THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

SFM - Q4 2016 Sprouts Farmers Market Inc Earnings Call

EVENT DATE/TIME: FEBRUARY 23, 2017 / 03:00PM GMT

THOMSON REUTERS

CORPORATE PARTICIPANTS

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

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

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

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

CONFERENCE CALL PARTICIPANTS

Alvin Concepcion *CITI - Analyst*

Shane Higgins *Deutsche Bank - Analyst*

Kelly Bania *BMO Capital Markets - Analyst*

Edward Kelly *Credit Suisse - Analyst*

Rupesh Parikh *Oppenheimer & Co. Inc. - Analyst*

Andrew Ruben *Morgan Stanley - Analyst*

Ken Goldman *JPMorgan - Analyst*

Stephen Tanal *Goldman Sachs - Analyst*

John Heinbockel *Guggenheim Securities - Analyst*

Karen Short *Barclays Capital - Analyst*

Scott Mushkin *Wolfe Research - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen. Welcome to the Sprouts Farmers Market fourth quarter 2016 earnings conference call. At this time all participants are in a listen only mode. Later we will conduct a question and answer session. (Operator Instructions) I would now like to turn the conference over to 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 fourth quarter 2016 earnings call. Amin Maredia, Chief Executive Officer, Jim Nielsen, President and Chief Operating Officer and Brad Lukow, Chief Financial Officer, are also on the call with me today. Sprouts' 10-K the earnings release announcing our fourth quarter and full year 2016 results and the web cast of this call can be accessed through the Investor Relations section of our website at 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 2017 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 issued today. In addition, our remarks today include references to non-GAAP measures. For reconciliation of our non-GAAP measures to the GAAP figures, please see the tables in our earnings release.

As a reminder, fiscal 2015 was a 53rd week with the extra week falling in the fourth quarter, making it a 14-week quarter and benefiting 2015's fourth quarter and full year earnings per share by $0.02. In addition, for 2015 we have presented adjusted net income, adjusted earnings per share and adjusted EBITDA with adjusted measures stated in the reconciliation table in our earnings release. For 2016 such adjustments would be immaterial. As such, we have presented net income, earnings per share, and EBITDA without adjustments.

For the fourth quarter end of January 1, 2016, diluted earnings per share was $0.12 as compared to $0.18 in the same period in 2015. For the full year 2016, we reported diluted earnings per share of $0.83. Flat to 2015 and a decrease of $0.03 compared to adjusted diluted earnings per share of $0.86 in 2015. The payments associated with the executive Chairman of the Board's retirement negatively impacted earnings by $0.01 per share in the fourth quarter and full year 2016. On a comparable 13 and 52 week basis and excluding the effect of the payments associated with the executive Chairman of the Board's retirement, diluted earnings per share would have been $0.13 and $0.84 for the fourth quarter and full year 2016 as compared to $0.16 and $0.84 in 2015, respectively.

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

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

Thank you, Susannah. Good morning, everyone and thanks for joining our call today. With the backdrop of a challenging deflationary environment during 2016, Sprouts continued to make significant progress in growing the brand in our business. Our team remained focused on new store growth, product innovation, increasing customer engagement, both inside and outside the store, and continued to raise the bar on customer service. The result of this hard work drove industry leading results including top line sales growth on a 52-week basis of 15% to over $4 billion, comparable same store sales of 2.7%, new store productivity of nearly 80% and our best overall customer scores to date. And all of these results in a highly deflationary and competitive environment.

I'm very proud of our team's accomplishments on each of these metrics which are truly remarkable and we look forward to continuing to build on our strategic priorities in 2017 which I will cover shortly. Offsetting these exceptional achievements was a compression in gross margin and EBITDA margins impacted by deflation in the competitive environment. While the deflation has lasted for an extended period, I truly believe Sprouts is positioned very well when we come out of this environment.

Let me first touch on the fourth quarter. In the fourth quarter sales rose to $986 million, up 14% compared to the prior year on a 13-week basis. Comp sales were .7%, driven by positive traffic of .4% as we cycled a tougher compare of 7.6% comp sales and traffic of 5.3% in Q4 of 2015. This resulted in an industry leading two-year comp of 8.3%. Despite a highly deflationary environment, we continued to experience success with one of the strongest quarters of tonnage growth during the year and continued momentum in the overall business, reinforcing the strength of our business model and the ability to maintain and grow a loyal customer base.

Though our traffic improved compared to the prior quarter, it was impacted by cannibalization from new stores opening, which remained above the higher end of our normal 125 to 150 basis points range. Our 2016 vintage had one of the highest first year average weekly sales in the history of our Company despite the deflationary backdrop and our cash on cash return model remains very attractive. Comp sales during the quarter were impacted by costs and retail deflation.

Cost deflation was approximately 2.5%, worse than our initial expectation and mainly driven by beef deflation and produce during December. Clearly, this has been the most challenging deflationary environment we have experienced since 2009 and the longest period of sustained food deflation in decades. The competitive promotional environment continued throughout the fourth quarter. We expect this environment to remain for the near term until deflation subsides. During this time we will continue to maintain our competitive position by being priced right and focused on customer initiatives to drive traffic to our stores. In 2016 we raised the bar on what was already a very successful holiday program in years past and delivered on our counts.

For Thanksgiving, healthy and better for you product sales were up significantly over the prior year as customers continue to look at Sprouts as their healthy holiday destination. Our marketing campaign both in store and across all the build channels during the holidays were exceptional and resulted in a significant sales lift and many customers trading up for their holiday meal.

Having personally spent significant time in many of our markets over the holidays, I was extremely happy with the customer traffic, tonnage growth, and customer compliments during the Thanksgiving and Christmas week and see that the quality offering in our value proposition is increasingly resonating with customers for the holidays. Before year 2016 we continued to make significant progress on our strategic initiatives in the areas of product innovation, customer experience, infrastructure investment and investments in our team members.

On the product innovation front we expanded our natural and organic product label program to over 10% of our revenue, an important milestone towards the goal we set a few years ago. And private label sales and comps continue to outpace our Company average in both sales growth and comps. We ended the year with over 2,100 private label items which are based on strict ingredient standards with the great taste profile at great prices. We implemented our food and deli expansions in 76 new and existing stores this year.

Offering the additional convenience of freshly prepared proteins, sides, salad bar, fresh juices and soup stations. We continue to enhance all Sprouts digital platforms with our robust following on multiple social channels with now more than 1.5 million unique digital subscribers. We continue to increase our engagement with our customers via email, mobile app and social media and are poised to accelerate personalization in 2017 which I will cover in a minute. Lastly, we expanded our Amazon Prime Now partnership to nine stores providing home delivery to our customers in four markets.

On the technology front, as we continue to grow new stores, we're making significant investments to insure we can scale effectively and keep the same level of operational and customer service execution that our customers expect and love at Sprouts. We successfully implemented (inaudible) a human resource system and a labor management system for the non production departments during the year. We also opened our new DC in Atlanta which will support ongoing growth in the southeast and enhance the freshness of produce in this region.

Lastly, our biggest and most important investment was in our nearly 25,000 team members. We made significant investments in training and training infrastructure for store team members during 2016. This investment has improved customer service in our stores, is improving retention, and establishing future leaders for Sprouts, given our pace of new store growth.

Under new store growth front, I'm very excited to report that yesterday I had a chance to spend time with our team and our customers at our first store in Florida and later this quarter we will open our first store in North Carolina, increasing our reach to 15 states and expanding our presence in the southeast. We have an experienced team in Florida that will carry the Sprouts culture, passion for the brand, and customer service. Our pipeline remains strong with 69 approved sites and 43 signed leases for the coming years.

Let me now turn to our 2017 strategic priorities and new store growth. Our 2017 priorities will continue our journey of product innovation, accelerate customer engagement across all touch points and investments in technology for scale and efficiency.

First, we will continue to further advance our product offerings centered on health, taste, and value to meet our customer needs. This includes growing our differentiated product label line even further which has grown revenue by greater than 25% annually over the last four years and we expect continued high growth from this ongoing initiative again in 2017. We will continue to roll out our enhanced deli program in more than 50 new and existing stores.

The new deli program sales continued to increase each month and are providing a nice mix lift to the basket. We recently added an experience culinary chef to the team to help further drive innovation in this area and insure product development is on trend and of high quality. Additionally, our emphasis on meat and sea food team member training and full service case enhancements we believe will continue to drive additional traffic to the store. Lastly, on the product front we will continue to work closely with our vendor partners as we jointly are focused on product innovation and compelling promotional opportunities.

Second, we will continue to accelerate customer engagement across all touch points to enhance the Sprouts experience and drive increased loyalty with the brand. We continue to feature meaningful content across all sprouts channels to engage with customers outside the store. Our enhanced mobile app offers customers exclusive coupons and we continue to gain traction with our customers as we have seen meaningful growth in known customer IDs, or KCIDs throughout 2016 to over 650,000 to date.

Now that we have a meaningful number of KCIDs, we will expand our personalization capabilities across our digital platform and bring richer and more relevant content and personalized offers to our customers. We will also continue the expansion of our Amazon Prime Now partnership which allows us to bring Sprouts products to our customers through home delivery. We remain extremely excited about this partnership and we will continue to add this service to new stores and new markets during 2017.

Third, we will continue to invest in infrastructure that will support our store growth and drive productivity improvement in our existing stores.

We have several major store level technology projects underway, including a deal management and ad planning system, a labor scheduling system to include the production departments in the stores, and our more automated ordering and inventory management system.

All of these initiatives are key for scale and increasing efficiency and will also enhance the category management process, marketing, and in-store operations. We will continue to focus on our team members, their training and strengthening their road map for career success so that we can scale with great leadership in our stores. On the new store front we will open 32 new stores in 2017 and over the next several years, we plan to open approximately 30 stores per year.

This pace of double digit growth allows us to drive a strategic initiative and deliver strong operations in our stores. On the financial front, this pace of growth will improve cannibalization, reduce pressure on operating margin and yield superior EPS results.

Before I hand it over to Brad, I want to say that I'm extremely proud of our team in the stores and the support office. As we continue to navigate this dynamic environment, our team is working closely together as one family and I'm extremely confident about our business model and long-term potential for one simple reason. Every city and state I travel to, customers continue to tell me why they love Sprouts.

With that, let me turn the call over to Brad and speak about our financial results and 2017 guidance.

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

Thank you, Amin, and good morning, everyone. I'll begin by discussing some of the business drivers for the fourth quarter and full year and then review our guidance for 2017.

For the fourth quarter, sales were up 14% on a 13-week comparable basis with comp sales growth of .7% in line with our expectations. As Amin mentioned, cannibalization remained at elevated levels, but the new stores net of cannibalization are extremely productive and while they impact comps in the near term, they provide very attractive financial returns.

Deflation of 2.5% in the fourth quarter reached its highest level for the year. Mainly driven by deepening produce deflation during December.

For the fourth quarter, gross profit increased by 4% to $278 million and our gross margin rate decreased 70 basis points to 28.2% compared to the same period in 2015. Nearly 20 basis points of this reduction was due to cycling leverage from the 53rd week in 2015. As well, recall we began to experience higher margins in the fourth quarter of 2015 when deflation started to set in for certain categories, particularly poultry, without the corresponding promotional environment.

In addition, occupancy expense deleveraged slightly due to an increase in average square footage growth in our new stores and higher rent expense. For the fourth quarter, direct store expense increased 13% to $211 million. And as a percentage of sales was 21.4%. Excluding the pre tax loss and disposal of assets in the fourth quarter of 2015, DSE as a percentage of sales increased 130 basis points compared to the same period last year.

The increase was primarily due to deleverage of fixed expenses associated with the lowered comp sales growth, higher payroll expense from planned increases in wages and training costs, and from cycling the positive impact of the 53rd week. SG&A increased 11% to $35 million for the quarter, an increase of 20 basis points to 3.6% of sales compared to the same period last year. This was primarily due to payments associated with the retirement of the executive Chairman of the Board, as well as cycling the positive impact in 2015 from the 53rd week partially offset by lower advertising expense.

Excluding the impact of the retirement expense and on a comparable 13-week basis, SG&A was flat as a percentage of sales compared to the prior year. EBITDA for the fourth quarter totaled $51 million. On a comparable 13-week basis, EBITDA decreased 14% when compared to adjusted EBITDA in the same period last year. This reduction was primarily driven by lower gross profit margins and increased labor costs.

Net income for the fourth quarter was $17 million, a decrease of $11 million from adjusted net income of $28 million in the same period of 2015. Diluted earnings per share was $0.12 for the quarter, a decrease of $0.06 from adjusted diluted earnings per share for the same period in 2015. On a comparable 13-week basis, and excluding the impact of the retirement of the executive chairman, diluted earnings per share would have been $0.13, a decrease of $0.03 from adjusted diluted earnings per share of $0.16 in the same period last year, again, on a comparable 13-week basis.

For the full year 2016, net sales grew to $4 billion, up 15% on a comparable 52 week basis. Gross profit increased 12% to $1.2 billion resulting in a gross margin rate of 29.2%, a decrease of 10 basis points from 2015. Direct store expense increased 17% to $829 million, an increase of 90 basis points to 20.5% of sales, excluding adjustments in 2015. And SG&A increased 19% to $127 million, an increase of 10 basis points to 3.1% of sales compared to 2015. EBITDA totaled $294 million, down $8 million compared to adjusted EBITDA in 2015, and flat on a comparable 52 week basis.

EBITDA margin decreased 110 basis points to 7.3% compared to 2015 on a comparable 52-week basis. Net income for the year totaled $124 million, down $10 million compared to adjusted net income last year. On a comparable 52-week basis, net income decreased 5%. Diluted earnings per share for 2016 was $0.83, down $0.03 from 2015's adjusted diluted earnings per share of $0.86 and down $0.01 from adjusted diluted earnings per share on a comparable 52-week basis in 2015.

Excluding the $0.01 effect of the payments associated with the retirement of the executive Chairman of the Board, diluted earnings per share would have been $0.84 for 2016, flat to adjusted earnings per share in 2015, again on a comparable 52-week basis. These results were driven by growth in top line sales and fewer shares outstanding due to our share repurchase program offset by higher payroll expense from planned increases in wage and training costs, as well as additional investments to build out infrastructure to support our growth.

Shifting to go the balance sheet and liquidity. For the year we generated $254 million of cash from operations, up 6% from last year. Through 2016, we utilized our strong operating cash flows to fund the business through unit growth, sales initiatives, and infrastructure projects, and invested $167 million in CapEx, net of landlord reimbursement primarily for new stores. In 2016, we undertook a comprehensive review of our capital structure in the context of our projected growth and strong free cash flow generation over the next three to five years.

This resulted in a realignment of our capital structure through the use of a stepped up share repurchase program which increased our leverage from .5 times to 1.3 times net debt EBITDA at the ends of 2016, with net debt inclusive of capital and financing lease obligations on the balance sheet. During the year we repurchased approximately 13.2 million shares for $294 million, representing approximately 9% of our diluted shares outstanding under our share repurchase authorizations. We ended the year with $12 million in cash and cash equivalents and $255 million borrowed on our $450 million revolving credit facility.

Looking forward, our expectation is for our net debt to EBITDA to be in the range of 1.2 to 1.5 times. We believe this range provides optimal leverage for Sprouts while maintaining a prudent level of financial flexibility. Subsequent to the end of the year and through February 10th, we purchased an additional 4.1 million shares for a total investment of $80 million year to date, fully utilizing our $250 million share repurchase authorization. And, as announced today, our Board has approved a new share repurchase authorization for $250 million to be used through the end of December 2018.

With our strong operating cash flows and modest debt levels, we are well positioned to self-fund our growth plan and enhance shareholder returns through our ongoing share repurchase program.

Let me now turn to 2017 guidance. Given the current deflationary environment and the expectation that it remains consistent through at least the first half of the year, we are maintaining a cautious outlook for 2017. We would expect many of our fresh categories to remain deflationary for the first half of the year until we cycle the deflationary events from 2016.

Guidance for 2017 is as follows; We expect comp sales growth to be in the range of 0% to 1% for the year. Diluted earnings per share of $0.86 to $0.90, resulting in EPS growth of 4% to 8%. This includes an estimated $0.02 benefit of the 2017 change in accounting standard related to reporting of the excess tax benefit for stock based compensation. This accounting change will serve to lower our effective tax rate to approximately 36% for the year. We expect net sales growth of approximately 12% to 13%. We plan to open 32 new stores and enter two new states, Florida and North Carolina. And CapEx will be in the range of $155 million to $165 million, net of landlord reimbursements.

As we know, we are currently in an unusual operating environment. Our midterm guidance set in late 2015 was established with the assumptions of a normalized operating environment and inflation of between 1% and 2%. We believe that as we cycle this difficult deflationary environment, we will show improvement in our comps and earnings. As we exit this environment, we will revisit our midterm guidance, but our expectation is a return to double digit EPS growth.

A few additional items of note on the 2017 guidance. Our tougher compares will be in the first half of the year as we cycle to higher gross margins in 2016 when deflation started to set in for many categories. We expect EPS to be slightly positive in the first half of the year with stronger EPS growth in the back half of this year. We anticipate that the deflationary environment will continue for at least the first half of 2017 with the expectation that we cycle through the higher points of deflation in many categories as we enter the third quarter.

As it relates to margins, we will continue to make price investments as necessary to drive traffic and to maintain our competitive position. We would expect gross margins to be lower than the prior year in the first half of 2017. For the full year, we expect gross margins to be relatively flat year over year. On the direct store expense line, we expect to delever DSE a percentage of sales for the year due to deleverage from our expected comp sales growth. As well, we expect depreciation and amortization expense to increase approximately 20% driven by higher store unit growth in 2016, as well as higher average square footage in our in your stores now typically at 30,000 square feet.

On the SG&A line, we expect to be relatively flat to slight delevered as a percentage of sales, mainly attributed to our expected comp sales growth. Below the EBITDA line we expect interest expense to be approximately $19 million, including interest related to financing and capital leases.

In conclusion, we remain confident in our business model and our strategic priorities to drive sustainable growth and shareholder value for the long-term. With that, we'd like to open up the call for questions.

QUESTION AND ANSWER

.