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EDITED TRANSCRIPT

SFM - Sprouts Farmers Market Inc at Goldman Sachs Global Retailing Conference

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PRESENTATION

Christopher Prykull - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Okay, good morning, everyone. I think we're going to get started here. So for those of you who don't know me, I'm Chris Prykull, I cover the supermarkets at Goldman, and delighted to have the Sprouts Farmers Market team here with us this morning. I'll give a short intro and then we can go right into Q&A. But I'd like to keep it interactive. And so if you have questions, it's actually a small enough -- we're being webcast, so please wait for the mic to come and we'll get to your question.

But without further ado, Sprouts was founded in 2002 on a belief that healthy food should be affordable. The company went public in 2013 and has delivered robust 18% revenue and 20% EPS CAGRs over the past 4 years, some of the highest in all of retail and definitely within food retail. Sprouts currently offers over 300 locations across 17 states with the plans for, I think, 19 states by the end of 2018 and generated nearly $5 billion of revenue over the past 12 months.

I'm happy to have CEO, Amin Maredia; and CFO, Brad Lukow, here this morning to speak about their vision for the next leg of growth at Sprouts.

QUESTIONS AND ANSWERS

Christopher Prykull - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

And maybe the best place to start would be more high level and thinking about sort of the future of food retailing or the future of grocery. How do you think the industry evolves over the next 5 years? What are some of the key items that you think will drive success for food retailers? And how do you think Sprouts is positioned?

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

Yes, good morning, Chris. Thanks for having us here. I think over the next 5 years, just context-wise, many of you know this, but there's 40,000 grocery stores in the U.S. There's about 7,000 stores, which are discounter stores, the likes of Walmart, ALDI, et cetera. There's 28,000 conventional grocery stores. And then there's about 5,000 specialty and other stores. And I would include the likes of Sprouts, Trader Joe's. Wegmans is more of a specialty because they're a combo model, I call it. And I think over the next 5 years, what we're seeing is not -- some of the 28,000 conventional grocery stores do a good job and they're pretty relevant. But there are many, particularly the regionals and some even national, which are under-invested, not quite on-trend, not as relevant. And they're continuing to lose market share. So as we look 5 years out, we feel pretty good at Sprouts about having the chassis of health and value pricing. And one of our big pushes over the last 2, 3 years, in addition to product innovation, is just to ramp them on the experience side, both in-store and out of store. And we'll continue to push on that. And I think that retailers who are on-trend, relevant and provide a good experience, price will certainly be an equation. But we don't see that as being the only equation. I think retailers who are strong and experienced will win the game. And we do think that -- as we have seen this year, last year, we'll continue to see shuttering of more and more stores over the next 5, 7 years.

Christopher Prykull - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Got you. When you think about the consumer backdrop right now, what are your expectations for the back half of this year relative to the first half? What are you seeing from your core consumer? You've had some pretty good numbers out there from both yourselves and peers on the top line. Do you expect that to continue? Just any insight into what you're seeing from customers would be helpful.

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

Yes, no surprise on this one. I think all of us see the same numbers. The overall consumer backdrop is pretty robust. And we can certainly see it in our business with trading up on organics and trading up on certain attribute-based foods across the store, which is always a sign of a healthy economy for us. And so I think that the overall landscape seems to be quite good. Competition is fairly rational. I think today, it's still competitive, but it still rational. And our traffic and tonnage have continued to be very consistent throughout this year. And so we feel really well positioned with the combination of that consistency plus strong new store productivity, feel really good about how we're positioned into the rest of the year against our guidance and into 2019.

Christopher Prykull - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Since you mentioned the competitive backdrop, and you said it still seems like it's been fairly rational, there's always going to be price investments or price optimization within food retail. But where do you think the share gains are coming from for some of these larger retailers that are putting up solid same-store sales numbers on a very large dollar base? I think you mentioned sort of some of these sort of independent grocers. How big is that pie? And can there be more -- how long of a tail of share gains are there that can continue to come from that pie?

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

Yes. I think certainly the larger retailers who have reported recently, who are more a combination of general merchandise as well as food, what we see is, from a Sprouts perspective, over 60% of our sales is in fresh. So we're significantly indexed in the fresh side of the business whereas some of the larger companies has an overall box of the 100,000, 150,000 square foot store that they have, it's a much smaller component. So I think if you really have to bifurcate and stare at where they're getting their gains from, is it coming from general merchandise? Is it coming from apparel? Is it coming from food? So we're not seeing any patterns. We're not seeing any patterns in our business. So the only guess game would be is it's only coming from potentially weaker players in the industry.

Christopher Prykull - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Fair enough. One of the things that I've been wrestling with and I've gotten some questions on is within food retail, it's quickly evolving over the past couple of years. Do you think there's been a shift of attention and potentially dollars from maybe price investments to SG&A and/or e-com investments? In other words, is SG&A maybe the new COGS for grocery in this current backdrop?

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

Yes. No, look, I think from a customer standpoint, we look at things in a simple way is we always want to be health and value. And value for us is on a relative basis priced really well in every market we operate in. And then in terms of investments are concerned, certainly I think people are trying to look at in a new world and sort of looking forward at a little bit of a black hole and anticipating that to the extent that e-com continues to grow, in food, 2.5% of sales are in e-com through either 2-day click or collect or home delivery to same-day home delivery. And with the anticipation that to the extent that it grows to 5%, 10-plus percent, how do you position for that new world? And what does one need to do to position in that space? We feel really fortunate with the size of our box being 30,000 square foot, we're always struggling for space, yet want to hold the discipline of the size of the box. So we don't see Sprouts having an issue of going, "Oh, we're over-stored and we have too much square footage, what am I going to put in this 25,000 square foot of the corner of my store?" We don't have that issue we're always struggling. And I think in the new world, smaller boxes will benefit from that to the extent we see shifting. And at the same time, I think people are trying to figure out where are the pockets where you can drive cost structures for e-com down, right? So where we've been fortunate is because we're not as dense as conventional grocers, which are typically found a mile, 1.5 miles, 2 miles apart, we see a majority of our stories -- a majority of our sales on e-com coming outside of 7 minutes, it's an additive for us on a net basis. So that incrementality is providing a nice tailwind and a leverage. Albeit small, it's continuing to grow month-over-month. But I think the future will certainly hold a combination of in-store and e-com in various methods for the customer. And where that number goes, it's kind of hard to anticipate sitting here 10 years from now. But we certainly feel like we're positioned really well. We also, last year, last comment I'll make is, we think about that in this context of even the 30,000 square foot box to really look at the modularity of the box and making sure that in that new world, our store has pockets which are positioned to be flexible and nimble as customer preferences change, that we're able to accommodate those within the context of our box. So because we don't -- we only have 300 stores today and we're going to be building hundreds more over the coming years, we can make those changes as we walk into new sites.

Christopher Prykull - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Got it. That's helpful. Maybe a different way of asking it from a more near-term perspective is do you feel that there has been less of an emphasis from some of your peers on heavily investing in price in the current backdrop because they're busy investing in buy online, pick up in store or investing in their own e-commerce platform?

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

Yes. I think that's right. I think it's not a surprise, right? People are chasing the share gain on e-com. And to the extent that they're chasing it hard, you can't reduce margins everywhere, right? And to the extent that you don't have incrementality, which Sprouts does and we have significant incrementality as what we're seeing today in home delivery, if you don't have that incrementality, it's a cost burden you have to figure out how to absorb into the business. And in a 4.5%, 5% EBITDA margin business, there's not a lot of room to just keep going lower. So I think that could certainly play out over time.

Christopher Prykull - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Do you have any sense for maybe when that could potentially reach an equilibrium or flip back the other way? I mean, it seems like there's still a lot of investment potentially to be made over the next number of years.

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

Yes. My sense is people are being smart about testing, right? People are trying a lot of different things. I don't think that the investment from any one competitor, as we see it from the outside and you see the same numbers that you guys do, it doesn't feel like anyone is betting the farm on any one thing. They're trying different things in where they think they can add value so that investment could continue. But to the extent somebody takes a position, a hard position, on, just as an example, being low cost on delivery fee, well, you can't take that away. You start inching the customer up, you're going to disappoint the customer, if not upset the customer. So if you start being overly aggressive on something that's not sustainable, then you know that's going to become a problem down the road. And I think most people have not taken an overly aggressive stance in that form. Couple had and pulled back fairly quickly knowing that there's no way that math is going to work. And you guys probably know who we're talking about because they have announced a pullback. So I think that's -- everyone is focused on trying to draw the cost structure in an efficient way to try not to have too much leakage to the EBITDA -- to the business model.

Christopher Prykull - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Very helpful industry color. Maybe moving away from sort of the backdrop and thinking about Sprouts, how should we think about Sprouts' long-term earnings algorithm in the current backdrop? Has anything changed versus when you IPO-ed versus maybe 2 to 3 years ago, there's been some differences in terms of where inflation sits and how that impacts the top line? But how should we think about the contribution from comps, the maturation curve of new stores and margins going forward?

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

Sure. From our point of view, we continue to see pretty significant whitespace opportunities to grow into markets that we don't have a lot of penetration in today. Today, we're opening about 30 stores a year. We can see that continuing into the foreseeable future, possibly step that up once a lot of our infrastructure and efficiency initiatives will be behind us after the end of next year. Certainly, if you look historically, 70% of our new stores were opened up in the original 8 states or existing markets and 30% in new markets. That's actually now flipping. In 2019, we'll be roughly 50-50. And from our point of view, historically, it's taken about 4 or 5 years to mature in a new market from a sales maturation and profitability point of view versus 1 to 2 to 3 years in existing markets. That's actually stepped up significantly in a positive way. When we look at our movement into Florida, the Mid-Atlantic, our visibility in what we're seeing today is those markets are performing more like an existing market. So that gives us a tremendous amount of latitude to accelerate growth in those markets, which have tremendous number of box opportunities for us. That also you see, our new store productivity has been consistently over the next 18 months been in the low 80s, which compared to historically we've been around mid-70s. So the great news is that these stores are opening up stronger. Average weekly sales are significantly higher than they had been historically. And that's one of the main drivers behind our increase in return on invested capital as a total company, now we're generating about 16% total ROIC. Combined with the free cash flow that these stores put out, we find ourselves in an enviable position in that we're throwing out a lot of excess free cash flow. And part of the algorithm is these stores are opening up stronger, I'll take that from an ROIC point of view, it does mean that your same-store sales, when they enter the comp base, are slightly muted. But again from a financial returns perspective, we really like that result. And from a free cash flow point of view, we've talked since over a year now the fact that we're generating a lot of excess cash, that we'll continue to return that to the shareholders in the form of an ongoing share buyback program, which is part of the algorithm. So we see over the longer term, sustaining EPS growth in the mid-teens.

Christopher Prykull - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Got it. That's helpful. And then any questions from the audience before I continue? So maybe just -- maybe one over here.

Unidentified Analyst

Given your long-term relationship in terms of outside supply versus self-distribution is with all your skill as you have greater scale and density in the core 8 markets and the (inaudible) U.S. markets, what opportunities do you (inaudible) self-distribution and lower cost of goods, better inventory turn, higher return on capital?

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

Yes. So as you know, we just redid our KeHE supply contract, a long-term contract. And what we see there is as we continue to, as we move forward, be leveraging in our existing markets. And then as we're opening in new markets, the cost of distribution in the first 2, 3 years tend to be higher. So as we're growing, that will continue to be a relatively flat activity. The leverage offsets the growth element at least in the near to mid-term. We're seeing -- if you think about where we are, in the next 2 weeks, we'll be 19 states and grow from the state of Washington all the way down into California, across the country into Florida, Georgia, Carolinas, now to the Mid-Atlantic. There alone, if we think about the number of potential store openings in those markets alone, pretty significant. So what that allows us to do is we might continue to open a state or 2, but we're really well positioned, I'd call it, when you have so many markets hitting it on cylinders, you're in the driver's seat on calling your shots on rent a little bit with the landlords as well as picking the right locations because you've got so many markets to pick from and also start building in those markets and move towards some level of efficiency. But I think as long as we continue to grow to new big markets, we would expect D&T to be relatively flat, maybe some leverage over time but relatively flat in the near term. The other comment I would make, and I think this is probably underappreciated, because we don't sell CPG products and when you look at certainly fresh produce, we sell 2 to 3x the fresh produce of a conventional retailer. And the natural organic foods we sell, I think what people may not appreciate fully is we behave more like a 1,000 to 1,500 store chain when you start looking at what we're actually selling in natural and organic foods. When you start lining up where Sprouts sits on the list of volume of natural and organic manufacturers, we're pretty high on the list that's just because of the velocity that we generate. So I think people might think that we have lack of scale leverage. But that's actually not true as it may seem on the revenue base or number of stores when you surely compare to the volume of the specific items that we move as a company. Hopefully, that's helpful.

Christopher Prykull - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Maybe a follow-up, a related question, produce, obviously very important piece of the Sprouts model. From a near-term perspective, how does the produce market look like right now from inflation, deflation perspective? Anything that we should be aware of as we look into the back half of the year? And then maybe longer term, how does Sprouts look to mitigate any disruptions in produce supply or spikes in inflation and deflation? And does that get easier as you scale? Does it get the harder as you scale? Is there anything to be concerned about as you get bigger from an availability of produce perspective?

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

Sure. We said in the second quarter, we saw some deflation overall from a total company standpoint. That was driven entirely by produce. And we said our expectation for the full year that we would be slightly deflationary from an overall point of view and that the overall business would turn slightly inflationary in the back quarter. And that's consistent with what we're seeing now. Again, the deflation that we're seeing now is limited to produce. We're lapping some very material inflation in things like avocados from last year. So from a crop point of view, what we look for is consistency more than anything. And we're seeing consistency of availability. One of the things that we have talked about a lot, a lot of our strategic initiatives are really focused on what today's consumer is interested in, which is squarely on the ready-to-heat-and-eat meals. And we've been introducing a number of additional items that are resonating well with our consumers. And we're seeing that in terms of foot traffic and basket items in those departments. And the nonperishable departments, we've seen -- and we've talked about this over the last number of quarters, are comping well north of the store average. So while produce, we still over-index at about 23% of our total sales, where we're seeing a lot of the growth is in the nonperishable departments. Also private label continues to be a tailwind for us. And we've got -- we're roughly 13% penetration on an overall basis today. That probably gets into the high-teens. And so we're seeing greater adoption of private label of products, not only from a new items' point of view, but there are more consumers that are adopting the Sprouts private label and we're seeing more and more items in the basket. So I think Q2, we saw sales north of 25% growth in private label. And more of that is coming from existing SKUs and greater adoption. From a long-term point of view on supply, we've done -- the team has done a great job in reaching out and developing additional relationships. As we moved to the Southeast, we now have grower relationships in the South and the East and even sometimes hearing that somewhere you can get some products, blueberries, out of Michigan. So the team has really -- one of the strong suits is the relationship with the grower community. So we see that as a long-term, sustainable supply perspective.

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

And one thing I would add from a longer-term perspective is, as Brad alluded to, our deli initiatives as well as private label in meat and seafood. Now that we've got the, I call it, the right product set in some of these departments with quality packaging, consistency of execution, we're actually starting to look at some interesting ways and testing some interesting ways to merchandise to the customer. And so what I see over time is we've gone through all of our focus on health, value and listening to the consumer over the last 6 years have gone from $12.5 million per store per year to over $17.5 million today. And what we see this next phase of growth is, particularly for our new stores and the way we can think about experience in-store, is continue to drive areas where historically Sprouts, it was not Sprouts' strong suit 5, 7, 8 years ago, like deli, like meat and seafood and the presentation, the quantity. The quality was always there but the consistency, the operations, the training, the presentation. And I think that as we hit that wave, it will help us continue, particularly new stores, drive north of that $17.5 million, I think, per store and also balance out the business, not to say that produce dollars will be any lower. What's more interesting is the overall sales of the stores are higher. So that's exciting for me because it's been a long transformation to see our average weekly sales go from $250,000 to $340,000 a week and now transforming north of that with this new model that we're looking to test. And we'll talk more about it when we have enough stores out there.

Christopher Prykull - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Got it. And maybe one quick follow-up because I want to dig into all the initiatives that you mentioned and any others that you have. But a quick follow-up on inflation, why don't you think we've seen shelf prices creep higher maybe across food retail despite some of the ancillary inflation in fuel, labor, freight costs? Why has that not necessarily showed up at the shelf yet meaningfully?

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

Yes, I think what you'll see is people have gotten -- what we see is in all of our pricing studies that when we see inflation, whether it's related to transportation, fuel or actual commodity cost, is the shelf prices in certain categories where it's more elastic, we've seen inching up of prices in regular retail. Where people are still aggressive is on front page ads, on ad items. So I think certainly if you were to not be passing on those cost increases in regular retail, you would see higher margin compressions at retailers. So they're actually happening where people are just aggressive on front page ads.

Christopher Prykull - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Got it, helpful. So turning to some of the growth initiatives that you do have in place, maybe starting with deli and/or prepared since you've mentioned it, maybe walk us through what the consumer response has been when you add deli and prepared. What type of sales uplift have you seen when adding those categories? What percentage of the base right now has deli? And how will that evolve over time?

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

Yes. One of the most significant findings that we're seeing, obviously the customers are adopting this extended product offering. And in new stores where we're opening up with a full offering, we're seeing deli penetration increasing upwards to 400 basis points, which is pretty meaningful. And it's on-trend. So we know we're hitting exactly where the customer wants us to be. And we've got a long runway ahead in terms of additional products to launch.

Christopher Prykull - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

How should we think about the margin implications of adding deli both from a merchandise margin perspective but then from an op margin prospective, given some incremental potential labor?

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

I think obviously it's a higher merch margin part of the business. It does come with greater labor. But Sprouts is now being recognized as a destination for that type of product. And when you are able to drive more foot traffic into the store because you're more relevant, that customer then picks up more items and becomes a more profitable customer over time.

Christopher Prykull - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Helpful. And is it a new customer to Sprouts because you have deli? Or is this an existing customer trading into other categories or a combination of the 2?

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

Yes, I would say it's both. Typically, Sprouts resonates really strongly with just a slightly older demographic. What we're seeing now with the on-trend work in meat and seafood and deli, that is resonating really well with the younger consumer in terms of the millennials, which is now the largest

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demographic in the United States. So that's what's giving us a lot of confidence in terms of consumer adoption and a long runway of greater product introduction, more loyalty, greater sales per store.

Christopher Prykull - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Helpful. Maybe as a follow-up, I know part of the pitch was the customer originally comes in for produce and then trades up to other categories throughout that customer's maturation shopping the store. Do still see that happening?

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

Yes, that's a really good question. One of the things that we've seen, a couple of interesting trends we've seen, is natural, organic and healthy food is becoming more and more prevalent, we're seeing a better basket earlier. So part of our -- what Brad talked about, hitting higher new store productivity, it's happening almost across the store. There's still a couple of departments, like vitamins, HBA, where that maturation of education and understanding in the product set still is a little bit more of a natural maturation in the store. But we're seeing both nonperishables as well as deli lifting faster right out of the gates because just the adoption is higher. 10 years ago, natural and organic was sub -- if you include produce and organic meats is less than $100 billion business. Today, it's well over $200 billion. So it's not hiding around in there anymore, it's more mainstream. So I think that's helping us. As well as what's interesting is we feel like we're hitting the tipping point right now, where when we're going to new markets and we talk to our customers, most of them have been to a Sprouts on a trip or family trip or travel or have heard of Sprouts. So we feel like we're also hitting that tipping point, which is leaning demand when we're going to new markets, which is having an implication, a positive implication on the maturation of the store is starting earlier.

Christopher Prykull - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Helpful. I guess, a couple of questions out there. Maybe starting here first and then we'll work our way.

Unidentified Analyst

(inaudible)

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

No, we actually are doing some very interesting things where we just started with a blank sheet of paper with some things that we would never change or don't want to change at this point certainly in our history because produce and bulk are sort of the center stage in our showcase products. And so we were pretty inefficient in space and back of house and production areas. So we're actually able to -- we've ended up with similar to higher linears in the same 30,000 square foot box with a much more approachable, relevant and easier shop for the customers. And of our testing that we're doing, the response from the first couple of stores has been extremely positive from the customers. We just finished a consumer insight study. So in short, what we're doing is we just we relooked at the 30,000 square foot and said, "Our business is different than it was 5, 7 years ago and business is going to change tomorrow, 3, 5 years from now." So we really looked at the modularity and the functionality. And just as an example, in this test, one of our tests, we're doing various tests, we ended up with 30% more physical production space for our team and at the same time, maintaining 30,000 square foot. And the customer's response was, "The store feels so much bigger and so much more open and it's -- you have so many more products, same products." So many more products in the stores, so really relooked at the shopability. So that's kind of exciting for all of our departments that we've been doing work on over the last 2, 3 years.

Christopher Prykull - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

I think we have the mic here and then we'll go over there.

Unidentified Analyst

So it sounds like everything is going really well. I'm just wondering as we hear from a lot of your biggest competitors in click and collect, how do you view that as a priority going forward?

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

Yes, from a priority standpoint, we had a thesis going in and it's played out to be true is we're really trying to capture incrementality. And when you just step back and look at home delivery, generally most of consumers who are coming into any retailer, including Sprouts, are coming from -- a majority of the sales are within 7 minutes of the physical location. And because of our spacing of our stores are further apart, what we're seeing in home delivery is the inverse. Majority of the sales are coming outside of 7 minutes. It's extending that convenience or eliminating that factor of convenience of having to drive longer to a Sprouts than your local conventional, who's around the corner from your house. So we knew that, that -- we at least felt that, that would be something we want to attack really well first. And there is -- from all of our learnings from not only Instacart but our previous relationship, we wanted to get into the underbelly of exceptional execution on home delivery first before we pick up click and collect. Because we think click and collect will be less incremental or -- and to the extent that's the case, that it could be a requirement. And the customary fees would offset whatever that requirement is but perhaps not as marginal. And our -- not Sprouts data because we don't do click and collect, studies that we've been able to gather suggests that to be the case. So from a prioritization standpoint, we've gotten -- we're in most of our major markets now with home deliveries, month-over-month, that's ramping really well. Our teams should get kudos for exceptional service. And on the Instacart platform, which we've only been on for 6, 7 months now and upscaled for really 3, we've got the best customer service score out of any retailer on that platform by a wide margin. So we see it's all about the brand, the relevance, the quality that shows up to your door and if you ordered 20 items and 19 or 20 items show up and not 15. So those are the pieces that we're really more interested in building the business in a very methodical (inaudible) a long-term way. And we've got the highest attachment rate out of anyone from Instacart is when customers shop with Sprouts, they're unlikely to move to somebody else. So that's pretty positive. So we'll move to click and collect and maybe even to the e-commerce, we'll try some interesting things over time. And to the extent that the customer response is good, then we can continue to do those things. Good news is the new platform we launched, web, mobile app platform earlier in the year, has a chassis and the capability to plug these other features in. So it's not going to be as much heavy lifting to do additional e-com channels if we choose to push those through. And we'll probably looking to test click and collect later in the year to see how the customer response and what the customer tells us.

Christopher Prykull - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

There's one more from the audience...

Unidentified Analyst

I'd like follow up on the competition issue. You said you were potentially fighting above your weight class in terms of natural and organics. But everybody has been kind of raising their game, the Publix, the Krogers, even ALDI. What are going to do just kind of stay ahead? What's your competitive edge (inaudible)?

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

Yes, I mean, our competitive edge is really at the end of the day is we think about the health, value and experience, and experience being in and out of the store. And we don't think -- I personally don't think anybody does all 3 really well today. So that last word of experience, we're laser-focused on, both in-store and out of store. And certain in-store features may only be applicable in go-forward stores. But that's okay because we're still in the second inning of our growth. And so we have a long runway, and so new stores can have those enhancements from an experiential standpoint of giving customers the ability to quickly get through their shopping and just explore a Sprouts, not to make it a chore when they're in the store. And then when they're out of the store, there's some things that we're developing and also thinking about to drive customer engagement in a more unique way than a traditional loyalty program because there's one platform that Sprouts has that's unique to most 95% of the industry and that's health, pure health. So I think we can stand on certain things from a loyalty and customer engagement standpoint that others can't. So that's going to be something that we'll be looking to accelerate over the next year or 2. And when we are ready to announce it, we will.

Christopher Prykull - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

So one of the things that I wanted to ask about was private label. I think on the last call, you mentioned that you have seen really, really good results or strength in existing SKUs whereas maybe before, some of the strength that you were seeing or the lifts that you were seeing were from adding incremental SKUs. When did you start seeing some of this robust growth in existing SKUs? How many incremental SKUs are you adding from here? And maybe walk us through the strategy going forward.

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

Yes, if you look at our private label sales performance over the last number of years, penetration has been increasing by about 100 basis points per year. We're adding about 200 items net new annually. We're at about 2,400 items. And it's really been over the last number of quarters where we have seen a consistent uptick in the loyalty, if you will, of our consumers, adopting more and more volumes of the existing SKUs. And really fundamentally, we believe it's because we have a differentiated go-to-market strategy on private label. It's just not about a international brand knockoff strategy. We are absolutely laser-focused on the quality of the product, the clean ingredient set. The taste profile has to be superior to anything out there. And the packaging is exciting and inviting for the customer. So all that taken together has really seen significant adoption increase over the last number of quarters.

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

I was just going to say is at the same time, given everything that's happened in the industry and the changes that have occurred in the industry, we've more and more become the place to come for innovation for both small manufacturers and large manufacturers. So we feel -- we still think it's super important for Sprouts to have a balanced strategy of working with small and new and innovative manufacturers because the next trend or the next great item can come from anyone and anywhere and no one has got license to it, but at the same time working with our large manufacturers for unique items and then having exclusives for some period of time. We know we may not get exclusive forever but for some period of time to launch. And then taking the private label strategy sort of mixed with that, so we'll continue. That's super important for us that we continue to have the balance. And the reason the balance is important is at the end of the day, it's the lens of the customer, not about, "Oh, let's just go do more private label." Because what does a customer wants, the best product wins at the end of the day. And Brad just touched on we're starting to see velocity as there's some very interesting categories where we're now the largest penetration against some fantastic national brands. And the customers who have private label in their basket have a significant higher basket size and more of a full shop across the store. So as that adoption has been growing, we're starting to see those baskets really widen out for a full shop in the store.

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

The only thing I would add, which is pretty exciting from our point of view is while e-commerce for us, home delivery is small but growing, we're seeing significantly higher penetration of private label on the home delivery sales. So that's just a testament to the quality of the product and it's getting out there. And the brand awareness and what a Sprouts private label stands for is unique. And there's a great demand for that.

Christopher Prykull - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Great. I think we have time for one more. So I'll ask the obligatory grocery margin question. How are you thinking about op margins longer term next year as you lap some of the investments that you all have made back into the business? Is it a key KPI for you? Or is it really more about driving earnings growth and EBIT dollar growth?

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

Yes. So I would say if we sort of level set and (inaudible) look at the last several years, where we have seen some decreases in overall operating margin, it hasn't been on the merch margin side. Over the last 4 years, our merch margin is within 3 or 4 basis points of where it was 4 years ago. The deleverage has come from incremental investments that we've made in store wages and benefits as we needed to enhance what the benefit package and wage compensation package has been. And obviously, we took 1/3 of our tax savings in 2018, which is $30 million, and we reinvested $10 million of that, starting in the second quarter of this year, to really position us well as we compete for the best talent out there. And while it's early days, we have seen this year a meaningful improvement and a lower turnover of employees, team members in the stores and greater customer service scores. And so that strategy is winning. Now the reality is that $10 million allowed us to get ahead of what will be -- what would have hit us in terms of some minimum wage rate increases in a few states in '19 and '20. So we took that opportunity. And importantly, the company is undertaking a number of technology initiatives this year, which will continue through the end of the second quarter into the third quarter of next year, which will allow us to scale efficiently, so fresh item management, which will transform how we think about ordering inventory, production planning of the items that we produce in the store if you think about bakery, meat and seafood, deli and some produce items as well. That program is active, and we are rolling that out again through all the fresh departments through into the -- beyond the second quarter of next year, which the early days, the indication is that we're seeing both sales increase because you optimize which items you need to produce when, so it's available for the customer. And you have improved shrink. You narrowed the bands of variability of shrink within stores that have similar volumes. That, together with deal management that we're rolling out now, is helping us to optimize the effectiveness of promotional activity. Taken together, our expectation is that over the next 3 to 5 years, once we get these initiatives behind us, we're looking at stable operating margins over that time period. So our view is, look, our competitors have long ago implemented these systems. The good news for us, that's tailwinds that we can choose strategically how much of those, the wins, get reinvested in the business from a pricing point of view market-by-market if we need to enhance our positioning in the marketplace. So we feel good about that.

Christopher Prykull - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Great. I think that's all the time we have. We went a little bit over. Please join me in thanking the Sprouts team for coming this morning.
