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EDITED TRANSCRIPT

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

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CORPORATE PARTICIPANTS

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

Brad Lukow *Sprouts Farmers Market, Inc. - CFO*

CONFERENCE CALL PARTICIPANTS

Steve Tanal *Goldman Sachs - Analyst*

PRESENTATION

Steve Tanal - *Goldman Sachs - Analyst*

I'm Steve Tanal, the supermarket, dollar store, and hard lines analyst for Goldman Sachs. And it's my pleasure this morning to host Sprouts Farmers Market for a fireside chat.

Sprouts is a rapidly growing, value-oriented, specialty grocery concept offering natural, organic, and healthy products at prices competitive with conventional grocers. The Company operates 240 stores primarily in the southwest, but has been expanding into the southeast and the Midwest as well.

The Company generated sales of roughly $3.6 billion last year.

Joining us from the Company are Brad Lukow, CFO, and Amin Maredia, CEO. Brad became CFO of Sprouts in March of this year, following time as CFO of 99 Cents Only stores and Shoppers Drug Mart, Canada's leading drugstore retailer, where he worked from 1994 until 2014.

Amin became CEO in August of 2015, after serving as CFO since 2011. He joined Sprouts following five years at Burger King in various strategic and financial roles.

I'm going to turn it over to Amin for a few brief introductory remarks, then we'll jump right into the fireside chat. And I'll be sure to leave some time for Q&A as well, as I'm sure we have many questions in the audience today. So with that, Amin?

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

Yes. Good morning, everyone. Thank you, Steve. And also wanted to welcome Brad to the team. I think this is my first conference since he's joined the team.

I wanted to just kick off by covering two things. First one is our overall strategic initiatives. And second, I think's the elephant in the room is what happened or what's happening in the environment?

So just to touch on the first one, we feel very well-positioned from a strategic perspective in the priorities we laid out last year and coming into this year, around continuing to move.

From five, seven years ago, we were very much a specialty retailer store. And we took on the initiative in 2011 to start shifting to a healthy grocery store, and have done a tremendous amount of work to round out the shopping experience in a convenient, approachable experience that customers tell us they love every day.

And last year we sort of took on this approach of saying, now we want to elevate the game even further to move from a healthy grocery store to a healthy grocery store and food destination.

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And so that's sort of our next wave over the next three to four years at Sprouts, continuing to push on food in a sense of the way customers are shopping today continues to change. Food defined 5, 10, 20 years ago was, how do I shop for my groceries, go home and cook?

And as we all know, more than ever today, food's all about either I buy groceries and go home or I want to buy something here and eat it hear or I want to buy something and take it home and heat it up or a frozen item that tastes great.

But the definition of what we believe is future is, is great tasting healthy food is one, is an anchor. Great approachable service when the customer needs the service is two. And then, of course, our having a great team around us, now crossing 25,000 team members, which is an amazing. It was 3,800 when I joined five years ago.

But taking a team of 25,000 towards 50,000 in the next four to five years and ensuring that that team's having fun, enjoying working at Sprouts and growing. Growing 14% unit growth, we need a lot of leaders in our stores. So on that front, we've had great success this year.

And then I'll talk about the overshadowing of the current environment is success in our private label program, which has continued to accelerate growth in both sales and comps, great success in our deli initiative.

We're going to continue to -- we are now up to 55 stores. We're going to continue to expand that deli program. And it's continued to be a evolution change. It's not a step change.

We're changing every day in that department and it's getting pushed out. So we'll build a platform which we believe we can keep doing more and more in that department without getting overextended in labor, is something we think about every day, and being smart businesspeople. Continuing to push with some of the things that we've done [quietly] in the meat and seafood side of the business.

And then the nonperishables business, in context in the first half of the year, then we'll talk about third quarter, our nonperishable business has continued to do fantastic with all of our great partnerships with our manufacturers and vendors.

We're spending more time today than ever looking at capabilities of our manufacturers and how do we expand and extend great tasting food into our stores, both for brands as well as private label. So that's all exciting.

In terms of the current environment and what's going on in the retail space is, one thing I wanted to ensure, I think everybody understands this, but just stated is, is that a great thing about Sprouts is, is it's a fresh, healthy grocery store.

It also means, when you think about fresh and healthy, almost 60% of our business is perishables. And that includes produce, bulk, meat and seafood, our deli section. I'll include dairy in there.

And when you have 60% of your business is perishables, and it just so happens that today almost every single one of those categories is highly deflationary.

And we've seen in the past when you have situations where a deflation in a category or two is out there, in the short term, generally it's positive, because people are able to expand margins for a short period of time before those retails come down.

We found times when cost deflation expands across multiple categories and it flows through to the consumer, i.e., you keep your margin rate the same. When that extends for three, six, nine months, it's not uncommon for somebody in the industry to get a little itchy with comps and they start to react and it moves fast.

And that's exactly what we saw happening end of June into July, but we weren't seeing a big impact to our business. And the investments in the industry have just deepened. I think one of the analysts called it the food fight recently in a report.

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And when that happens, in the short term, the retailer who started first, it's a sheer, short-term game of buying some traffic, until everybody else gets into it, because our industry's always been very competitive and no one lays down on price.

And so as we and others have come on stronger, I think today where we sit, sitting here literally, we're probably in a zone where everybody's very aggressively priced so retail deflation's significant for most retailers. And the more perishable you are probably the more exposed you are in the near term.

And our experience from the past has been when deflation sort of dissipates and you get back into a flat or positive environment, things tend to turn pretty quickly the other way.

And the last time we witnessed this deep as this was in 2009, and we were in the same situation where traffic was softer, pricing was much deeper than cost deflation, so it was deep into retail deflation. And it lasted about six months in 2009, 2010. But the consumer was in a very different place at that time, as we all recollect the environment at that point in time.

But the feeling of our team today is is that this is short-term in the guidance. I'll let Brad talk about it. But we just assume that this competitive environment will last through the rest of the year.

And we've taken actions in the last couple of weeks as soon as we saw deepening. And we feel confident in our ability to manage through these situations. Clearly, margin compresses. But we've seen this before and it takes weeks to react. You can't react over night because you have a lot of commitments on promotions in the near term.

So we got exposed a little bit. And I think that we're back in the saddle and pushing hard, and that's where we sit today.

And I'll stop there and I think maybe, Brad, if you want to add anything else, otherwise, we can take some questions.

Brad Lukow - *Sprouts Farmers Market, Inc. - CFO*

Yes, I think you've covered it.

QUESTIONS AND ANSWERS

Steve Tanal - *Goldman Sachs - Analyst*

Okay, great. Sure. Maybe just a couple quick ones on that, and then we'll jump into some of the other questions.

So I guess the part that was most surprising was sort of how quickly it did change. We heard from you guys not too long ago in the second quarter.

Now, I wonder if the change to the comp, would you say it's more traffic or more ticket?

And would you say that the environment is irrational at this point? I mean, it sounds like that's what you're describing.

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

Yes, I would say it's a combination of [both] traffic. Certainly in the short term immediate until we begin the program to react to the environment, our traffic was down quite a bit.

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And one week doesn't call a trend. But since we've acted, things are looking better, because it just takes time to push that activity through the system.

Of course, if you're the first one out of the gates, you probably benefit for a few weeks until the rest of the people catch up to you. So this is simply who moves first, right?

So it's all short term and interesting on one hand and maybe not as interesting in the long term, but, certainly, something that we've got to deal with on a day-in/day-out basis.

But we've just made the assumption, given that it's still competitive and deeply competitive that it lasts through the rest of the year.

What we've seen is, we've not seen shelf, retails at the shelf move significantly. We've seen a lot of ad promotions and in-store promotions, that's where we've seen the heaviest of the activity inside the stores.

And, Brad, maybe give a little bit more color around what you're seeing.

Brad Lukow - *Sprouts Farmers Market, Inc. - CFO*

Yes. I think we certainly, Stephen, saw an acceleration through late July and into August with regards to very sharp, deep promotional pricing in the protein area, which has been double-digit deflationary since about this time last year.

So as Amin said, once you have sustained deflation over several quarters crossing several categories, eventually the competitors stop sweeping up the margin and start investing on a short-term basis to try and drive that traffic.

And with our 60% of our business being in those perishable business and subject to that [deep] deflationary over an extended period of time, you get caught up in that.

But we've responded. As Amin said, this is not playing out on shelf. It's just the way it played out in 2009 and 2010. It was ad pricing.

I mean, we've looked at promotional front-page ads from Q3 of last year versus Q3 of this year, and there's an order of magnitude difference in terms of the level of investment that we've seen in the marketplace.

And, clearly, from a structure perspective, we don't see that as being sustainable. We see that as short-term and we're starting to see some short-term evidence that we think it will ease.

But we wanted to be very cautious coming out with the revised guidance, in terms of our full-year EPS view takes into consideration that there is an unabated level of investment in the marketplace throughout the balance of the year.

Steve Tanal - *Goldman Sachs - Analyst*

Understood. And just to maybe move on a little bit, but, obviously, a related topic, your latest thoughts on deflation. And maybe if there's a big difference that you're seeing between input cost and retail prices and how you see that dynamic playing out.

Brad Lukow - *Sprouts Farmers Market, Inc. - CFO*

Yes. Going back to the protein story, we're going to be lapping that double-digit cost inflation at the end of this month. And, certainly, that's been a category that's been very promotional over the past couple of months.

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If you look at produce, we've actually seen produce go from mid-single-digit inflation in the first quarter to 1% inflation in the second quarter to now it's running at about 1.5% deflation.

And that really is influenced by Mother Nature and crops. You get visibility one to two months out. We believe that stabilizes based on what we're seeing now in the crops.

But we've also -- bulk is a big part of our business. And that went deflationary double-digit in November of last year.

So if you look at protein and bulk in terms of the year-over-year comparison, that starts to stabilize into the fourth quarter. And then, of course, the produce piece is variable.

So looking at the third quarter versus the fourth quarter on the input cost side, looking towards the high end of the one to two range on deflation. So we're running at almost 2% right now. And for the reasons I just gave, it should stabilize and lower in the fourth quarter. That's on the cost side.

Your question on the retail side, obviously, that's where things have heated up. The retail deflation has well exceeded the cost inflation over the past four to six weeks, playing out on the promotional front on front page ads.

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

And just add to that, as we moved towards yearend and into next year, Brad talked about the abating of deflation on number of areas. And where we sort of see visibilities, is probably the areas that might still continue to be a little bit deflationary into early part of next year will be beef and pork prices is what we're seeing in our numbers and our quotes right now.

But I think outside of that we'll have lapped most of the other areas. And then, of course, produce is subject to Mother Nature.

So, generally, in sort of November, December timeframe we start seeing the early signals of what the first quarter looks like.

But produce is one of the cycles, that generally is touch and go. It tends to be a lot of items are six to eight weeks growing, there are other items which are longer.

But it's touch and go in the sense that it can turn inflationary and deflationary very quickly just based on the environment.

Steve Tanal - *Goldman Sachs - Analyst*

Great. That's really helpful. Now, I guess do you still view conventional supermarkets as your primary competitive set, maybe more so as you seek to be a destination store?

And do you see an opportunity to eventually take share from the specialty channel?

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

Yes. So couple of things there is, broadly speaking, anybody who sells grocery is a competitor, doesn't matter size, scale, and their approach to the marketplace.

However, what we see in our consumer data, we're very, very, a very consumer data driven company. And what we see is, is majority of our customers when we open a new store do come from the conventional stores. But then we also see a lot of people coming from specialty and some from club, so then it starts falling off.

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The other comment I would make is, is we are generally positioned, a lot of our stores and our businesses, because like fresh, healthy food, and natural and organic food is, on average, higher price than CPG products. It just is.

So we tend to have a lot more of the middle income consumer, anywhere from 40th percentile of median income to 80 to 90 percentile of median income of a given market. Especially in new markets, that's kind of square of where we go.

So once we're deeper and we're more branded in a market, then we have, I call it once we earn our rights to the customer, we have earned that right to push up on the higher incomes and push down further downstream. And we've seen very productive stores in some of our mature areas there.

So we generally don't see an impact with Aldi's opening in California, example, we've not seen hardly any impact from that. It's just I always tell people, you just have to go walk into our store and their store, and you'll recognize in about 10 seconds it's just a very different consumer.

So, and then on the specialty side, I think that there's this collage of everybody talking about fresh and natural and organic. And where we feel like our differentiations, really ours is one the anchor of having a convenient shop is a foundation that we have that I don't think changes over time just because of our box size.

Second is our low cost of capital, we're able to put a lot more stores in a lot of places because of our average net build cost, sub $3 million.

And then third, just, again, influencing that being a healthy grocery store and then also trying to become more of a food destination for 1200, 500, near the homes. And that's driven by not Sprouts having a big idea, it's driven by what the consumers, what we're seeing in consumer trends and what we're hearing from the consumers that they want to see more from Sprouts.

We do a lot of the customer segmentation studies every year, and then certain areas we look at more than one times a year to keep up with the trend.

And so we're continuing to build. I think one of the important things is, as people are carrying more specialty or natural and organic products is, for the last two years, Sprouts has -- and this has actually been a pleasant surprise even for me, because I expected that as over time conventionals might carry more natural and organic product, there's, inherently, you'd say there's a risk of Sprouts' business being impacted.

But every data point we look at, we have a lot of data, would spend ROI on other sources. And every quarter, even sitting here today, we continue to well outperform conventional channel, club channel, specialty channel in our non-perishables and our specialty departments.

So, and a lot of that has to do with our focus and our partnerships and our vendor agreements and partnerships and how we go to market, because that's what we're focused on every day.

We're not focused on trying to figure out what to price Coke or Doritos. We're focused on how to push natural and organic product knowledge to our customers and how to drive [trial] to our customers and how to get it into their basket.

So it's not part of what we do. It is what we do. And we've just doubled down our efforts on doing even more work with our manufactures and partners around it.

In fact, Jim, Jim's not here today because he's sitting in Colorado with a big manufacturer talking about how else we can work closer together deeper.

So we feel really good about the authenticity we bring to the space in a convenient format and just great tasting food. And so it's been a continued winning strategy for us.

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And with our EBITDA target rates, it's still at 35%, 40% cash-on-cash return. If the industry gets more competitive, and we've got to invest in price faster than our natural investments that we've been making every year, it's still a 30-plus percent cash-on-cash return business and one that we feel very confident about continuing to gain share and grow.

Steve Tanal - *Goldman Sachs - Analyst*

That's great. Now, I wonder as the conventionals have done a better job in perishables had natural and organic, and clearly they have, at least some of them, has customer acquisition become any more difficult over the years if you think back?

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

Yes, I think that it makes everybody better, right? So when more people are focused on carrying fresh, and I think there's a lot to be said for a couple of things, is one is saying you're going to carry product and actually executing it. And we've learned it over 20 years how to execute it and feel like we're pretty good at it.

And also dedicating the time and the energy and the labor around it is pretty significant. I think most people, even investors when they walk in our stores, the first question often I get is, is, gosh, there's a lot of labor sitting in your store. Can you cut labor?

Well, it's there for a reason, right? And so we've always been over invested in labor in that context or appropriately invested in labor to bring that experience.

And as far as, as more people bring these trends, it's not surprising, right, people are focusing on the trends, I think Sprouts is, I feel like we're ahead of the game today. But the space around food and getting even better tasting food, and our big focus now is also this industry's done a phenomenal job of getting better and better in technology of natural and organic products, but has a long way to go in terms of food, in terms of taste profile.

So Brad's sitting here, he's probably laughing because he hears the word taste out of my mouth three times a day. And we're really penetrating even further to get better in every part of the store.

So now it's all about not just carrying the product and not having great service, but it's having great tasting products.

So we feel like at our size and scale, this affords us the opportunity to turn into innovators in the industry and not just carrying it on the shelf and hope somebody puts it in their basket.

Steve Tanal - *Goldman Sachs - Analyst*

Sure. Shifting gears a little bit, you mentioned private label, I mean to start. How do you view the long-term potential from a penetration perspective? I think you're around 10% or so today.

Clearly, your peers have suggested you've got some upside there. And if you could talk about maybe the areas where you see that opportunity by category, that'd be great.

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

Sure. So private label, remember, produce is 25% of our business and perishables, different areas of perishables are pretty big in our business. So it skews that percentage and the opportunity.

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So, clearly, there's a number of departments within the store. And I generally don't like to talk too much detail where we're working very close with our manufacturers. And one of the reasons why we always get great compliments from manufacturers is we'll never surprise a manufacturer [around] just calling them one day and saying you're out because we're taking this category over with private label.

We're really trying to be innovative. Our approach to private label early on was just punching through the commodity products, right? Frozen corn's interesting, but not really, right? So, or organic ketchup or organic mustards, not really that interesting.

What we're really focusing on is what are the trends in categories where the consumer is headed and the preferences are headed? And how can we round out and build categories and over time let the food and the taste and the flavor profile and the sourcing of the food and the quality standards of the food stand on its own?

And it's always been, in my mind, a vision of when I walk into the grocery or frozen department, can I do a full private label shop at Sprouts, right?

Doesn't mean that we don't have other great brands next to us, but let the customer choose what they decide.

And there are several categories where we're well outselling the national brand today. And I think that's the customer speaking to the taste.

And that's the piece that's exciting is, when I see that threshold cross on a category on its own. And we don't give spacing up top in private label. You got to work your way to the eye level, right? You don't get the eye level upfront just because you're Sprouts. You got to earn your way just like any other manufacturer to the eye level.

And so kind of bringing that discipline into the organization has really worked well, and our private label sales are growing well north of 30% and continues to accelerate.

And the last several weeks we just approved more positions to go deeper there. And it's an area that's exciting, but it's not about commoditizing.

It's about creating differentiation and uniqueness that somebody can get excited and drive longer to come to Sprouts because they can't find that flavor profile or that attribute profile. Whether it's gluten-free or vegan or something else, they can't find it somewhere else. And they trust that authenticity. And I think that's the way to wield a great business.

Steve Tanal - *Goldman Sachs - Analyst*

It's great. I want to make sure we leave some time for questions. I believe we've got one here in the front. If we've got roving mics, that'd be great. While they're on their way down, I might jump in with one.

So the expanded deli offering, what kind of sales [in your] margin lift has it had on the units that you've seen it in?

Brad Lukow - *Sprouts Farmers Market, Inc. - CFO*

Yes. So we've, through 2016 to date, have about 60 stores with some elements of the deli offering. So not all stores get the similar elements. It depends on the volume of daytime traffic, noon hour, 500 traffic. A lot of stores have the full set, which is salad bar, the service case, the HMR, the juice, the coffee bar.

And we've had tremendous feedback from consumers. It just is one additional area of the store where we are more relevant today than we were last year. And so we're seeing a very significant pickup in sales throughout that initiative.

And based on what we've seen to date, we're fully expecting to continue to roll that out. Most of the new stores going forward will have elements of that initiative, and we're continuing to build out that initiative for our existing store base.

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So we're very pleased and we're going to continue that. And while it's early days, it's been eight months into the year, but the early indications are that tremendous incremental return on invested capital.

Steve Tanal - *Goldman Sachs - Analyst*

Great to hear.

Brad Lukow - *Sprouts Farmers Market, Inc. - CFO*

Sure.

Unidentified Audience Member

I have two questions for you. First, just a clarification on the deflation side of things, when you said you expect that to abate kind of towards the end of the fourth quarter just based on kind of the year-on-year comps, are you referring more to the cost input or are you suggesting that kind of the point of sale deflation will abate as well? That's the first question.

And the second is, can you provide any insight into kind of what geographies, like whether it's an MSA, whether it's a region, you're seeing the most price competition?

Brad Lukow - *Sprouts Farmers Market, Inc. - CFO*

Well, first on the deflation question, it was specifically with reference to the input cost side. So while we're running closer to the 2% deflation in the third quarter, given we're lapping significant deflation from last year in September for proteins and November for bulk, our expectation is on the deflation front it's lower in the fourth quarter, probably closer to the 1%.

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

On the cost side.

Brad Lukow - *Sprouts Farmers Market, Inc. - CFO*

On the cost. That's the cost.

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

And I think the retail piece is, is really a market dynamics. And as evidenced by our adjustment in such a short time period, it's as fluid as ever.

Unidentified Audience Member

(Inaudible - microphone inaccessible)

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

Yes. On the driver piece, I think that it's been competitive across the board. We have a couple of markets where we don't have -- some of the retailers who've been quite aggressive, we don't have in those areas the traffic, and the comps look fine, right?

So and there's some small pockets of those in the country. But vastly, where a lot of our stores are, it's been fairly competitive. Parts of Texas have been fairly competitive because you just have regional players as well as the national chains there. Houston's been -- we have five stores in Houston, so we're not overexposed there. But Houston's a good example of a market sets, probably one of the most competitive in the country today.

Steve Tanal - *Goldman Sachs - Analyst*

A question there?

Unidentified Audience Member

Your former PE sponsor just bought Fresh Market. And it sounds like their game plan is to move their business model closer to yours, which was so successful for them.

Are there any ramifications for that to you?

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

Yes. So --

Unidentified Audience Member

Especially as you kind of move into the southeast where they're strong.

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

Sure. I think it's just you want to respect any competition, despite where their starting points are. It's a different world to shift businesses today and to improve businesses today than it was 5, 10 years ago. Things are moving pretty fast.

And so the only impact from a Sprouts perspective is being, again, smart, wise, and disciplined about how to think about positioning against them. We think we have a great business model. But, look, when you have five competitors, no matter who they are, selling food versus two competitors in a two-mile radius, it's going to be more competitive and there's going to be more market share, right? There's always going to be splitting of dollars.

So we don't have an overlap with them today of meaningful size. And we'll just be wise and smart about -- bad news about going second or third in positioning is sometimes you have to pay higher rent. Good news is, you get to pick your location and cut somebody off to the customer.

Steve Tanal - *Goldman Sachs - Analyst*

Any other questions? We've got one question there.

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Unidentified Audience Member

In your core markets, can you talk about which competitor in particular is driving the lower promotional prices that you are responding to now?

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

I think it's the large conventionals. And particularly, you can see in the ads that as we were deflationary in meat, poultry was already deflationary beginning, tail end of last year and going into this year and continued. But beef and pork also became deflationary.

And when you're in that kind of environment, going into the summer grilling season, I think retailers, one in particular, who leads in many ways with meat, they promote other things as well. Obviously, being a full grocery store, they're promoting CPG products and promoting dairy. They're promoting produce. But they're heavy in meat.

That's where we saw the early signals of getting pushed into meat. And then it deepened in meat. Buy one get one free. Buy one, get two free. Buy one, get three free. At some point it's not a productive process.

And so that's probably my clue to naming the retailer. You can probably find the ad pretty quickly.

And it really has generated excitement across other retailers, because I don't think anyone likes losing traffic or market share, one and the same, market share.

And so right now, I think the winner's the consumer.

And somebody asked the question yesterday in saying is there any net dollar gains out of that process? And the answer is, I don't believe so. In fact, I could argue that I know so. I don't think there's a net dollar gain for anybody on a combined basis, certainly.

And as other people get more competitive, there might be some shared tradeoff from the weaker players, but that trade from the weaker players to the stronger players is just not enough to capture dollars for the collective group.

Steve Tanal - *Goldman Sachs - Analyst*

Any others?

Unidentified Audience Member

Just another question on the deflation. You referred earlier to maintaining your gross margin percentage. Is it not possible to maintain penny gross profit on a dollar basis? Would that just leave you priced out of the market?

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

Yes. I mean, I think we're a very sales-driven and traffic-driven company because we're in the early stages of building our business in the grand scheme of the next 5, 10 years.

So if the question specifically is, is could I be better off on a profit dollar basis if I took -- I can look at my ad today, and of the 23 things that are on the front page, if I priced a little less on 10 of them, could I get more dollars and be more productive? Yes. Is that going to be lower traffic? Yes. Is my gross profit dollars going to be higher? Yes.

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But that's not a long-term view on it is, we're a sales-minded company. We're a sales-driven and margin-minded company. And when it gets to the [sub]-competitive environment, we're as aggressive as anybody else in the marketplace.

Unidentified Audience Member

Not seeing that elasticity? Because my question was actually the other way, is that you're lowering your prices to maintain percent margin.

But if you were to lower your prices and not bring them down as much to maintain dollar gross profit.

Brad Lukow - *Sprouts Farmers Market, Inc. - CFO*

Our pricing as it relates to promo on ad is really fundamentally driven around what's happening in the marketplace from a competitive standpoint.

And we are a value retailer. We're recognized for that, particularly in produce. So our focus when it relates to ad pricing, it's not looking at maintaining a particular percentage or penny profit. That front page ad is really to get traffic in the door.

And to Amin's point, we have followed in the marketplace where we've seen deeper investments on the front page and we'll maintain that approach to drive traffic into our stores.

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

I mean, just wanted to add that we absolutely have margin targets. But when it's competitive and the price [set] in what's coming in and how we're priced in the marketplace shows that we need to invest more to be competitive, that's when we open up the margin rate conversation.

And as a discipline, we have a formal discussion every week at the Company around it. And these days, I think it's about six times a day I'm calling Jim around something in some market.

So, but still, that's just kind of being [sure] in the near term and making sure that we're as competitive as we need to be to achieve our long-term results, as opposed to sticking, because that can very easily -- the position could be is, is this is the margin target for the quarter, stick to the margin target and lose sales and traffic.

Unidentified Audience Member

What is your forecast of how long the produce deflation will last?

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

Produce is a tough one to call. So one thing I will say is, the produce season, as we go into the fall, is looking quite good. So produce quality, and we're seeing citruses early. We're seeing other -- stone fruits are coming through quite nicely. The holiday grapes are looking good.

So all of the data points look good. And so, generally, what you see is, is the inflation in produce is driven as a function of lack of product availability.

The only problem with huge inflation in produce is when there's lack of product availability, it's typically driven by product being wiped out because of some bad weather or not having enough good quality product.

And as a principle, we at the Company don't like promoting heavily average or subpar quality products.

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So it cuts both ways is when there's -- in the ideal world, we'd like produce just to be at zero inflation/deflation, right? Maybe slight inflation is fine. But when it's highly inflationary, it probably means that the product quality is not that good.

We see pretty tight high correlation to that. So because it's our traffic driver, we'd rather just see flattish to slightly up, maybe slightly down. Either way is fine. It works well.

But the key we think about is, is because it's so important to our business is the quality and the pricing's getting on the shelf to the customer. And so we're looking much better.

We always say is we don't like making excuses at the Company. But the last two, three months, there are a number of areas in produce that were a lot tighter. Berries is huge. And the berry quality over the last two, three months has been softer and availability was tighter. But that has started to loosen up quite nicely here in the last week or so, last week or two. Berries were tough. Apples were tough. Grapes were tough.

So last two, three months is a tough environment. But that's just every day in/day out, we deal with it. But it was probably a little bit more unique in the last several months.

Steve Tanal - *Goldman Sachs - Analyst*

There's a few prepared questions that we're asking of every company. I think we have some color on some of these.

But one that I'd ask, Omni-channel margins, obviously, you've got a partnership with Amazon Prime in some stores. Are those margins -- how do they compare to the store margins, sort of lower, same, or higher? And what's the key difference?

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

Yes. So generally, I think broadly in retail, and I'll speak about Sprouts, but I think people take different positions in how they approach Omni-channel and what ad prices are given to the customer and what prices are not given to the customer.

And we have a hybrid model where not all of the sales are passed on to the customer. And Omni-channel sort of allows us to be competitive, yet, not give it away outside the store.

And our relationship with Amazon's been very productive. We're now in seven stores, and we'll continue to expand to a few more stores.

And we're having, as we have mentioned before is discussion about a longer-term partnership with them. And we're continuing to work through that. And at the appropriate time, if that's finalized we'll announce it.

I do think for both Amazon and Sprouts, truly definition of a great partnership is when it's adding value and incrementality to both. And I think this relationship has the ability to do that.

And adding non-fresh incrementality to them on their flywheel, as they refer to it as, just because it brings more traffic -- not that they need any more traffic on Prime now, but repeat traffic's always helpful for any retailer.

So this one's been unique. I spent well over a year looking at every possible model of looking at domestically and internationally of what is the long-term right solution for Sprouts? Is it to build something on our own? Is it to partner with somebody? Is it to buy a company?

And the challenge always for any food retailer is simple, is if it costs $8 to $10 to deliver it to the home, on a $40 basket, who's going to pay for it?

Economics 101 would tell us it's got to be the supplier, the firm, or the customer. And 25% is a lot.

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So I think here we have a unique opportunity where it adds value to both of us and it actually flows better for both of us. And I think that's where we found the right partner here.

So we're in discussions with them now to see how we can expand. And it's exciting, but it's early in the discussion. So I'll leave it at that.

But I think it can provide some pretty exciting times for Sprouts and even more incrementality to our cash and cash return model over time.

Steve Tanal - *Goldman Sachs - Analyst*

Great. And then last very quick one on these, wage inflation, do you perceive it to be a net negative or net positive for your business? And do you think it'll be a bigger consideration in 2017 versus 2016?

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

Yes, I think we've made some strategic price investments in a few areas of the business where we're investing. So it's very tied-in, because we were getting more into food and food service, doing some things in the meat and seafood program.

At the beginning of 2016, we made some adjustments which were not across the board in the store but were very driven with intent to drive retention, training, as well as upward mobility in areas of our store, which are more difficult to operate frankly.

And we wanted to make sure that we were hiring the right people, training the right people, and retaining the right people in those areas.

And our operations and HR team have done a really good job of moving that wheel, because as you do more deli work is, it's a great, high-margin business, but it also has higher labor.

And also, at the end of the day, though, when you look at the contribution is how I think about it, is what is the contribution of that to the store? It's productive.

So generally speaking, there's two elements of this, right, just from a pure finance and business perspective. Wage inflation [on equals] not good for any retailer.

But we really think about it as a little bit -- we think about it a little bit differently and really looking at the quality of the life of our team members also.

So Jim and I were in northern California not long ago, and we saw that we were very aggressively priced to the market. And we saw our wages, and made a decision on the spot to move both retails and wages, because paying $2,800 rent for a 300-square-foot apartment doesn't fly for somebody who's making $12, $13 an hour. It just doesn't.

So if we're going to retain good talent, that's important. And we didn't move it across the store. We increased the floor. But we looked at the key positions where we know we don't want to afford turnover. There are some positions that you don't want to do that.

And so we were smart, I'd like to think we were smart businesspeople in making those decisions around it, but also looking at the -- we don't even use the term employees. It's our team that we really care about.

And when they come in, if they're stressed about what's going on at home or making the next paycheck or the next bill, pretty hard to spend the time with the customer on the floor, so.

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Steve Tanal - *Goldman Sachs - Analyst*

All right. That's great. Thanks so much.

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