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

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CORPORATE PARTICIPANTS

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

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

CONFERENCE CALL PARTICIPANTS

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

PRESENTATION

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

All right. Good morning, everybody. We're going to get started on our next presentation here with Sprouts Farmers Market. Really pleased to have Jim Nielsen join us again, President and COO of Sprouts, I think since 2015, but has held various roles in natural and organic space since 2002 and a long history in food retail. And Brad Lukow, CFO of Sprouts, a position he's held since 2016, and also brings a long history from Canadian retail to Sprouts. So thanks for joining us, everybody. I'm going to kick it off with a lot of questions, but feel free to submit questions through the app or just raise your hand and we'll get a mic over to you if you have a question.

QUESTIONS AND ANSWERS

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

So, I guess, always a lot of questions on produce for Sprouts given how important it is to your model and with the deflation that's kind of -- surprisingly kind of crept up in the last quarter. The question I wanted to ask is, is there ways that Sprouts can make the produce volatility or to just kind of lessen the impact of the produce volatility on your model? You've been doing a lot of, I think, initiatives over the years growing deli and making the model a little bit more diverse. But, I guess, how is that going? And are there things that you can do more? Do investors just need to realize that there is this element of produce volatility and it comes and goes?

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

I'll start with the produce. We've always deal with Mother Nature, so it's always going to be subject to Mother Nature. What we're doing on our end from a supply-side if one continues to strengthen those relationships we do have with our current growers, but with our expansion and our new geographies, we're now able to diversify a little bit the demand, kind of east and west. So that's picking up a little pressure from the demand side.

And then also, with some of the new technologies, we're able to partner with those growers and build up planning schedules so we can kind of secure supply and create a level of consistency year-over-year. Beyond that, with our BI analytics and some of the commercial tools that we have, from an in-store perspective, and we can do a better job as we look at the geographies of really looking at elasticity by marketplace to help with produce pricing in-store and continue to enhance our current pricing strategy that we already have. And then from a promotional standpoint with those tools, it just helps us kind of stable out some of the volatility in supply.

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

Okay. Kelly, I would add that over the last couple of years, we have really had a big focus on expanding the deli offering in our stores, and that's resonating extremely well with our customers. Meat and seafood has been another real area of focus, and we are seeing great results, great response from our consumers on our CSI scores. And private label continues to be strong tailwinds for us. So we continue to see the business mixing more favorably as we look forward, focusing on these important areas of the business.

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

And, I guess, at this point, how long do you expect the produce deflation to last? And how is that compared to typical cycles? Is it typically a couple of months then it's gone? I know it's always different and it depends on Mother Nature, but based on your history, I guess.

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

Yes, I mean in the last couple of years, '16 and '17 were a little bit unusual, but if you look beyond that, '15 was fairly flat from an inflationary state and '13 and '14 were inflationary. So as we look forward to the remainder of the year, we're actually coming out of that deflationary state we've been in the back half, just a little bit of shift in growing seasons. In back half, I would project it to be fairly flat on a year-over-year basis.

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

Okay, and is the -- has the quality improved and your ability to promote and drive traffic, is that improved as the supply has...

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

Well, quality wasn't really the issue, it was kind of the supply. The quality has been fine. You're always subject to some quality issues when you're thinking about the first of season and last of season, but right now, the quality is good, supply is good, no issues on the quality and in the commodity group

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

Okay. And any major differences regionally as you look at comps the last couple of quarter or the competitive environment?

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

Yes, we've seen pretty consistent results right across the country in all of our markets, existing markets, new markets. You always see a little bit of variability depending on what's happening from a competitive standpoint. But, by and large, over the last few years, pretty consistent. We're seeing continued strong (inaudible) productivity, particularly in the new markets that we're entering into. The brand awareness is improving as people understand what we're all about.

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

And I think some of your new stores now are starting to creep up closer to the East Coast, Marilyn. What else can we expect in terms of this expansion of the East Coast?

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

Yes. We've announced that we're very interested in expanding into the Mid-Atlantic states. We've already started to open stores there. They're performing extremely well. I think that area is very attractive to us in terms of our uniqueness, our go-to-market strategy. But the whole health value, selection, service, strength, that are the pillars of Sprouts. We're seeing it resonating very well with our consumer base, which is a very broad demographic across the U.S. So the Mid-Atlantic will be a growth market for us. As you know, we've grown into Florida, and that's a strong market for us as well.



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

And maybe just talk about the vitamins and supplements category, which I feel like we maybe sometimes don't talk about enough, but it is really important part of your strategy. So are -- what are you seeing there? You're seeing that progression toward that category as the stores mature just like you would expect?

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

Yes, we've continued to see strength in the nonperishables, we've called that on several calls, but specific to the vitamin supplement, there's -- we continue to create a stronger point of difference between us and other retailers. When you really look at not only the trend base assortment we have, but the promotions, everyday value, in-store and I really attribute that to -- this segment is somewhat difficult. You can look at data, but the data is created by innovative people that understand the industry. And so you look at over 100 years of true vitamin supplement experience in our building. So I give those guys all the credit. That, coupled with our intentionality around training in-store, we continue to make that a point of difference, not only on the service side, but on the product side. So that we had engagements there, and we still have that gravity to brick and mortar, which we continue to see great sales from Q1, benefit a little bit from the wellness push there with the flu season we have, but continues to run strong and has been for since we've merged the companies together.

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

And what about fresh and prepared or partially prepared kind of -- and the meal kits? Where is that opportunity for Sprouts?

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

Yes. So, as we look at, I think people are looking for things that are closer to ready to cook or ready to eat. And so our focus has been and continues to be around the ready to cook. We've recently launched some new programs with great success. So the ready-to-cook items is ready -- as well as the heat and eat getting home have seen great growth in the heat and eat category as well as ready to eat now with 130 stores that we've added the full service delis to plus the 20 that we had before. We're getting good gravity inside of the stores. We've seen good growth in baskets, not only in the number of items in a basket, but new baskets within those categories.

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

And maybe just talk about the fresh item management tool that's rolling out. How does it impact your business longer term? And how important is that also if you develop your online ordering platform even more and more?

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

Yes, so fresh item management, it's a very important tool that's going to help us scale and add efficiencies across all the fresh departments in the store. We are rolling out that technology, which is a third-party platform that's hosted. It's proven technology, best-in-class. And we're rolling that out now to one of the departments. We'll continue to be very pragmatic and roll that slowly over the remaining fresh departments between now and the first quarter -- through the end of the first quarter of next year. That's obviously going to give us scale and efficiency. Clearly, some of the benefits that we'll see starting in 2019, we'll have better in-stock position. So your sales will be improved, you will always be in stock. Shrink is also an important benefit that we would expect to derive from the system. And so, that's the plan. It's going very well, and we look for that to be completed in the first quarter of next year. So, as we pointed out previously, obviously, there's cost associated with that. This is a big investment year because that's going to pay dividends for many, many years. So as we pointed out on our most recent call, we have, in the second quarter, the biggest amount of investment for the fresh item management program. As well we talked about previously part of the tax reform benefits that we'll be reinvesting into wages and benefits in the organization that starts in the second quarter. So as we think about DSE expense for the current



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year, we still fully expect to be delever for the full year, 20 bps to 40 bps, the heaviest period of investment scheme 2, which will probably delever 70 bps, but we're still on track and on plan for the year.

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

The only thing I would add to the fresh management system that we rolling out, that's pretty standard when you think of the mature grocery sector. So it's a game changer for us and with all the new employees and the growth, it kind of simplifies the business. And so we could put that towards service and fresher product on the shelf. And because we do a lot of third-party distribution, kind of work bottoms up today in terms of supply forecast and (inaudible) demand. So that level of consistency and ordering will provide better in-stock position not only in-store, but driven from our distributors being better in stock as well.

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

I always thought Sprouts had a relatively good strength versus industry standard, but maybe I'm not accurate on that. So is -- what's the opportunity on shrink? Is it to get even better than industry average or get in line?

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

Yes. So, we've had improvements over the years, but fundamentally, when you move onto an automated platform that's using a demand forecasting algorithm, and you integrate that with your production planning system so you know, which SKUs to produce, when during the day based on when you sell it, you integrate that also with your labor management system, so the whole thing is tied together and adds a lot more efficiency versus today, which is much more manual in nature, and so by definition, you can't be in stock as well as you would be once we're on the system. And we're already seeing -- we have started rolling it out in one department and we're seeing some benefits there. So it's proven that this solution will work, and we just need to get through the rollout period.

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

And part of that -- again, that's the growth, right? As you onboard new people into a new environment at a new retailer, they have adjust to the business. And if you don't have systems, it takes a little more time. So as we've had more new people, we have had significant amount of growth in the last few years, and systems like this are critical to help manage that.

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

And it sounds like the savings from this really come in 2019. So should investors be expecting saving from that to kind of be flowing through or how do you think about reinvesting that? Wages again or other areas?

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

Yes. So the good news is we have the tailwinds. Most of our competitors have long ago implemented similar systems. So I think that just provides us with a lot more flexibility in terms of whatever's happening in the marketplace, but there's obviously going to be some tailwinds for us.

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

So maybe we'll shift gears and talk about delivery and lot of things happening there. Amin walked through some points on this topic that are pretty compelling for Sprouts because it sounds like you can really expand your market given your density in a lot of markets. So, I guess, are you finding that to be the case still today? Is anything changed there? And how can this be EBITDA margin neutral for Sprouts and the industry?



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

Sure, we now have over 2 years' experience with home delivery. So as a company, we've learned a tremendous amount of information around how you need to manage this day in, day out in store. Because we do not have a densely populated network and our stores are more spaced apart relative to others that have a very dense mark or footprint, we clearly see from the data on where we're shipping to that there's a lot of incrementality for these sales. We see the ZIP codes that we're delivering to and obviously when you're outside the trade area because typically roughly 7% of your sales are coming from within a 7-minute drive time, and we see where the orders are coming from. It's incremental so that's point number one. Point number two is the product mix that we sell for home delivery is more accretive just relative to the mix is beneficial for the company. And then, clearly, all the order fulfillment's being done out of the store. We're leveraging all the existing fixed costs. So we see particularly with our new arrangement with Instacart, which is going quite well, that it's not a drag on EBITDA. It's EBITDA neutral from a margin point of view and we're picking up incremental business that we expect to continue to grow.

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

And do you think Sprouts needs any more direct platform for their customers to order and ship some of the nonperishable side or is Instacart and that model sufficient in terms of providing that solution for your customers?

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

That's a great question. Fortunately, we chose a platform to launch our new mobile app on which is now integrated with Instacart, and that will provide many additional benefits as we look out into the future in terms of capabilities. We certainly, with this new platform, have the capability of expanding e-commerce, if you will, to extend the shelf. Certainly, a platform to enhance growth of private label and the like.

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

So could there be opportunities on the vitamins and supplements?

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

Absolutely. We'll be focused on it. As Brad mentioned, we've got a great breadth of product in store and people actually, they come to us because they need that consultative service. The opportunity we see as great growth categories in e-com, you can -- you see in pet, you see in baby just because we're a little bit restricted in terms of our size, trying to keep that convenience for our customer. So the ability to expand those as well as put our private label out there that continues to grow and have better brand strength and is in almost 50% of our baskets now. It's just a great opportunity for us to carry items that are incremental to what we saw today.

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

Okay, interesting. And with this online grocery and the comments you just made, does it make you think about your unit growth and where you're putting stores, particularly in existing markets? Does it make you think about that any differently?

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

Yes, that's a good question. We're very, very sensitive and diligent around site selection and lessons learned from a number of years ago around going into new markets potentially spacing stores too close together until you've built the brand awareness. So now we're absolutely taking it into account that while home delivery is pretty small today, it will continue to grow. And so that's absolutely in our thoughts as we look at site selection and spacing between stores. For sure, from a capital investment and returns modeling perspective, we don't build in any expected upside from



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home delivery. So that's all just incremental to the returns when we model our new stores. So again, when we look at new markets in particular, we look to space further apart and then infill as the brand awareness develops and grows stronger, but always recognizing that you now have an expanded trade area, if you will, with the home delivery.

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

And I guess, with the change from the Amazon platform to Instacart, maybe it's still too early days, but do you think you're going to reach different set of customers? Are those customers that were on Amazon? Do you have any sense of how many are also on the Instacart platform that clearly, resonated with your brand?

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

Yes, I think it's early days, too early to tell at this point because we just now launched Instacart across most of our major markets that were previously serviced out of the Prime Now platform. But what we are seeing is really nice pickup in terms of average weekly sales, the markets that we've opened up in. It's clear that customers are coming to Sprouts on the Instacart platform because of the quality and strength of the brand because we're known for fresh. And it was no different with Prime. We know that we're one of the best on the platform just because of the freshness that Sprouts -- and value that we represent. And even though it's early days, if we look back to the first handful of stores that came onto the platform in the first quarter, those stores are -- those sales from those stores are increasing quite significantly. So it will take us through to probably the fourth quarter this year on transition. Obviously, if we shut off 1 market entirely out of the 15 stores that we're servicing all the geographies and then ramp up Instacart, we expect based on what we're seeing in the early days that it will continue to grow at a strong pace. And we're quite excited about it, particularly because we've gone about it based on our 2 years experience, recognizing that what's critical to home deliveries is don't mess up an order. You have to absolutely have perfection. You have to be in stock, and you absolutely need to have the product that is available, that the customer's ordering and it better be fresh. And so our customer service scores are extremely high, even though it's early on Instacart because of our experience that we had over the last couple of years. So that was really important for us to not disappoint the customer and just get that repeat business.

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

I think the only thing I would add to the Amazon versus Instacart, as Brad mentioned, 2 years ago when we started Amazon, so again early days here in Instacart, but one thing we can see is the basket is 20% higher than Instacart. And it mixes out more accretive than the Amazon basket as well in terms of department mix sales.

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

And, I guess, what is your philosophy -- there's a lot of different models that you can go down on the Instacart platform. So what is your philosophy on where your pricing needs to be on that platform? Does it really depend by market? And who else is there or you committed to offering those same in-store prices or is that different than maybe what was on Amazon?

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

I would just anchor back to it because we know we got a lot of competition out here. But I would tie it back to -- look, Sprouts has always founded on health and value, and we will always anchor back to health and value. Is not what we started to do, it's something secondary. It's something it's a foundation of our business, and we will continue to deliver to our customers the healthy, fresh value offer.



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

Okay. And, I guess, any thoughts on order online and pick up in store? I think I mean, maybe alluded to maybe reevaluating that down the road. What do you think about that? Because a lot of the traditional supermarkets and Walmart seems to be going very heavy with that. So I guess 2-part question. Does that make that customer that you're attracting from the traditional supermarkets and taking share from them more difficult to take because they're getting hooked on that convenience of order online and pick up and then what opportunity for you?

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

Sure. We'll continue to follow trends. I'm sure it's something that we'll test in the not-too-distant future, but for us when our box, by definition, is convenient. Because you're 30,000 square foot, in and out, easy, great service. We are very, very convenient. And so for us, we saw that there was a greater opportunity to launch first with home delivery. It's -- I believe it's proved to be the right decision because clearly, we've got the incrementality of the deliveries and orders coming from outside our customary trade area versus with the pick up in store. I think there's more cannibalization because it's the customer that is going to drive to your store anyway and maybe it's more convenient for them just to stop at the front and pick it up and if you're 60,000, 80,000 square-foot box you are not as convenient by definition. So -- but at the end of the day, we have the platform to be able to launch that and it's all about priority. So this year there is a strong focus on systems and technologies that will enable us to grow and scale and add efficiencies. And it's very important priority for us this year transitioning into the Instacart platform and really growing that business, which we haven't even begun to put a marketing and advertising push on yet. So that's all the upside. We wanted to first get the operational piece buttoned up in all the locations that we're in now. So yes, we'll definitely be where the customer wants us to be.

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

And I think you are a high-growth young company. You have to prioritize and we've learned a lot over the last few years about how many priorities or too many priorities. And that's where we made the decision with Instacart. "Hey, let's make sure that we can stand it up, let's make sure we have the right service." We don't want to alienate the customers. We've got 1 opportunity here to execute well. And so they -- as we list the priorities in terms of technology and training, some of the other things are important. While it's there and we're fully aware of it, we're building out our new prototypes with a box to service click and collect. It's just about, again, priorities and home deliveries, as Brad mentioned, is right now we want to get that out, get it in the full marketplace, but wouldn't be surprised to see something around quick and collect and some test stores in 2019.

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

Is that -- I think you mentioned on the last call that the new stores that you're putting out are a little bit bigger than your average, maybe 30 versus 28. Is that -- was that maybe extra space could go to down the road?

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

It's a small part of the space, but look, we were at averaged around 28,000 square feet. The prototype for multiple years, I think 1 to 2 years, has been 30,000 square feet. And it's a mix of -- there's a lot of heritage stores that are even smaller than that. So in order to grow the deli business, create an eating area where you can actually sit and enjoy something that's ready to eat, do the proper things from a food safety processing perspective in the back of the house. Yes, we added 20,000 square feet of our stores. Not only is it going to help us execute create a better shopping experience. It will also give us ability to grow higher top line in terms of sales within a store. So in those stores that we're 23, 24, 25,000, at certain volumes it becomes an uncomfortable shopping experience. You can only put so many check stands in. So we'll have the ability to drive higher top line sales in those stores as well by providing a better experience.



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

And, I guess, going back to the click and collect question with so many traditional supermarkets adding that capability, are you finding -- that's increasing those customers' loyalty to traditional supermarkets and making it difficult or do you see that down the road as being more difficult too. Or do you think they'd prefer the delivery...

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

I kind of like our customer count right now. I mean, obviously, we've got to prioritize everything, and we want to execute well. So we'll move swiftly as we always have. We'll test on there as we always have. That's what I like about this organization is very disciplined about -- have an idea of getting our ROI model. We use quantitative and qualitative data to decide whether we're going to move forward with something.

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

Yes, I think one of the big advantages in moving on to our own platform together with Instacart is the power of the data. So now we will have the data when a customer orders through delivery.sprouts.com. We own all that data. We can then integrate that with all of our direct-to-consumer marketing and promotions, which is now we have the foundation with the new app that we just launched. So we see a lot of synergy and be able to mine that data and sort of be under the radar screen and create value-added offers for you based on your purchase history and your interest from a dietary point of view. So I think that's going to give us some pretty strong tailwinds and we're really in the first inning of that

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

Not only helping the consumer with the value added, as Brad mentioned, it's much easier for us about the vendor and the trade and really show them what the -- billing a win-win, which is always kind of a -- the foundation of Sprouts in terms of our partnerships with our vendors.

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

That's a really good point. If there's any questions, feel free to submit to me or here's a question.

Unidentified Analyst

Just a question on the promotional environment. With the growth of discounters and online, how has that impacted your outlook and also how are you thinking about resource allocation? The reason I ask that some of the manufacturers have talked about sort of mid-single-digit price increases, yet when looking at what we're hearing from the retailers, it sounds like it's still very promotional.

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

Did you hear the question?

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

It was around the promotional environment.

Unidentified Analyst

Yes, your outlook for the promotion and pricing.



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

Oh, promotional environment. Look there's always going to be competitive in the retail grocery environment. So it's relatively unchanged from 2017. The nuance in '16 was that you compounded competition with historic lows in deflation. So outlook in terms of competition is kind of standard in terms of where we are today. I don't anticipate it getting significantly different, getting better and/or worse. But some of the new technologies that we put in and we're putting it right now are going to be really exciting because some of the subscribers are used to having in terms of optimizing promotion so it puts us in a better position to see how do we attack these better and [ensure pricing] really looking at elasticity, not only by category, but by geography promotional effectiveness by geography. So if it does get more competitive in the future, some of those systems are setting us up well to compete very well.

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

I guess, asking everybody about rate. I know you've had a lot of questions on it, but I think...

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

I could answer the (inaudible) question regarding CISCO.

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

What's that?

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

It's -- from -- so the ELD, obviously, we found that the people weren't following the ELD. It's really hitting the spot market specifically not for the contracts. So if you look at our business, we self distribute the produce side of the business and the majority of our business is contract, and we've recently gone out and renegotiated our contracts in advance of that. So the savings have been unable to offset any kind of spot market cost increases. And if you well plan the spot market although it's a bit more difficult today, it isn't horribly challenging. Where it's going to hit, hit first is distributors because they do a lot of pickup. It's on inbound freight, on outbound freight and so what you will see over time is manufacturers work with their distributors. You may see cost increases. I would anticipate seeing cost increases, as I said in the Q1 call. They'll flow through at different paces. It's kind of a slower process from when a manufacturer makes a change. In a downside, there's a certain amount of time they have to give you. And our teams will do a great job, I'm sure, of working with the manufacturers on if there are any cost increases. But our grocery department is not a -- we don't believe we don't set the floor on a lot of items. We're a fast follower and we will anticipate the ability to pass those through in light of it should be in the area of 1-ish, 2%, and that's segment always had a 0 to 2%, which is what (inaudible) cost side as well. So it'll be out there for a few years.

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

So could that be a good thing for the industry that maybe a little vendor...

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

We (inaudible) some inflation. So, yes, it could be. We would anticipate everybody passing it through, and we'll watch and quite frankly, with the systems we have now because there's a better ability to go back and look at those price changes we have and really analyze movement in a very strategic way to see that did you (inaudible) anything. You had a pretty elasticity metric, you go get pre post movement. Some items may be able to flow through and some may not. So I would hope so.



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

And, I guess, just another question on that. Is produce or the freight costs built into the produce cost or how is that different?

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

You can pay (inaudible).

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

Okay, okay, okay. But even despite, I mean, the produce side of the business, is it experiencing higher freight costs and it's still deflationary or is it...

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

We've got of the consistency in terms of the way we run freight so there is more contract areas so a few less than the spot market, and we do some FOBs through our contract carriers. So it had less volatility. What we did see in that first, let's say, 4 weeks of January, when the law went into effect, there was a little bit of a tightness in trucks and some challenges coming out of Mexico. But we are not having any issues right now in terms of on-time cost. It seems to be in line, and we continue to work more on building up more FOB through our own contract carriers as we, again, priority -- prioritize and work through those. So a lot of our flow business that we do is on an FOB. So pretty well inflated.

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

Okay. I guess, we have 2 minutes left. If there's any questions, just let me know. I guess, here's one question. Let me see here. How sensitive are your prices at competitors -- are you to prices at your competitors? And how do you monitor prices in the big data age?

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

Well, it depends on what category. So everything is different and we define -- I am trying to be very careful here. We put everything in 3 segments. One player shelf in terms of major departments and then each category is also segmented that way in terms of the relevance and then it's also segmented by consumer segment. So it's just all dependent upon what is the department, what is the category in terms of the level of sensitivity and pricing. But the most sensitive pricing is obviously on the fresh side, more specific around produce because it's an apples and apples and apples. That's where we've done a really good job of not expanding other areas of the produce department as well as just being one of the freshest produce retailers in the country.

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

Maybe just we'll just wrap it up with a question on wages. So last couple of years has been investments in wages. How do you feel about that over the next couple of years? There are some retailers kind of making some big commitments in terms of entry-level wages. So is this something that we should expect to continue over the next couple of years?

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

I think some of the commitments that you've heard out there are pretty long-term. The way we've looked at it and like if you look back over the last 2, 3 years, we've really stepped up in terms of our wages in training from a competitive standpoint and we've seen great outcomes as a result of that through reduced turnover, better customer service scores, better engagement. So that's actually been a net positive for us. Obviously we



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took 1/3 of our tax reform benefits this year, and we invested that and we're starting in this quarter in benefits and wages. That is really fundamentally allowing us to get ahead of increases that were going to come in 2019 in any event from a minimum wage standpoint. So I think there will be pressures on an ongoing basis, there has been over the last 10 years, but through some of these tools and automations and technology, we're able to partially offset that through improved productivity. And I think in terms of wages going forward, it'll be a function of the economy and how strong the economy is where unemployment goes over the next few years.

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

Great. I think we'll wrap it up there. But thank you, Jim, Brad.

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

Appreciate it. Thank you.

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

(inaudible)

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