

THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

SFM - Sprouts Farmers Market Inc at BMO Capital Markets Farm to Market Conference

EVENT DATE/TIME: MAY 15, 2019 / 1:30PM GMT



MAY 15, 2019 / 1:30PM, SFM - Sprouts Farmers Market Inc at BMO Capital Markets Farm to Market Conference

CORPORATE PARTICIPANTS

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

CONFERENCE CALL PARTICIPANTS

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

PRESENTATION

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

All right. I think we're ready to move on to our next presentation. Thrilled to have Sprouts here at Farm to Market again with us with Brad Lukow, and Susannah Livingston with -- from IR is also here in the front row. So Brad, you are interim Co-CEO, I think going on about 5 or 6 months. You've been CFO for the past 3 years. Your Co-CEO is on medical leave. So please send our best to him on that front. But from the outside looking in, it does appear that you're juggling a lot right now.

QUESTIONS AND ANSWERS

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

So I thought maybe if you could just start by telling us how you think the organization is executing at this time when you're sort of down a couple of leaders? And maybe just take this opportunity to tell us if you were to become the permanent CEO, what, if anything, would you do different at Sprouts. That's a lot to take on but...

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

Sure. First, I'd just like to say that Jim would have loved to have been here. And Jim has always put the company first, and for the first time in his life, he's putting himself first and taking care of some medical issues, so we're happy about that. Look, I think over the last number of years, the company has done a great job in building up the talent bench, and so we have a lot of depth of experience in grocery and specialty across the organization, our -- that includes the merged chain, the operators. We've brought in some great talent even over the last 18 months. So there's certainly a depth of experience in the organization. Yes, it's busy, obviously, juggling a lot right now, but we're executing on our strategic initiatives. And I'd like to say it's never about one person, it's really about the team, and that's sort of the culture at Sprouts. It's all about the team and executing together. It's a very collaborative organization, and we're not getting off our game plan, we're continuing to execute. Look, in terms of the future, but there's no disagreement either within the management team or the Board in terms of our strategic direction, every year we have an offsite strategy session where we update our initiatives and look at our strategic platform going forward over the next 18 to 24 months, and that's what we're executing on now.

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

All right. So I guess to just dive right in, and by the way, if you have questions, you can submit them here on the app, I'll try to check that. But I guess I wanted to start off with just the broader environment. It feels like we went into this deflationary phase, 2016, 2017, and we've come out of it, but it feels like it hasn't gone back to the way it was before. I don't know if you would agree or disagree with that. And how much you would attribute the current environment to that external inflation backdrop or just the competitive environment or maybe it's a combination?

MAY 15, 2019 / 1:30PM, SFM - Sprouts Farmers Market Inc at BMO Capital Markets Farm to Market Conference

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

Yes, I think it's really a combination. If we look at our product mix, it's fundamentally different as opposed to our conventional supermarket competitors, where 23% of our business is produce-related. Obviously, you can't control the weather, and we've had ups and downs in terms of the weather issue impacting supply, which also impacts our ability to promote and get quality products into the store. As we talked about, for our first quarter, we had some unfortunate weather in California, lots of rain that really drove some hyperinflation in a number of important traffic-driving categories, like Weg that were up over 40%. When that happens, it's never a good thing because one, you can't get the product supply and you can't pass along that type of cost increases. So it puts pressure on both your comps, traffic and margin. And we're continuing to see challenges in the second quarter with regards to availability. California's had more rain, and we've had cold weather in Mexico impacting imports of important commodity items that we use as traffic drivers. And so growing seasons are 6 weeks long. It can change very quickly, but I would say we're impacted more than others just because of our significant product mix in produce. There's no question the competitive environment continues to be a difficult one as more and more competitors are looking to focus on fresh, which is where the customer wants to be, but we've always focused on fresh and have that relationship with our consumers, and they know that they come to Sprouts, they get fresh product that's very authentic. That's how we started the organization. We didn't start as a less-healthy grocery store and adding fresh to it. But the reality is everybody is pushing into the produce area, and it does become more competitive.

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

And as you think about just the produce backdrop, we only have a couple years of history of following you publicly. So if we go back further, is the produce backdrop the same or is it becoming more volatile?

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

I would say that if you go back 3 to 4 years, even 5 years, inflation across our business from the cost point of view was anywhere from 2% to 4%. And it was an environment where most of that cost increase was being flowed through to the consumer. If we look at 2018, we were in a deflationary environment. I think produce was deflationary for us on a cost basis of over 5%. And so that makes it challenging just being able to deal with that deflationary environment. This year, as I mentioned, we're seeing some hyperinflation in a few categories, which is never a good thing. Notwithstanding some recent weather reports out of California on potential bad weather this week. The cherry season is shaping up to be meaningfully better from a volume standpoint than the prior year. And really, the weather setup for this week, and we'll know more by the Thursday of this week whether or not we get hail or not, but the reality is even with some loss of product coming out of California in the south, if we get the bad weather this week, will still be greater volumes than last year.

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

Okay.

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

And the production out of Southern California is like 30% of the cherry crop, which runs from May 10 to like June 20. From then on, it moves up to Washington. Washington is where it's at. It's the -- it represent 70% of the cherry crop, and it's setting up to be a very good summer for cherries.

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

Okay. That's very helpful. Is there -- as you think about just produce, a couple more questions there. I think California, for the first time in I think it's been 7 years it's officially out of the drought. Is there any impact on the produce longer term aside from the 6-week weather cycles?



MAY 15, 2019 / 1:30PM, SFM - Sprouts Farmers Market Inc at BMO Capital Markets Farm to Market Conference

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

Yes. What happened during the drought years, a lot of the California growers ended up acquiring lands in Mexico where the water situation was much more favorable. That actually led to a lot of deflation in 2016 in areas like bulk. So I think from a supply standpoint, I think the country is in a better position now. During the summer months, 80% of produce is coming from California. But in the winter months, November through February, upwards to 40% is coming from outside the U.S., including South America and Mexico. So while produce continues to be a key driver, and the trends are eating healthier, the supply has been able to keep up with the demand because of the expansion of these farmlands by the Canadian -- or the California growers into Mexico.

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

What about technology? Is there any technology impact on the produce market? It's just an area where we don't really hear a lot because there are so many distributors. So we always ask Sprouts on the produce front.

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

It's really about growing core relationships. And our point of differentiation versus most of our peers is that we don't operate on a contract basis with our growers, and it's all about relationship. In fact, the guys are in the field as we speak today, meeting with multigenerational families, and we -- Sprouts delivers on our commitments to the growers in terms of what volumes we'll take, and it really is about relationship in order to secure the supply. As it relates to technology, there's an interesting, probably little-known piece of technology that's existed for some time. And it was actually tested in Southern California this week, and I have a video of it, these hail cannons. Hail cannons are in the fields. They go up like a sonic boom, shot into the upper atmosphere where cold air is meeting warm air, and it actually -- where the hail is formed, it actually breaks down the large hail, golf ball size, into little shards. So from a technology standpoint, I think that's applicable to go cherries and stone fruits seasons. So there are some little-known technologies that are out there that are helping to protect the crop.

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

Interesting. Okay. Couple of questions here on the app. How concerned are you about the possibility of Mexico border closure? And do you have any contingency plans for that?

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

That heated up over a month ago and is really abated. So we don't really have any concerns at this point in time. Certainly as we extend into the summer growing months, we have grower relationships with other parts of the country. So we've developed relationships as we've moved eastward into Florida, Georgia, Michigan and certainly deep relationships throughout California. So at this point in time, it doesn't appear to be a near-term risk to us.

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

Okay. And another question here, geographical growth plans for new store openings. Maybe just talk about what you're doing there.

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

Sure. 2019 represents the first year where more than half of our new stores will be opened up in new markets. Traditionally, we've been about 70% in our regional 8 states, Texas West. Over the last few years, we've continued to enhance both our site selection, analytics, our go-to-market strategy, our marketing and promotion and advertising grassroots into the local communities to really build out the brand. And now that we're in 19 states across the U.S. coast to coast, the brand awareness is significantly greater than it was even 3 years ago. And that's why we're seeing our new store



MAY 15, 2019 / 1:30PM, SFM - Sprouts Farmers Market Inc at BMO Capital Markets Farm to Market Conference

productivity consistently now in the low 80s as compared to 5 years ago being in the mid-70s. The consumer awareness of the brand is significantly greater. The results, our new store productivity is great, our average weekly sales continue to be stronger and stronger every year. And so it's the right time for us to continue to increase our penetration in these new markets, and we see tremendous whitespace opportunity, particularly in Florida and the Mid-Atlantic states.

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

And maybe just on that note, just a comment about the new Philadelphia store, which is I think the closest store to here. So you'll probably have some visitors there.

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

It is. So we've developed a new enhanced prototype store over the last couple years really to enhance the consumer experience in a material way, both in the produce -- or sorry, in the deli area, bakery as well as the meat and seafood. And it's essentially we -- what we've done is we've taken the production activity that was in view of the consumer behind the service case and put that -- move that to the back of the house. We've now taken the deli and it is an island, a rectangular island with all the product around the perimeter, with surface -- service from the middle of the island, and the consumer experience is materially improved and -- as well as our presentation in the meat and seafood and bakery. The consumer verbatim comments are they can't believe how much more product that you have in the store. The reality is it's the same product. Yes, we've continued to enhance and develop new items, particularly in the ready-to-eat category, but it's all about the merchandising and the experience in the store. So in 2018, we opened 5 new prototype stores. We opened our most recent one in San Luis Obispo at the beginning of Q2. There will be 8 of the 28 stores this year being in the new format. And then 2020 and beyond, there will be -- our enhanced proto will be in every location. The impact is pretty significant in terms of the product mix enhancements. So deli, we have seen sales mix increase by 400 to 500 basis points. As it -- the experience really takes it to a new level. We're really presenting to the consumer that we are absolutely in the game of meal time with the seating area in the store. And the younger generation, millennials are much more attracted as compared to our previous format. And so we're seeing that resonating very well at particularly 12 o'clock, 5 o'clock time frame. So not only our average weekly sale is stronger consistently in each of the new protos that we have out there, but also the margin mix is stronger because the mix of what we're selling is better than the previous model.

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

So is deli -- did you say that deli penetration goes up 400 to 500 basis points? What goes down?

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

The produce goes down. Yes, so ideally -- and what we've been focused on over the last number of years is to build out the Sprouts offering as a more full shop, healthy grocery store. And traditionally, when we open a new store, produce is the big draw, then it's meat and seafood, then it's dairy, then grocery, and the nonfresh departments become the -- those departments that take longer to develop, like vitamins. Now what we're seeing is the experience is so different that the fresh departments, including deli, are starting much stronger, which is I think is a great outcome because the trend today for consumers, particularly younger consumers, is that it's more grab and go, what can I -- most consumers don't today decide on what they're having for dinner until they're on their way home. And now we've got great solutions to pop into the store, either eat in store or take it home and heat it up and you've got a great quality meal with fresh, clean ingredients, which is a huge differentiator from -- versus most of our competitors and at great prices.

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

Going back to the new store productivity. One of the questions I've been meaning to ask you guys for a while, your -- you've changed your top line expectations over the new store contribution. I think it used to be 20% to 30%, now I think it's more like 15% to 25%. So I'm assuming that's because



MAY 15, 2019 / 1:30PM, SFM - Sprouts Farmers Market Inc at BMO Capital Markets Farm to Market Conference

of new store productivity and how strong that's coming on. Is that -- have to do with inflation or deflation at all? And it just seems like a pull-forward in that regard.

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

Yes. It has nothing to do with inflation, deflation. It's absolutely that the stores are opening up stronger. So the good news is they're opening up stronger. The bad news is for public company, the comp waterfall is reduced, but your financial returns are much stronger and the free cash flow generation continues to improve.

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

Right. So how do we think about the mature store comp with this kind of dynamic happening?

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

So mature stores comps are still positive. Notwithstanding that the mature stores are impacted by 95% of the cannibalization that we create by opening up stores in existing markets. So what we always look at the health of the business is what are the comps post cannibalization. I guess that, that's what we've done from -- we've cannibalized ourselves to take more of a market share position in an area, and then those stores recover. So we're still healthy from that point of view.

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

Okay. Getting some questions here on home delivery and the Instacart. So lots to talk about there. So maybe we'll switch gears. How is that relationship going? And how is home delivery impacting -- or sorry, home -- the pickup evolving with Instacart?

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

Yes. So we've got a great relationship with Instacart. We first started rolling stores onto the program at the beginning of 2018. This time, last year, we rolled off our 17 stores that were on Amazon Prime, and we continue to build the business from home delivery standpoint. We have -- we share the top score consistently on Instacart from a consumer scoring perspective in terms of their experience with us. And it really comes down to we've got 4 years of experience with home delivery. We know what it takes to execute in store to ensure that the experience is right that the -- if you order 20 items, you get 20 items or else, the consumer you're just going to disappoint, and they'll chose somebody else. It really comes down to the brand, and we saw the same thing when we were on the Amazon platform. We outperformed our peers in the specialty space on home delivery and the same thing with Instacart, and it all comes down to the brand and trust. So if you go into a store and you're picking up fresh product and it's not fresh in the store, the chances of you not getting disappointed on home delivery is the challenge. So because we were all about produce first, and we turn it every 3 days. In the store, it's incredibly fresh, and home delivery, it's just as fresh. We have seen, obviously, tremendous growth in home delivery. It'll be approximately 2% of our business by the end of this year. It grew north of 60% last quarter. It's really -- and that growth is really a mix. I would say upwards to 80% is coming from repeat customers, 20% -- roughly 20% from new customers coming on. So every quarter, we're seeing new customers coming on to rate our adoption. When we originally were thinking about click and collect versus home delivery. We really decided around home delivery because as a brick-and-mortar retailer, we are by definition highly convenient. It's a small format, 30,000-square foot box, easy to get in and out of, and so our expectation is that the home delivery would appeal much greater to our core customer than click and collect. Having said that, we are piloting. We're in 18 stores in 6 markets now, and as anticipated, the overwhelming majority of our core customers and consumers are opting for out of the store being home delivery. If they have to go on their phone or computer to generate the order, you might as well just have it delivered, and it's very convenient. And I think the difference from us fundamentally is beyond the store format, which when you compare it to a conventional, that's 60,000, 80,000, 100,000 square feet, which by definition is not convenient. Our network of stores is also much more dispersed. The distance between our stores is far greater than any conventional supermarket. So on the conventional, you drive 3 or 4 minutes, you're at another store, which means it's much more cannibalizing for click and collect. And for us, based on the data that



MAY 15, 2019 / 1:30PM, SFM - Sprouts Farmers Market Inc at BMO Capital Markets Farm to Market Conference

we see, still greater than 50% is not cannibalizing ourselves, its incremental business, which -- obviously, as the penetration of home delivery increases, more of that will be cannibalizing. But for us, I think it's -- our view is we need to capture as much share of wallet as we can. And so whether that consumer wants to engage with you in the store or out of the store, we're going to be there to meet their needs.

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

Right. Can you explain just logistically how the pickup works at Sprouts? I mean, do you have to put in coolers at the front or...

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

We do.

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

Okay.

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

Yes. So we for the last few years have built out the front of our stores with a back-of-house, if you will, area to the extent that we were going to require some square footage for coolers. And we've done that in the stores that we're doing the test in.

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

Okay. And the new unified digital platform, can you talk about that? That seems like a pretty big deal for Sprouts.

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

Well, it's really about aligning our differentiated experience in store with online. So today, we don't have a differentiated platform with Instacart. It's pretty much plain vanilla. What we're developing will have their targets the middle of the year is when you come to sprouts.com, you will no longer be bounced back out to a vanilla Instacart platform for your order. It will be a platform that's controlled by us, which allows us to present items, recipes, products, suggestions in a much more differentiated way. So it's more of a seamless experience for the consumer.

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

Okay. One question that's topical maybe in some other parts of food retail is as all of this industry starts to shift online, you're seeing more talk about advertising from the vendors and playing for -- paying for product placement and promotions. Is that something that you guys will be able to do with the unified platform? Or how does that work with your relationship with Instacart?

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

I think -- so certainly more and more of the traffic coming through our website will give us the capability of expanding our promotional relationship with our vendor partners.

MAY 15, 2019 / 1:30PM, SFM - Sprouts Farmers Market Inc at BMO Capital Markets Farm to Market Conference

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

And as we think about maybe 2% by year-end, I know this is the big-part question asked -- answer, but where do you think that goes next 3 to 5 years? And how does that change the profitability? How do you adapt to that?

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

Sure. One of the interesting things is that in the U.S., when you look at e-commerce, the vast majority of e-com's done in packaged goods and nonperishable products. The vast majority of consumers today still find it important to be able to get in the store, look at the products, smell it, and they just want to select their own product, and that trend continues. So when we look at the mix of our business, 60% of what we sell is perishable. So I -- my expectation, it's hard to predict over the next 5 years, but I -- my expectation is that we -- maybe we get to 5% to 7% over 5-plus years versus if you're talking about a conventional supermarket, where 40% of the square footage and sales is coming from packaged goods, the consumer is really indifferent whether or not that's being delivered to their house, whether they're picking it up or going into the store, it's not a perishable item, it's less sensitive. And it's the most sensitive to being commoditized from an online point of view.

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

Right.

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

And I think the other point is that we have a very different experience in our store from a service point of view, while others have pulled back on service. A lot of have removed butcher shops. We continue to believe in our consumer data and research reinforces the fact that our customers really appreciate that small farmers market feel with a great service, get anything cut you want that's differentiated as well as our service platform that we have within our vitamins and (inaudible) area is very differentiated. So I've -- for those reasons, I believe it will continue to be very important for our consumers to have that in-store experience, which is where I think the enhanced prototype comes in because I think it's all about experience from a four-wall point of view going forward, and the results today certainly confirm that we're on the right track with that new proto.

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

So the other 40% of the store that is more packaged, do you think you need a direct ship-to-home solution? And I guess, I especially think about vitamins and supplements, which I know have that in-store service element. But is there a way to get your customer any of that more on the ship-to-home parcel kind of side?

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

Well, today they can order pretty much everything across the store. Our experience to date is that consumers prefer to come into the store because they have that relationship with the team members that are very skilled and experienced and trained and the efficacy of the products that we sell, which are all natural. And then some other time, you can fill it in. If you know what product that you want to buy, then you can get it on the Instacart platform through Sprouts.

I think over time, we'll see improvements in technology to drive out efficiencies from a home delivery standpoint both how we pick the product in the store, looking at fastest-moving items or touching it twice. So there's some technology improvements that can -- that -- we're already talking to Instacart about in terms of improving that over the longer term. As you see less incrementality, it becomes more and more important to try and reduce those costs to serve.



MAY 15, 2019 / 1:30PM, SFM - Sprouts Farmers Market Inc at BMO Capital Markets Farm to Market Conference

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

How does the fee structure defer for pickup versus delivery with Instacart?

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

So we have a pick, pack, deliver fee that we've negotiated with Instacart and a separate fee for the click and collect tests that we're doing. Obviously, significant component of the cost is the final mile and the drive time. So obviously different fee for click and collect.

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

What about from the customer perspective?

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

Yes. So the customer -- more than 50% of customers that are on the Instacart platform choose the express membership, which is the annual membership, unlimited deliveries for \$99, which was reduced from \$149 a number of months ago. And that resulted in a step-up of consumers trying the platform. And again, as I mentioned, upwards to 80% of our customers that use Instacart platform through Sprouts are repeat customers. So it's resonating really well, and as I said, it comes down to the power of the brand and the differentiation points. Included in that is our private label product that is highly differentiated from a (inaudible) ingredient set quality standpoint, which continues to grow at double-digit comps. So again another reason why we continue to see our home delivery business increase is that loyalty you can only get it at Sprouts.

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

Right. I guess another question on this topic. You've -- in the past you've bucketed your customers into different categories, like value focus, you've had health conscious, convenience focused. I'm assuming the convenience focused are most interested in this, but are you seeing penetration across those customer categories?

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

We are. I would say that it's more age-based. So today how we see from the core customer that is using the home delivery platform through us is aged 25 to 44. 40% of them have children. And so we're starting to learn more and more about that customer. And one of the important elements of developing that unified experience on sprouts.com is that our objective is to capture more and more of the transactions through our website. When we do that, we get 100% of the data. So we start learning more about that customer. And what that, right, then plays into is understanding the total customer between out of the store, in the store, which will then give us greater capabilities to do personalized promotions and deepen that relationship with the consumer.

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

Okay. Just switching gears maybe to the fresh item management tool, which is a big initiative at Sprouts. I think you -- the message at least in the fourth quarter was that the training costs and some other costs were going to kind of mask near term the upside from the benefits from these tools. But when do we get to the point where the benefits start to outweigh the costs? And can you give us any metrics on those costs? And what does that do to your comp leverage point down the road?



MAY 15, 2019 / 1:30PM, SFM - Sprouts Farmers Market Inc at BMO Capital Markets Farm to Market Conference

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

Sure. So we extended the period of time to roll out fresh item management across all of the production departments, which lead with bakeries and meat and seafood and then deli and then into bulk. As we had some very good learnings as we started the roll out, our focus was not around speed, it is around ensuring that the team members could easily retain the new knowledge around how to use the technology and the system. As a result of that, we've altered slightly our training approach, and we're tracking according to our plan. This year, we'll have production planning in all of our production departments by the end of the third quarter. So the big training costs that we see in 2019 is through Q1 through 3. We're already starting to see some winds in the earlier departments where we converted bakery. And so over time, we would anticipate that shrink costs come down. There's a couple ways you can go about rolling out the platform. You can either pursue maximizing sales first or shrink. So the team that we've got on, on the implementation have worked with the system and a few other companies and have been down this road before. And the way to go about it is to first optimize your production up and maximize sales, which in the interim generally hurts you a little bit on shrink, but then you come back and you do some SKU rationalization and you end up improving shrink. So all that will result in a lower level of comp to -- requirement to deleverage, which for us has historically been around 3%. I think that gets down to 2.5% or lower. We're also -- beyond production planning, we're starting some areas of the store with computer-assisted ordering. So once you determine what you have to produce, then you've got the algorithm on what you have to purchase to be in stock for the production activity. And then the final stage next year will be linking the engineered labor standards to the production plan. But the bulk of the heavy lifting is through the first few quarters of this year, and we start to see the benefits thereafter. And it's not a onetime benefit. Usually, it takes a couple years to fully fine tune and improve the operation of the tool.

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

So should we -- as I was listening to what you were saying about the shrink, should we expect some volatility in gross margin for a couple of quarters as you kind of refine...

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

Yes. We've had even in the first quarter had a little bit of higher shrink, and we'll probably see that in the second quarter and third quarter but then -- and then stabilize and improve thereafter is the objective.

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

And I guess in terms of other technology. You have the Workday Financials, you have new production planning. There's a lot of different systems. Is this kind of the new norm that we just have constant technology investments? Or do you really believe that this will start to roll off by the end of maybe next year or level up?

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

I think we'll continue to have technology investments. The difference is that we were coming from a very, very low level of investment spend in technology back in 2016, increased in '17, '18 and a pretty significant increase in 2019. I think the rate of increase or decrease going forward, we're now -- I'm more looking at it from a dollar investment perspective. We'll be not seeing a significant dollar increase going forward, probably plus or minus the same amount of spend as initiatives like FIM roll-off, like Workday Financials roll-off. Our next focus is going to be developing and enhancing our digital platform and loyalty program that we're looking to introduce a first element out in 2020. But I think the very high dollar increases year-over-year are behind us, but we'll continue to invest in technology. Really focused on 2 things, efficiency and scalability but also fully focusing on the customer and enhancing the digital experience and driving that loyalty platform.



MAY 15, 2019 / 1:30PM, SFM - Sprouts Farmers Market Inc at BMO Capital Markets Farm to Market Conference

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

Okay. Last one just on wages. Where are you with wages? Do you see more pressure coming? There's still minimum wage increases rolling through. How do you feel about that?

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

Yes. We continue to see labor pressure. Obviously, last year with the significant income tax benefit, we reinvested 1/3 of those savings, about \$10 million into enhanced wages and benefits, really just getting ahead of what was going to hit us in '19 and '20 from a minimum wage rate increase point of view. And when you're almost at 0 unemployment at these days, you continue to have labor pressure as you're focusing on competing for great talent. So we'll continue to see labor pressure going forward. I think, you're looking at roughly 3% cost per labor hour increases but we have also in the early days of delivering on productivity enhancements. So for the most part, we're able to offset that with sales per labor hour productivity improvements. And I think the other element that puts us in a good position is that you can -- as a team member, you can develop a full-time career at Sprouts. Just the nature of our operation, and we have assistant department managers, department managers in a very short period of time based on aptitude and attitude. You can actually make a 6-figure figure fix -- a 6-figure salary and make a career out of it. So there's not a lot of our competitors who can offer that. So I think that's an area that we're focusing on. It's not just what is your starting wage per hour, it's really around showing a career path for a team member going forward.

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

Right. Perfect. I think we're out of time. So I think we have to wrap it up there, but Brad, thank you so much for your time.

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

Thank you, very much.

DISCLAIMER

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

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

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

©2019, Thomson Reuters. All Rights Reserved.