commence any real marketing and advertising until we were satisfied that the operational execution was there. So from the perspective of growth with no promotion, it's exceeded our expectations in terms of how fast the growth of the average weekly sales and baskets have been with the Instacart program.

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

And then when you look at your data so far on Instacart, any characteristics you can share on that Instacart order versus in-store order or versus the Amazon Prime Now?

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

The interesting thing is we are seeing Instacart orders being roughly 20% larger than the Prime Now orders, which were already 2x what the in-store basket size was. And I think part of the reason for that is when someone raises an order for home delivery on Instacart, it's with intentionality. They're not also building a basket for non-grocery, and they're taking advantage of leveraging their annual fee across the network of retailers that are on Instacart, and so they're consolidating their orders, their more attractive orders. The mix is better. When we look at the department mix, it's a more profitable basket for us relative to the Prime.

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

Okay, great. Now I'd like to discuss your new store expansion. So you continue to migrate towards the East Coast, Florida, Georgia and Maryland. Maryland has been one of your recent openings. So if you look at some of your, I guess, newer markets, how have those stores performed versus expectations? And any major surprises in these markets versus maybe your legacy markets that you're more penetrated on, on the West Coast?

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

Yes, we are really pleased with the fact that our new store productivity over the last couple of years has been in the low-80s. Our typical or historical benchmark and target has been 75% new store productivity. We've gotten a lot better from a data analytics perspective on site selection, being able to really pinpoint exactly where our core customer is. And our go-to-market strategy from a marketing and advertising perspective is much more robust today, really utilizing social media, engaging with well-known local food and health bloggers, community events, billboards. We opened up in Florida to great fanfare. The customer knew who we were, opening up well before the first day of operations. So the great learnings from that is, look, that brand resonates across all the markets in the U.S. and that core customer. Again, the fact that we're going after middle America, and that 6% to 8% growth in natural and organic is giving us some tailwinds. Historically, when we opened our stores, and we're roughly opening roughly 30 stores a year, 2/3 of those stores would be in the existing markets and 1/3 in new. And part of that is it takes longer to mature a store in a new market historically. It takes about 4 to 5 years to mature from a sales point of view, whereas 2 to 3 for the existing market. I would say that one of the things that we're really pleased with is Florida, is performing like more akin to an existing market, which we're obviously very pleased with, and the performance is very strong, and looking to accelerate the growth there. Early days in Maryland. We've opened up there as well, extremely pleased with how the brand has resonated from day one when opening up our first store in Ellicott City. And when we sit back and look at the attractiveness of the market, we obviously consider competition. I think there's -- when I look at who the competitors are and the quality of their stores and the lack of innovation, the lack of reinvestment in their stores, and broadly, the absence of specialty, I think it's a tremendous large market opportunity. So we're pretty excited about that.



JUNE 19, 2018 / 2:15PM, SFM - Sprouts Farmers Market Inc at Oppenheimer Consumer Conference

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

Okay, great. And then so clearly, new stores continue to perform quite well in your new markets. So as you look at your mature store base, how are the stores performing versus expectation to peers? Because we look at the data, externally, it appears that at least when you look at your comp store sales guidance, there's a fairly minimal comp growth within your mature store base.

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

First of all, I'd say that our mature stores are continuing to comp positive. They are obviously impacted by a lack of inflation more than your newer stores just because of the higher sales mix. There's a number of initiatives that continue to resonate with those mature stores, and that's the meat and seafood, the deli initiatives that is driving positive traffic and positive comps. But obviously, negatively impacted by an absence of inflation, but we're still pleased. I mean, we're -- if you look back over the last few years, what has driven added traffic into very mature markets are the new initiatives that are resonating with the consumers who want that more fresh and prepared product, as well as private label that has been growing at 25% to 30% a year.

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

And then as you look at your mature store base, you haven't talked about remodels. I think, at least, in recent calls, like, how do you think about the remodeling opportunity that needs to be done on your mature store base?

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

Yes, so fortunately, we're a pretty young company, and we've been opening a lot of stores. So our store base is pretty fresh. I think when we look at the entire store network at the end of this year, there's only 90 stores that would not have been touched in the last 7 years. We're remodeling roughly 14 stores a year, and it's a pretty CapEx-friendly model, with about \$160 million a year for all capital, with about 82-plus percent devoted to new store and remodels and initiatives. So even though there's 90 stores that haven't been remodeled by the end of this year, we have gone back into a number of them to do these initiatives, whether it be deli, whether it be salad bars and more prepared foods. So it's obviously part of our ongoing capital plan. We'll look to touch the stores every 7 years or so and keep them fresh and on trend.

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

Okay. And then staying on the topic of merchandising, so clearly, a big focus, and a number of players are growing their way from categories within the store. So curious, what are the key efforts at Sprouts right now to try to capture more of that growth in away-from-home segment?

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

Yes, so we've done a lot of work over the last 18 months in really improving the breadth and depth of on-trend meal alternatives for customers. If we look at our in-stores and how we're designing our stores, they all have a seating array at the front of the store, where a customer can come in, grab a sandwich or a salad and have it right in-store. We've really focused on ready-to-heat and ready-to-eat. So the example I gave earlier on the prepared salmon or the skirt steak that has the vegetables all cut up as well and the shrimp dinner that's all fresh. And what we love about it, and it's early days from a rollout point of view, but it's resonated significantly with that customer and its value. So the customer's not having to make a trade-off between price and value and the quality of the product. And the fact that we're convenient, 30,000 square-foot store, it's easy to pop in and pick that up on your way home. You don't have to schedule what you're going to eat 2 or 3 days in advance. There's lots of alternatives in the store that are very attractive, and are appealing to the customer. So I think we're just trying to maintain being right on trend with where the customer wants to be. And we've experimented in a couple of locations with a little bit different presentation of that product, and it's resonating extremely well with the consumer is what we're seeing.



JUNE 19, 2018 / 2:15PM, SFM - Sprouts Farmers Market Inc at Oppenheimer Consumer Conference

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

Okay. And then on the private label front, so very strong results in, really, the last several quarters on -- by the way, you continue to grow the penetration there. Everyone out there is focused more aggressively on private label. So what do you believe Sprouts needs to do to maintain that differentiation as really every player out there continues to grow their private label assortment?

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

Yes, I would say, first of all, our go-to-market strategy on private label is differentiated from the bulk of our competitors in that this is not a strategy around national brand knockoff for significantly greater margin. This is anchored in health, value, clean ingredient set, a fantastic taste profile, and we see huge opportunity insofar as we're only at a 12% total store penetration of private label. We have to keep in mind that 24% of our business is produced with limited private-label in produce. So if we strip that out, you look at core categories like grocery, there's around 20% penetration today. Frozen and dairy is also approaching 20%. We think that, over time, we can get that overall 12% to the 15-plus-percent perspective, and it just builds that loyalty is what we're seeing. When we have one or more items of private label in a basket, it's significantly a more attractive basket to us. And so we're just going to continue on the pathway of sticking with the strategy, and we see a long runway ahead to continue to differentiate with private label.

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

Okay. Another very topical area right now is personalization. So some of the leading conventional players have recently highlighted efforts on the personalization front, including Albertsons and Kroger. Whole Foods and Amazon is rolling up the Prime discounts in a number of markets and also starting to capture important consumer data. So if you could remind us of the key efforts from Sprouts on the digital SaaS personalization front.

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

Yes, we're so we're doing a lot of foundational work in that regard. In the beginning of this year, we launched our new mobile web and mobile app, a far more robust platform that's going to give us the foundation for -- to really take it to the next level from a customer engagement outside of the store point of view. So our approach has been one of providing a lot of knowledge to our customers who have expressed to us through how they indicate what they're interested in, and whether it's vegan or what have you. They're interested in education, and we're using that platform to provide customers with a lot of product education. We now have a full library of items, great recipe ideas. And now with home delivery and the fact that the company that we engage with, who provides our platform for the mobile app has been acquired by Instacart, which now gives us the opportunity, going forward, to have a seamless integration for the customer building that order, and then choosing to have it delivered to their home. So that's foundational. We are engaging in a lot of push notifications to customers, again, based on what they have indicated to us that they're interested in. So whether it's new product introductions, particularly private label, communicating around promotions that are relevant to them. And we have now 1 million known customer IDs that we think this just provides the foundation to get much more advanced over the next year in personalized offers with our customers.

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

And when you look at all these digital efforts, like when do you start -- when do you believe those start to be more impactful in driving the top line? And then as you look at all the data collection that's starting to happen at Sprouts, when do you think you can actually start to use the data to drive demand, and I guess, better results from some of these personalized promotions?



JUNE 19, 2018 / 2:15PM, SFM - Sprouts Farmers Market Inc at Oppenheimer Consumer Conference

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

Yes, it's early days, but what we do see, because we contract it for the first time, we see exactly where the customers are spending their time on the app and the web. And so it gives us great insights in how to better communicate to customers around areas of the store and products that they're interested in. It is very early days from the perspective of personalized offers. Again, we're there today, but there's a long way to go. So I think, number one, the most important thing for us is customers through their engagement on the app and mobile web, are showing that we are relevant, and we're the products that they're interested, and the information and knowledge that they're gleaned from, what we're now providing to them, gives us the insights that we can take this a lot further.

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

And as you look at your redesigned website and app, how has that consumer reception been, thus far, versus expectations? And also curious, what are you doing to actually get consumers to use the website and app more frequently?

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

Yes, so I think it's -- when you look at the items that are on the app, and we have separate areas around staple trending and unique products, and they're always being refreshed, and they're seasonally relevant and great ideas around recipes. So we're seeing a significant spike in the amount of time, and the number of customers who are going to the app. So that gives us some confidence that we're on the right track. We have the foundation, and now the focus, going forward, is just to leverage that data and provide a lot more personalization and deepen that loyalty relationship with our customers.

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

Okay, great. I'm going to pause and take questions from the audience. Are there any questions? Just wait for the microphone.

Unidentified Analyst

Do you have any concerns about the trade skirmishes that are now occurring around NAFTA related to sourcing produce?

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

Yes, I would say that roughly 80% of the produce that we sell in our stores is domestic, and so I don't -- any analysis that we looked at it when prior to tax reform being finalized around potential tariffs coming in is not a meaningful impact. And I think if there are tariffs that are -- that do become reality, then I think when you look across the industry, I think you're going to see that, that would get -- ultimately get passed on to the consumer. But we're largely domestic player, and we continue to deepen our supply relationships with local growers. We've moved into the Southeast of the U.S., and we've developed new relationships with domestic growing. So we've -- actually are strengthening our domestic supplies sources.

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

Just wait here. Over here.

Unidentified Analyst

Would you be kind enough to share your thoughts about what the consumer is choosing to do with their dollars just more recently over the last 6 to 12 months? And in the light of the following, it's clear that there is a dichotomy in terms of what the consumer is willing to pay versus not and



JUNE 19, 2018 / 2:15PM, SFM - Sprouts Farmers Market Inc at Oppenheimer Consumer Conference

the changes that are taking place across supermarkets in general, and more specific, the center aisle, which is not going to affect you as much. But just share your thoughts about what the consumer is doing and how you're positioning yourself to benefit from what the consumer is doing.

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

Yes, so I think, as we talked earlier, the consumer's in a better place. But post the Great Recession, everybody is focused on value. Obviously, food away from home is -- I think it was a year ago where the line crossed with food at home. And so I think what's particularly relevant today is supermarkets have to be on trend with giving the customer what they want in terms of ready-to-eat, ready-to-cook, fresh items that are value-add that take away the friction. So we'll do the work for you. I think that's the best thing that we've done in terms of deepening that relationship with that customer who wants that type of experience. I think the benefit from a Sprouts point of view is that we don't sell CPG product. And if you're a conventional supermarket, that's how you start it. And it's roughly 40% to 45% of their total sales mix in a declining industry of packaged products that are not necessarily healthy for you when you look at the ingredient set, and consumers are less and less interested in that. And it's -- when you think about products that are available online, you're less fust as a consumer to order a packaged good online because you're not worried about its freshness. And so I think that puts conventionals in a difficult position, whereas Sprouts was originated out of fresh product. We never sold CPG. And so from a consumer standpoint, when they walk into our store, they don't have to guess where the healthy product is, where the less unhealthy or the unhealthy product is. So I think that's -- we remain focused on trend, and continuing to develop value-added products for the customer.

Unidentified Analyst

(inaudible) what is the (inaudible)

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

Just wait for the microphone, sorry.

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

Sorry, can you hear me?

Unidentified Analyst

When you think of your average customer, what type of income -- annual income we're thinking about? And what do you think they're able to spend on a per-capita basis?

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

Yes, so when we open a store, whether it's a new market or existing market, but let's take a new market, we look to target between the 40th and 80th percentage of the point of median household income. We found that, over time, as the brand deepens with customers, they become more familiar with who we are. We can actually -- we're able to scale both up and down. So it's a broad demographic. That's the interesting thing about who we target. We're not going after the top 1% or 2% of the household income in America. So I think that puts us in a very good place because we -- if you look at the entire basket of goods coming out of a Sprouts store, it's still meaningfully less expensive than the alternative.

Unidentified Analyst

What is that number? Is it 50,000, 45,000?



JUNE 19, 2018 / 2:15PM, SFM - Sprouts Farmers Market Inc at Oppenheimer Consumer Conference

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

Around 45,000 would be median household.

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

Okay. I'll continue with a few more questions. So before we wrap up, I'd like to quickly cover some financial questions. So first, on guidance, so the guidance implies a (inaudible) later this year, at least on a stacked-year basis. So what gives you confidence of being able to lap the compares, being able to drive that acceleration, especially in light of an environment with not much food inflation out there?

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

All right. So I think where you have to anchor back on your 2-year compare, we saw very deep deflation in 2016 at the back half. So it's a far easier compare. It's not like we're looking to significantly grow our average weekly sales. It's really the comparison against the 2016, which was a 1% comp in the back half of the year versus 4.4 in the first half. Also, a number of our initiatives are coming online. We're just starting the roll out of what's been highly successful in these more prepared, ready-to-cook meals, and some of our remodels are more back-end loaded as well in 2018.

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

Okay. And then on the gross margin like, can you talk about some of the key puts and takes as you think about gross margins for the balance of the year?

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

Yes, so gross margin was up roughly 25 basis points in the first quarter when we talked on the call. We had the benefit of an enhanced product mix because of lack of availability in produce for part of the quarter. Our original guidance at the beginning of the year called for a slight deleverage in overall total year gross margin, which is largely related to occupancy, and so that's we'd anticipate being slightly deleveraged for the balance of the year on that line.

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

Okay. And on longer-term guidance, I think given last week, your team publicly commented on the expectations for double-digit sales and EPS growth going forward. So food at home deflation obviously continues to disappoint. So how does Sprouts think about managing the business and achieving these goals if we continue to see these inflationary pressures that may persist for an extended period of time? Are there other offsets in the model to help you still be able to deliver that bottom line goal?

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

Yes. So first of all, I would say that on an ongoing basis, we're looking at 30 stores, 30 new stores a year that we're opening. And obviously, you get the year 2, 3, 4 growth rate that's giving you over 100 basis points, 150 basis points of comp contribution, and that will be sustained. We're extremely happy with the new store productivity, so that just gives us more confidence in terms of the ongoing business model. And the practical reality is the deflation that we saw in the first quarter is not a systemic issue like it was back in late 2015 through '16 where you had multiple categories that were deeply deflated, where you had to go back to 1960 to get a comparable experience. And so when we think about operating in effectively a 0 inflationary environment, we're still seeing traffic and growth through our strategic initiatives in our mature stores, and we're getting the benefit of the newer vintage stores of comping of high single digits. So all that, combined with better free cash flow from tax reform, is only improving our return on invested capital, which is now, total company, over 16%, and based on double-digit top line growth and mid-teens is where I'd say



JUNE 19, 2018 / 2:15PM, SFM - Sprouts Farmers Market Inc at Oppenheimer Consumer Conference

on an ongoing EPS basis going forward. We know we're on trend. We're with the consumer. We know that the natural and organic industry is growing 6% to 8%. We're going after a broad middle America, and we're a great value with health. And I would add, where a number of most of our competitors are pulling service out of the stores, we've actually added service. The fact that we've got great service in the vitamins area, where people look to us to be instilling a great product knowledge to them, which can be a complicated area. We've got meat and seafood, full butcher shop in all of our stores, giving great options for our consumers and just being on trend. So we're very bullish on the long-term prospects.

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

Okay. And I guess, on food inflation, since we really -- we haven't got any questions yet, just your latest thinking on food inflation for the balance of the year and what you guys are seeing currently (inaudible).

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

So again, if you look at Q1, every other category outside of produce was either flat to slightly inflationary. We saw produce deflation continue through the first couple of periods in second quarter. And our line of sight now that the growing seasons trend has now moved to California, we see crop yields are going to be fairly consistent with that of the prior year. We would expect to exit the quarter and produce being pretty flat, and would expect the back half of the year on an overall basis to be slightly inflationary, and that should land us at roughly flat from a total company inflation point of view for 2018.

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

Okay. And then one of your centers for suppliers recently took price supposedly across their entire portfolio. So just curious, are you starting to see any price increases coming through of any significance in the back half of the year?

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

We haven't seen it. I mean, there's a lot of press around transportation cost. I would just add that we self-distribute all of our produce, which is 1/4 of our business, and we've long been compliant on electronic logging devices. And we probably expect to see some inching up on trans cost which was in the back half of the year. I think what's very different from us, from our point of view, is we have extremely low cube items. It's not like we're moving tractor trailer loads of paper at a high cube, low value. So it becomes a rounding error in the scheme of things.

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

Okay, great. Thank you.

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

Thank you.

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

Thanks, Brad.



JUNE 19, 2018 / 2:15PM, SFM - Sprouts Farmers Market Inc at Oppenheimer Consumer Conference

DISCLAIMER

Thomson Reuters reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Transcripts are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT TRANSCRIPTS IS A TEXTUAL REPRESENTATION OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND WHILE EFFORTS ARE MADE TO PROVIDE AN ACCURATE TRANSCRIPTION, THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON REUTERS OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT TRANSCRIPT. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2018, Thomson Reuters. All Rights Reserved.