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SFM - Sprouts Farmers Market Inc at Barclays Eat, Sleep, Play - It's Not All Discretionary Conference

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PRESENTATION

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

While the landscape has changed significantly since Amazon bought Whole Foods, and there's a lot to talk about, we feel very strongly that the Sprouts business model will not necessarily be impacted by this acquisition. So today, we're very fortunate to have Chief Executive Officer, Amin Maredia, to discuss the Sprouts story and the ever-changing landscape.

QUESTIONS AND ANSWERS

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

Thank you. So we're starting with some standard questions, if that's okay for everybody. But one is going to be much more relevant for you to answer than, say, maybe my last 2 companies. On tax reform, obviously, things have just evolved in the last couple of days. So maybe tell us a little bit on puts and takes on the tax reform, what it might mean for your growth strategy, what it might mean in terms of how your view on your ability to pass that on or whether or not to get arbitrage layered where you retain it.

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

Yes. So I think just the basics is we're a full domestic taxpayer. And based on what we've seen so far and based in both the House Bill as well as the Senate Bill, which can certainly change as we work through the final changes, it will benefit us on rate. We'll continue to maintain our full interest rate expense ability because of the relatively low leverage the company has. And then we'll also benefit from the depreciation, cash -- from a cash flow perspective, from the timing of cash flows. In terms of usage, this is something that I've been spending time with a lot of CEOs, Fortune 100 CEOs, talking about what they're planning on doing. And what I've been very pleased with is this tax reform can work very well. Based on what I'm hearing is CEOs are leaning and talking to their boards about being more balanced in terms of shareholders, customer and employees as well. And I think given where the intents of the tax reform is to lift all boats to the extent that they're -- most companies are balanced, I think Sprouts would recommend something similar to our board. And so we'll wait to see how things play out with the final legislation. But I think the punchline will be a fantastic benefit from Sprouts. And then it's a matter of -- in terms of competitive landscape, I think it'd be too early to call how companies will think about how much of this they'll give back to the customer. So we'll play that by ear, and we have a very sound pricing strategy. So I don't think we'll be the leaders in that. We'll see how the market plays out on that front.

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

Okay. Obviously, Amazon/Whole Foods, you seem to be the punching bag of that acquisition from a narrative perspective. And I don't know that I agree with that, but I guess, we've been trying to publish weekly kind of changes that we see in the store. And frankly, I mean, sometimes there's been very strange changes. Sometimes we notice things that don't make a lot of sense to us. But there really haven't been a lot of changes from what we observed. But curious if you could share your thoughts.

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

Yes. I mean, I think it's probably best to kind of look at the wide frame. It is -- the Whole Foods brand, over many decades, has been built on a set of integrated activity that's really made the brand unique and different. And to date, I think all your writings and what other people have wrote about have been a lot of tactical, and I don't want to say minute changes, but tactical changes that might be going on in the store. So what I'm more interested in is sort of seeing how the entire integrated activity of it plays out. I think at the same time, I think the broader construct is what we're seeing and continue to see. And I think in the next 5 to 10 years, because anytime you start talking about Amazon/Whole Foods, I think you've got to step back and look mid to longer-term. And I think that brands that are relevant and product brands that are relevant and experienced brands that are relevant and customer service, which is slightly different than just experience, having that knowledge in our format, being a natural and organic player, having knowledgeable service is super important. Having the right set of customer engagement points is super important. So Sprouts competes in the broader narrative of both the conventional space and the specialty space. And we don't think of ourselves as competing in the $150 billion business. We're really competing in the $850 billion business. And if you include food at home, then $1.5 trillion business. And so at the end of the day, I don't think any one retailer is going to win by themselves in this space. And in brick-and-mortar, you literally look down the road and say who's the best on the street? And in engagement and in e-commerce, who is best connected to the customer? So when the customer decides to shop, they're thinking about your brand vis-à-vis somebody else.

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

Do you -- I mean, I guess, what I wonder is when you look at the appeal that Whole Foods has in terms of number of households, it would seem that the number of households that shop at Whole Foods regularly, I mean, Walmart obviously would dwarf it, but a large percent of those customers are going to be Prime customers -- are Prime members already, I would tend to think. So doesn't it -- does it make sense in your mind that they have to kind of evolve the concept to broaden the appeal by introducing more conventionals or not necessarily?

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

Yes, I think there's 2 elements of sort of that question. One is around Prime members or members through any loyalty program shopping in the store versus sort of home delivery or perhaps click-and-collect but really outside-the-store activity. And our sense is what we see over time is companies, which -- brands which are more, I don't want to use the word specialty in nature but which are more separated apart in distance, the Costcos of the world, the Sprouts of the world, we think -- I think, that those brands will benefit from the home delivery business because you can extend the trade area. And we've already seen that in our sort of early tests is traditionally in home grocery, most of the customers come from within 7 minutes. And what we've seen in home delivery is a lot of our deliveries are outside of 7 minutes for the convenience reason. And in that situation, if you're a conventional who has stores every 2, 3 miles, you're basically cannibalizing your own sales. There's a margin pressure on the business to where brands are distanced well. It is actually -- it can be -- it's a profitable activity. I won't say it's margin-accretive necessarily. In our case, we think it could be margin flat to perhaps margin-accretive. But more importantly, it's more profitable and it adds to our cash-on-cash return model. In terms of integrating purchases in the stores themselves, I think it will be -- actually, I think it will be a while, and customers at the end of the day are -- we're 2.5% online today in grocery, and that will continue to move up relatively at a relative clip because everybody's investing in it. But I think all else equal, everybody has that availability of that service, and the best brands are going to win and the best product sets and the best price and the best service is going to win. That's how we've positioned ourselves and our business, and we're excited about looking at the opportunities on that front. And we spend -- especially given that our brand has got a lot of -- given that it's had a lot of tailwinds over the years, albeit the deflationary environment, we spend a lot of time focusing on the opportunities as opposed to the risks in the business unless they're massive risks in the business.

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

So since you brought it up, the penetration right now online, like you said, 2.5%. I mean, U.K., you could argue, I mean, I've heard different numbers, call it 7. Maybe it's 10. I would say that the U.S. consumer is more focused on fresh than the U.K. consumer. So how do you think of where the actual penetration could go? Because if you talk to just anyone who covers Amazon, the number is like 25% to 50% -- anywhere from 25% to 50%. But I guess in the U.S., you have more of a focus on fresh in general, so it seems to me you can't get to even to U.K. levels.

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

Yes. I mean, the U.K. and then you more specifically look at the City of London, it's at 13.5%, 14% today and that's been at it for 15, 20 years. Certainly, I think again, in the U.S., I think the acceleration will happen faster in urban areas versus suburban areas. Sprouts is mostly a suburban format. We do have semi-urban stores, though. So I think that the way we think about the business is that this 2.5% today is mostly nonperishable, and we sort of plan for -- let's imagine the world. Let's not worry about whether it happens in 2 years, 3 years, 5, years, 7 years. Let's plan and make sure we're there for the customer to a point where, let's say, this 2.5% goes to 10%. I think at that point, more of that spend will be fresh. It won't be a predominant component, but it will be more than it is today. And when that happens, I don't think that every brand has a license to capture their fair share of the 10%. I think brands that really resonate on all the things I talked about earlier will probably look more like 80-20 or even 75-25. And the brands that don't resonate are either gone or going to be 98-2 online. So I think the best brands are still going to win in that equation, and that's how we're planning and how we're planning and really now, sort of accelerating our thought process around not only our business model in brick-and-mortar but also our engagement strategies with the customer outside the store. How are we engaging with the customer? How are we living our brand that we live every day in the store? How are we allowing the customers to live that outside the store?

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

So I know, obviously, on June 16, everyone assumed that you would naturally move away from Amazon. And I think you probably surprised people by maintaining the partnership with Amazon Prime Now. So at which -- I mean, maybe you can explain your thought process behind it.

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

Yes, I think we're currently in a position where I can't talk about the contract and the partnership itself. What I will say is that we're in 8 markets today, and we're continuing to look at ways to grow beyond the 8 markets to all of our markets. So I think what's probably the narrative that's probably more important is we've seen some great activity from our customer in the demand profile for home delivery of fresh from Sprouts because of the brand. And the comment I made earlier about extending the trade area, and that extending the trade area is super important because we think that's it's a structural advantage for Sprouts compared to the conventionals because when a majority of those sales are cannibalizing a store, it's a burden cost because no matter how you cut it, it costs somewhere between $10 and $14 to pick, pack and deliver to the house. And someone has got to bear that cost. It's either the customer or the retailer or the service provider. It's never going to be the service provider. And for the retailer, they can take on so much and the customer signal today is that they're not wanting to pay $14 or even $12. So we feel -- we're pretty excited. I won't talk more about the partnership at this point, but we're pretty excited about the fundamentals of improving our cash-on-cash return profile of the business by extending the trade area.

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

So when you talk about the customer draw that you got from the delivery, it sounds to me like you're saying it is a typical customer, but it is just not a customer that has a store accessible. Or do you think you're broadening your appeal with a completely different customer set?

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

It's convenience. I think that convenience is, and I always tell this story because I fight this -- I won't name the retailer, but I show a certain other food retailer showing up on our home credit card from time to time. And Sprouts is 8 minutes away but somebody else is 2.5 minutes. And it's always on that quick milk and then ends up being a $60 basket, right? And so the point around convenience is super important. If I'm sitting at home and I want to go to Sprouts, but it's 15, 17 minutes away, it's harder to swallow except once a week or every other week. Here I can now go once every other week or once a week. And if I'm going every other week but filling in with somebody else, now I can do that with home delivery from Sprouts. That's the component that I think that we think is a structural advantage because generally our stores are spaced wider apart than the conventional stores.

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

So I guess, when you think about your real estate strategy, with this in mind, as something that's permanent and continuing to expand all your markets, it has to be changing your real estate strategy going forward.

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

Yes, the real estate side is really getting fun because we're in a lot of markets. We're opening still 10% a year. But if you think about being in 18, 19 states next year but only opening 32, 33 stores, it gives you a lot of flexibility. In terms of flight selection as well as we're predominantly a suburban model but as we continue to evolve our deli food section, we have more stores in what I call semi-edge or semi-urban -- well, not the edge. It's really semi-urban areas, not quite urban in the middle of the city. And having those semi-urban locations is, if you've got 2 or 3 in the right locations, you can converge to home delivery to 1 million people in a big city. So we're pretty excited about -- we're actually looking forward to things going online. And if the customer preference goes that way, we actually think that's a benefit to Sprouts because the fundamentals of health -- fresh, health, convenience, value is stat -- at the bar stat. The quality and store experience at Sprouts, our ratings and our customer service scores are higher than most other brands. So the bar has been set for us to be now for us to take advantage of that convergence into our urban area, where we may not go build a store there but certainly can capture some of the home delivery there.

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

So when you think about -- I guess not necessarily trade area because we already talked about how much wider the trade area is. But when you think about what the population draw could be on a store now with this model versus just the bricks-and-mortar, what do you -- what would be the difference?

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

I don't think the draw. So it's interesting, the draw to the store, we've not seen a huge uptick, but we've not seen cannibalization. Except some -- there's some element that over time, there could be more people making that longer trip into the store. But generally, what I would say is that the incrementality is caused by 2 things. It's convenience because I don't want to drive 15 minutes today. And the second element is -- for Sprout is when you build a location in a semi-urban area, you may just be 4 miles into downtown, but somebody who's living in downtown, doesn't want to drive 4 miles out, it's a 20-minute commute. But certainly, delivery becomes an option from Sprouts. That's the sort of the second piece is the convergence point is going to the customer, into their home in the city as opposed to them having to come out, which most of them -- most customers don't want to do except maybe the weekend or once every other week or once a month.

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

So how should we think about the potential upside ROIC from this dynamic?

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

I think that over the next couple of years, we'll have a little bit more clarity around that. So I'll hold as to what we think that upside could be until we get actual evidence around what we think that number could be. So we'll potentially share, to the extent that we're starting to see a step change over the next 12, 18 months into our numbers, then certainly, it will be obvious and we'll start talking about it. But I think you'd be jumping the gun on the matter at this it and making some assumptions that's probably easier not to do.

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

Okay. So another, I guess, pushback we get is that you obviously have a lot of potential drivers of margin expansion. But -- so I guess the question is how much, when you think about upside to margins, how much of it is really, I guess, mapped by the fact that there are things that you just can't control, right, in terms of the external environment? Because you've laid out a lot of drivers which are all very interesting.

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

I think just to summarize the drivers very quickly. The plus drivers are private label. We'll continue to expand 20-plus percent, a fantastic piece of business, and it's not the generic version of our private label strategy. It's very focused on health, taste, unique flavor profiles, things that you can't find somewhere else necessarily until a year or 2 later when somebody else carries it. And then we'll move on to somebody else, attribute-based product. So it's a very focused strategy to be more unique than, I'll call it, the commodity version of -- I won't name a retailer but blank. Very smart. Let's not kind of a food retail, Walflu, right? A version of it, right? So that's not what Sprouts is in context. We're not a commodity-based private label strategy. It's differentiation in our strategy around private label. So private label is one. What we've been doing in deli. In our new stores, we're seeing -- starting to see some meaningful step change in mix to the positive in the deli department. And it's been interesting because I think it's just when you walk into the store, you just know you're -- more in the Sprouts. There's more in the deli business. But when you're retrofitting all the stores, we've seen good lifts and good ROIC, but we're seeing big lifts in deli and new stores, which is exciting for us. So those are the inputs to margin expansion. The other important is just now the size of the company at over $5 billion in revenue next year to invest in certain technologies, which were not as interesting from dollar size or just resources. But it's 3 particular areas: fresh item management, deal management and business intelligence. And the benefits that we see driving out of those is one, better in-stock; therefore, higher sales. Much better shrink. There are 2 or 3 departments where our shrink is just flat out high. And we also see benefits in promotional effectiveness. I call it -- we had the first couple of aha! moments in the last month, where it's like we always thought A was better than alternative B. And the data is clearly showing B is much better to overall profit dollars for the company. And not having the negative halo impact on other categories, et cetera, or other brands within the category. So that's exciting. So that -- the combination of that technology investment and the top line, we feel pretty comfortable that it will allow us to compete -- continue to be aggressive as needed to invest in price and try to maintain our 7% EBITDA margin levels, plus or minus, right around that range, which ties back into the 35%, 40% cash-on-cash return in a mature year. And our new store productivity, frankly, with what we're starting to see now, now that we're started to see new store productivity to the extent that our cash on cash return starts coming are exhilarating. That's just the benefit. Now it could in the mid- to long term have an impact on potentially comps upside. But certainly, you're just accelerating the P&L. So I think most logical business people would take that all day long.

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

One thing you didn't mention was the labor in that. There's a labor piece to it.

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

Yes. So we measure labor. We always look at -- a lot of our analysis is done on a contribution basis, so we're very data, very ROIC, very -- what's the right thing to do with the business. We've always had the philosophy at Sprouts to be sales-driven and margin-minded. That's just who we are. And margin-minded just simply means that if it's unproductive to your profit dollars, you always want to pause and make sure that it's strategic in nature and just not tactically you're trying to hit a quarter. And looking at all the stats, I think, the stock price, I think that the story is underappreciated in the sense that for 10 straight years, we've continued to generate positive comp sales, including through the recession. If you look at the latest quarter and the more near term, it's 3% to 4.5% comps, inclusive of 1.25% cannibalization. So for the health of the business, I always look at comps and traffic on that excluding cannibalization because that's a temporary fact and that we've done it to ourselves. So when you look at that number for the last quarter, it's almost 6 comp and very healthy traffic. And when you look at our business, adjusted for inflation over time, it's a very healthy business. And so while we went through this deflationary period, I would say the only negative to the business from my perspective has been the exuberance in retailers compressing on retail margins during 2016, which is normalized again. But otherwise, we feel really good and then to add new store productivity, which I talked about. So we feel like the business is one of the best in food retail and has been. And when you -- and we were -- in the deflationary period, we were impacted 2x of any other retailer because over 60% of our business is fresh. I don't think there was --

another point I probably could have talked about heavier is all the deflation was in the fresh categories. It was in produce, it was in meat, it was in berry, it was in bulk. And that cost deflation by itself was for us almost 2x of a conventional retailer.

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

So going back just to the initiatives in terms of the store, when you started testing the deli and expanding the whole meal replacement, in new stores, in new locations, I think you started out not necessarily putting the deli in because you thought -- or expand the deli because you thought you needed to have brand equity. And then this kind of changed since then because you realize that you are recognized for it.

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

Yes. And that's sort of a test and learn, where we're always focused on the long term. And when you move too fast, I think you can sometimes make mistakes. So that was a judgment call we made at that time. In hindsight, we probably could have started in new stores 2 years ago given the mix that we're seeing today. But the reason for the judgment call was if you're not doing the expected volumes and the labor can eat you, and then you can't pull it out of the store once you give a customer certain products, a salad bar, an olive bar, an 8-foot fresh taste. You can, but it's a disappointment. And so that's the offset around it. And I think the reason for the deli was not -- it was really more trend-driven. Where consumers are headed today, we all know it's fresh and health for sure. But convenience -- fresh and convenience, combination of fresh and convenience, I call it ready to eat, ready to heat, ready to cook. All 3, right? Ready-to-eat, meaning I can literally stand there and eat it in the store. Ready-to-heat is throw it in the microwave. And ready-to-cook means you've all done the prep work. I'm just doing a little bit more than throwing it in the oven or the pan fry at home. That's continuing to accelerate. What's been interesting even in the frozen categories, where fresh, natural and organic frozen has gotten better. That's to the point of convenience. That category is very interesting also is that customers know now they can get healthy food in the frozen department in case they don't want to stop at the store again for ready-to-eat, ready-to-cook. So I think it's really the whole deli area for us on the business has been fundamentally driven by consumer trend.

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

So when you think about the 4 walls now, maybe 2 questions. So how do you -- where do you think you can get better on the merchandising side? And then where do you think you can get better on the actual, I guess, execution operationally? Shrink sounds like a big area of opportunity, but maybe those 2 separately.

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

I'll take it in reverse. Well, let me take it in the right order. On merchandising, this is a hard one. And Jim is listening. Our stores have done an exceptional job in merchandising. I don't know if there's probably -- there's always opportunity, but kudos to the sales and merch team. They're really, really good and they're good at what they do. In terms of operational and other execution, the technology ability to bring technology into the store is the biggest service we can do to our stores. Because when you think about something as simple as the deli section, if you had the right technology, you know exactly how many of what items you need to produce throughout the day so they're fresh, so they're in stock. You know based on that production how much you need to order, so you're not doing manual ordering and checking inventory. You already know, and you might look at it again and make a judgment call and change it. And that flows into the labor management model by 15 minutes on when you need the labor in the store. So when we start thinking about perishable technology in our store that we're putting in place, we started with nonperishables in '17. We're going into the perishables department in '18. It really comes to a combination of better products, fresher product, greater sales from in-stock positions and automation to allow our team members to focus on the customer as opposed to figuring out how much of what I need to order in every single department. So that -- hopefully, that answers your question unless you have another piece that I missed here.

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

Well, maybe on the shrink. I mean, it sounds like you're really early innings on that.

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

Yes, we are in the early innings in certain departments. Look, I think that the nonperishable side of the business is easier, right? You've got longer code dates and you're ordering every day. So there, you just have to be good at ordering, right? Not that any department is easy. It's easier. In the perishables side, ordering -- we're in the early innings, and it's a combination of no one individual can be a perfect mathematician on how much to order perfectly. So you get to cause natural shrink. And at the rate we've been growing and we've been moving people around, frankly, you always have leakage through that process, right? You're always trying to train and open more stores quickly so there has been a -- I don't think -- it's not been a greater leakage. The leakage has just been there. So the opportunity to capture the shrink and it's particularly in perishables, including produce, deli, meat -- less of a degree, bakery, but really, those 3. And when I look at produce, deli and meat, it's north of -- it's almost half of our business. So it's a pretty big area. And we think through this technology, there's probably over a couple of years well over meaningful numbers. If we don't have to invest it back in price, it's a meaningful number to the EBITDA of the company. And so we're laser focused. This is -- these 3 things, we hired a new person who's been there, done that. And the partners we've chosen have many, many other players, who have proven this technology risk, so this isn't "Oh, let's see what we can do." We know exactly what we think -- we know exactly what we can do, and now it's executing it well.

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

Okay. Since you mentioned price, investing in price or maybe needing to, obviously, people assume that all prices are going to come down in nonperishables, especially at Whole Foods, and in produce and that you will have to follow that. So I guess, produce aside, maybe can you talk about in nonperishables, how many SKUs you would have with direct overlap with what's in Whole Foods? And where you think your price points are now versus theirs?

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

Depending on category-by-category, when you look at relative items, I'm going to talk about outside of private label. And private label overlaps actually not -- which is interesting. And that's been very deliberate on our private label strategy and how we moved over the last 5 years. In the non-private label. On a like-for-like, you have staple departments like dairy, where you're going to have a higher overlap. And then, you've got other departments like grocery, where the overlap is actually not as high as you would think, because of the way we go to market. The way we go with market, with private label, we're very selective on which categories we go deeper into private label on and where we can add value for a simple reason that over time, we know we can -- it could get commoditized. The reason for focusing more on the fresh departments and more on private label is it's harder to replicate, harder to commoditize. You can't commoditize the Sprouts brand in some sense. You're going to have a relative product that's a commodity-like item. In terms of -- the other key that's important is convenience is so important in this business, particularly if we believe, let's use the word -- let's use a 10% or 15% number. 10% as a mid-term number of home delivery. 90% is still being done in the store. And from a convenience perspective, we think -- we still think that, that plays an important element of the overall business. Tell me your question again because I...

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

Well, in terms of actual overlapping SKUs.

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

Oh, overlapping SKUs, yes. The other piece I was going to mention was -- that's important is convenience is so important in this business. We have over 25 price zones, and each price zone in the company has department-level strategies. So I call it being surgical and micro versus macro just because a retailer, any retailer, right? The business has been competitive for 50 years, maybe more competitive in the last 20. But whenever some retailer, no matter who it is, changes a price, we are very mindful around where they sit, price position, where we sit. Sometimes we may move; sometimes we may not. And if we decide to move, it may only be in certain markets. So any particular retailer, we know exactly the distance location. And convenience matters. A customer is not going to drive another 3 miles past your store to go pay the same price somewhere else, right? Unlikely to happen because convenience is so important in this business. So we feel that we have great muscle memory in our sales and merch team to be very surgical in making pricing decisions, and we've done that since the inception of the company.

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

Right. I think we -- I don't know how much time we have left. So maybe I'll see if there are any questions from the audience.

Unidentified Analyst

You mentioned Fortune 100 when it comes to like taxes and how that's going to be reallocated. But in retail specifically, what are your peers thinking about their mix shifts? And will all savings either go to the customer via price -- lowering pricing and giving them more value, or investing in CapEx, the further infrastructure to compete with the more competitive environment? And so shareholders end up getting less than the market.

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

Yes. I don't think anyone I've spoken to has spoken about disadvantaging the shareholder. I think the more -- I don't want to say the more reflective. The people have leads who I have a high degree of regard for, have thought about it from a sustainable business perspective, and saying, "Are there areas in the business where if I spend money here, I know I'm going to get the return?" Whether it's maybe not across-the-board but wages in certain positions in the store, as an example. So Sprouts is growing its deli business fast. And we need more talent in that area. Is that an opportunity where we get better talent or make sure we retain the talent that we do have? So I think people are looking at this in a very strategic manner and in a sustainable manner. What's interesting is people tend to bring up shareholders and their team first, and price has been either non-existent or throwing it in, what I say the customer meaning price. You might see a little people watching what others do, and I think that's positive so that people don't get irresponsible in investing in price unless it's that strategic to the company that they need to invest in price because they're behind. And most of the good retailers probably would tell you they have a pretty good handle on where their pricing strategy is set, and they're looking at more, "Is somebody going to force me to pull down with them?" A few are going on the offense a little bit and trying to pick up a little bit more traffic, and that's fine. So this could actually end up working out well. If this mindset is across many companies, you could actually see 0.5% plus in the GDP. I could actually see that if people are responsible about this. It could be a very positive impact around it. And I was at a CEO Forum not long ago with 130, 140 CEOs, and this was a pretty commonly dinner conversation of doing the right things strategically and responsibly. And I can see it having a -- if we have enough companies, enough leadership in boards with this mindset on having a wave effect, which has actually been great for our business because as the economies continue to roll along, we continue to see trade-up in the business. We're always very mindful to make sure that we still are value and we give a breadth of product for the value budget customer who's coming in and somebody who may be feeling really good and is ready to trade up. We've seen trade up in many categories over the last 6 to 12 months. And whether it's attribute-driven or organics at the same time, we're always mindful of balancing value in that chain even though we've seen a great run there.

So I think for Sprouts, to the extent that the economy continues to run well, which is very positive, so maybe I'm more optimistic that people will reinvest in the business. I think a great -- for the most part, great businesses -- good businesses, great businesses already have already have sufficient cash flow. They don't need this tax reform, to be honest, to invest before in CapEx. If they had another idea, they had the money, right? I.e., there's a reason why you see a lot of shareholder buybacks not from leverage but also just from cash flows is because I can't find another -- we at Sprouts said somebody else can't find another 15%, 20% ROIC idea. Therefore, shareholders, I'm going to give it back to you. So I don't think CapEx has been in the retail space a big conversation.

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

(inaudible)

Unidentified Analyst

So gross margin has come down over time. And just listening to Kroger and Walmart and others, it seems like they're going to continue to invest in price. So when we think about your P&L, should we assume that gross margin continues to come down but that through technology, you can start to drive better operating leverage expense and that's how you're going to keep the EBITDA margin from ...

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

Eroding further? I think that's exactly how we're thinking about it in the frame that you just gave is that these are either offsets or potential upside. And we always think about pricing decisions as if we have an opportunity in a department to drive sales and margin dollars, then we'll invest in price. Otherwise, we are not necessarily going to be the first to market just to go drive to kill margin tollers. That's just not a good business. And we've done that. We've continued to do that in the past category-by-category, where we know if we invest in price, we can get that trade-up from the customer from a conventional or a natural item to an organic item. So that's a good investment because the margin dollars flow better. So it's more tactical at that point. To answer your question, broadly speaking is the other thing to remember is that historically, we've not been impacted, and I think this is the same going forward, is impacted by discounters. Our business, our direct competition is really the conventional grocers and the specialty grocers. So discounters have not had, even when they invest in price, have not had an impact to our business. We've not seen it in the past because it's a very different shopper when you walk in the stores. So our goal would be to continue to maintain that EBITDA margin level unless the market would have to invest a lot in price. And I don't think conventionals have the room in price. Conventionals particularly have the -- we have enough -- so much in price that we can't offset it is what I would say, with everything I know today.

Unidentified Analyst

What has -- I mean, your EBITDA margin has come down over the last couple of years. So what was different? Is it now that you have the ability to use the technology that you couldn't use that's changed?

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

That is the savings that we expect in '18 and '19 because we're in early innings of these technology deployments to be able to offset that margin compression. And remember, the other piece was -- is you not only had cost deflation, but you also had retail deflation. So cost to retail spreads widened through 2016 for Sprouts. That cost of retail deflation spreads have continued to narrow back. And part of that was just people getting itchy fingers because they were tired of seeing negative comps. And I call it -- you're not going to get any more dollars. You're just going to get a reaction from another retailer like Sprouts down the street, not going to let you take the traffic, right? So it just brought everybody down in margin compression. We're not seeing that level of aggressiveness/irresponsibility today. People are being more selective. They're investing where they truly feel like they can get more margin dollars, at the end of the day is what we're seeing on the ground, ex one particular retailer that we'll see where that goes.

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

One here. The last one.

Unidentified Analyst

A couple unrelated questions. First, what is labor run as a percent? And you read a lot of states have mandatory increases coming. I know particularly in California in a bunch of counties. What do you think labor is going to grow at over the next couple of years? So that's one. And then, two, as you think about this Whole Foods, Amazon and the whole Prime ecosystem that they've been able to sort of join into, are there things you can do to create an ecosystem, a delivery, one-time delivery fee that someone can pay to basically compete with them more head-to-head and sort of create your own ecosystem? Have you thought about that?

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

Yes. In terms of labor, I will answer in the order. In terms of labor, we've always said that about 3% comps is what we sort of think about the flow through being neutral at for Sprouts, and that embeds -- it embeds the labor, the wage increases that we've seen and we expect to see mandated and are likely to see in certain states for the next 2, 3 years. In terms of productivity improvements, that's also part of the projects that I talked about is there's some elements of productivity -- labor productivity improvements in there. But when I talk about the upside that can be used to offset price, I don't think about those numbers because I'd rather use those numbers in the first instance on customer service to drive sales. So we've always been very, again, top-line-minded and making sure we're not trying to -- because we've seen some conventionals drain labor to a point of hurting the top line of the business. And in terms of ecosystems, it's very interesting. I probably should be careful in how I say this, but it's very obvious that there's ecosystems forming out there, 3 big ones and potentially a fourth in this sort of retail world of marketplaces. I'll just name one, and I won't talk about the other 3 for now, but you could probably figure that out, pretty easy. Walmart is one when I think about ecosystem. They're just an ecosystem on their own. They're big enough to be the ecosystem on their own. And then there's others, who are -- some have been growing very quickly in scale. And if you go to the website, it starts looking like a virtual street. And they've been doing a lot of announcement, so you can probably figure that one out. And then I think we're starting to see other technology companies who are knocking on the door of retailers to form ecosystems because they know search is important and traffic is important. And so I think that the world will be not with 1 competitor. I think we'll see 3, 4 big ecosystems forming. And whoever decides each -- 2 or 3 of those will need to decide how big of a marketplace they want to be and how big of a first market they want to be. And if people want to be a big first market, there's a little company in China that's probably heading over to build an ecosystem here. So the nice thing about competition and platforms is when there's technology needed and ecosystems needed, someone is going to fulfill that spot. And I do not believe that 1 or 2 companies will capture share. Now timing might be interesting to look at. So that's at least my personal perspectives when I think about the midterm and long-term. 1,000 years, we've never seen 1 company or 1 ruler rule all. So I don't think we'll see it in the future, which is a great way to end.

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

Yes, exactly. You definitely couldn't escape the Amazon conversation here. Thank you very much. Appreciate it. And I'm going to -- I'll be in here 2:00. So I think you've done [cliff].