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CORPORATE PARTICIPANTS

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

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

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

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

CONFERENCE CALL PARTICIPANTS

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

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

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

Christopher Mandeville *Jefferies LLC, Research Division - Equity Analyst*

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

Erica A Eiler *Oppenheimer & Co. Inc., Research Division - Equity Research Associate*

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

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

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

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

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

Marisa Sullivan *BofA Merrill Lynch, Research Division - Research Analyst*

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

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

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

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Sprouts Farmers Market's Second Quarter 2018 Earnings Conference Call. (Operator Instructions) As a reminder, this conference call is being recorded. I would now like to turn the conference over to Susannah Livingston. Ma'am, you may begin.

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

Thank you and good morning, everyone. We are pleased you have taken the time to join Sprouts on our Second Quarter 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 second quarter 2018 results, our 10-Q and the webcast of this call can be accessed through the Investor Relations section of our website at about.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 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. I want to start out the call today by addressing Sprouts' position in a rapidly evolving industry. Sprouts continues to be an industry leader and innovation in health and our value prices continue to resonate with our customers. Our new stores are performing very well, indicating the strength and differentiation of a brand when entering new communities in existing markets and new geographies across the country. Our existing business also continues to perform very well with continued positive traffic and tonnage performance. Traffic has been consistent throughout the year and remains strong.

These strengths are demonstrated in our double-digit top line and EPS growth for both the quarter and year-to-date. Our strategic investments, which I will speak to shortly, plus our investments in technology and team members which increased this quarter, continue to improve our overall customer experience. We expect these investments to generate operating efficiencies and savings, which will give us the flexibility to strengthen our competitive position. Even with these increased investments, we continue to drive double-digit EPS growth. With 2 solid quarters behind us and a good start to the third quarter, we are confident in raising the bottom end of our EPS guidance for the year by $0.02 to a range of $1.24 to $1.28.

For the second quarter, sales rose 12% to $1.3 billion, driven by a comp of 2%, continued positive traffic and tonnage in our core business as well as solid new store productivity. The strong new store productivity continues to be driven by product innovation, enhancements in our merchandising and new store marketing programs. Our sales growth continues to be underpinned by positive momentum in private label and our focus on making the Market Corner Deli a destination for today's on-the-go shopper looking for convenient meal options. Overall, the promotional environment remains competitive and we continue to maintain our pricing strategies across all departments and geographies.

On the new store growth front, in the second quarter, we opened 7 new stores including our first store in South Carolina, which brings our presence to 17 states covering many major regions coast-to-coast and we are on track to open 30 stores this year. Our pipeline remains strong with 50 approved sites and 35 signed leases for the coming years. During this second quarter, we also passed our 300th store mark, a great achievement in our 16th year of operations.

Now I would like to expand on our 2018 strategic priorities focused on product innovation, customer experience, our team members and technology. Sprouts has been a driving force for innovation in the natural and organic food segment since its inception. We have nurtured and grown many brands that now serve as category leaders. At the same time, our sales and merchandising team is constantly researching new and trending products to meet customer preferences whether they are national brands, private-label or locally sourced. Our carefully curated mix of products designed to appeal to customers who may be just starting their healthy living journey as well as those that follow a specific attribute based diet. Today, innovation is the driving force behind many of our initiatives, positioning us well to meet the evolving everyday customers needs.

In private label, we are proud to offer products ranging from staples like organic vegan broth to specialty items like grass-fed beef that meet strict quality standards at an exceptional value. Private label revenues growing north of 25% and sales have reached 13% of total revenue through new product introductions and increased customer engagement and messaging. We are pleased to see acceleration and productivity of our existing private label SKUs which is further driving private label comps.

Our Market Corner Deli initiative includes healthy ready-to-eat and ready-to-heat items that have become the cornerstone of our program. These product innovations, together with our enhancements across the department, are bolstering our sales and adding to our expansion of prepared food and meals. We can continue to test product introductions and merchandising with great success as Sprouts continues to become a destination for healthy meals on the go.

On the convenience front, we have expanded our home delivery service through our partnership with Instacart. And today, we are in 190 stores with more coming on board this year, bringing this convenience to most of our major markets. We are pleased to have some of our -- the best customer service scores on the Instacart platform, reflecting the freshness of our products and our strong operational execution.

Second, as we have mentioned, this Tax Cuts and Jobs Act was a catalyst to allow us to invest an additional $10 million this year in our team members. The second quarter marked the first quarter of these incremental wage and benefit investments. Our continued investments in our team members will help ensure that we provide great service in-store, attract and retain great talent and develop a stronger workforce as we continue to grow across the country.

Shifting to technology. Investments in technology will enable further cost efficiencies and establish a strong foundation from which Sprouts can scale and grow effectively. The implementation of fresh item management will improve our ability to have fresh products on the sales floor at all times while reducing strength and out of stocks. For our team members, this represents a fundamental change in daily operations and I'm happy to report that they are embracing the change with excitement. The initial results out of the bakery department have been positive and we continue to adapt the learnings as we rollout the system across additional fresh departments. The overall project is on track to be completed by the end of the second quarter of 2019.

In summary, while the operating environment remains competitive, our unique model, which is focused on health, value, selection and service continues to resonate with our 175 million customers who will visit our stores in 2018. With our strategic initiatives well on track, we remain confident in our ability to deliver strong business results this year and over the long-term.

Before I hand the call over to Brad, as announced earlier this morning, I'm pleased to share that we've promoted Dave McGlinchey to Chief Merchandising Officer, which will support our continued commitment to innovation and leadership in the fresh, natural and organic industry. Dave joined Sprouts in 2017 and brings more than 20 years of grocery merchandising experience. And over the past year, has made significant contributions to the business in developing and implementing innovative merchandising practices and new technologies, setting us up for future growth and success.

With that, let me turn it 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 second quarter and then review our guidance for 2018. For the second quarter, sales were $1.3 billion, up 12% over the prior year, driven by comp sales growth of 2%, accelerated tonnage, consistent traffic year-to-date and solid new store productivity in the low 80s. Overall cost deflation was just over 1% for the quarter, almost entirely driven by produce and cannibalization was in the range of 125 to 150 basis points. Additionally, we continue to see momentum in private label and deli as well as strong growth in our nonperishable departments, resulting in a 2% comp for the quarter. And though our investments in people and technology are higher this year, our continued efforts in improving labor productivity and controlling store expenses, coupled with a good start to the third quarter, resulted in our confidence to raise the bottom end of our EPS guidance for the year.

For the second quarter, gross profit increased by 11% to $380 million and our gross margin rate decreased by 10 basis points to 28.8% compared to the same period last year. This deleverage was primarily due to slightly lower merchandise margins in certain categories. Direct store expense increased 16% to $273 million, an increase of approximately 70 basis points to 20.7% of sales compared to the same period last year. This deleverage was consistent with our plan and was primarily driven by investments in our team members wages, benefits, training and also higher depreciation expense. As a reminder, the planned $10 million incremental investment in our team members this year represents approximately 1/3 of our tax reform savings for 2018. These costs were partially offset by our continued improvement in labor productivity.

SG&A increased 14% to $43 million for the quarter, an increase of approximately 5 basis points to 3.3% of sales compared to the same period last year. This deleverage is primarily due to increased advertising expenses as well as strategic technology investments.

EBITDA for the second quarter increased 2% to $89 million, a decrease of 60 basis points to 6.7% of sales when compared to the same period last year. The decrease in margin was mainly driven by increased operating costs from the timing of our planned strategic wage investments that I previously discussed.

Net income for the second quarter was $42 million and diluted earnings per share was $0.32, an increase of $0.03 or 10% over the same period last year. The improvement of reported earnings per share is primarily due to higher sales, a lower effective tax rate and fewer shares outstanding due to our share repurchase program.

Shifting to the balance sheet and liquidity. We continue to support our unit growth and strategic initiatives with solid operating cash flows of $171 million year-to-date. We've invested $92 million in capital expenditures, net of landlord reimbursement, primarily for new stores. During the second quarter, we were opportunistic and repurchased 4.4 million shares for $95 million. We ended the quarter with $23 million in cash and cash equivalents, $458 million borrowed on our $700 million revolving credit facility, $299 million available under our current share repurchase authorizations and 1.7x net-debt-to-EBITDA. Return on invested capital was 15.9%, aided by a lower effective tax rate compared to 12.8% last year. Year-to-date through August 1, we have repurchased 8.3 million shares of common stock, returning $191 million of capital to shareholders.

Now let me turn to 2018 guidance. Due to the solid earnings performance in the first half of 2018, we are raising the bottom end of our full year EPS guidance by $0.02 to a range of $1.24 to $1.28, resulting in EPS growth of between 23% and 27% for the full year. We are maintaining our guidance for all of the following: Net sales growth of 10.5% to 11.5%; full year comp sales growth in the range of 1.5% to 2.5%; and our effective tax rate will be between 19% and 20% for the full year. CapEx will be approximately $165 million to $170 million, again net of landlord reimbursement. And we will open approximately 30 new stores for the year.

A few additional items to note on the full year 2018 guidance. We expect inflation to be slightly negative for the full year. As it relates to margins, we continue to expect gross margins to deleverage slightly year-over-year. For DSE, the planned investments in our team members from the tax reform savings started in the second quarter and will represent the highest period of DSE deleverage this year. Looking forward, we continue to expect DSE to deleverage by approximately 30 basis points for the full year. We also expect some deleverage in SG&A for the full year.

Below the EBIT line, we expect interest expense to be roughly $28 million, including interest related to financing and capital leases. With regards to our tax rate, we expect our effective tax rate to be approximately 25% for the back half of the year and that should be our long-term rate under the new tax reform structure. As for capital structure, our capital allocation priorities remain unchanged. First, unit growth. Second, investments in the business. And third, returning capital to shareholders.

With regards to the share buyback program. Again, we were opportunistic and pulled forward some of the repurchase dollars that we had planned for later in the year. For the full year, we expect to maintain a net-debt-to-EBITDA ratio in the range of 1.5 to 1.6x.

In conclusion, we remain confident that the investments we are making this year in our team members and in technology will strengthen our business. And those benefits coupled with our solid free cash flow generation and healthy new store productivity will result in long-term shareholder value creation.

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

QUESTIONS AND ANSWERS

Operator

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

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

A couple of questions. So just on deflation. Can you may be give a little more color on what exactly what the percent decline was in produce? And then talk a little bit about what you're seeing into the third quarter in terms of overall deflation in produce and I guess in any other categories?

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

Karen, it's Jim. I will say that it was the primary driver behind the deflation that Brad mentioned in there, so over the 1%. And what we are seeing -- and it was really driven by year-over-year improvements, the crop yields that we saw in the veg category, what you saw on the PPI index. Not much related to the tariffs. We are seeing a little bit of that impact on apples today in the cold storage environment. Moving into the quarter, we would anticipate to be slightly deflationary in produce. We will continue to benefit from those year-over-year, improvements in yields. And you'll start to see a little bit more impact on the -- from the tariffs, just on grapes and apples as we move into new crop.

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

Okay, that's helpful. And then just looking at overall gross margin guidance. I think originally, Brad, what you said is that gross margin, you would expect slight deleverage to largely be coming from occupancy. But you did in this call just talked to several or some categories seeing lower merchandise margins. So I guess first question is which categories are you seeing lower merchandise margin? And what's the cause of it? And then may be just explain on your guidance for the year?

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

Sure. We did see in a couple of categories just slightly lower merch margins. We are also seeing a tiny bit of occupancy deleverage in the second quarter. I think our comments and our view for the back half of the year are pretty consistent with what our expectations were that we talked about on our first quarter call that we are only anticipating slight deleverage in the overall gross margin rate. And much of that is related to occupancy deleverage. So from a competitive standpoint, we are seeing pretty consistent activity in the marketplace. But obviously, week-to-week, month-to-month, you're managing your category mix, your promotional spend, et cetera. So we are tracking to our plan.

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

Karen, the only thing I would say is as we continue to invest in technology, we are starting to see the benefit of that from a merchandising standpoint. If you look at everyday pricing, we're using better elasticity metrics to enhance our current pricing program as well as the promo optimization which is improving our forecast, driving sales. And then really helping us better plan how do we benefit the department as well as the four wall basket.

Operator

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

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

On the inflation side, I just wanted to kind of ask a high-level question. I mean you guys met guidance earlier in the year for a bit of inflation. And now we are expecting deflation. That's sort of been the pattern for a while. And the natural foods industry is still growing. So you would expect to have some kind of pricing power in the industry certainly versus conventional where you can understand with lack of demand that pricing power would be difficult. Do you guys have any sort of high-level thoughts why inflation just has not kind of materialized? Or in your view, is it just basically more to do with these strong produce crops or other commodity cycles?

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

Andy, it's Jim. I mean, as you're referring to, kind of, the natural space and the nonperishable environment. We are seeing a little bit of inflation relative to the ELD and we are able to pass that through. So this was primarily driven by produce on a year-over-year crop yields that we discussed. And to a lesser degree, meat. So, like, we're a fast follower in the produce side and we've been testing some different things in order to optimize sales in gross margin. And we do believe we are the leader in the natural food space. So as it relates to produce, again, if you look at the PPI index you can see some of those year-over-year significant cost decreases. So this is really all produce and to a lesser degree, meat.

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

So I don't know if you would tell us this. But is there cost inflation on the dry grocery side of your business?

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

Yes. I think I referred to this in Q1 when we were talking about freight implications of freight. Not only fuel which is up significantly, but freight costs. We are starting to see some of those we anticipated at the back half of the year. We are starting to see some proposed cost increases that are coming through the channel. And I would anticipate to see more of those in the back half. And early indicators are that we are able to pass those through. But we watch those closely as we pass those through and just make sure we are looking at we are optimizing sales and movement as we pass those through.

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

And I just wanted to ask, I mean when you were talking about the investment technology and training investments in wages, you referenced better eventual cost efficiencies and I would think label productivity. But I think you said you're going to use these -- save efficiencies to maintain Sprouts' competitive positioning. Can you kind of elaborate on what that means? Sometimes that's just sort of automatically, we think, price investments. But obviously, could be other thing, service levels or something else.

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

Yes, that's a great question. I think just in terms of technology, just to make sure everyone's -- we are all in the same pages, the investments are really driven for the purpose of -- in our fresh departments which we will continue to accelerate as a overall mix in our business, particularly in bakery, deli, meat and seafood. And as that continues to accelerate, we wanted to make sure we are putting out the freshest of products on the floor, we're in-stock all parts of the day particularly at peak hours as well as we are managing and optimizing strength. But the intent is really to drive sales and then to benefit strength. And so as we started bakery, as Brad and I talked about, we are seeing good adoption in the stores there and starting to see good in-stock positions and freshness in that. So that's what that exercise is really intended to do. It's not as much of a labor productivity exercise as it is as sales and a in stock and shrink exercise. And as we do that, we believe that it will enhance both sales as well as shrink. And to the extent that it's a little early to call exact, we have some overall industry data on what this type of work can generate, but still a little early to call exactly the level of benefit we expect to have on shrink. But to the extent it does, it gives us greater flexibility to either take it to margin or position ourselves from even stronger from a price position standpoint. So I think in short, it provides more flexibility to the company over the next 12, 18 months as we move forward.

Operator

(Operator Instructions) Our next question come from Chris Mandeville with Jefferies.

Christopher Mandeville - *Jefferies LLC, Research Division - Equity Analyst*

Brad, you referenced a good start to 3Q. Can you just talk a little bit about the comp cadence during Q2 and what you're seeing quarter-to-date? And then along with that, can you just remind us of what type of impact you're seeing from those stores that have transitioned from Amazon to Instacart?

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

Sure. As we set out on our first quarter call, we talked about our comp sales range for the full year being 1.5% to 2.5%. And clearly, that results in a fairly meaningful increase in the 2 year stack. And sitting here today, where we are in the third quarter, we are very confident with regards to the previous guidance that we put out there. So we are absolutely in line with our internal expectations that's based on our 1.5% to 2.5% for the full year. We are very pleased with the number of elements with the Instacart program. Obviously, we talked about during the transition period, having a slight negative impact for the full year. But from an operational standpoint and adoption from customers, we are very -- we are seeing very strong adoption. We are seeing tremendous results in customer service, satisfaction scores. And so we are absolutely tracking to our expectations and plan for the Instacart and we continue to expect and we are seeing increased weekly sales according to our plan and would expect that to continue through the balance of the year and into '19 as we add more and more markets.

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

One thing I would add on the Instacart piece is, for Sprouts, it's a little bit unique and that it benefits us from a trade area expansion standpoint because the stores are placed further apart. So we are pretty excited about continuing to take our products to more customers to eliminate that driving inconvenience to the extent that they live 10, 12, 15 minutes away from the store.

Christopher Mandeville - *Jefferies LLC, Research Division - Equity Analyst*

Brad, just a really quick follow-up. I apologize for this. But would you go as far as to say the quarter-to-date comps are trending better than what you observed in Q2? Or has the continuation towards deflation actually maybe cramped the numbers a little bit?

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

We are tracking very well with regards to our expectations. And again, clearly the back half of the year has a meaningful step up in the 2-year stack and we are very comfortable sitting here today.

Operator

Our next question comes from Ken Goldman with J.P. Morgan.

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

I jumped on a little late, so please forgive me if this was asked already. But at the start of the year, you had indicated that the EPS guidance range, I think you were really talking about the lower end considered. Maybe the possibility of matching some price investments of competitors, if tax reform led to that and so forth. I'm guessing part of the reason that you took up the lower end of the range today is that you haven't really seen that kind of incremental price investment yet. Just trying to get a sense of where you're seeing the rationality or the relative rationality in pricing today and how the competitive environment is and whether your guidance still factors really that possibility of heightened competitive levels.

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

Yes, I'll speak the competition and then give it to Brad from a guidance perspective. From a competitive standpoint, as Jim said, it remains competitive. We have good disciplines and with technology that's really helping -- starting to help us even have stronger disciplines around our framework of competition. I think what's different this year than past year is particularly when we think back to '16 is a lot of the deflation today is driven in produce. It's one category whereas in '16, if you will recall, you had extended period of deflation in multiple categories which were starting to lead to negative comps for some of the conventional retailers. So people started getting much more aggressive. So I think the -- while it remains competitive particularly on ad and promotions, the environment is different, very different today. I would phrase it as maybe, frame it as more rational than back in '16. So that allows us to really stay with our plan and continue to execute. What we are seeing is consistency and good strong results in tonnage and consistent traffic in the business.

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

Ken, I would say that in the context of our full year guidance that we issued in February, it was right on the heels of recently announced tax reform. And so there was uncertainty around what companies would do from a reinvestment perspective, whether any of those savings would go incrementally into price versus labor cost increases. And clearly, we saw the latter investments in incremental labor. And you're absolutely right. The lower end of our guidance range was wider to the downside just because of that uncertainty at the beginning of the year. Now clearly, sitting here today through the first half of the year with EBITDA up over 7% year-over-year to date and we are seeing a pretty stable environment, it certainly gave us the confidence to bump the bottom end by $0.02.

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

Can I ask a quick follow-up also? The call was cutting out a little bit earlier. You give a deflation number for the quarter. Could you repeat that again for us?

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

Just over 1% total company on cost deflation.

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

For the second quarter?

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

For the second quarter.

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

Yes. Full year, we would expect a slight deflation for the full year.

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

Overall. Overall. Just slight.

Operator

Our next question comes from Edward Kelly with Wells Fargo.

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

So I have a question actually just sort of thinking about beyond 2018. I know it's early to think about next year. But just looking at things sort of bigger picture, it seems like you could see quite a bit of improvement in the (inaudible) cycle, deflation, labor investments, your investment in technology, new store productivity is obviously very good. Just sort of thinking about things bigger picture here. What are the puts and takes as you think about next year? And are we on the right track in thinking about how we could see some more meaningful acceleration in performance?

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

Yes. I think from a broader perspective, I'll put the inflation aside, it's too early to call what we would see in '19 at this point. But from a core business perspective, when we look at the business, you're right that the new store productivity continues to work well. And as we continue to develop our meat and seafood program and deli program which is really starting to resonate with the customers, our sales and merchandising team and marketing team have done a fantastic job of relooking at how we can merchandise some of those innovations even better in our stores and we are trying some new things in newer stores and we are starting to see great results from that. So we are excited about our new store program, first. Second, I think from a product perspective, our private-label and deli is really starting to -- not only the uniqueness, the trend, the quality, the attributes of the program are really starting to hit stride with the customer in a more meaningful way. I think we alluded -- we've alluded to this before. But this quarter has given us great forward look and that we are starting to see private-label growth not only from unit or increased number of items but also we are starting to see acceleration in penetration of our existing set. So great work there. So I think we've got some, from a puts and takes standpoint, we feel really good about continuing to be a leader in the industry and driving sales in the core departments. We will let inflation/deflation do what it's going to do and play its course. So we're really focused on the controllables. And then as we go down the P&L, we will provide additional color, probably on our year-end call as to what we think the benefit of the fresh item management program will be because we will be halfway through that program and have better visibility of what we are tracking. So it's starting to feel better and more consistent in terms of our business and the health of our business. And so we are feeling positive today.

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

The only thing that I would add is that the tailwind you could catch and I'm really excited about, one is, the people that we are putting on board in here in terms of the senior leadership position and we called out Dave McGlinchey today as someone who reports in the Chief merchandising space is bringing on better talent and we brought 2 senior leaders in operations as well to have a great pedigree. So we are continuing to build out that kind of middle-to-upper management that's going to be helpful, but our intentionality around that knowledgeable service and our stores, we talked about the customer service program in meat. The ongoing product training that we continue to do on the stores. In fact, next week we are having our SproutsFest. We are bringing all of our department managers in both the vitamins and the grocery space and we educate them for 2 straight days. I think that could continue as everybody is kind of adjusting the other direction in terms of knowledgeable, friendly service. That can provide strong tailwinds in '19 as well as beyond.

Operator

Our next question comes from Chuck Cerankosky with Northcoast Research.

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

Could you be -- give us any detail on what benefits you're seeing in-store or anticipate from the increase in compensation? Say, lower employee turnover, more customer engagement, et cetera?

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

Yes, that's a great question. We are seeing a meaningful step change in our team member retention. And based on a team member survey, we have fairly good disciplines and understanding what our team is thinking. We are continuing to see team member engagement scores come higher and we are still attacking some areas that we can get better at. And Jim alluded to the training and really the mission and what we stand for. So from a people perspective, we feel very well-positioned from a pay and benefits perspective as well as what we are starting to see. We are getting close to best-in-class in the industry in terms of turnover, but we don't want to stop, we want to continue to drive that. Because we know that retention is sort of a key element to service. Jim talked about spending a lot of intentionality around training. And over the last couple of years, our board and the management team has been very aggressive in investing in our team. And that's on purpose to make sure that we can deliver and differentiate the Sprouts model in terms of service and we are really starting to see that both in terms of operational execution and customer service scores in the stores.

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

The only thing I would add is as the brand gains strength, our ability to be fully staffed, I think I had mentioned in the last quarter we were 100% staffed which was the first time we've been 100% staffed and now close to 52 weeks. So I think one, we've had a great recruiting department that we've assembled here. But beyond that, the brand is starting to resonate. The high-growth potential for moving up to the organization and having this as the long-term profession is really helping us in that arena.

Operator

Our next question comes from John Heinbockel with Guggenheim Securities.

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

Actually, a couple of questions on private brand, maybe for Jim. When you look at your private brand penetration, new customers versus those that mature. So you think about that education process. How much higher, roughly speaking, is the private brand penetration with those more mature loyal customers, number one? Two, when you think about what's going to happen with space allocation in private brand. How much greater do you think that ultimately gets? And then the third piece, as you get scale here, right? Is our private brand margins actually getting a lot better? Or will get a lot better over time or do you put that back in the pricing?

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

All right. So one question, John. All right. I'll nail them all for you. So in terms of penetration, up 160 in the quarter. Look, we should finish around over 13% for the year. And then what's giving us a lot of confidence is the acceleration of existing items. Early on, we were getting lot of tailwinds from the new item launches. But now as those kind of taper a bit, we are seeing much better acceleration existing. I liken that to the quality of products, the packaging, the trust that people have in our brand. So we are seeing 70% growth in baskets, but we are also seeing increase in traffic. So we are having good adoption to those items. So we had mentioned it before, I really think that by 2020, we could probably get to closer to 16% to 18% penetration which is a bit of a step change from what I talked about and just as this is based on the run rate that we have, some of the great products we have in the pipeline and just the trends that we've seen in that space as it relates to space on the shelf. Look, what we do is we optimize the sales per square foot, on the shelf or any area of the store. And you've got to prove that out. So it's just a simple game of math. But I wouldn't see a big step change over the next couple of years of that private-label dominance. We love our vendor partners. They've done -- we have a lot of great strategic partners that have helped propel us in the industry, helped us with innovation exclusive products. So the next couple of years, I'd see it to be somewhat muted in terms of how that's positioned and allocated. And as it relates to margin, as we continue to get bigger and have bigger buying power, we'd anticipate some slight relief in cost that we would able to take here as an organization and not necessarily pass it through. We are already priced extremely well in the category, not only against the CPG brands but also against our competition.

Operator

Our next question comes from Scott Mushkin with Wolfe Research.

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

I wanted to talk about obviously we went through prime week with Whole Foods. And our data shows since Whole Foods has been acquired by Amazon, there's some pretty big reductions in fresh, particularly on the produce side. Our data also shows that they're probably going to start next week at 25% discount for prime members on the vitamin area. So I just wanted to get some insight on what you think this is doing? Maybe not directly to you, but just in marketplaces like Los Angeles or Houston or Denver, just give some insight on what you guys are seeing out there. Thanks.

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

Yes. I'll stay broad here. Because obviously, as far as Sprouts is concerned, we don't speak to any specific competitors. But what I will say is as different competitors have deployed different strategies over the last year call it, during that period and particularly this year, speak to the first 6 months and into third quarter, we see our overall tonnage is accelerating. Our traffic is very consistent. And when we put -- when we look at core stores which are not being cannibalized by our own new store openings, those core stores are very consistent and strong in terms of traffic and overall performance. So a lot of that has to do with our overall business model around health, value, service and selection. So it's not any one pillar and we remain very competitive in price obviously in the marketplace. So I think there's probably a lot of concern around what can one or other competitor do to Sprouts. And I think we are laser focused on our business. And to date, we feel pretty good about what we are seeing or not seeing. And to your comment around the industry. It's hard to comment on what it's doing to the industry because it's -- I know there's a lot of estimates out there in terms of what margin investments they may have made or what comps, drivers may be happening. But we can only speak to what we are seeing in our business. It's hard to see -- it's hard to clearly see what it may be doing to other competitors.

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

Scott, the only other thing I would add is not related to -- just trying to be macro here. But just in the space kind of like the natural space which requires a higher touch as you focus on kind of that health enthusiast type customer. As we've done -- the team here has done a fantastic job of just really enhancing the products we carry, making sure we are trend leading, we are not trend following. We've talked about the private-label and some of the other enhancements and on the deli side which is where the consumers going tomorrow. But when you think about price, we talked about data-driven decisions. We are making better decisions there. But we've always had -- a strong price advantage against those in the natural space on the produce end. So there is a long way to go to get to our current price position as it relates to the natural specialty space.

Operator

Our next question comes from Robbie Ohmes with Bank of America Merrill Lynch.

Marisa Sullivan - *BofA Merrill Lynch, Research Division - Research Analyst*

It's Marisa Sullivan on for Robbie Ohmes. I just want to circle back on the Instacart discussion earlier and see if you can quantify the Instacart transition impact from Q2. And then just when will the transition turn from a headwind into a tailwind? And then what does that look like in the back half of the year?

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

Yes. So as we pointed out on our previous call and again today, we do have a bit of a hit on the transition period which commenced in the second quarter. In terms of what we are seeing now in performance and the growth in the number of stores that we are offering to service in and the adoption by customers, I think that becomes -- there's no more headwinds once we get to the fourth quarter is where our line of sight is and that's consistent with our expectations and our plans that we talked about last quarter.

Marisa Sullivan - *BofA Merrill Lynch, Research Division - Research Analyst*

Got it. Do you expect it to become a tailwind in the fourth quarter?

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

Yes, we certainly, based on the path that we are seeing as we would expect it to sort of transition in that period and then going into next year, we would see continued acceleration as a positive.

Marisa Sullivan - *BofA Merrill Lynch, Research Division - Research Analyst*

Got it. If I can just follow up really quickly. You talked about advertising expenses being an incremental spend. Can you just give us a more detail on what do you guys are doing differently in the space that's driving the incremental cost?

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

Yes, I think the primary driver is we are being more intentional in our new markets in terms of both marketing, grassroots being in the market well ahead of the store openings. And we learned that in one of our major markets that we entered last year were extremely well. So that's become part of our core plan as we entered the mid Atlantic this year and parts of Carolinas. We will ensure that our brand awareness is strong, leading into the first store openings.

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

I would only add, as you look long-term, Marissa, the cost of paper and distribution of paper when we talk about freight. All those things are obviously are headwinds internally. But as you look forward and you look at the digital space and what we are able to do today with not only impromptu sales that we can do, we can do them from an advertising perspective very cost-effectively. So as you look out, there should be good benefits to the P&L as it relates to advertising in 2020 and beyond.

Operator

Our next question comes from Paul Trussell with Deutsche Bank.

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

On the store footprint, you obviously have the Georgia DC helping you build out on the East Coast. If you can just talk about the mid Atlantic regional performance that you saw for additional units up and down the East Coast? And that I also apologize if I missed it. But I want to just talk about product category performance into 2Q. How was the fresh business in other areas of the store?

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

Yes. I'll go and sequence you as is. Mid-Atlantic, we just opened our second store. We're pretty excited about the region in terms of what we see in terms of competition and how we can be positioned and bring value to the customer in that region. So the first 2 stores are performing well. So good start there. And again, we -- the last question, we spent a lot of time in grassroots and getting to the market early to drive brand awareness there also. To your second question around...

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

What was the second question?

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

Can you repeat your second question?

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

Sure. Just about product mix performance.

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

Oh, yes. I think product mix performance is, as we said in the remarks -- opening remarks, is nonperishable is performing very well. Our perishables, we're seeing -- on the perishables side, we are seeing great good momentum. And our food area, the deli area, we are also continuing to see good performance in meat and seafood. But overall stepping back, the tonnage of the store is very healthy and we are really pleased with where the tonnage continues to move.

Operator

Our next question comes from Judah Frommer with Credit Suisse.

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

Maybe first, just another one on the competitive environment. If we try to look out past deflation in produce, it still seems like fresh and produce specifically are a battleground area in the industry. So what are you seeing competitively kind of in fresh versus the rest of the store may be even if you could parse out deflation? And then just a quick follow-up on Instacart. Are they coming to you through -- are customers coming to you through Instacart or through Sprouts and are you getting customer data there?

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

Yes. So we will do it in reverse order. I'll answer Instacart. So Instacart, we are doing through both instacart.com and our private-label. The benefit there is is there are many customers who have the $149 membership and they use multiple retailers so many of the customers use instacart.com. But we also have a good mix of white label customers coming through our sites and we are working on some enhancements there which we are excited about. And in terms of data, through our anything that's coming through white label, we have access to that data and anything that's going through instacart.com as long as that customer has provided a affirmation to provide the data, then we also see that data there. So we are starting to be able to see some interesting things around customer data and where we can go in the future with that. Jim, I'll let Jim cover the other question.

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

As it relates to the fresh side of the business and this is general competitive activity, consistent with prior quarters in terms of what we are seeing in promotional spend, everyday price, there has not been a step change. And there's just a handful of retailers that are making those investments across the country on an everyday price perspective. But no material change in that, but extremely pleased. As we continue to look, how do we continue to create even more points of difference in produce assortment as we look in our value add and organics, the specialty items and that experience we have in store in terms of vendor engagement and messaging around different products and different products and messaging about our growers is something that we are very focused on. But no real step change on the competitive front. And then as it relates to meat and seafood, what we sell a different grade of meat. It's a natural meat. We've done a better job of communicating to the customer not only from the market vehicles we have print and digital. But the customer service plan that we put together where we have deeper educated service, first in the store that specifically identify to help the customer kind of navigate through and tell him about the points of difference and the attributes. And even lead them into some of the new products we have, the ready-to-cook stuff where we have one-pan meals and a great marinated product like program is just helping to accelerate those launches. So overall, feel very comfortable in the space and don't see any step changes in terms of prior quarter of everyday pricing or promotional activity in both of those areas.

Operator

Our next question comes from Rupesh Parikh with Oppenheimer.

Erica A Eiler - *Oppenheimer & Co. Inc., Research Division - Equity Research Associate*

It's actually Erica Eiler on for Rupesh. So you mentioned before that you're seeing a little bit of an impact from tariffs on apples and cold storage. I was just curious how are you thinking about the potential impact of tariffs on the business with regards to food deflation?

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

Yes, look, I hate to say too much because again I'm making assumptions and we are projecting. So cold storage apples, as you transition you want a clean crop going to that store. So you not only is that the category itself had headwinds. So inherently, you have a little bit heavier supply. So you've got the apples and really back half materially, you've got grapes that could have some potential negative impact. But you can put those in the cold storage and through October, November. So we will see. Right now, it's not super deflationary in terms of grapes. So we will continue to watch. In the nuts side, as that tree crop continues to get harvested this year, it's a big exported category. I would anticipate that a lot of the growers will try and move that at not excessive cost discounts. But the longer this potentially goes in the back half of next year as you get backed up a little bit in the cold storage, you could see a little bit pressure on the cost side. With that said, the data insights that we have and everything that we are doing today, some of these things can better be accretive to gross margin or create a good promotional opportunity for us to drive in footsteps. So there are puts and takes on both ends. But it's really too early to tell of the overall implication. It will be really more of a 2019.

Operator

Our next question comes from Ben Bienvenu with Stephens Inc.

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

You highlighted the continued success of deli. I'm curious to hear a little bit more about where in the day that you're seeing the lion share of that success? And then as you look at the opportunity, within private -- within the deli offering, both across the daypart and then across the total store penetration, how the continued success of the program has made you think about the long-term opportunity?

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

Yes. Where we really invested our time and effort has been around -- we had some good ready to eat programs. We've added some things there where we've, if you walk our store today compared to 2 years ago, it's really the ready to eat and the fresh products that people are taking home. So we are seeing good traffic in the 5:00 or the evening shop and then also on the weekends where people are adding items to the basket for multiple days for the weekdays, so for the next 2 or 3 days. So we are continuing to see that home program develop nicely and the -- besides health, one of the things we are pretty excited about is some of our recent launches. We hired a new head chef last year and the taste profile of our products has meaningfully step changed and our customers are starting to notice it. And so that's really providing a lot of good tailwinds in that program. The deli case and then to-go-homes, quick heat, quick for the same day or next day.

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

The only thing that I would added on the deli side is we are seeing great -- again, we talked about the quantitative. But as you look at the qualitative on our 4C scores and customer service scores for those stores that have these components which are 150 today, about 50% of our stores, we think we can get to about 70% over the next 3 years as the stores have these elements. We are seeing the customers respond with more customers are making deli and Sprouts their primary shop. So as we baseline that against the other stores that don't have the elements we are seeing a nice uptick from our consumers. So nice gravity there as well.

Operator

Our next question comes from Vincent Sinisi with Morgan Stanley.

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

Just want to go back to the produce deflation for a second. Obviously, the results were in line with expectations this quarter which is great. But just may be kind of more holistically, how would you compare where you are sourcing from your supplier relationships now versus the last time we kind of saw certainly heavier than what we are seeing as of today, deflation in produce kind of, I know folks of course still remember that. So it seems like you're certainly dealing with it well so far. But may be just if anything further changes as we get into the back half from a cost or a promotion standpoint, how would you compare your supplier relationships now versus the past?

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

Yes, I mean, I want to step back as an organization what we want for our customers is the highest level of quality delivered to our customers and product that you can eat today and you can eat 2 or 3 days from now. So just trying to get closer to source. So a long time ago, we went more direct with our growers, not only we could focus on quality, the quality of product, some of the potential new innovations they may have, insights that they have. And that's really served us well in terms of what our customers are saying about us on our minimal complaints in terms of quality. And look, it's a marketplace, right? So prices are going to change and -- it couldn't tell you that it's going to materially different with those. It's really around the focus of innovation, breadth of assortment, consistency of supply and quality of products and well positioning us for innovation. But I think everybody is in that same boat in terms of what is overall cost. Unless you want to buy a product that's 10 days old from a broker that is not a long-term good strategic decision for any high-growth business.

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

Okay, that's fair. And then maybe just a fast follow-up. Just on Instacart. Still obviously early days but in about 190 stores, I think you said today. How much advertising are you guys doing around that? Is that any part of some of the increase in advertising? Or is it more you're kind of letting folks discover whether it's through Instacart or in-store? That will be great.

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

Good question. As we had spoken about previously, early on, we wanted to make sure that our execution was solid and the customer service scores were solid because we do think that once our customer attaches, they can attach for the long-term. So we started the, not only the launch slower initially in the first quarter but as we accelerated the launch, we will continue to monitor closely our execution. As that execution is top notch outside today as well as the customer response is accelerating, we are now starting to -- we have been for the last month or so, integrating our home delivery messaging as well as driving awareness across most of our marketing channels, including in-store, and digital. So we are starting to accelerate that and feel good about taking that direction and we will continue to come up with innovative ideas ourselves as well as with Instacart to drive greater awareness and grow this business.

Operator

Our next question comes from Kelly Bania with BMO Capital.

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

Just wanted to ask about freight. It seems as though the challenges in freight market are still out there and you guys have been pretty so far immune to that. But just curious if you're seeing any challenges with fill rates or on-time deliveries and are you just working through that? Or are you seeing it at all?

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

Kelly, it's Jim. As it relates to just fill rates and on-time deliveries, no negative impact on that arena. Where you would see the impact I'm not suggesting that we do is if you're not well planned and well focused, if you have to play the spot market in freight, you could experience obviously not only higher cost but fill rate challenges. But to date, we are not selling -- seeing any fill rate opportunities, not only from our third-party distribution but as well as our own. Again I'd liken it to better people here in the building. They can make better decisions and they now have access to better data that is helping us better forecast what the needs are for the business.

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

Okay, great. And then just maybe another one on Instacart. As you think longer-term over the next several years, is that enough for Sprouts in terms of delivery of groceries? I know you talked about maybe considering a click and collect option. But with others maybe investing in their own proprietary delivery or other technology solutions, just curious if you're still considering anything else? Or is the focus really going to be on Instacart?

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

Yes. I think that we are continuing to look at. We are developing some enhancements and deeper enhancements on sprouts.com and on our channel because we think it's important for us to fully integrate the shopping experience on our website. So whether customers are looking at content and wants to push out into the cart and wants to either pick it up at the store or do home delivery, we want to ensure that full customer experience is on the Sprouts app, so we got a good roadmap of making enhancements there. So I think that's the first element. Once you go from there, then it's a matter of saying do you want to build your own delivery capability or not? And of course, things can continue to evolve. But we think that Instacart has a good platform, where they're able to leverage and be really close to the customer from many retailers and has, it's a more efficient network certainly today than Sprouts could execute on its own. But over time, I think as technologies come in and as, whether it's driverless technology, voice technologies and other technologies, as that evolves, we will certainly look at all options and make sure that Sprouts as a company can avail the lowest cost structure to fulfill what our customer wants ultimately, which is groceries at their doorstep.

Operator

This concludes the question-and-answer session. I'd like to turn the call back over to Amin Maredia for closing remarks.

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

Thank you very much. Thanks for the questions and the engagement. We look forward to speaking with many of you. And I think we due to time, weren't able to get to 2 or 3 analysts. But we will make sure we reach out to you shortly here right after the call. Thank you very much.

Operator

Ladies and gentlemen, this concludes today's conference. Thanks for your participation and have a wonderful day.