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SFM - Q3 2015 Sprouts Farmers Market Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to Sprouts Farmers Market third-quarter 2015 earnings conference call.

(Operator Instructions)

As a reminder, today's program is being recorded. I would now like to introduce your host for today's program, Susannah Livingston. Please go ahead.

Susannah Livingston - *Sprouts Farmers Market, Inc. - IR*

Thank you and good morning, everyone. We are pleased you have taken the time to join Sprouts on our third-quarter 2015 earnings call.

Amin Maredia, Chief Executive Officer; and Jim Nielsen, President and Chief Operating Officer are also on the call with me today. Sprouts' 10-Q, the earnings release announcing our third-quarter 2015 results and the webcast of this call can be accessed through the Investor Relations section of our website at www.sprouts.com.

During this call, Management may make certain forward-looking statements, including statements regarding our future performance and growth, product expansion, new store openings and 2015 expectations and guidance. These statements involve a number of risks and uncertainties that could cause actual results to differ materially from those described in the forward-looking statements. For more information, please refer to the risk factors discussed in our filings with the Securities and Exchange Commission, along with the commentary on forward-looking statements at the end of our earnings release filed today.

In addition, our remarks today include references to non-GAAP measures. For a reconciliation of our non-GAAP measures to the comparable GAAP figures, please see the tables in our earnings release. We believe these adjustments -- adjusted results provide a good basis to assess the operating and financial results of the Company, period over period.

For the third quarter ended September 27, 2015, we reported diluted earnings-per-share and adjusted diluted earnings-per-share of $0.21. Adjusted diluted earnings-per-share increased 17% from $0.18 in the same period in 2014.

With that, let me now hand it over to Amin.

Amin Maredia - *Sprouts Farmers Market, Inc. - CEO*

Thank you, Susannah. Good morning, everyone, and thanks for joining us today. The last three months in my new role as Chief Executive Officer have been fast paced.

I have spent a significant amount of time with our leadership, walking stores including competition and meeting many of our great vendor partners. I have had an opportunity to visit many of our markets, gaining even deeper insights into how we can best advance our brand differentiated and attract new customers. I joined Jim and our merchandising team at several industry expos and events, and we all walked away truly energized by the continued innovation in the natural and organic sector.

Jim and I have also had a chance to travel together extensively and connect with key members from coast to coast and continue to see their commitment to the Sprouts passion inspiring, educating and empowering our customers to eat healthier and live a better life. Our team of 20,000 plus is stronger and more passionate than ever and I could not be more proud to lead this Company on our growth trajectory. Let me now shift to the third quarter.

During the third quarter, the strong execution in sales, merchandising and operations helped grow our sales 18% compared to the prior year. Reflected by strong comps growth and solid performance from our new stores. Our comps sales for the third quarter exceeded our expectations and accelerated to 5.8% from 5.1% in the second quarter of 2015.

Attaining a 5.8% comp in a zero inflationary environment is a testament to our business model and our ability to continue to be even more relevant to our customers every day. Our traffic ticket split was 75% traffic and 25% ticket for the quarter, demonstrating our ability to contract -- attract new customers into our stores with great products, strong merchandising and exceptional execution. Importantly, the increase in comps was realized in departments across the store.

During the quarter, inflation begin to normalize leading to a near zero inflationary environment. Low levels of produce inflation were offset by protein deflation.

From an industry perspective, promotional activity in the third quarter was relatively consistent with the first half of the year, and we remain committed to maintaining our competitive positioning. The competitive environment is a constant for the grocery space. We have long had processes in place to monitor the changing environment and quickly respond to competitive moves and are getting even better in studying and learning from the resulting customer response.

Our continued momentum and industry-leading traffic and comp sales are driven by a number of factors. Our laser focus on providing both health and value continues to attract new customers. Our convenient and easy shopping experience and approachable and knowledgeable customer service continues to separate Sprouts from the competition.

Our vendor relationships have continued to strengthen. Vendors, whether small or large, understand Sprouts focus and commitment to the natural and organic sector and our win-win mindset.

I will now turn to our strategic priorities. We recently updated our strategic priorities and one outcome from this process was the confirmation of our annual unit growth of 14%. Year-to-date, we have opened 26 new stores in 13 states and have 1 more opening in the fourth quarter, to end our year with 27 new stores for a total of 217 stores in 13 states. Our strong real estate pipeline includes 53 approved sites and 46 signed leases for the coming years.

Our 2016 pipeline is full, keeping us on track to meet our 14% unit growth and the real estate team is focused on our pipeline for 2017 and beyond. We will continue to keep balanced growth with approximately 70% of our growth in existing markets and 30% of our growth in new markets. We continue to believe this focus is an effective strategy as it leads to strong financial returns, with existing markets offsetting the investment in new markets as new markets take longer to mature.

For the third quarter, cannibalization improved to 240 basis points from 175 basis points in the second quarter of 2015. We expect cannibalization to continue to normalize into 2016 and 125 basis points range.

New store productivity came in at 75%, on target with our long-term model. As I mentioned, it is typical for stores in new markets to open up at a lower productivity than stores in existing markets, due to lower initial brand recognition. And they typically take four to five years to reach maturity, rather than two to three years in well established markets. We have seen this process for many years, including in places like Dallas, Denver, San Diego and other cities.

This quarter our new store productivity included a high number of stores in new markets. The mix will improve in the future and we expect new store productivity to be in the 75% to 80% range going forward.

Our Southeast expansion is meeting our expectations and we look forward to building on our momentum. Jim and I were in the markets a few weeks ago and left excited with the passion, energy and focus of our team and the customer feedback and response. It is great to hear customers continuing to say, I love Sprouts, across the country. I'm excited about the current year progress.

We have been focused on introducing new and expanded deli offerings, expanding our private-label and specialty product assortment, growing our social and digital interactions, improving customer engagement through team member training, and updating our legacy stores with the expanded offerings we first implemented in 2013.

This year, we have rolled out our new and expanded deli offerings into a select number of new stores and existing stores. These enhancements include features like a new salad bar, stocked with ready to eat, healthy and flavorful salads, a full-service deli case with prepared proteins and healthy side dishes and an improvement and expanded assortment of component meals and side dishes. We are pleased with the results from this test and are currently planning to incorporate many of these offerings into a greater number of new stores in 2016, and will also begin to roll out to some of our existing stores in 2016.

These enhancements require an elevated level of customer service in the store, so the expansion will include a keen focus on customer service training for our team members. Sprouts private-label continues to be an important growth category for the long-term. In the third quarter we exceeded 1700 private-label items, and we continue to introduce new and innovative products focused on unique flavor profiles and specialty attributes. These products continue to resonate with our customers driving our brand, driving comps and sales growth well above Company averages.

As we turned the corner into the fall, our favorite private label pumpkin items are back in our stores, building on our success from the prior years. As for attribute driven specialty categories, we continue to experience sales growth well above Company and industry averages. This is a clear indication that our authenticity, value proposition, in-store experience and knowledgeable service is resonating with existing and new customers. As more and more customers embrace the need for a healthy diet, we believe our depth of products, and our knowledgeable services in these categories, will continue to result in sales growth that is outpacing the grocery and specialty channels.

We are excited about the opportunity to increasingly engage with our customers through digital, marketing and other channels. During the third quarter we launched a partnership with Amazon Prime Now to offer some Los Angeles and Orange County area Prime Now members Sprouts' fresh, natural and organic food with home delivery in one or two hours. We have been very thoughtful about working with the right partner for eCommerce delivery. A partner who has a strong customer service philosophy and an unmatched technology and operations infrastructure to reach new customers.

We will continue to work on our mobile, digital and in-store strategies, which we believe will attract new customers and enhance our relationship with our existing guests. We will share our plans on this front early next year.

Of course, there's no better way to connect to our customers than in our stores. This year we will -- we have continued to invest in training to build on our great customer service program and further expand team member knowledge -- product knowledge. This program will further enhance the engagement with our customer that they expect and give our customers even more reason to say, I love Sprouts. Given our aggressive growth plans, developing our team and future leaders who are ready for growing responsibilities, is exciting for our team members and their families.

And lastly on the sales initiatives and store remodel front, we are near completion on our 2015 initiatives. We have remodeled five stores to date with one more to be completed this quarter and all sales initiative projects are now complete. These investments continue to help drive comp sales and improve the overall shopping experience for our customers.

As we turned the corner into Q4, we just finished training for this year's holiday program and look forward to building on a very successful 2014 season. We have refined our assortment of holiday items of this year based on prior years' learnings, while adding some new and unique items giving our customers everything they need for healthy, happy holiday.

Before I conclude, I want to provide more context on our midterm targets in our release this morning. Our business fundamentals remain strong and our current strategic initiatives continue to drive those solid momentum in our stores, as demonstrated by our results in the third quarter. Our Management team and I are laser focused on keeping Sprouts an innovator in the natural and organic sector, becoming even more relevant to our customers and their healthy living journey and positioning us to maintain a leadership position in this industry for years to come.

And we believe investing even further when we have momentum is the right thing to do for Sprouts. These midterm investments are primarily in two areas.

First, as Jim and I traveled the country over the past two months and spent countless hours with our sales, merchandising and marketing team, it is very clear to us that building greater human resource capacity and bringing more technology to our sales, merchandising and marketing team is critical. This will allow them to continue to focus on broad category innovation, as well as promotions and pricing excellence. To support this effort, as well as getting ready to analyze data expected from our out of store customer digital experience to be introduced in the next 9 months to 12 months, requires technology and business intelligence capability investments, and we are going to do just that.

Second, given our rapid unit expansion, I firmly believe that positioning our team members better to engage with customers and building a career with Sprouts requires even more training and better wages in certain critical positions at the store.

Jim and I actively engaged our incredible Board of Directors in our vision and direction of Sprouts and we are appreciative of their support for us to build a Company with, one, a strong team of innovators, two, team members positioned for exceptional customer engagement, service and grow professionally and personally and, three, a Company that can deliver solid consistent results year after year. As a result of these plans, we have adjusted and broadened our EBITDA and EPS targets, which gives me even greater confidence to underwrite our expansion plans, comp sales growth and total sales growth targets which we are leaving intact at 14% unit growth, mid single-digit comp target and 15%-plus sales growth target.

In conclusion our third-quarter results speak for themselves. Our fourth quarter is off to a great start and we recognize that today the grocery industry is innovative, dynamic and competitive. But with our plans in product and category innovation, plans to enhance our in-store and out of store experience, and spending significant time maintaining our culture, which is a personal priority for me, we believe we can continue to be a strong player in the grocery space.

With that, I'll turn the call back to Susannah to talk about our financial results and guidance.

Susannah Livingston - *Sprouts Farmers Market, Inc. - IR*

Thank you, Amin. Following Amin's highlights of the business drivers, let me cover the operating results and guidance.

Third-quarter gross profit increased 16% to $262 million, resulting in a gross profit margin of 29%, a decrease of 50 basis points compared to the prior year period. This compression in gross margin improved significantly when compared to the 90 basis points compression in the second quarter, mainly as a result of coming off the exceptional produce season in the first half and early part of the third quarter from last year, as well as cycling the significant number of stores opened less than 12 months. We expect this compression to continue to improve in the fourth quarter.

Direct store expense was $178 million for the quarter, DSE included $900,000 of pretax loss on disposal of assets in the third quarter of 2015. Excluding this item, DSE as a percentage of sales de-leveraged 20 basis points to 19.6%. The most significant drivers were the timing of capitalization of store development expense, higher investment in employer training, as well as higher labor costs at new stores.

Our continued investment in training for our team members is key, so that they can continue to engage and assist our customers. This was partially offset by lower utilization and medical benefits and lower bonus expense when compared to the prior year.

SG&A totaled $27 million for the quarter. SG&A included pretax secondary offering expenses of $900,000 in the third quarter of 2014. Excluding this item, SG&A as a percentage of sales remained unchanged at 3%, compared to the same period last year.

A few factors impacted this neutral result. Lower bonus expense was a benefit to SG&A, in addition a decrease in the number of new stores opened in the third quarter lead to lower advertising cost as a percentage of sales, compared to the prior year. This was offset by higher stock competition expense due to the recent management transition and higher corporate overhead, as we continue to build out infrastructure to support our continued growth.

Adjusted EBITDA for the third quarter totaled $74 million, up 12% from the same period in 2014. Adjusted EBITDA margin rate was 8.1%, a 40 basis points decrease compared to the prior year, mainly driven by gross margin rate.

Adjusted net income for the third quarter totaled $33 million. An improvement of 19% from 2014. This increase was driven by higher sales, as well as lower interest expense as a result of additional voluntary paydown on a revolver, a decrease of interest rate from our April 2015 refinancing, as well as lower effective tax rate due to increased charitable donations.

Shifting to balance sheet and liquidity. Our balance sheet remains strong as our business model continues to generate robust operating cash flows. Year-to-date we generated $179 million of cash flows from operations and invested $79 million in net capital expenditures. Primarily for new stores.

We ended the quarter with a balance of $160 million on our revolving credit facility and with $132 million of cash and cash equivalents. With robust returns on investment, and strong cash position, our first priority will continue to be investment in opening new stores. Continuing to enhance our business through innovative sales initiatives and maintaining superior store conditions.

With that said, given our strong cash generation, we also have the opportunity to establish a share repurchase plan. We announced today that the Board approved a share repurchase authorization for $150 million to be used over a two-year period. This authorization amount allows us to continue on our aggressive growth plan, while protecting against dilution through share repurchase, all while maintaining financial flexibility.

Let me now turn to 2015 guidance. Net sales growth is unchanged at 19% to 21% for the year, including the 53rd week.

Based on the strength of our third quarter we are increasing are annual guidance for the following: comp store sales growth of 5% to 5.5%, adjusted EBITDA growth to 11% to 13%, adjusted net income growth of 16% to 18%, adjusted diluted earnings per share of $0.83 to $0.84 and we expect

CapEx to be in the range of $100 million to $110 million. In addition, we are guiding comp store sales growth for the fourth quarter in the 5% to 6% range.

A few additional items to note on the 2015 guidance. First, we assume a full year inflation of near 0% to 1%. Which compares to a 3% inflation last year.

Second, as it relates to margins, we expect fourth-quarter's gross profit to come back in line to slightly negative when compared to last year's margin rate, as we come off the exceptional produce season experienced in 2014 and we will have cycled the significant number of stores open less than 12 months of age.

The above items are expected to yield an overall EBITDA margin for the year of approximately 8.3%, and around 8.2% on a 52 week basis. I think it is worth reiterating at this margin our cash and cash return by year three to four still remain healthy and consistent at 35% to 40%. Reinforcing the strength of our model.

Also as we noted on our call last year, a change in methodology of capitalization of new store development cost positively impacted our EBITDA by $3.6 million, or 50 basis points, in the fourth quarter of last year and we will be cycling that impact this quarter. Lastly, our weighted average share count will be approximately 156 million shares for 2015 and our corporate tax rate will be approximately 38%, as enhanced deductions for our food donation initiative positively benefit our tax rate.

In conclusion, our broad consumer appeal, coupled with our promotional approach continues to drive traffic to our stores, resulting in solid performance and giving us confidence as we plan for future years. With that, we would like to open up the call for questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Karen Short, Deutsche Bank.

Karen Short - *Deutsche Bank - Analyst*

Hello, thanks for taking my question and thanks for all that color. I just wanted to change gears a little bit. I guess, bigger picture obviously in light of last night's news investors tend to look at your margin structure and compared it to Whole Foods, with the thinking that Whole Foods' structure isn't sustainable, and therefore yours isn't either. I guess I'm just wondering in your words can you address this concern and comment on why your margin structure is in fact sustainable and why the comparison is flawed? I know how I would answer, but I would like to hear how you would.

Amin Maredia - *Sprouts Farmers Market, Inc. - CEO*

Yes, Karen, let me start and then Jim can add. When you look at our business model, our primary competitors are the everyday grocery stores and our business model is different than them with our focus on fresh, it has always been on fresh. As well as a focus on natural and organic products. So we have a fundamental different business model than they do and so given the product sets that we carry today we have always thought of sitting in the middle of specialty and conventionals is the right place to sit, with the combination of our investment requirements as well as our product mix that sits in our stores.

We remain committed to by department, by department as well as by geography to maintain certain price spreads in different departments throughout the store. And for us what's important is continuing to focus on sales drivers. The margin management's obviously important, but not at the expense of losing traffic or sales drivers.

We have been able to successfully do that, as you have seen this quarter. And the last thing I would point out is we did have the first half of last year an incredible produce season and it went through the end of July in early August. So our produce, our gross margin compression that we had in the first half of the year, that has continued to improve so our compression in the first two quarters was 90 basis points each, 50 basis points this quarter. We expect that compression to even narrow further.

So for us we are continuing to remain competitive in the marketplace. There are certain departments that we do see over the next two, three, four years, packet side could be one, where you might see further pressure and we are taking active measures on doing innovative things in those departments to relieve those pressures, and also get into other categories which have higher margins and are harder to duplicate. In an effort to mix, get a better mix and manage that competition as we see it coming down the road. As I said, I think competition will be a constant in this industry for the next three to five years. We don't see it changing.

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

This is Jim. Just little bit more color, to Amin's point, a lot of initiatives around deli, so we think that improvement in mix, in margin mix is going to help us increase private label. Actually broke 7,000 SKUs this quarter, finished up with about 200 extra skews this year, looking at 300 next year, and going to break the $300 million mark in private label this year which is about an 80% increase over the last three years in top line sales, so really pleased with the trajectory there. Accelerating our transition from trial to lifestyle customer through better in-store messaging in connection with our team members. And as we pointed out here we are continuing to invest in training team members, so the overall total execution should also give us some support on bottom.

Karen Short - *Deutsche Bank - Analyst*

Okay, that's helpful and one quick question on the produce season, obviously, because that's still meaningful to your business. If this winter does pan out to be the wet winter on the West Coast with El Nino, that productions that we are seeing in terms of predictions, what does that actually mean for the produce supply for you?

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

It is pretty hard to be mother nature, but it is extreme weather. We've talked to a lot of our suppliers and have a really good relationship and generally in first position in terms of getting supply. As we look forward we do see a little bit of inflation. There is a level of concern about El Nino, but I think overall we feel pretty comfortable where we are at and the relationships that we have and feel like if there's a supply tightness that we will be in the right position to capitalize on it.

Karen Short - *Deutsche Bank - Analyst*

Great, thanks.

Operator

Meredith Adler, Barclays.

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Meredith Adler - *Barclays - Analyst*

Yes, I wondered if you could talk a little bit, I've already gotten a question about whether some of you review about the midterm is related to the cost of labor. And you did mention that you were raising wages and selectively, and I was just wondering if you could talk a little bit about the availability of labor costs and where you see that going?

Amin Maredia - *Sprouts Farmers Market, Inc. - CEO*

Sure, Meredith. I think that labor has been tightening for a couple of years in different markets. Two years ago it was tightening in Texas, Oklahoma, parts of Nevada, Utah, so we consistently have seen labor tightening happened over time in different parts of the country, and we've been investing in our wages at different levels accordingly.

Separately than that you also have these step change where different companies have announced whether it is $9 or $9.50 or $10 or intention to go to certain levels over time and where we see it, we look at it in two ways is, we're fairly competitive in the marketplace today. We've analyzed fairly deeply critical positions in the store and over the next two to three years we want to move those critical positions be even better paying and better benefits to our employees in those critical positions. And that's a strategic advantage.

And because we are growing so fast we need team members who are growing, learning and making a career at Sprouts and so those will be part of our investments that we've talked about. Training as well as moving on wages in certain positions, certain regions so it is not a peanut butter spread. We are being very surgical, if you will, about it and being smart about it. And we see that as a benefit and we have very aggressive targets for our HR department to continue to improve our retention at all levels through these programs, because that does reduce you training cost over time when you have that strong retention. I think, in short, we have been continuing to invest where necessary but we want to be even more aggressive in certain positions.

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

Meredith, this is Jim. On thing I'd just like to add is what's really given us a great ability to recruit and retain talent is being a growth Company. There's just so many opportunities out there for people in upward mobility and a lot of other organizations the growth rate is zero. Maybe 1%, so that growth is really helping us attract better and better talent and retain better and better talent.

Meredith Adler - *Barclays - Analyst*

Great. I don't know if you feel comfortable just mentioning broadly which kinds of positions you feel you need to put the focus on. Is it department heads? Something like that?

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

Meredith, this is Jim. Our focus has been primarily around the entry-level position as well as the fresh departments in attracting great talent on that end of the business. But as we've adjusted pay scales, obviously we don't want compression, so it flows through the system. Those are the areas that we have the highest level of focus really, in the fresh departments and those entry-level positions.

Meredith Adler - *Barclays - Analyst*

Okay, great. Thank you very much.

Operator

Vincent Sinisi. Morgan Stanley.

Vincent Sinisi - *Morgan Stanley - Analyst*

Great. Good morning go, thanks for taking my question and congrats on a nice quarter. And thank you also for switching the time of your release here. Wanted to ask, going back to gross margin commentary. I was hoping you guys could reconcile for us the comment earlier that promotional environment has remained consistent with the first part of the year. Is it safe to say that you are seeing continued, basically overall competition, but nothing of a step change and has that changed at all since produce specifically has gotten more in line from a pricing standpoint? Then maybe just additional color on the fourth quarter specifically, in terms of the extent to which we may expect it to be down year over year.

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

Yes, Vinny, this is Jim. In terms of the promotional environment what we are seeing yes, you are absolutely right, it is fairly in line from Q2. But what we did see and it is obviously reflected in our traffic is that while our number of promotions, which is critical, is exactly the same as prior quarter and prior year, we did see better level of traction on the promotions. And I give our merchants a lot of credit for having more relevant promotions that are really capitalizing on some of the industry trends, and doing a better job with in-store messaging in and out of the store. And Amin alluded to it in his script, but our execution of these promotions has been fantastic and the community recognizes that and appreciates that. You, can look at more of the same, but we are really pleased with the level of execution on promotion.

Amin Maredia - *Sprouts Farmers Market, Inc. - CEO*

I think to your fourth quarter question as Susannah mentioned is, is that we continue to see that improvement in year-over-year margin. And so we see it closer, that 50 basis points probably to be cut in about half, so around 25 basis points or maybe even slightly better than that, year over year, so it is continuing to improve in that sense, the compression is continuing to improve.

Vincent Sinisi - *Morgan Stanley - Analyst*

Okay, very helpful. Thank you, guys, and if I could slide one quick one in there. Just in terms of the initiatives that are seeing in some of your newest stores. As we go through the fourth quarter and into next year, should we expect in terms of putting them into some of the existing stores, should we expect a more notable rollout, should we get more consistent updates with that, or will it be more just a normal part of the process?

Amin Maredia - *Sprouts Farmers Market, Inc. - CEO*

Yes, I think given the number of new stores that we have, the number of remodels we have planned for next year, and a couple other stores where we are -- but we have had an opportunity to enlarge the stores, just given the workplan and all of our sales initiatives we're going to be putting it into a majority of the new stores for next year.

So about two-thirds of the new stores will get the deli initiatives, and then as far as existing stores concerned you can think of it as a multi-year plan. We are going through right now how many stores that we can fit into all of our work streams. But we will provide that number at year-end, but I would say it is not going to be a meaningful number of stores, probably somewhere between 30 or 40 is what I would gauge to right now.

Vincent Sinisi - *Morgan Stanley - Analyst*

Okay, very helpful. Thanks very much.

Operator

Kelly Bania, BMO Capital Markets.

Kelly Bania - *BMO Capital Markets - Analyst*

Hi, good morning, thanks for taking my questions. Just a couple questions on the midterm guidance. I guess first, just curious on the choice of language there with midterm and not long-term. I guess just curious are you suggesting that this is a couple of years investment and then you plan to get back up to that 20%, or should we think of this as similar to the long-term investments? I guess that's the first question and then related to it, it is obviously very focused on technology and people investments and didn't hear much on price investments. Just curious if you could talk about how you feel across your differ departments, where if there is any opportunity for some more price investments or promotional activity?

Amin Maredia - *Sprouts Farmers Market, Inc. - CEO*

Sure. I think the midterm point, think of it as probably a three-year sort of a middle pace, I think looking out there's a number of these human capital as well as technology initiatives that we see happening, as well as at the store level the training and team member wage and benefits adjustments over a two to three year period. At that point I think we can adjust.

We would think that we would start getting incremental leverage, but I think that would probably be something that we would look to and determine whether we as a Company feel much better about our position of being ahead of the curve, if you will, for our growth and we have sufficient investments which might lead to perhaps getting more leverage at that point in time. Or do we, three years from now, continue to maintain similar levels of investment but they may just be in different places of the Company and keep our long-term growth targets the same. I would think of midterm as three years.

To your second question in terms of price flexibility. As we've always said is that we have -- we get leverage from our existing stores, Jim alluded to mix from private label and mix from deli initiatives that we have been doing. So we'll always continue to think about having enough flexibility to investment price to the extent that the market continues to get more competitive. And when we look at our EBITDA and EPS guidance, with our EPS guidance of 14% to 18%, we wanted to ensure that we had a range that where we can, year over year over year, deliver on that guidance on a systematic basis.

And so that widening of the range was to reflect to build further room for price investments if necessary. To the extent that we have a really bad produce season again, whether it is in 2016, 2017, 2018 in the future, that can always change things for a given year, but we feel pretty good about being able to pull enough levers to deliver on the numbers that we pointed out this year. Pointed out in the fall.

Kelly Bania - *BMO Capital Markets - Analyst*

That is very helpful. Thank you, Amin. The other question I want to ask, if you take what you said about gross margin for the fourth quarter, I think it implies about somewhere between 60 and 70 basis point decline for the whole year, I was just curious if you can or if you look at it this way, parse out how much you think of that was due to the produce deflationary environment versus just responding to the promotional environment?

Amin Maredia - *Sprouts Farmers Market, Inc. - CEO*

Yes, I think it is a little bit difficult to parse out exactly the components, but what I would say is that if you just look at the seven, eight months of the year compared to how good 2014 was, versus what we saw in 2015, I would say probably about half of it was really, a little over half of it was happening in the fresh department. Then the other components are a combination of what we are seeing in a little bit of more promotional activity in certain nonperishable items, not even categories just items. And then also having a little bit higher mix in year markets, always puts a little bit further compression on gross margin as well. So that's how I will summarize the overall number.

Kelly Bania - *BMO Capital Markets - Analyst*

Thanks very much.

Operator

Scott Mushkin, Wolfe Research.

Scott Mushkin - *Wolfe Research - Analyst*

Hey, guys. Good to talk to you. I just wanted to talk about the, I think you mentioned Amin in your prepared remarks that the new store productivity, kind of your thought process there is 75% to 80%. And I know that you referenced I think last call that the cannibalization rate had jumped up quite a bit. So I wanted to see where the cannibalization rate your thought came in this quarter? And then also talk about a little bit the cadence of these stores that are coming in less productive than they had a year or two ago, and what the maturation cycle looks like for them as far as comps go?

Amin Maredia - *Sprouts Farmers Market, Inc. - CEO*

Sure. First on the cannibalization. Our cannibalization improved in Q3, in Q2 it was 175 basis points, in Q3 it was 140 basis points. We see it continuing to improve to about 125 basis points or so going into next year and remaining there with 70% of our stores and, obviously being in existing markets.

Then in terms of new regions, what we've generally seen is about a four to five year -- in new market, in existing markets it takes about three years to get to a 35% to 40% cash on cash return. In new markets it generally takes four to five years. Sometimes you hit stores that will go faster and once in a while we will see stores go slower, but generally I would say four to five years is what we have seen as a historical trend.

And we have, as I mentioned is, we have lots of trend analysis on this as we grew in Dallas, Denver, northern California, so we have a consistent history of being able to go into new markets and gain our success in new markets. And the one thing I would add is when Jim and I were in Atlanta we were throughout the Southeast but in Atlanta a few weeks ago, I just saw a very positive momentum in not only brand building but also that customer engagement and customer response.

So I think that the customer, the brand is starting to really pick up and when these big cities they tend to pick up. In Norcal which was our last big city, northern California, when we got to about 10 stores then we really started to see the sales lift in all of the stores together because our brand got much stronger in the area.

Scott Mushkin - *Wolfe Research - Analyst*

That's perfect. Your older stores are comping positive, I take it, or your seven plus year old stores?

Amin Maredia - *Sprouts Farmers Market, Inc. - CEO*

Yes, obviously we don't give detailed analysis, but what I would say is even our oldest vintages are positive comping and they're positive comping really well. And I think a combination -- they're comping well and I think it has been a combination of a lot of these great initiatives to keep driving more traffic into the store and driving people into other departments. So the new initiatives is driving new traffic as well, and just footsteps into the stores and into the counts. Weekly counts that we see in our stores.

THOMSON REUTERS

Scott Mushkin - *Wolfe Research - Analyst*

Perfect. So then I just had one about the current environment, because you guys seem pretty upbeat about the fourth quarter. We are starting to hear that produce is again becoming a point of competition in the fourth quarter in some markets in the Southwest and Southeast, and I just wanted to see if you guys are -- are you seeing that and is that a concern as you look at your over your long-term guidance that your number one, the reason people go to your stores becoming a frequent item to be promoted, maybe a little deeper and stronger particularly for some of these grocery chains?

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

Scott, this is Jim. In terms -- how are you doing? In terms of impact to produce and we are seeing good comps across all departments, first and foremost. Looking at what has there been investment, we did see a little investment in some geographies for fresh as well as nonperishable. But on the nonperishable side, continue to see improved velocity, that SKU productivity for us which really speaks to the strength of a truly natural retailer and also supported by all the innovation that we had not only in items, but promotions. But our produce pricing plan that we have had, that we've stuck to continues to provide success for us. So I don't have a crystal ball, I can't look two, three quarters ahead, but it feels very consistent to me in terms of the overall investment in the trade from Q1 to Q2 to Q3 and the start of Q4.

Amin Maredia - *Sprouts Farmers Market, Inc. - CEO*

I think the other thing I would is, Jim alluded to is, we are seeing, you talk about produce-centric. As we have built these partnerships and promotions and actively looking at ways to drive other departments, our promotions as we had mentioned this has been a zero inflation year, and to drive 5% comp in second quarter and early third quarter when we saw tremendous deflation in produce, and still had nearly 48 comp in second quarter, that means you really are driving traffic through other departments. And people are coming into the other departments, so that has been our focus.

Produce is still key to our business, but our focus has been to continue to become a full grocery shop and have other departments also become secondary traffic drivers. And that is something that we are starting to see, but we want to really focus on that in the next two to three years, and therefore the investments in some of these areas to help our teams to help drive improved customer engagement and experiences into other departments.

Scott Mushkin - *Wolfe Research - Analyst*

That is great, thanks for taking my questions.

Operator

Rupesh Parkh, Oppenheimer.

Rupesh Parkh - *Oppenheimer & Co. - Analyst*

Thanks for taking my questions. I have two questions on your midterm targets. The first one, as we look at your comp guidance for mid single-digits and that compares with 6% plus before, is it fair to say the wider range is mainly due to volatility in inflation or is there something else going on there?

Amin Maredia - *Sprouts Farmers Market, Inc. - CEO*

Rupesh, that's exactly right. One of the things that we have sort of seen is people focusing on a number without inflation, so the logic -- our logic is not to -- the intention is not to change the comp guidance from that historical number, but it's to more account for how that number will look year to year given inflation in that particular year.

Rupesh Parkh - *Oppenheimer & Co. - Analyst*

Okay, great. The second question, just on the DSEs store align, so again saw limited leverage this quarter and with some of the commentary that you have had about making some more investments in training and even in wages, how should we think about, I guess the leverage potential for this line? What type of comp do you think you need going forward to leverage the DSEs line?

Amin Maredia - *Sprouts Farmers Market, Inc. - CEO*

I think we've really stood back as a Company and looked at, starting to look at a combination of comps and what comp drives, what the margin management looks like, what DSE leverage and actually looks like. Our DSE leverage generally starts before any incremental investments around the 4% mark. And when we provided this medium term guidance is, we are really taking an approach of not being able to manage to those sustainable growth numbers by pulling levers in each of those lines.

And not having a precise point to the extent that you have got to invest more in margin than we have to be flexible as a Company to be able to react in other lines and meet our broad guidance range that we have given today. I would say because of the investments that DSE will continue to be flat to, I don't think maybe slightly down on a given quarter by quarter, but on an annual basis I would think of it as relatively flat because of these investments.

Rupesh Parkh - *Oppenheimer & Co. - Analyst*

Great, thank you for all the color.

Operator

Bill Kirk, RBC Capital Markets.

Bill Kirk - *RBC Capital Markets - Analyst*

Thanks for taking the question. In the release and I guess on last quarter's call you've been the calling unit expansion opportunity coast to coast. Does your existing versus new markets mix eventually have to shift to favor new markets, and if so, how long does that take to happen? I guess I ask because the last coast-to-coast attempt we saw didn't go too well, so wondering what you can do differently.

Amin Maredia - *Sprouts Farmers Market, Inc. - CEO*

I'm not sure of your specific question, but we think generally think of it as when we open in new markets as I said earlier, markets generally take four to five years to fully mature. At the same time we see our stores that opened in Atlanta when we first went to Atlanta almost two years ago now, performing very well. The stores that are newer are obviously not to that -- not to those same levels, so we feel very confident based on what we see and the reasons and what sales we are seeing, what the customer demand is.

We have some -- we have a few stores in the Southeast which are already hitting that 35% to 40% cash on cash return. That gets us -- it's really the listening and watching the customer response that is for us the focus and making sure and we feel good about what we're seeing from the customer.

So I'm not sure if I'm answering your question, but the maturity curve is four to five years but based on customer response, we feel very good that Atlanta looks very much like Dallas or Denver did the first phase of growth.

Bill Kirk - *RBC Capital Markets - Analyst*

I guess the question is, does the mix of unit expansion, the existing versus new market mix, does that eventually have to shift or what point does that have to shift where more of the unit expansion is a new markets versus existing?

Amin Maredia - *Sprouts Farmers Market, Inc. - CEO*

Okay. I'm sorry. That's a sliding scale. As we keep growing over the next year or so, Atlanta starts becoming a recent market. We think of it -- internally we think of it as new markets, recent markets and mature markets. And mature markets are really are older eight states the first eight states that we grew in and so over the next year or two then basically Georgia becomes a recent market, Kansas, Missouri become recent markets.

And then we start thinking about Tennessee and Alabama are today our new markets will remain new markets for another year or two, then they become recent markets is how we think about it. We think about the margin structure and the sales productivity, our expectation is for those to continue to move and how we modeled them for those stores. Georgia I would say next year starts behaving like a recent market as opposed to a new market.

Bill Kirk - *RBC Capital Markets - Analyst*

Okay, thank you. That's my one question.

Operator

Edward Kelly, Credit Suisse.

Edward Kelly - *Credit Suisse - Analyst*

Yes, good morning, guys and thanks for taking my questions and congratulations on a good quarter in a tough environment. My question is really related to new store selection and the model in general. The environment has obviously gotten tougher over time and you have had some increased cannibalization, that's coming down, and then you talk about things like deli, expanded deli being an opportunity. Is there any change in terms of how you are thinking about the stores either from a new site selection standpoint? Size of the box for instance? How is that really evolving for you guys over time?

Amin Maredia - *Sprouts Farmers Market, Inc. - CEO*

Yes, the size of the box is when we build from ground up we're generally still shooting for 28,000 to 30,000 square foot, so the box size is very similar. I think we've been able to continue to design, Jim and his team and Ted and the construction team, have done a great job over the last few months in actually redesigning that 28,000 to 30,000 square foot box. Even for next year to facilitate some new product and to be more innovative in how we flow the back of the store and the size of the store without expanding the box and being able to do more in deli.

I would say today that we like the ease of shopping, the convenience, the low profile in the middle of the store to stay with that 30,000 square foot. In terms of site selection, we've continued to learn a lot and get better at site selection. We made this comment on the last call, one of the things that we have learned over the last couple of years is, and this has already been implemented in go-forward sites, is making sure our new markets not to open stores too close together.

And you always want to make sure that you've got obviously all the right site characteristics and the density and the traffic flows and the ingress egress. So those have always been in place, but I think we've learned a little bit more about -- even though they may be different trade areas within a particular market, just not building too many stores in a 10 mile radius at the same time.

As those markets mature, you can -- we have found that we can build stores four or five miles apart and that's not a challenge at all. And that I would say anywhere in our core five, six states we've continued to do that. With a blended 100, 125 basis points cannibalization and they're great profitable stores. So we've learned a lot and I think we are continuing to apply that logic, particularly in new markets.

Edward Kelly - *Credit Suisse - Analyst*

Great, thank you.

Operator

John Heinbockel, Guggenheim.

John Heinbockel - *Guggenheim - Analyst*

Hey, guys, I wanted to drill down on the two items that you talked about as investment buckets. The first one, I think you talked about HR and IT as it might impact merchandising. So I'm curious what things will you be able to do going forward that you are not able to do today because of whatever constraints, if there are any? Then secondly, investing in store level labor, maybe for Jim, where do you think that there's the most opportunity by department? I don't know if it is health and beauty care or what, but the most opportunity to improve service levels? And if you measure yourself versus your conventional competition, do you think you service levels are of a stable with that competition? Are they widening? Do you think you can widen it, curious as to that?

Amin Maredia - *Sprouts Farmers Market, Inc. - CEO*

Yes, I will answer the first one and then let Jim answer the store question. On the first one with respect to sales merchandising and marketing, Jon, it is improving and getting better and better as a Company on the ability to one, having the team, having more time to work with manufacturers and others in the channel on building product pipeline and working with them closely on product. I think we've stretched our teams a lot and so that innovation we don't want to stretch that innovation curve.

Second is building these technology tools for sales, merchandising and marketing, is intended to then get better at promotions, cross promotions and pricing decisions. We do a very good job today, but it is very resource intensive and manual today so applying technology there will be important and as we roll out more out of store and digital engagement, which we'll roll out to the street in the next six months, as we roll out our plans on that front we are going to get a lot more data about the customer.

And when we get that data then we also need to be able to apply this business intelligence and data analytics around that work. It is really -- that's the mindset in that area and then I will let Jim answer the questions around the store.

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

Hey John, it is Jim. First of all, I'm never pleased with service-level, I always think we can be better, but when you compare it to the industry, we definitely do set the standard so I'm excited about that. But I'm more excited about the investment in training And part of that investment in training is service-level training.

And execution which will help give a better shopping experience for our consumer. One of the tools we use, one of the other pieces of technology that we are investing in, is a labor management system. Make sure that not only do we have the right production schedules made, but do we have the right people in the right place at the right time. And we see an opportunity to get better there, utilizing technology.

John Heinbockel - *Guggenheim - Analyst*

Okay, thank you.

Operator

Robbie Ohmes, Bank of America.

Robbie Ohmes - *Bank of America - Analyst*

Hey, guys, thanks for taking my question. I was hoping you can give a little more detail on the Amazon Prime partnership. Maybe remind us how it works and what would need to happen to make you want to roll it out? And are there any other potential partners you are testing with like an Instacart? Just anything you can tell us about that would be great.

Amin Maredia - *Sprouts Farmers Market, Inc. - CEO*

Sure. I think the last consumer insights study we did, first I think everybody knows that we are more leaning a some urban and suburban environment. We don't have as many stores in urban environments, so when we did our last customer study we learned from our customers that -- because we, such a big piece of our businesses is perishables that they really want to be shopping Sprouts. They would not use home delivery significantly.

However, LA is obviously a very dense market, parts of San Diego, other cities that we operate in are fairly dense and so what we want to learn from our customers for us is, this is as much of a learning exercise to see how we can add value to our customer. And see how that customer engagement moves over time. And are we bringing new people in, into the system.

So I think for us it's we are going to learn from this, we are going to see I think five -- in urban environments today I think it is in the next two, three, four years it will be a requirement. In semi urban requirements and suburban areas I think it will take longer from an adoption standpoint, so for us this is a purely learning exercise and we will see how it goes. We are not working with anybody else at this point and have no intention to do so at this point.

Amazon has been fantastic. The Prime Now team has been fantastic with us in really supporting us on this, so we are planning on rolling out to a couple more markets to learn more and how the dynamics shift and see if we can really draw a new consumer in. That's where we stand on it today.

Robbie Ohmes - *Bank of America - Analyst*

Can you remind us how it works? Is it their people in your stores picking the product and just structurally how it is set up?

Amin Maredia - *Sprouts Farmers Market, Inc. - CEO*

Yes, we are very sacred about our box. So we actually pick it and package it and the Prime Now team picks it up and delivers it to the customer. It is a one hour and two hour service from a Prime Now customer standpoint, two hour service is free and then our one hour service has a up-charge on it.

Robbie Ohmes - *Bank of America - Analyst*

Got it, that sounds great, thanks very much.

Amin Maredia - *Sprouts Farmers Market, Inc. - CEO*

Okay.

Operator

This does conclude the question and answer session of today's program. I'd like to hand the program back to Amin Maredia.

Amin Maredia - *Sprouts Farmers Market, Inc. - CEO*

I want to thank everybody for their time today and for your continued interest in Sprouts. We look forward to speaking to many of you in the coming days and weeks and seeing you on the road. Thank you.

Operator

Thank you, ladies and gentlemen, for your participation in today's conference. This does conclude the program. You may now disconnect. Good day.