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SFM - Sprouts Farmers Market Inc at Barclays Eat, Sleep, Play – It's All Discretionary Conference

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PRESENTATION

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

Hi, everyone. Thank you very much for joining us. Obviously, my name is Karen Short, and I am the food and retail -- Food and Staples Retail Analyst at Barclays.

With us today, we have Sprouts, so we're very pleased to introduce Brad Lukow. And obviously, you all know, this has been a fairly exciting couple days, so we are going to try and clarify a couple of things right off the -- from the very get-go.

QUESTIONS AND ANSWERS

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

So I guess, maybe Brad if you could help kind of frame Amin's departure for everyone listening to the webcast and then I guess also maybe give a little context on severance agreement that was filed yesterday. Obviously, there's some numbers in there. So...

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

Sure. Look, I think, for probably a little bit over a year now, Amin has been thinking about what he wants to do next. He's had a tremendous run at Sprouts, highly successful. But at the end of the day, each one of us makes a personal decision around what we want to do with the rest of our life. And so he and I actually had that conversation about a year ago that he was giving some thought to that. And then I think, just recently, he had a conversation with the board, expressed to the board that he really has a desire to move on and do something else. And the context is, look, the board's decision around time frame and how to move forward is, over the last few years, the company has been really successful in deepening the bench and the talent across the organization. And that really gave the board the confidence and not only in the broad management team, but also in Jim and I to carry on at this point. And if you have a long drawn-out period where he was still in the building, I think the board felt that it's really -- could add to confusion in the building, and they just felt really comfortable in moving forward. And the reality is, look, Amin is still around from an advisory capacity through March. And so it's actually a good process in terms of the timing.

Yes, we filed an 8-K. It sets out the terms of the payments that will be made. We'll take a charge in the fourth quarter in connection with that, which is typical in the marketplace in connection with the resignation.

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

And then -- sorry, just to clarify on that. So there'll be onetime charge for the severance but then on the cash flow, it'll be across the entire period of time.

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

It's over a period of time, yes, but the charge would be in the fourth quarter. And I think it's important to also point out, look, there is -- there was no disagreement between Amin and the board on strategic direction of the company. There's no change in any of our initiatives, our focus areas as we look to 2019. The company in its -- our annual process, we do a strategic off-site review every year. We did that in early September. It's a broad management team that participates in the developments and update of our strategy. We presented that to our board at the November Q3 board meeting, got everything approved in terms of our focus areas and initiatives for 2019. So nothing changes with that regard. I think it's also important, people are wondering around, okay, what does this mean from a financial performance perspective? Again, has nothing to do -- Amin's decision to leave the company. He's leaving on a high note. The company continues to perform very well at the November 1 Q3 earnings release, we put out our updated guidance for the year. Our comp range at that point in time was 1.7 to 2 comp for the whole year. The midpoint of that implies a 1.2 comp for the fourth quarter. We are actually trending towards the high end of that 4-year range for a couple of reasons. One, we're starting to finally see a reduction in the deflation that we've been experiencing in produce throughout the year. And secondly, we had a really strong start to the holiday selling season. So for that reason, we're going to be towards the high end. EPS guidance, again, at the third quarter, we called out in the range of $1.28 to $1.30. We're still comfortable that we're in that range, with 2 small exceptions that I'll point out that'll be onetime charges in the fourth quarter that are outside of those -- that guidance parameter on EPS. So one, we just talked about, the severance charge that we will take. And also you might have seen in the recent media, we made the decision to close 2 stores, one is in the greater Atlanta area and one in Alabama. And I think we've talked about before, probably last couple of years, when we entered these markets back in 2014, our site selection analytical toolset were not as well developed as they are today. And at the end of the day, for these couple of sites, we've really put the stores too close together. So when we went back and looked at the mapping of our surrounding stores, it just made sense to close these particular stores, and the sales will move to surrounding stores. So in connection that -- with that, we will take a onetime charge related to the closure of those 2 stores. All of the employees have been offered positions in the surrounding stores, so we're taking care of the team members. But at the end of the day, it's 2 stores out of 315. And I'd just point out that, our new store productivity over the last couple of years now has been running very strong in the low 80s, whereas in the past, it's been around 75%. And it's really a testimony to our much more robust site selection analytical tools that we use in selecting sites and our go-to-market strategy around marketing and advertising grassroots. So I just want to point out that there are those 2 onetime items. Outside of that, again, we're trending to the high end of our comp range and in the range of $1.28 to $1.30 on EPS outside of these items.

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

Okay. I just wanted -- so just to clarify, so on the call on Thursday, the comment on guidance, which I think you're a little hesitant are -- on, just so that everyone's clear, was specifically just because there was going to be the severance that was going to hit.

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

That's right. Because we were in the process of pulling together the materials for the 8-K. We weren't in a position to articulate that on that day. And we wanted to make sure there wasn't any confusion. We thought it was a better opportunity. We knew we were going to be here today and we could set that out.

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

Okay. And I don't want to beat a dead horse, but we've gotten a lot of questions about some of the filing -- Form 4s that were filed subsequently on Friday. So one notable absence on the Form 4 filing was Jim, obviously. And I think there's some tax reasons for him not being able to purchase.

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

Yes, Jim was actually a little disappointed, more than a little disappointed that he was not able to also buy I bought because of the -- there was some short-term profit swing rules in the U.S. from -- that are very punitive from a tax perspective. And Jim, earlier, within a 6-month period, had sold some shares under a 10b5-1 arrangement as a normal course and was not able to take advantage of what I viewed as a great buying opportunity.

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

But Shon was because his selling was in January?

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

That is correct. Shon Boney, one of our directors, made a meaningful purchase.

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

Right. Okay. So -- well, I actually wouldn't -- one more comment that I felt was noteworthy is that there was nothing in the severance agreement about noncompete. So I think that was actually noteworthy from the perspective that you're trying to dispel rumors [from] peers.

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

So as a standard agreement, as part of his original employment agreement, Amin does have a noncompete for 1 year, and we specified, basically, he can't compete against any direct competitor in our business. So it's a 1 year. And Amin hasn't decided what he wants to do next. But just to be clear, there is a noncompete.

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

Okay. So and one more housekeeping. I guess, I wanted to try to get into this finance lease commentary that you made on the last call. So I guess, the first question I have is, can you explain for everybody what the difference is between a finance lease and a capital lease. And -- because obviously, what you're seeing -- faced with is not going -- is not something that any other retailer is talking because most retailers have capital leases if they have any.

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

Yes, so to be clear, we have only 4 capital leases. Most are operating. We find ourselves in the unique position of having 45 of these financing leases, which are really failed sale leasebacks. So during the period of time where construction was being undertaken on these properties, we were deemed under the rules because we were doing certain components of the building that we were the owner of the building from an accounting standpoint. As a result of that, we have these 45 financing leases where we have the asset on the balance sheet is comprised of 2 components. One is the leasehold improvement dollars, which was actually cash expenditure on our part but also a notional building value because we are deemed to own the building. In terms of how that works from an accounting standpoint today, under the current rules because we are deemed to own the building, the leaseholds and the building are depreciated over a 40-year period of the, and then it's a debt model in terms of what the expense is. So just to reiterate what we said on the third quarter call, and now we're in a position to solidify what the impacts of these numbers will be in 2019. It's important to level set on -- what happened in the accounting in 2018. So for these 45 financing leases, there is -- the total expenses is about $15 million pretax. So $11 million is interest expense and $4 million related to both the building and the leaseholds is $4 million. So $15 million in total. Under the new accounting rules that we'll adopt prospectively at the beginning of 2019, all of those leases become operating in nature. So the historical accounting treatment does not continue. The $11 million of interest goes away. It's replaced with $18 million of straight-line rent expense above the line. And so why is it higher? Under the financing leases, it follows a debt model. And as you're into the later stages of the leases, more of the cash out the door every month is going to reduce the obligation on the balance sheet as opposed to the interest charge. You start all over again from square one at the beginning of the year on these operating leases and it's straight-line in nature. And so therefore the charge of $11 million of interest goes to 0. You now have an $18 million OpEx rent expense above the line. And there's no change in the depreciation, it stays at $4 million. And the reason that doesn't change is, you go from, yes, the building comes off the balance sheet, but the leaseholds that used to be amortized over 40 years, because we were deemed to own this whole building, is now amortized over the remaining lease term. So there's actually no change. So stepping all the way back, you're going from a $15 million pretax expense to the $22 million pretax expense. No change in the cash. No change in cash we're paying for rent out the door, but we'll have an $18 million negative impact on EBITDA from a year-over-year perspective and $7 million pretax from a total expense point of view.

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

Okay. So again, what's new from when you had the call is that we need to put -- add an additional $7 million in expense?

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

That's right. And so at the time, we were deep into the analysis and we thought that's where we're going to land, but we hadn't completed it yet. We've completed the work. Our auditors have completed their review of it. And I guess, the last thing I would just add is that all these operating leases we're now setting up an asset and an obligation on the balance sheet. It'll be roughly $1 billion, which translates into pretty much 8x rent.

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

Okay. Well, I'm going to stick to component -- composition, I guess, of '19 a little bit. So the couple other things that you talked about as the benefits of shrink and possibly the labor scheduling is something we should start to see the benefit of in the back half more than earlier on in the year. So I guess, 2 questions, do you -- this shrink clearly should be upside to the second half. But I'm wondering about labor a little bit in the face of rising wages and cost pressures. Is the labor scheduling tool kind of going to be a running-to-standstill situation? Or will it actually be upside in terms of labor scheduling in the back half?

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

Yes. Maybe I'll just anchor first on the fact that from a wage standpoint this year, reiterate that we have made a $10 million incremental investment which was funded out of 1/3 of our cash tax savings. We made that decision to really get ahead of minimum wage rate increases that were going to hit us in '19 and '20. We -- so we don't lap that until the end of Q1. So we have some headwind, which is about 6 basis points until we lap at the end of the first quarter. From a fresh item management perspective, we're really pleased with the ongoing rollout. We're going department by department. We pilot stores. We have learnings coming out of the pilots. We tweak the system to optimize between sales and shrink. And the current program, which is unchanged from the last time we spoke, is to have all of the fresh departments completed by the end of the third quarter. And that's -- there's 3 components to this. It's recipe management, which then feeds into production planning of how much of each item to produce. And then ultimately, it's then order quantities, to be able to order the right amount of product to feed that production schedule. And the final piece, which will be later in 2019 and into '20, is linking the industrial engineered labor standards to the production plan. So to remind everyone, the heavy lifting in terms of the rollout, which is all training expense, will be through the first have and into the third quarter of the year. We've got some really early wins and learnings coming out of the whole program. And if you step back and think about how we handle production planning and ordering today, it's all manual in nature. And so when you're rolling out and opening as many stores as we are, it's very difficult to get consistency across the organization. You've got team members who have 10 years of experience in how to run production planning, and they think they're actually better than the system, which is actually one of the change management learnings. But then you have all these other people's that have joined the company. And it's difficult to operate without these automated tools. So part of the benefit in terms of the shrink is just, look, we have too much variability in our shrink numbers for stores of the same volume just because of the lack of automation and tools. So first and foremost, we're pushing for making sure that we're optimizing the production to maximize sales, and our in-stock position is optimized. And at the same time, tighten up the shrink. So those will be tailwinds that will start in the back half of 2019 and really give us more benefit in 2020 and beyond. And look, there's ongoing labor pressure. It's an industry-wide issue. We've been able to, through the implementation of labor scheduling in the nonproduction departments, really to drive efficiency, which has largely been able to offset most of the ongoing labor cost increases.

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

Okay. So first half, though, again, training will be one of the burdens on the P&L from a shrink perspective.

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

That's right.

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

Maybe a little color, and I mean my thought process is that the shrink opportunity could be several hundred basis points. I mean, is that fair or not? Not even close?

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

Yes, you -- you're -- you should come in and join the team. No, I mean, that's -- that would be...

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

That would be high.

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

Really on the high side. Look, we'll have more comments around what the experience is and what the expectation is as we get deeper into 2019.

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

Okay. And I guess, maybe talk about the comp to leverage fixed cost once you pass this. I mean, I think we've been in that 2.5%, 3% range, do you see that changing as you get past the investment?

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

Yes. I think the -- we've really been in the 3%, 3.25%, 3.5% range in terms of being able to leverage. And I think it's important to step back and look at what have been the points of deleverage over time. And it's probably something that we should have talked a little bit more about to give greater clarity. In our gross margin, it includes rents today. And if we break that margin down further and look at just the pure merchandise margin rate, 4 years running through the end of this year, we'll be within 2 to 3 basis points of what it has been. So we've been able to really reinvest in price and hold our merch margin flat because of ongoing private label sales growth, which has been running in double digits on a comp basis, 25% total top line. The nonperishable part of the business has been running high single digits, obviously, a stronger margin rate. And the deli initiative, which is again a higher margin area of the business is becoming a real area of growth for us. So for all those reasons, we've been able to reinvest, maintaining our competitive price positioning. The team under Jim has done a fantastic job with our vendor partners in driving innovation and driving cost of goods improvement. And from an occupancy standpoint, we've been deleveraging over the last few years, primarily because we've taken our model up to 30,000 square feet, which before systemwide average was around 27,000. And so that's driven some deleverage. And some areas of the country, we're experiencing increases in construction costs, particularly in California. So we see that over the next couple of years flatten out. Wages has been an area of deleveraging, and we've addressed that in terms of really stepping up, and we think we're really competitive from an overall benefits and wage point of view. And lastly, I'll say that SG&A, as we have expanded the network now to the East Coast, we're moving up into the mid-Atlantic, we're expanding in Florida, we've had to made SG&A's investments in standing up the teams that are servicing those areas.

So as we look at the back half of '19 and through '20, we should be flat to starting to leverage on SG&A. So all that to say, is over there, when we look at over the next 3 to 5 years, we should be at a flat EBIT margin.

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

I am sorry, there's a D&A component to that too that rolls off.

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

That's right. D&A, which is part of -- largely, it's buried in DSE, has been deleveraging. And again, that will continue slightly for the next couple of years. But we see our CapEx, which is around $160 million, $170 million over the next couple of years, we'll start to see much less deleverage there.

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

Okay. So maybe just on real estate. You commented that back, I guess, in 2014, you had a slightly different real estate process and you really fine-tuned it today, obviously, resulting in these 2 store closures from Atlanta and Alabama. Maybe talk a little bit about what has changed in terms of the process.

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

Yes. We have significantly more robust tools and analytics, psychographic data on customers. So a map to our core customer, value seekers, prestige customers. We have a great insight now into the number of core customers, pinpointed locations around the trade area. For instance, we know now based on Visa data that we get 3 times a year, exactly where our sales are coming from. And we know that 75% of our sales come from within a 7-minute drive time. And going back to the point around our entry into the greater Atlanta area in 2014, the look back on that with the tools that we have now, we placed the stores too closely together. And so with that, with the site selection analytical tools that we have today, as well as how we go to market using social media, local food bloggers there are well known in the area, resonating with customers who have a real desire for healthy food option, all of those tools brought together and the operations team, I think, have been really strengthened in terms of how we operate. Not only opening the store, but operating the store on an ongoing basis has resulted in these low 80s new store productivity. So that gives us a lot of confidence as we look to continue expanding the brand, particularly in new markets.

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

So my understanding was Atlanta, part of -- I mean, I appreciate that it was -- it's a geography situation, but was that you put all hands on deck for the first, say, month or 2 with the opening of Atlanta and then the team kind of was left alone to manage the market and some things kind of slipped through the cracks. I guess, was that also part of it? Meaning if you need a really strong opening and you need the momentum to be maintained to...

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

Yes. We've fundamentally -- well, we fundamentally strengthened the operations teams right across the country, not only in new markets. We brought different processes to bear, and we've augmented the team with some great talent from outside the organization. And it's just resulted in better in-stock position on a day-in, day-out basis. The presentation of the product in the morning versus at 5:00. We've Dan Sanders, who leads our operations team for Jim, I think, has done a fantastic job, improving processes, and our execution in store today is meaningfully better than it was 2, 3 years ago.

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

Right. I actually -- I want to go back to this, but just -- since we just finished the topic of margins. So I think people who are skeptical of your story point to the fact that you can't maintain your merchandise margins because you're eventually going to run out of opportunity on the merchandise margin side. Maybe can you talk to that? Because obviously, we can all see there has been a remarkable stability in the merchandise margin for the reasons you cited. But maybe looking forward, talk to the other point, other contributions.

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

Yes. I think, as I mentioned earlier, the fact that it's 4 years running, our merch margins are flat because the team, under Jim, has done a fantastic job. Also, we're on the leading edge of innovation and trends. We -- as Jim would say, we set the trends, working with our vendor partners. If it's out in the marketplace, then -- it already, broad distribution, then we're moving onto the next thing. So the team has done a fantastic job, particularly in private label. And our private label strategy is not around a national brand knockoff approach. It's really around fantastic-tasting food, clean ingredient set, non-GMO, unique product formulations, packaging. That has resulted in, year-to-date, over 10% comp sales growth. And obviously, it does come at a higher margin rate. And in terms of sustainability of that growth, we're at about a 13% penetration today. Across the broad industry landscape that may seem like a low number, but produce is 23% of our business and very little private label other than bagged lettuce, et cetera. Jim and the team really believe that we can get to the 16% to 18% total company by 2021, roughly, when we look at the opportunities that are presenting themselves. So that together with continued significant comp growth in our non-fresh departments, which come at a higher margin, is on trend and continuing to drive overall company performance. That together with the fresh item management that we talked about will drive margins. But also, we haven't talked yet about deal management today. We're in the early stages of implementing our deal management system, which is an Aptera's Dunnhumby application-hosted solution that we're starting to get some early wins around promotional effectiveness. Looking at elasticity of demand, affinity items to mix back stronger margin for on-ad items. And we're literally on the ground floor on this. It's not that we haven't done this as an organization, but when you're doing it in Excel spreadsheets, you just can't get at it. And we recently stood up a fantastic MP&A team to work with the merchant team, and so we think we got a lot of runway to go there.

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

Sorry. This is working with Dunnhumby on one of their other suites.

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

Yes. We have stood up the Aptera's Dunnhumby solution, which is all around optimizing promotions. And so the team is just in the early stages. And we've -- many of the management team, including myself, who have stood up these solutions many times over years, this is not a one-shot deal. There's ongoing evolution and learning of how to use the tool more effectively. So I think that's going to give us some good tailwinds.

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

What do you think the time frame would be for you to actually be able to really leverage that, I guess, information?

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

We're starting to, already. But it's really a learning exercise. When the merchants get more comfortable with the tool, now the MP&A team will be working with the merchants on the tool. So we'll start to see some benefit, our expectation is, in 2019 more meaningful. And so for all those reasons, we feel very strongly around our ability to maintain margins.

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

While in that same price?

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

That's right.

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

Okay. So actually on the store opportunities, I wanted to talk a little bit about the units you'll be opening going forward. I've been in the Philly store, it's a great store. It's a little different from some of your others. So maybe can you talk a little bit about that. And how unit openings going forward may look as it relates to your typical prototype versus, say, a Philadelphia-type prototype?

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

Sure. Over the last couple of years, we've done a lot of work, collaborative team and with some outside help on really trying to take the box, the format, the experience to a whole another level for our consumers. So the Philadelphia is 1 of 5 stores that we have now in that new store that we're calling an enhanced prototype. And in essence, what it does is takes up the in-store experience to a whole new level, particularly in the deli area and meat and seafood. So our standard-format store in the meat and seafood and deli area in particular, we have the production work that is being undertaken in clear view of the customer, while, at the same time, trying to serve the customer. This new format takes the production activity and puts it in back of house, and the focus is on serving the customer and having a tremendous shopping experience in the store. So the Philly store that you would've seen would have like an island, a rectangular island format for the deli with all the food around all 4 sides and the service from the center. The meat and seafood area just takes it to a whole new level in terms of the presentation of the product. And it's interesting, the feedback. We've used an outside third party to do a lot of consumer research after opening these 5 locations. And the feedback across all age groups is actually quite interesting. The comment is, wow, you have so much more product in these stores. And the interesting thing is actually it's the same product, but it's the presentation and the experience. And we believe strongly that we will win by enhancing the in-store experience. We know historically that we have not really strongly drawn in the millennial generation into our stores. I can tell you, based on these 5 first stores that we've have rolled out, that we are attracting strongly all age demographics. And importantly, the whole move into enhance deli in the stores over the last number of years where we've got seating areas, it's much more trend forward in terms of the customer coming in, seeing us as a daytime 12:00, 5:00, coming in, have your lunch or dinner, ready-to-eat product. Our location in -- one of the locations in Arizona in more for a semi-urban area that has a hospital down the street. I've been in the store many times at noon hour, and it's just hopping so we are really being seen now as a relevant destination for food. And so as we look forward, this is absolutely going to be our format. We've looked at the 2019 pipeline. That's already been completed. We were able to put this new format in place in 9 of the locations next year. Our sort of -- our decision criteria around which stores would get it for 2019 was really around we didn't want to delay opening, and we didn't want to incur a significant cost, if you have to go back to municipalities for revised drawings and approvals. So 9 of the stores, roughly 1/3 of the stores, will have the new format in '19. And we're really excited about the fact that in 2020 and beyond that is our new format. We can't really go back and retrofit. Just -- it's cost prohibitive because it is so meaningfully different in terms of the presentation and experience and the construction.

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

And I mean the volumes are very high, especially at lunch and I guess maybe a lot -- little less at dinner. But is there a point of friction on payments because it seems that, that might have been the case in the Philadelphia store and it was well past the grand opening?

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

Yes. It's a good problem to have. When the team is certainly focused on a number -- exploring a number of technology solutions that will reduce friction in the store for the customer, whether it be ordering or payment or both. That's absolutely something the team is looking at because we know that we're getting really tremendous foot traffic in the stores at those peak times, and we don't want to disappoint the customer. So we think we have a real opportunity as we look forward in 2019, sort of, back half to start testing and implementing some solutions that will take that friction away.

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

Like payment on the app?

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

That's right.

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

Okay. I might just stop and see if there's any questions in the audience. The time is flying because there's so much to discuss.

Unidentified Analyst

When you talk about your deli product, is that considered a private label? And is that sort of as a percentage of your total private label penetration?

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

Yes. No, deli has a mix of private label. So we have Market Corner Deli items that are branded Sprouts. So there is -- there are a number of items within the deli department that are private label. But it's a mix of both, branded and non-branded.

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

So I want to, actually -- I'm going to get into digital in a second. But it also just want to cover the topic of inflation, deflation because when you look at '19 in terms of comps, if we're not in word of inflation, there's a concern that you may not be able to do kind of a 3-ish percent comp. Maybe can you talk to that a little bit? And I guess, bigger picture, in this industry in general, we haven't seen inflation at all for 4 years. So you did allude to the fact that there was some relief on produce. But what are your thoughts on whether or not we will ever get back to wage inflation...

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

Yes. So I think it's important to clarify, based on our sales mix because we over-index in produce, we're much more impacted than of our competitors. If you think about the conventional supermarkets, that are -- would be less than 10% of their sales, or 23%. And if we look across all the categories this year with -- so produce is really leading with the deflation on the cost side and a little bit in meat. But when we look across all other categories, it's actually been inflationary. So the fact that we're seeing now some movement down significantly on the deflation side on produce, we're getting closer to flat from an overall total store point of view. So our viewpoint is that, in a flat environment in terms of inflation, deflation, you're probably in the 2% to 3% comp range.

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

Okay. Maybe just covering digital a little bit, so when you look at '19, is there going to be a greater focus or allocation on -- from CapEx on digital? And I know there's been some -- Amin, obviously that was one of the -- his efforts, and it's been divided between you and Jim from an IT versus digital perspective.

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

Yes. Let me sort of just level set around our digital efforts. And it's not a big CapEx, it's more operating expenses. And we had to set the foundation properly. And we did so by putting out our new app last year, which has tremendously better functionality, as evidenced by the fact that dwell time is up, like -- something like 40%. There's so much more content on the app in terms of recipes, in terms of items, it's -- the item catalog is in there, articles around healthy living. So customers are really engaging with us on that app. That's -- but that's foundational. The next step is really around how we can take that to the next level. So we've started things in terms of push notifications to our customers. We'll be able to -- next year, be in a position to allow customers to use the app, build recipes, decide on whether they want to pick that up in store, they want to shop, or do they want it delivered to their house. And there's -- we're really just scratching the surface. And I would just say that, the whole area around digital has been a collaborative effort between the merch team and the marketing team. Over the last 18 months, we have been able to bring in some incredible talent into the marketing team, focusing on digital. And I would just say that, that team is really pumped and excited around where they can take this to the next level. Jim has always been involved in the marketing side. And in the meantime, he's taken over responsibility. So -- but this is not a situation where the merch team, under Jim, has not been involved. It's really been a joint and collaborative effort pushing us to where we are today. But foundation is set. Now we have a real opportunity going forward to take it to the next level and really engage with that customer inside and outside of the store.

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

So from a spend perspective, CapEx allocation to digital or IT shouldn't really change meaningfully?

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

No. That's right.

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

So yes, just upgrading what you currently have.

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

That's right.

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

And can you maybe just remind us how many stores actually have Instacart because I think there's one market where it's not necessarily realistic currently.

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

Yes. We have -- 207 stores today have Instacart home delivery. It's really only some areas in the southeast, including Florida where Instacart's not really to stand it up and get. We want to make sure that they're absolutely ready to deliver, what we have is the #1 service on their platform based on the consumer feedback. So we are seeing really strong growth in Instacart home delivery sales, while it's a small as a percentage of the business, we're seeing pretty strong percentage increase, and we've already eclipsed the level that we're at on the Amazon network. So we're pretty, pretty excited about how that will continue to grow. And I think part of that is because we've got a lot of years of experience in how to execute that. And the team within sprouts has done a fantastic job, really working collaboratively with the stores and with Instacart to make sure, if you order 20 items, you're getting the 20 items that you ordered. And the fact is that when you think about the fresh side of the business, we turn produce every 3 days. You're guaranteed you're going to have fresh product. So I think for those reasons, it's really been something that has ramped up quickly and has exceeded our expectations.

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

Okay. And I guess maybe last question. As you think about -- so Philadelphia obviously seems to be a home run from an execution perspective. How far north can you go with your current infrastructure in terms of distribution?

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

Yes. So when we're looking at -- in terms of where are the big pockets from a geographic standpoint of opportunities, it's really the Mid-Atlantic states, so Maryland, Jersey, D.C., Virginia area. We see tremendous opportunity in terms of the desire for our format, healthy food for less. In the context of the competitive set there from a conventional standpoint, I think we feel very good. And the stores that we've opened up in Maryland give -- together with Pennsylvania and obviously opened up in September in Philly have reinforced our view in terms of the opportunity to really drive significant growth in that marketplace. And obviously, we're opening a lot of stores in Florida as well. We see tremendous opportunity there and the stores are performing really well. So those are 2 great areas of market opportunity for many years to come. And for the first time, I think ever, more -- a greater percentage of our stores that we opened in 2019 will be in these new markets as opposed to the historical. We've been generally a 70% of the stores opening in our original market. So that takes some pressure off of cannibalization as well. And it helps balance the portfolio from a growth point of view.

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

We all want you in New York or at least -- or maybe, Connecticut. But on that note, we'll end. Thank you very much for your time, very interesting.

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

Thank you.
