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SFM - Q2 2019 Sprouts Farmers Market Inc Earnings Call

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OVERVIEW:

Co. reported 2Q19 net sales of $1.4b, net income of $35m and diluted EPS of $0.30. Expects 2019 net sales growth to be 7-8% and EPS to be $1.05-1.09.

CORPORATE PARTICIPANTS

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Sprouts Farmers Market Second Quarter 2019 Earnings Conference Call. (Operator Instructions) As a reminder, this conference call is being recorded.

I would now like to introduce your host for today's conference, Ms. Susannah Livingston. Ma'am, you may begin.

Susannah Livingston - *Sprouts Farmers Market, Inc. - VP of IR & Treasury*

Thank you, and good morning, everyone. We are pleased you have taken the time to join Sprouts on our second quarter 2019 earnings call. Jack Sinclair, Chief Executive Officer; and Chip Molloy, Board Member and Interim Chief Financial Officer are also on the call with me today.

The earnings release announcing our second quarter 2019 results, our 10-Q and the webcast of this call can be accessed through the Investor Relations section of our website at investors.sprouts.com. During this call, management may make certain forward-looking statements, including statements regarding our 2019 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 SEC filings along with a 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 a reconciliation of non-GAAP measures to the GAAP figures, please see the tables in our earnings release.

With that, let me hand it over to Chip to say a few words.

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - Interim CFO & Director*

Thank you, Susannah. Good morning, everyone, and thanks for joining our call today.

To kick it off, I want to express how excited we are to have Jack here at Sprouts as our new CEO. We went through an extensive search process to find a proven leader with significant industry experience. We were very pleased with the quality of applicants and their passionate beliefs and the potential for the Sprouts brand.

Jack's 35-plus years of grocery experience, his intimate knowledge of merchandising, store operations and supply chain, combined with innovative thinking and humility set him apart. Jack is passionate about sustainable, healthy foods which align spot on with Sprouts' culture and purposes. I look forward to working with Jack in my interim CFO role and as a member of our Board of Directors.

In addition, as of today, Jim Nielsen will be transitioning to a senior advisory role until March of 2020. We are very pleased that over the next several months, Jack will have the opportunity to leverage Jim's experience and knowledge of a natural and organic industry.

With that, let me turn it over to Jack to say a few words. Afterwards, I will return in my interim CFO capacity to discuss our second quarter results and updated guidance for the year.

Jack L. Sinclair - *Sprouts Farmers Market, Inc. - CEO & Director*

Thank you, Chip, and good morning, everyone. I'm pleased to have the opportunity to speak with you all today on my first earnings call with Sprouts. Over the past few weeks, I've been spending time in the stores and lots of dialogue with team members across the company.

In my years working in the United States, I've admired Sprouts from afar, so I'm excited to be in the middle of the business now. Sprouts is a unique format and a unique brand. We have an opportunity to grow because we can expand access to fresh, healthy and affordable food. Consumers across the country are becoming increasingly concerned about feeding healthy food to their families. Sprouts is best place to serve this with those concerns and provide the healthy alternative. That is why I'm so excited to be here and lead the growth of this brand.

I believe in creating a culture of transparency within the company and with all our stakeholders. I believe in creating a culture of clear accountability and meeting our commitments to each other. I believe in our customer-centric culture and always listening to our stores and our customers to help us improve and understand how to improve our business.

Today, I do not have all the answers as to how we're going to improve, develop and grow this business, but we will build a world-class executive team with depth, diversity and the capability to capitalize on the significant growth opportunity in front of Sprouts. As for grocery retail, we all read the same headlines, the competition is fierce, and there are many retail outlets where customers can find food, even healthy foods. The future will be defined by those that follow the customers, those that stay in front of or create the product trends, those that bring a differentiated and unique experience, both in-store and digitally. And those will grow profitably. They will be the winners. I'm confident that Sprouts can be at the forefront.

We have a tremendous opportunity to expand a well-loved brand with a unique, healthy product assortment across the United States. We have a great foundation, but we have significant work to do. Leaning on my background in companies of scale, I know we have opportunities to evolve this business model to be even more efficient and effective.

I look forward to working with the team to build upon strategies that capitalize on our strengths and determine new paths to win over customers. I plan to share more detail with you all in the coming months and look forward to meeting many of you out on the road or in our offices in the near future.

I will now hand it back to Chip to discuss our second quarter results and guidance.

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - Interim CFO & Director*

Thanks, Jack. Now turning to the second quarter results, net sales were $1.4 billion, up 7% compared to the same period last year. Comparable store sales increased 0.1%, and comp transactions were down slightly. April was our most challenging month this year, driven by limited produce availability, reducing our ability to promote and drive traffic. Trends were better in May and June but still below our expectations.

Our online sales, while still relatively small in total, increased 170% expanding our reach to new customers while also providing a convenient alternative to current customers. The online basket has a higher penetration of private label items and less promotional items producing a higher gross margin.

In addition, our click and collect test has expanded in the Phoenix market as we further engage with customers regardless of how they shop. Product innovation continues to drive double-digit sales growth in private label items, which reached 14% of total company revenue in the second quarter. More than 45% of our baskets contain a private label item, a testament to the consumer adoption of our brand.

For the second quarter, gross profit increased by 6% to $465 million, and our gross margin rate decreased by 35 basis points to 32.8% compared with the same period last year.

This was primarily due to the increased product costs not fully reflected in retail pricing and slightly higher distribution and transportation costs.

SG&A increased 9% to $383 million or 27.1% of sales compared to 26.5% in the same period last year. Excluding the 35basis points impact from the adoption of the new lease accounting standard, SG&A deleveraged 20 basis points. This primarily reflects investments in new stores, increased interchange fees and increased costs associated with the expansion of our home delivery program.

For the second quarter, our depreciation and amortization cost increased 12% to $30 million or 2.1% of sales, an increase of 10 basis points compared to the same period last year. EBITDA decreased 8% in the second quarter to $81 million, and EBITDA margin decreased 100 basis points, including the noncash impact from the lease accounting standard. For comparability, if the second quarter 2018 results reflected the same lease accounting impact, EBITDA margin would have decreased by 65 basis points.

Net income for the second quarter was $35 million, and diluted earnings per share was $0.30 compared to $0.32 in the same period last year. As a reminder, the lease accounting standard change will result in a net incremental expense of $0.04 per share for fiscal 2019 or, a penny a quarter.

Shifting to the balance sheet and liquidity - We continued to utilize our strong operating cash flow from operations, $249 million year-to-date to support our unit growth and sales initiatives. So far, we've invested $84 million in capital expenditures, net of landlord reimbursement, primarily for new stores.

During the second quarter, we opened 6 new stores with the addition of two new states - Louisiana and New Jersey. As we planned, one lease expired and was not renewed; and one store was relocated, resulting in 326 stores in 21 states by quarter end.

Our recent store vintages continue to open strong in both new and existing markets, which we believe reflects the opportunity to extend our reach. We ended the quarter with $59 million in cash and cash equivalents, $515 million borrowed on our $700 million revolving credit facility, $55 million available under our current share repurchase authorization and a net debt-to-EBITDA ratio of 1.4x. During the quarter, we repurchased 2.4 million shares for a total investment of $51 million and total year-to-date investment of $163 million.

Now let me turn to 2019 guidance. We are adjusting our guidance today, reflecting the year-to-date performance and our expectation for the remainder of the year. For the full year, we now expect net sales to grow 7% to 8% with essentially flat comps. Gross margins should be down approximately 20 to 30 basis points and SG&A should grow approximately 10.5% year-over-year.

Earnings per share should be between $1.05 to $1.09 with a tax rate of approximately 24 percent. We continue to expect our Capex spend to be between $170 million to $175 million, net of landlord reimbursement, and are on track to open 28 new stores.

In closing, speaking for our Board of Directors, we still believe there is a tremendous opportunity going forward for Sprouts. The passion our customers and team members have for our brand combined with the white-space opportunity to extend our reach both from a marketing and new store perspective is not just encouraging but exciting. That said, there is work to be done, and we are not satisfied with recent results. We believe the hiring of Jack is a major step towards reversing recent trends and creating a path that captures the opportunity in front of us.

With that, we would like to open up the call for questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Kelly Bania from BMO Capital Markets.

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

I guess just curious here what your assessment -- I realize it's early, but what your assessment of the issue is here. Do you attribute some of this comp weakness to just a lot of the management change that's happened in the past several months? Is the market actually becoming more and more aggressive in produce, and that is not having the same traffic-driving capabilities that you used to? Are you losing customers? Just, what is your initial assessment and what are the options at this point?

Jack L. Sinclair - *Sprouts Farmers Market, Inc. - CEO & Director*

Thanks, Kelly, for that question. And it's a good question. The fundamentals, as I look at a business, I preface. I wouldn't see it today with it. Since the early days, is that this business has done incredibly strong foundation in terms of what is working at. The foundation of deeper expertise and knowledge in this segment, the natural and organic sector is right through the business, and it's really encouraging when you meet people and understand that they're in a different league in terms of the knowledge of this sector.

And I think the customer interest in healthy eating is as strong as it's ever been. And I think we're well placed in that in terms of having that foundation. I think it's difficult for me to comment on whether the disruption over the last few months had made a difference to that comp number.

The one thing I will -- we are clear about is that promotional mix that we have in our business, this combination of EDLP and high-low and how we're managing that balance has probably got out of sync, and there's an opportunity for us, I think, not only to grow the comps but stabilize the margins at the same time, and that foundation I think is right in the middle of how we're exercising price. I don't see a more aggressive price environment out there as it has been over the last few months. But I do see that the opportunity in front of us is our opportunity to stabilize margins, build on a foundation of the business and grow comp sales from that.

I'm very encouraged by the new stores as well. It's really -- we opened a couple yesterday. It's very encouraging to see the passion of the customers and the passion of the people in the stores behind the mission of what the brand's about. So I think there's a real strong foundation, and I think if we get ourselves over the next few months managing this better, we'll be in a stronger position going forward.

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

And just -- there's a comment in the release about just the brand expanding its footprint. Can you give any indication of your commitment to this kind of pace of opening stores or is there any likelihood that you may want to slow this as you kind of get things back in sync here.

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - Interim CFO & Director*

Kelly, it's Chip. We're looking hard at that piece, and it is clear to us, you think about retailers and their lifespan, especially those that have been really successful. You look at a lot of the different brands, and there's a period in their life where they're really growing their square footage. They're expanding their reach, and they're going after the customer. And then there's a period in their life where that starts to slow down, and they're really focused on productivity, and they really try to drive and expand their operating margin and drive earnings through that.

You can look -- the predecessor would be like Five Below is today. It's growing like crazy and doing a really good job. In productivity, Home Depot is on the other end of that. Home Depot has done a great job on the other end. Our early look is that we've tried to do both. And to do both really well is very, very difficult. And so we're sitting here as a company with what we believe is a differentiated model with differentiated product, differentiated experience in the stores with a lot of white space in front of us.

So yes, we are going to reevaluate in how we go to market and how we extend our reach, and we're going to look at how big the box is, how much the box costs and how fast we can grow this. I don't foresee us slowing down growth, if anything, it's going to go the other direction.

Jack L. Sinclair - *Sprouts Farmers Market, Inc. - CEO & Director*

And just to reinforce that Chip, I think there probably is an opportunity for us to approach this store growth slightly differently in terms of how we've operated.

And looking at the format, I think there's opportunity to do them slightly smaller and probably an opportunity to do them in a slightly more concentrated geographic approach going forward.

Operator

Our next question comes from Rupesh Parikh from Oppenheimer.

Rupesh Dhinoj Parikh - *Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst*

So following up on Kelly's question just on store growth. As you look at your current store basis, I mean, your newer openings in newer markets like New Jersey, Louisiana, Philadelphia, et cetera. What are you seeing right now for those stores? Are they collectively meeting your expectations? Just want to get a sense of how your store base is performing.

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - Interim CFO & Director*

Yes, Rupesh. The stores for me are expectations in many ways. We're exceeding our expectations. First year on average, we're -- on average -- not every single one, but on average, all of our stores are beating the performance on average of what we expect. We got some real winners of late. Some of the stores in the Mid-Atlantic are winning in a very positive way, very early on.

That said, we're now opening stores that we thought about 18, 24 months ago. So the lead times -- how do we go after that and go after that in an aggressive way and do it in a productive way is something that we're going to look at.

Jack L. Sinclair - *Sprouts Farmers Market, Inc. - CEO & Director*

And Rupesh, the customer reaction has been very strong in -- I don't think in most of -- all our new stores have delivered on that. I think the issue that we have created, we've created some stresses and strains in our supply chain in terms of how is that working going forward, and that's something that a growing business often gets itself into, so I think there's some real opportunity for us to mature how we're serving the stores. So we're doing it more efficiently than we are at the moment while retaining the customers' excitement around the format.

Rupesh Dhinoj Parikh - *Oppenheimer & Co. Inc., Research Division - MD & Senior Analyst*

Okay. Great. Then I guess also with growth, so I think prior -- or maybe at least earlier this year, the thought was that you'd get back to double-digit EPS growth next year. Obviously, there's been a lot of changes out there that have taken place. Is there any initial insight in terms of how you're thinking about the earnings algorithm going forward?

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - Interim CFO & Director*

We have work to do there, Rupesh. I know that this is a company that had quote an algorithm there a couple of years ago. That was really trying to march towards that, and quite honestly, we haven't been achieving that over the last 2 years. So it sort of a don't want to jump into the definition of insanity and put it out there and not achieve it. So we're really going to work hard over the next couple of months, really strategizing how we think about this business over the next 3 to 5 years, how fast we want to grow, what type of investments that takes and, therefore, what we can drop at the bottom line.

But I am very confident that this is a company that can grow and can grow and keep it's gross margins stable, and there -- how much investment we have to do we'll have to figure that out as it relates to our overall operating margin and, therefore, what our earnings growth will be. But more to come, I think we'll be in a really good position before the end of the year to really speak to that.

Operator

Our next question comes from Scott Mushkin from Wolfe Research.

Scott Andrew Mushkin - *Wolfe Research, LLC - MD and Senior Retail & Staples Analyst*

So I guess this is more just kind of on -- just understanding the operations right now. I think you said Jim's going to be the adviser to the company, and Jack's trying to kind of get to know the company. So I guess my question is like who is making the decisions on a day-to-day business, given the changes in the organization?

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - Interim CFO & Director*

Yes, Scott. This is Chip. That's a great question. I'll start with Jim. Jim has given his heart and soul to this company over the years. I mean that literally. He's really given it, been all in, and we, and I'm speaking for the board, have been incredibly grateful for everything that he's given to this company to help grow it to where it is today.

But Jim's at a time in his life where Jim really needs to focus on Jim, and so he's really working hard to do that. But I've had conversations with him. I met with him, and he's excited to help Jack transition in his new role. We're very fortunate to have Jim still be engaged at some level for the next several months. So that's really good for us.

But the decisions now are made collectively. We are really trying to coordinate it between Jack, myself and our executive leadership team. We are meeting together weekly as an executive leadership team. We're putting it all on the table, and we are collectively making decisions. I'm a chain-of-command guy. Jack's got 51% of the vote at the end of the day. So that's the way it's going to work. But right now, we are storming norming. So we're getting through that, but I think we're -- it's been very productive. I'm very encouraged by our weekly executive leadership team meetings and the conversations we're having there and the decisions that are getting made during the week after those meetings happen.

Jack L. Sinclair - *Sprouts Farmers Market, Inc. - CEO & Director*

So my challenge in this -- sorry, Scott. Yes. My challenge in the middle of that question, which is a good one, is how to harness the sheer energy and morale of the company, which is very strong, and how to harness that appropriately.

As Jeff said, we're putting in a much more disciplined meeting structure than we had before, which is going allow us -- and maybe that is a consequence of all of the changes over the last few months, but I think that discipline structure and the clarity of that structure is much clearer today than it was a few weeks ago, and that's something, I think, will allow us to have the kind of the levers and the control on a short-term basis that allows us to manage the business effectively.

Scott Andrew Mushkin - *Wolfe Research, LLC - MD and Senior Retail & Staples Analyst*

Yes. Appreciate that. My follow-up question goes to, really how and why the competitive climate will get better. And with that, how do you really change the comp sales trajectory? Maybe, it's a little early Jack for you to kind of think about that, but it does pop into our head this -- the competitive climate just seems stuck in a very, very difficult position and so just wondering how and why it will change and how you can change the comp sales trajectory?

Jack L. Sinclair - *Sprouts Farmers Market, Inc. - CEO & Director*

Sure. As you can imagine, Scott, it pops into my head a lot as well in terms of how we think about our competitive dynamics. And the one thing I'm pretty clear about is, that we've got a very unique proposition and the destiny of the businesses is in our own hands. And our business model, our format, the way we go to market and the catching in which we've got great expertise on, those are the areas that we can be -- have a strong mode on. We can have a strong mode now that whatever -- honest, whatever anyone does, we've got a strength there in terms of areas particularly produced, which I think retains the reputation that it's always had within Sprouts, particularly in the vitamin area, particularly in the bulk area. Those are areas that other people aren't coming after that to any great extent when I look at the competitive dynamics.

So the control of that is in our own hands, and what I like about -- what I really liked about the opportunity of coming here is, this brand, it needs to tell some more stories about what it does for the control that we have will allow us, I think, to chart our own course in this space, and the other guys, they have to change to be us, and they're not likely to do that when I look at what other people are doing. So we're watching closely. It's early days, but I'm feeling pretty confident that we've got both the people and the positioning that will allow us to chart our own course going forward.

Operator

Our next question comes from Chuck Cerankosky from Northcoast Research.

Charles Edward Cerankosky - *Northcoast Research Partners, LLC - MD of Research, Equity Research Analyst & Principal*

Similar to what Scott was getting at, when you're looking at the food retailing environment right now, can you tell us why you think it's so difficult to pass through higher food costs while consumers are saying expanded discretionary income?

Jack L. Sinclair - *Sprouts Farmers Market, Inc. - CEO & Director*

Yes. I think, again, it's a good question. I think within our world, what we've done, and I can't really comment too much on why everyone else can't give, but within our world, we've had a situation where we've got ourselves a little bit mixed up between our way and EDLP pricing, and we won't have EDLP pricing, and we're worried about high-low pricing.

There's a reason why within the context of the very clear promotional strategy we can't get ourselves into a place whereas food prices go up or down that we can't retain the perspective of having retail price inflation in line with those changes. There's no reason why we need to be not able to pass through margins as cost prices. Change. And the volatility, probably, more volatility in the fresh food space that we have to manage probably a little bit more carefully going forward.

Charles Edward Cerankosky - *Northcoast Research Partners, LLC - MD of Research, Equity Research Analyst & Principal*

Are you saying when you look at the in-store spending activity, let's say, your best customers to the degree you measure that, do you think you're holding their share of wallet for food purchases?

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - Interim CFO & Director*

Chuck, this is Chip. I think that's a question that, quite honestly because of our time and ability, it's just one that, Jack and I, digging into the customer and the segmentation and the movement of customer, is something, honestly, that we just haven't gotten to in the last couple of weeks.

Operator

Our next question comes from Andrew Wolf from Loop Capital Markets.

Andrew Paul Wolf - *Loop Capital Markets LLC, Research Division - MD*

Jack, I just want to ask you kind of your view on scale which you mentioned, in other words, these very large prices, in relation to Sprouts, so let's just say, granted, we were to agree that Sprouts is well positioned in the market, what is your view on Sprouts' relative scale to complete and a real changing landscape, and in particular, I'm pointing to the resources to really fully develop digital and e-commerce?

Jack L. Sinclair - *Sprouts Farmers Market, Inc. - CEO & Director*

Yes. Well, let's talk about all the other areas in terms of what, and I'll come back to digital and e-commerce. I think the opportunity for growth in our business through scale comes about, I think, I said in my remarks about how we can drive more efficiency. That efficiency -- I certainly think there's significant efficiency in supply chain going forward that we can build on, and there's some very good work being done by the team. And now that, I think, will come to fruition over the next 12 to 18 months in that space.

I think there's very significant opportunity in terms of marketing and branding, in terms of utilizing the scale that we're getting to and telling much more stories about what exactly this brand and the purpose of this brand stands for. So I think both of those areas, I think, the resources can -- are in place and can be put in place to create some real strength in terms of how the brand can go to market.

I think private label, there's an opportunity, it's been getting well in the business. I think there's significant further opportunity to grow in private label as we evolve scale going forward. And in terms of how we think about our pricing and promotional approach and working with our vendors and working with our -- I think there's opportunities to scale and working that efficiently. So supply chain, branding, private label, how we work in terms of promotion and pricing activity, I think, scale brings some benefit to that, that, I think, we can bring some focus to.

With regards to digital and e-commerce, I think the reality of it is we've done some really good stuff in that. I mean we've talked in the market. We talked in our release about the absolute numbers in that, and I think we will have to meet the customer where the customer needs to be met. And I think the tests we're doing on click-and-collect, I think, has been -- and I need to get into in a little bit more detail, but I'm encouraged by the work that's been done so far in that within the scale of resources that we have.

And from early experience of -- some people who have been very good at this in my experiences, working hard to get that right in a few stores allows you to scale it going forward. And I think that's the right approach. And our home delivery system and the work that we've been doing on that certainly growing at the moment. And it's something that as we work on this over the next few months, I think we'll think hard about to meet the customer the way the customer wants to be met in that space, if that answers your question, sir.

Andrew Paul Wolf - *Loop Capital Markets LLC, Research Division - MD*

And just a follow-up on I think, everybody's sort of asking -- it's interesting that your company or Sprouts is still doing fair and well with new stores, and yet, the comps aren't well. It's pretty unusual. But Jack, it sounds like to so some extent you think it's self-inflicted with the lack of clear pricing strategy.

I assume that there's also some cannibalization in their but -- and in the Scott's question is also just the reality for competitive environment. So how would you sort of like -- I'll just frame it in a more general way, what is your thought of why there's such a divergence between the new stores opening so strongly and the comp base being pretty flat?

Jack L. Sinclair - *Sprouts Farmers Market, Inc. - CEO & Director*

So I think I kind of think I've captured that over some of the questions we've just been talking about. I do believe it's in our own hands to manage that. Yes, we got to be very careful and watch the competitive dynamic and where we're operating now across -- I don't know how many. So many states we are operating in. There is a different dynamic and everyone from South Texas to Jersey to what we're doing in California and Arizona, and the grocery market does change pretty dramatically from one market to the next.

I think there's some opportunity for us to think about how we exercise, how we really look at competitive pricing within that context. But ultimately, how we choose to manage the cost price inflation or deflation is in our own hands, and we have a brand strength that, I think, protects us in terms of how we can manage that going forward. So -- and just to reiterate what we said, I do believe this is self-inflicted within our own hands to manage this.

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - Interim CFO & Director*

And this is Chip. I also think that we do have really good new store productivity. I think that's a sign that says this brand hunts. It hunts in new markets. It's really encouraging to see the new customers that we're attracting in those new markets that we're going to and being able to attract them early. That's very encouraging.

I'll also say on other side is, we work really hard for the grand opening, and then we don't always come back later with a really good marketing plan and a really good branding plan and really helping the customers throughout the market place understand who we are and what we stand for. And so we need to do a better job there, and with that, comes -- when you're building the kind of square footage, even that we're building today, there should be a natural comp coming from the maturation of the stores that we believe should be higher, and it's not to our satisfaction today.

Operator

Our next question comes from Ken Goldman from J.P. Morgan.

Kenneth B. Goldman - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Please, pass along best wishes to Jim and for his health. Two questions from me. Jack, you're signing your name to guidance, but you're acknowledged today, you don't have all the answers. Is it reasonable to maybe assume you're giving yourself some downside cushion as many new CEOs

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understandably do? Or really, are you just very comfortable with the back half guidance, which I think is a lot lighter than people expected, sort of being that true reflection of your outlook?

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - Interim CFO & Director*

So Ken, I know you addressed that question to Jack, but I'm going to take the answer.

Kenneth B. Goldman - *JP Morgan Chase & Co, Research Division - Senior Analyst*

That's why, I'd take anybody.

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - Interim CFO & Director*

So for starters, we got a month in the bag and the month -- so we're 1 month into the quarter, and our comps are slightly positive. Well, I think there's somethings to consider. First and foremost, Jack and I have been in a building in terms of weeks, not months, and we're rigorously seeking to understand what's happening in the business, what's happening -- what's working, what's not working, what's within our control, what's not within our control, and there are early signs that Jack and the team are going to find opportunities that are going to really help us drive some traffic, drive some comps, do that with stable margins and deliver on the bottom line.

But we delivered a 0.1% comp in Q1 and a 0.7% comp in the first half of the year, and quite honestly, we believe it will be irresponsible for us to expect or communicate that there's going to be any sort of significant changes and trends in the very near term. So that's why the guidance is what it is. And I would say, unless you really need something else that Jack can add. I think that -- hopefully, that answers your question.

Jack L. Sinclair - *Sprouts Farmers Market, Inc. - CEO & Director*

I think that makes sense so that's a good one.

Kenneth B. Goldman - *JP Morgan Chase & Co, Research Division - Senior Analyst*

No. I think the tone of that answer was very clear. Thank you for that. And then I want to ask this question -- I'm not very good at making -- in sort of softening my questions, so forgive the bluntness here. But I'm skeptical -- okay, yes. So that's true. I'm skeptical that you can grow your gross margin over time, really not because of anything you're doing wrong, just because the industry's tough.

You talked today about stabilizing and maybe growing it. What is Sprouts' core competence? What does it do in your view? Again, it is for you to review that, that is better than its competitors. Because to me, without that being a clear answer and you may not have it yet, and so I'm putting you on the spot a little bit. I'm not sure how you can grow your gross margin over time. So again, it's a little blunter than I wanted it to be, but thank you for any answer you have.

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - Interim CFO & Director*

That's alright, Ken. Blunt's okay. As it relates to growing, we're not saying today that we're going to grow gross margins. That's not -- what we're saying it's stabilizing. We do believe -- now is there an opportunity to grow? Maybe. But right now, we do believe that there is opportunity to stabilize our margins and still go to market and compete because we do have a differentiated product. We do have a differentiated experience, and we're not a conventional grocery store. And so competing -- and we're allowing the conventionals to drive our business as opposed to leveraging the strengths that we have in our business and going forward and marching forward. And in that business case, there is an ability to stabilize your margins.

So I'll turn it over to Jack.

Jack L. Sinclair - *Sprouts Farmers Market, Inc. - CEO & Director*

So I think the differentiation, which is at the heart of your question is -- and I've worked in grocery over many countries, in many places over the last few years. I've not been in a company where the morale and the sense of purpose within the organization is clearer, so then how do you then translate that into a differentiation for our customers coming into the store? What does Sprouts have that other people don't have? The low format -- the low-profile nature of the format is very unique in terms of grocery. And it creates a sense of trust in what you're selling that I think is very unique.

When you don't cramp your store food, make it as high as you can make it, and you're not frightened to show all aspects of the store, I think there's a real straight in that. I think departmentally, I think, the way sprouts presents produce and the way it comes to the market in an organic nature all that, in a way, puts in front for the customer, is unique to the presentation and the product, and the pricing is pretty unique in produce.

Then you look at the bulk category. Now a few grocers have done few things in bulk. But we're pretty unique in terms of being -- it being at the core of the format, and I think, increasingly, with people's concern about packaging and the concern that people have around broader aspect of the grocery world, I think, that we're well placed there.

The pricing advantage then allows to bring people to access product for the core (inaudible) needs at 20%, 30% below what they would pay in packaged goods is again unique, and the strength of vitamin and supplement department is very unique as a partner of grocery offer. So the comp -- those 3 things are very unique and different, and I think what the team have done in terms of around the dairy and the meat counters is pretty impressive as well.

So there's some really format advantages, pricing advantages and product advantages that I think we can capitalize on, and it's great credit to the people that built this business, Jim and many other people who built this business, but they've created that differential in that mold going forward, and that's something that I can build on.

Operator

Our next question comes from Karen Short with Barclays.

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

Jack, look forward to working with you. A couple of questions. So just on the -- I guess the quarter end on guidance. In terms of the comp possibly turning negative in the second half, and I know you said it's positive in July, but guidance implies negative for the second half. Is that a function of the fact potentially that you do think you need to do some pricing adjustments across the store, and that will take a hit on comp eventually to rebuild traffic, maybe just a little clarification there?

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - Interim CFO & Director*

Well, Karen, thinking pragmatically, implying a negative comp on back half of the year when the first half was 0.7% would imply a negative 0.7%, so we're talking about basis points here. We're not talking about fundamental changes in the business.

And like I said, the backdrop here is, we're still working through how to manage the business, and it's going to take some time. And so for us to even imply that it's going to be significantly different, so the difference between a 0.7% in the back half, front half and a minus 0.7% in the second half, we're talking about -- and this in my opinion, may not be others, is we're talking about a very, very tight range that at the end of the day, does it buy us some flexibility? Maybe, but not a lot. So we're really looking at how to improve on the business. Are we satisfied if it's a negative comp?

Absolutely not. Are we going to drive towards something differently? Absolutely so. But we're also going to do that in a methodical way and a thoughtful way till we build for the future. That's the answer I can give you, Karen.

Jack L. Sinclair - *Sprouts Farmers Market, Inc. - CEO & Director*

And Karen, it's very early days for both of us to actually shape that exactly what the strategy is going to be around this. So I think to Chip's point given us the opportunity to really set in stone what we need to do going forward, I think is the right place to be for us at the moment.

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

And then just bigger picture. So I appreciate kind of the comments looking at companies kind of in their life stages, I guess. With Five at one end of the spectrum, and I guess Home Depot at the other. And obviously, you said you'd like to gravitate more to the Five Below side of things.

But I guess, maybe help me understand because you're kind of in a tough spot where you're small enough that you can be nimble, but you're big enough that you really need to keep investing in systems and things like that. So you have investment cycles that are just going to have to continue surfacing over time.

So I guess I'm not totally convinced that Five is the right analogy because it doesn't seem that it's going to be as easy for you to grow EBIT or EBITDA, I mean they're growing EBITDA 20%. Maybe a little more color there on how you can find that balance?

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - Interim CFO & Director*

Well, Karen, I would tell you that when I use the analogy of Five Below, I can give you 10 or 20 others that went through this cycle in the go-go days in the '80s and the '90s and the 2000's, and I know it's a different time and a different place. But in using that, you can look at the alters of the world.

I mean there are a few retailers out there that have white space around them, and I think what's exciting about this business is that this business is one of them. We truly believe it's one of them. I think Jack came here believing that it's one of them.

Is it 20% a year, like Five Below is doing? That's a pretty difficult scenario. Because it's a very -- they have a simple box. It's not a lot of cost to get into that box. It's not a lot of risk because it's not complicated, and it's not a lot of cost. But is there a better -- can we -- is there a better place for us where we could grow, the curve could look a little different? Absolutely. But some of the things we need to work on is our box cost has gone up 50% over the last 3 to 4 years to build a box. Why is that? Well, there's a lot of reasons for that that we need to really dig into and understand.

If we could build a box less expensively, we could take more risk, and we could grow faster, but we need to do that work first because if we were going to build the same cost box today that we have and just go out and start -- try to blow off 15% a year, you are absolutely correct that you would not be able to absorb that in your cost basis, and you would not be able to create any sort of legitimate earnings growth whatsoever.

So we're trying to find that right balance, and all we're asking for is a little patience over the next quarter -- the next 2 quarters, really, by the end of this year to where we can explain where, we think, we can really take it and what that algorithm that was brought up before will look like for us.

Operator

Our next question comes from Chris Prykull from Goldman Sachs.

Christopher Prykull - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

I just wanted to ask about operating margins. Looks like on a trailing 12-month basis, you're sitting around 4.1%. How are you thinking about that over the long term? I understand it's early, but maybe just a little bit of color versus maybe some of your peers in the industry. I mean you still do have premium margins versus traditional grocers. I understand that Sprouts is different. But what are your thoughts there over the next couple of years?

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - Interim CFO & Director*

Well, I think that's not that dissimilar than sort of the previous question as when you're growing -- it depends on the pace of growth, right? So if you're going at a really fast pace, and you're having to put the infrastructure in place, and I'm talking about the store structure, the brick-and-mortar pieces of that, then your operating margins going all the way down to operating margins, sometimes may go the other direction for a while.

Hopefully, in a gross margin environment, it's flat. And then the real operating margin opportunity is on the back end when you're slowing down that growth, and you're going to the productivity model.

As it relates to our competitors out there and where they are, most of the competitors that you're looking at with those really small margins, it's just -- it's a different model. It's a different business model. It's a different strategy. It's a different mix of goods in the stores, and we have -- in many ways, we sort of allowed ourselves to think that, that's how we should compete and who we're competing with, as opposed to leveraging what is so different about our business model and going and building it. And that's kind of the shift, take back into control what's great about this business and go grow that as opposed to becoming something we're not.

Jack L. Sinclair - *Sprouts Farmers Market, Inc. - CEO & Director*

Yes. Just to kind of reinforce that, I do think the unique nature of our business should allow us to continue to produce a superior margin performance to the traditional grocery space. There absolutely is no reason for that going forward, stabilizing gross margins and building on the efficiencies that we can get from scale. But its early days, and we've got to work this one through going forward. And to Chip's point, the pace at which we launch new stores will always create some ups and downs in this going forward.

Christopher Prykull - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Got it. That's helpful, and then I just want to go back to a previous question that was answered. If we had to hire sort of 1 to 2 or 1 to 3 key levers that you believe will reaccelerate comp growth. What do you think there'll be? And is price one of them?

If you go back to the Whole Foods' story, comps, well, they tried to change price unsuccessfully, and we all know what happened there. So why will Sprouts be different?

Jack L. Sinclair - *Sprouts Farmers Market, Inc. - CEO & Director*

Well, as I said at the outset, I think from a pricing point of view, we can stabilize margins by getting more effective at balancing this mix between EDLP and high-low where I think we double down on both as opposed to it really being pushed -- having some precision by category and by market as to how to effectively manage that.

The second part of this is, I think from a branding and marketing point a few, we're fairly traditional in how we approach this. We spend a lot of our money on print. The loan's moving on, and I think bringing the stories to life of what this brand is about in more effective way I think will attract new customers. There's a massive white space out there even within our catchment area of people who are not shopping with us, and I think that's the opportunity we've got in terms of changing the messaging around our business so that we can get ourselves into a place where the 2 differentiations communicated more effectively, both within the stores that we're opening and within the existing store base. So that combination of managing our promotions and pricing more effectively and bringing a strong brand into the business, I think will, I hope, over time see a significant improvement in our underlying business.

Christopher Prykull - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Great, and then if I can just stick one last one in. I think last quarter you said digital sales were about 2% of total sales. If they're up 170% in the quarter, does that mean that in-store comps are running down 3%? I mean is that the map that we should be thinking about? And so what's the update in terms of cannibalization from digital sales?

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - Interim CFO & Director*

So we're doing almost, not quite, but it's been a big ramp we're at a point where we're doing almost $3 million a week there. When you're right at a 0.1% comp and, obviously, haven't gone back to do the backward math and what that means. But when you doing a 0.1% comp clearly and you're growing your digital, it's going -- your core comp is going to be slightly negative, I mean, that's just math. So that is true as it relates to being as negative as you're saying. I have to go back and do the math. I don't think it's that material at all.

And then as it relates to what was the final part there, Chris?

I think that was it, right? Okay. All right, next caller, next question

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Operator

Our next question comes from Edward Kelly from Wells Fargo.

Edward Joseph Kelly - *Wells Fargo Securities, LLC, Research Division - Senior Analyst*

I just wanted to ask about how much time you've had actually to sort of think about the business and where you need to go. So I hear you loud and clear today on the call around confidence in the competitive position, the differentiation, the idea that growth will not sell. But the financial results do raise questions about that whether the comp, the margin, seemingly new store returns I guess have you seen enough Jack to give you confidence that, that's all right that you should still be growing stores in the way that you have in the past? I understand the narrative at the end of the day that the reason I want to keep that narrative, I'm just kind of curious as to your confidence and how much you've seen so far?

Jack L. Sinclair - *Sprouts Farmers Market, Inc. - CEO & Director*

Yes. I think it's a good question, and I think fundamentally, as I preface the whole conversation that I'm having with you today is, it's early days in terms of as I think this one through. But I've spent a lot of time in stores and I've spent a lot of time with the team here over the few weeks that I've been here and I have got -- it builds confidence because when you look at the numbers, you maybe wouldn't feel as confident as I do, but when I need -- the foundation of the business is so strong, so unique and so different that it gives me a lot of confidence that we can harness that.

And I think the other thing that gives me a little confidence is when you talk to customers inside the store, they have a real passion and love for the brand, the people, the customers that are there. And the more I experience that, the more confident I get going forward that we'll get real differentiation and a real chance of being really the leading grocer across the country if we can get this right.

And I do believe that from a marketing and a branding point of view, we've been very traditional in our mediation or articulation of our brand, and I think there's huge opportunity in that, and I do believe the task is that we have that are so different. We could be telling the story so much more effectively about the whys and wherefores of the benefits that customers can get in terms of the strength for his healthy eating and this trend for looking after their family.

Most customers and grocers are just trying to look after their families a little bit better, and I think the reality of us really positioning this healthy-for-less business model is something that gives me a lot of confidence.

Now putting all that into numbers is going to take some time to get to that point, but certainly, to the question, I have a lot of confidence that the underlying performance of the business should be and could be much better.

Edward Joseph Kelly - *Wells Fargo Securities, LLC, Research Division - Senior Analyst*

And just related to that, Jack, could you help us understand, and I know quantitatively it's not fair to ask you this question, but just qualitatively the amount of investment -- as the company to where it needs to be. And I think there was an expectation in prior management that the 2019 would be the bottom from a margin

(technical difficulty)

really seemed fair to -- for us to expect that, given that strategy would change a bit.

So any thoughts or help around that and just the cadence of how we should think about the margin, I mean, in terms of 2020, and whether we can see it below or before it stabilizes or goes higher?

Jack L. Sinclair - *Sprouts Farmers Market, Inc. - CEO & Director*

I got caught a little bit in the middle of that call in the middle of that question, maybe just if you don't mind, just clarifying it. I got bits of it, and you cut out in the middle of couple of bits there so. Can you maybe ask it again? I would appreciate it, around the margin question.

Edward Joseph Kelly - *Wells Fargo Securities, LLC, Research Division - Senior Analyst*

The question is really just around margin and how prior management I think had an assumption around some stabilization there for 2019, and it just doesn't really seem fair for us to hold you to that, given that it does seem like there's investment that needs to be made. And I know you don't want to quantify investment, but qualitatively, can you just talk about whether that needs to accelerate from here before margins can stabilize?

Jack L. Sinclair - *Sprouts Farmers Market, Inc. - CEO & Director*

Well, again, I think you're right. So from a qualitative point of view, I believe we could be more effective at passing on the inflationary costs, food cost so that we don't have to see diluting gross margins going forward.

The timing of that is a good person. I don't know exactly or not. We're in a position to clarify that right now. But going forward, this should be a stable -- from a stable margin to growing margin over the next 3 to 5 years. There's no reason why that can't happen.

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - Interim CFO & Director*

And I would say that you're talking about investments, when you go down to the operating line, a lot of that's going to depend on how we determine sort of new store-to-store growth, the trajectory of that, and then as it relates to any other infrastructure, we have some infrastructure needs in supply chain and some IT infrastructure needs there. But we have made a tremendous amount of investments in the past, and I don't see the pace of investments in the outside of new stores and I don't see the pace of investments really accelerating at all if nothing else will sort of be muted, and hopefully, the top line will leverage against that ongoing same amount of growth or same amount of...

Operator

Our next question comes from Mark Carden from UBS.

Mark David Carden - *UBS Investment Bank, Research Division - Associate Director and Associate Analyst*

So another question for you guys on scale. As you grow from being really an effective regional level more of a national retailer, how do you avoid running into supply issues in produce. And more specifically, is it getting any tougher to find enough attractively priced produce opportunities from growers that you can then really promote heavily across your store base. And Jack, I know Walmart's mix is a bit different, but is there any lessons you can drop on from their experience there?

Jack L. Sinclair - *Sprouts Farmers Market, Inc. - CEO & Director*

Great. So in terms of produce sourcing, which I think is something that I have spent a lot of time looking at over the last -- one of the thing is that we've got 5 produce distribution centers and in that those distribution centers, we have our own sourcing team. They can take advantage of the opportunities that exist in growing seasons across the country effectively. And the expertise of that team is pretty good, so I have been pretty impressed by the opportunity that these guys have got in terms of as we open new stores in different places that we can source effectively through the knowledge and then working with the growers and maybe expanding the repertoire that we're operating locally because we build on that expertise.

And I think we're well placed to grow in different markets because of that. You identified one of the challenges, which is -- I talked about earlier, which is the supply chain challenge that links with that. Are we distributing things too far in terms of -- not can we source it, but can we get it to the customer in the optimal condition, and that's something that we're going to do a lot work on to get that right.

But the reality of growing in the United States is people are buying produce all over the United States. So there's no reason why we can't source produce effectively all over the states, and I think the team are pretty well placed to do that effectively.

With regards to Walmart, we did very similar things at Walmart when I was there in terms of trying to get much more closer to the drawing base. I'm working that one through, and I think you're all pretty aware of this strength of Walmart's supply chain and distribution. I think there's some lessons we can learn from that.

Operator

And we'll move onto our next quarter. Our next caller comes from Chuck Grom from Gordon Haskett.

Charles P. Grom - *Gordon Haskett Research Advisors - MD & Senior Analyst of Retail*

Congrats, Jack, on the new position well deserved. I just to keep the focus here on the comp and just trying to unpack really the difference between the older stores being weaker versus the waterfall changing, and I'm just trying to understand both dynamics considering, now, to your point, Chip, that if we're doing about $3 million in revenue from digital that suggests your store is probably comping down say 1 to 2 points. So just can help us look over the past couple of quarters versus, let's say, the past 4 to 5 years, which dynamics changed? Has the waterfall changed or has the older stores just not performing as well?

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - Interim CFO & Director*

I don't have in front of me or near the last couple of years, but my -- I might go off on a limb here from what I have seen is that it's kind of been both, right? So it's been -- we heard -- when you've gotten down to a 0.1% comp that shows all the pieces. So one, of course, when thing's not working, if your core stores are coming negative or your new stores aren't performing, the encouraging part here is the core stores are negative but not -- now I'm talking about the old vintages' stores, yes, of course, they're negative, slightly negative.

We are still seeing a ramp on the new stores but we're not seeing the ramp that we wanted in new stores, but some of that is -- what I would argue is the way we have manage it. So it's a mix on both sides of the equation, and that shows all your works when you got a 0.1% comp.

So we have work to do on both. You've heard a lot of comments that Jack's made today about really the core stores. At the end of the day, how can you drive more traffic, how can you then turn that into comp, and then how you can do that in a profitable way. And there's a lot of work to be done on the new storefront, I believe, as well. Where we put the stores, the concentration of new stores, the cost of new stores and the size of new stores, how much money we invest in new stores in the very beginning for all intents and purposes sort of juicing up the front end.

There is work and analysis that needs to be done there that I think there's a tremendous amount of opportunity in the future to change that trajectory in a positive way, but of course, with new real estate, that's going to take 18 to 24 months to see that change in a meaningful way.

Jack L. Sinclair - *Sprouts Farmers Market, Inc. - CEO & Director*

And Chuck, just from a -- regarding the question around digital and the physical sales in the stores. I think increasingly and the way philosophically I look at that is if the customer chooses to buy digitally or buy, or we see it delivered, but as it's still upsetting the Sprouts standard, I would put the 2 together in how we about things. Increasingly, that's the way that we have to meet the customer where the customer wants to buy, wants to access the brand, and if we got the right offer, we'll have to find a way of making sure it gets to them appropriately. So the overall comp that matters.

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - Interim CFO & Director*

Yes. And someone asked earlier, that was the part I forgot. Was there cannibalization because of the digital? Now it's coming to mind again. So of course, there's going to be cannibalization in the digital world. What's the really encouraging part is that large portion of those customers that are shopping with us digitally are doing so -- they're new customers. That's the piece to look at, not what's being cannibalized.

We're touching new customers that really don't know our brand and never been in our stores and they're having it delivered, and if you talk to our partner there on the digital side, they would tell you that it's pretty amazing to look at how new customers are attracted to our brand without ever having been in our stores. So that's the positive side of the digital equation.

Charles P. Grom - *Gordon Haskett Research Advisors - MD & Senior Analyst of Retail*

Okay and just my follow-up, Jack, you said something I haven't heard Sprouts say in a long time is that the mix of the high-low versus EDLP has gotten out of sync. So maybe if you could just flush that out for us in a relatively recent phenomenon, and I guess how long do you think it'll take you to fix that?

Jack L. Sinclair - *Sprouts Farmers Market, Inc. - CEO & Director*

I don't know whether it's been a relatively recent phenomenon or not, I need to dig into the background to actually understand that, I'm really looking at today in terms of how that plays out. But going forward, I think we got -- you got to be very careful with how you manage those things and how you don't disrupt the business too much in making those changes.

But certainly, we have to understand the prices, the combination of both, but you can't look at them independently with the combination of what you're investing in promotion and what investing in your base pricing, combined to create a value for the customer. And that's increasingly what we'll be working on. Hopefully, it won't take too long to get to the bottom of that.

Operator

And that does conclude today's question-and-answer session for the conference. I would now like to turn the call back over to Jack Sinclair for any closing remarks.

Jack L. Sinclair - *Sprouts Farmers Market, Inc. - CEO & Director*

Yes, so thanks very much for your interest in the company and thanks very much for your time today and attention, too. It is great to be part of this business and thanks very much for being here today. I really look forward to all our future updates. So thanks.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program, you may all disconnect. Everyone, have a wonderful day.