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SFM - Q4 2019 Sprouts Farmers Market Inc Earnings Call

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OVERVIEW:

Co. reported 4Q19 net sales of $1.4b and diluted EPS of $0.27. Expects 2020 net sales growth to be 5.5-6.5% and diluted EPS to be $1.17-1.23. Expects 1Q20 diluted EPS to be $0.45-0.47.

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to Sprouts Farmers Market's Fourth Quarter and Full Year 2019 Earnings Call. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions)

I would now like to hand the conference over to your host, Susannah Livingston. Ma'am, please go ahead.

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

Thank you, and good afternoon, everyone. We are pleased you have taken the time to join Sprouts on our fourth quarter and full year 2019 earnings call. Jack Sinclair, Chief Executive Officer; and Chip Molloy, Board member and Interim Chief Financial Officer, are with me today. Also with us today is Denise Paulonis. Denise will officially take over as our CFO beginning tomorrow.

The earnings release announcing our fourth quarter, full year and 2019 results 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 2020 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 the commentary on forward-looking statements at the end of our earnings release issued today.

In addition, our remarks today include references to non-GAAP measures. For a reconciliation of our non-GAAP measures to the GAAP figures, please see the tables in our earnings release.

With that, let me hand it over to Jack.

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

Thank you, Susannah, and good afternoon, everyone. Thank you for joining our call today.

I'm delighted that, during the fourth quarter, we drove positive comps while delivering an improved margin profile well ahead of our expectations and a testament to the changes we're making. While these results may not be repeatable at the same level, I'm encouraged by the organization's dedication to improve our business in the short term as we reshape our longer-term strategy.

We've made some fundamental changes in how we run our day-to-day business. And not only are some of those changes beginning to have a positive impact on financial results, they're also helping us to understand the future opportunities. In a moment, I will share more on our early wins and highlight some of our early thoughts on how we expect to consistently deliver long-term profitable growth.

When I joined Sprouts, I made a commitment to building a world-class team to help us achieve our purpose. With that said, I want to extend a warm welcome to Denise Paulonis, who has joined our leadership team as Chief Financial Officer. Denise brings a strong financial and strategic background to Sprouts, rooted in speciality and food retail expertise. Denise will officially take over the reins of CFO from Chip beginning tomorrow.

I also want to welcome our newest Board members, Joel Anderson and Doug Rauch. Joel brings a wealth of retail experience from high-growth Five Below to Walmart.com and Toys"R"Us in addition to a strong multi-channel marketing [brand]. Doug is also a welcome addition to our Board, having played a key role in the national expansion of speciality grocer, Trader Joe's. Today, he remains very passionate about affordable nutrition through his leadership of the Daily Table, a nonprofit food retailer with a focus on the environment. I look forward to all the many contributions as we grow our brand, expand our footprint and provide greater access to healthy foods.

Before I hand it off to Chip to discuss the financials, I want to personally thank him for his support over the last several months. His leadership, business acumen and integrity have been invaluable during this time of transition for our company. I look forward to continuing to collaborate with him at the Board level.

Chip?

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

Thanks, Jack, and good afternoon, everyone.

I'll begin by discussing our business results for the fourth quarter and full year and then review our outlook for 2020. For the fourth quarter, net sales were $1.4 billion, up 8% compared to the same period last year. Comparable store sales were 1.5%, with the continued upward trend in the 2-year stack to 3.8%. The non-perishable categories were strong, and we experienced the benefits of driving the right holiday trends early in the season, like the expansion of our vegan and plant-based holiday meals and sides.

For the fourth quarter, gross profit increased by 11% to $469 million. And our gross margin rate was 34.4%, an increase of 120 basis points when compared to the same period last year. While we were cycling tailwinds from deep promotions in the fourth quarter of 2018, our early efforts to balance our price position, comp and improve margins paid off in the fourth quarter. Despite experiencing some early margin wins, our traffic was still slightly negative.

As 2020 progresses, the correct balance of driving comp and traffic while continuing to stabilize margins will remain a focus area for the team.

SG&A increased 10% to $387 million or 28.4% of sales compared to 27.8% in the same period last year. 35 basis points of this deleverage is from the adoption of the new lease accounting standard. The remaining deleverage is due to higher health care costs, the expansion of our home delivery program, ongoing strategy work and cycling the California payroll tax benefit in 2018.

For the fourth quarter, our depreciation and amortization costs increased 10% to $31 million or 2.2% of sales, an increase of 5 basis points compared to the same period last year.

Store closure and other costs were $3.9 million mainly related to the noncash impairment of 3 stores.

Our interest expense was $5 million. For the quarter, our earnings before taxes was $42 million, an increase of 27% when compared to adjusted earnings before taxes in the same period last year. Our effective tax rate was 24%.

Fourth quarter diluted earnings per share was $0.27 compared to diluted earnings per share of $0.10 and adjusted diluted earnings per share of $0.19 in the same period last year.

For fiscal year 2019, net sales grew to $5.6 billion, up 8%. Gross profit increased 8% to $1.9 billion, resulting in a gross margin rate of 33.6%, an increase of approximately 5 basis points compared to 2018, mainly attributed to the more thoughtful promotional approach in the fourth quarter of 2019.

SG&A increased 10% to $1.5 billion, an increase of 50 basis points to 27.5% of sales compared to last year. 35 basis points of this deleverage is from the adoption of the new lease accounting standard. The remaining deleverage is attributed to investments in new stores, expansion of our home delivery program, higher health care costs and increased credit card fees partially offset by increased rent credits during the year.

Our interest expense was $21 million, and our adjusted earnings before taxes was $197 million, a decrease of 5% when compared to adjusted earnings before taxes in 2018. Our effective tax rate was 24%.

For fiscal year 2019, diluted earnings per share was $1.25 compared to diluted earnings per share of $1.22 in 2018. Adjusted diluted earnings per share was $1.25 compared to adjusted diluted earnings per share of $1.29 last year. As a reminder, the lease accounting standard resulted in a net incremental expense of $0.04 per share for fiscal 2019.

Shifting to the balance sheet and liquidity. For 2019, we generated strong cash flow from operations of $355 million, up 21% for the year. The robust cash generation this business produces continues to support and self-fund our unit growth and sales initiatives. We invested $157 million in capital expenditures net of landlords reimbursements, primarily for new stores. For the fiscal year, we opened 28 new stores and closed 1, ending the year with 340 stores in 22 states.

During the year, we also repurchased 7.95 million shares for a total investment of $176 million.

We ended 2019 with $85 million in cash and cash equivalents and $538 million borrowed on our $700 million revolving credit facility. Reflective of a strong balance sheet, we continue to maintain a low debt position, ending the year with a net-debt-to-EBITDA ratio of 1.4x.

Now let me turn to our outlook for 2020. Two items to point out. One, 2020 will be a 53-week year with the extra week falling in the fourth quarter. The company estimates the impact for the 53rd week to be approximately $120 million in total sales, $9 million in earnings before taxes and $0.06 in diluted earnings per share. And two, though we are encouraged by our fourth quarter results and are optimistic about the direction we are heading, our strategic work is still ongoing. Therefore, this outlook only factors our current business and does not factor any potential strategic changes.

For fiscal 2020, on a 52-week basis, we expect net sales to grow 5.5% to 6.5%, comps to be in the 0% to 1% range, EBT to be $187 million to $197 million, diluted earnings per share between $1.17 and $1.23 and an effective tax rate of 26%. We expect our 2020 CapEx spend to be between $120 million and $130 million net of landlord reimbursements. This is slightly lower than previous years due to opening fewer stores. We anticipate opening approximately 20 stores in 2020.

A few other items to note. We expect gross margins to be slightly positive for the full year with more benefit expected during the first 3 quarters. SG&A will continue to be pressured from occupancy, e-commerce and labor and benefits.

We expect to utilize our strong cash generation to invest in our business and to pay down a portion of our revolver debt. Quarter-to-date, we've paid down $50 million on our credit facility and expect an additional $50 million to $60 million paydown before the end of Q1.

For the first quarter, we expect comps to be in the 0% to 1% range and diluted earnings per share between $0.45 and $0.47.

It has been a delight to serve as interim CFO during this transitional time period and work directly with Jack as he leads our company and strategy moving forward. I am confident to hand the reins of CFO over to Denise, whose knowledge and expertise in retail will help keep the business moving in the right direction.

Now back to Jack.

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

Thanks, Chip.

Over the last several months, we challenged ourselves to make key fundamental shifts in how we run our business, leading to some early signs of improvement. During the fourth quarter, we refined and balanced our promotional strategies to target our core customer and eliminate inefficient promotions. To be clear, we're still promoting and providing value to our customers, but we're doing so differently. We focused our promotional activity by responding to opportunities in the marketplace rather than reacting to promotional pricing elsewhere, resulting in improved cost of merchandise. We focused our display and presentation in-store on items that differentiate us in the marketplace and provide uniqueness to the customer. If the composition -- if the competition zigged, we zagged.

In our core fresh categories, we focused less on commodities and more on our strengths in assortment. On apples, we promoted unique varieties like Lucy Glo. At the holidays, we focused on greater attribute-driven products like no antibiotic of our turkeys rather than commodity items. This has been a profitable change, and we're exploring how to develop this approach even more broadly across our portfolio.

We are becoming the platform for innovation, where our vendors come to us first because we can move quickly to put new healthy products in our stores. We've implemented new initiatives to accelerate our innovation pipeline, like our innovation summits, targeting emerging brands and our new think tank panel comprised of partners in the industry that incubate start-up brands. These programs led to successes in our grocery aisle with the addition of Pipcorn, packed with nutrients and taste, and Van Leeuwen oat milk vegan ice cream. All these changes have created a platform from which we can build. Our brand can and will be known as a treasure hunt for healthy eating across this country.

Enhanced cross-collaboration has helped teams work together to better plan and source our products. We reorganized our produce-buying group to enhance our vendor partnerships, increasing availability to Sprouts and improving our costs. These improved vendor relationships allowed us to highlight Driscoll's Sweetest Batch blueberries, which are bigger and sweeter, increasing sales in the fourth quarter. All these changes resulted in meaningful differences in how we promote price and source our goods. And we did this all the while driving gross margins, contributing to much of the quarter's success.

This progress and the team environment we created resonated across the entire organization and across the store portfolio. As a result, we're making progress across the country. The East Coast division opened half our new stores in 2019. And with relatively new leadership, the results were commendable. Both Florida and Georgia improved their store operations, and Georgia greatly improved their financial position, which had been lagging in past years. And that's a testament to focused leadership with a clear set of priorities. We plan to build on this success as both Florida and Georgia provide growth opportunities for the future.

A restructured store bonus plan, laser-focused on what our store team members can control has proved to be a successful incentive, driving sales and engaging team members across the organization.

In 2019, we completed the production planning phase of FIM resulting in workflow improvement, better curation of assortment and a reduction in shrink in our fresh departments. We also entered the second phase of FIM, deploying computer-assisted ordering which, when completed, will provide fresher product to our customers, improve sales floor conditions and reduce unproductive inventory. Additionally, we completed industrial engineering labor standards on all in-store activities, and we'll be integrating the labor standards with our labor management system to properly schedule resources based on production needs by item. These initial positive results are setting the foundation on which we will continue to build.

As Chip mentioned, we're keenly aware that our traffic remains negative. We're taking a long-term view and know as we move towards a new marketing strategy, a stronger everyday price position and pulling back on unprofitable promotions may result in continued traffic headwinds. We expect an adjustment period and then profitable customers will respond.

The retail landscape remains fluid, and we continue to evolve how we connect with our customers. I'm pleased that during 2019, we enhanced our touch point with our customers. We increased our digital subscribers to over 2 million accounts, up more than 35% for the year. As well, our home delivery continues to expand, ending the year up more than 150%, and we continue to see increased adoption. We tested self-checkout in a handful of stores to a resounding positive response, and we will extend the test in many more stores in 2020.

There is much work ahead. Currently, we're testing some tactical changes in our marketing, including how we reallocate the mix of our media spend. We're focusing less on print dollars and redirecting these funds to different channels and different content to drive brand awareness, personalization and store traffic. We've experienced some positive test results in the early stages but have not yet declared victory and look forward to additional testing and data as the months progress.

Looking ahead, I want to share some of our initial conclusions from our strategic work to date. The foundation that made Sprouts will remain, a healthy brand rooted in the farmers market heritage that is good for you, good for your family and good for the planet. We will lean on innovation either through market trends, national partnerships or private label investments and will remain value-orientated and accessible to the everyday consumer.

With considerable transformation work in front of us, we've identified a handful of opportunities. One, through our early segmentation work, we have a deeper understanding of the current and future customer at Sprouts. We understand what is important to these customers, where we have opportunities and how we will integrate changes to reflect their preferences. Two, we expect that store growth should accelerate beyond our historical 30 stores a year with a smaller box size that is less complicated and more profitable similar to many of our older Southern California stores which continue to produce above average profits. Three, we will plan to enter new markets with a greater concentration of new stores. Four, all markets, both existing and new, will be supported by a more effective and efficient supply chain network, improving costs and guaranteeing freshness of products due to shorter distribution times. This point is of great importance. Though we have 340 stores, our supply chain has been disjointed with our growth. This will be corrected in short order and will separate us from other competitors who lack this infrastructure. And lastly, marketing will evolve to promote more brand awareness, so customers understand why they should shop with Sprouts and their loyalty and a greater share of wallet. The concentration of stores backed by our supply chain network and a focused marketing program on our target customers coupled together will create optimal store economics. I look forward to sharing the detailed strategic vision with you all at our next earnings call.

A new chapter is starting to take shape for Sprouts. With the positive fourth quarter results behind us, the dynamic leadership in place and an inclusive team member culture, we are all even more energized for the work and challenges ahead. I want to thank all the team members at Sprouts for their dedication and their enthusiasm displayed to our customers every day in the stores. Even more so today, I remain confident in the team's ability to focus on creating a more efficient business while implementing a strategic plan to position us for long-term profitable growth.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) First question comes from the line of Paul Trussell of Deutsche Bank.

Paul Trussell - *Deutsche Bank AG, Research Division - Research Analyst*

And congrats on the early progress, and welcome Denise and I guess until next time, Chip.

My first question is really regarding the top line. It sounds like traffic is still slightly negative. So maybe talk a little bit more about the outperformance you saw versus initial expectations in the fourth quarter. And then just looking at the strong 2-year stack that that produced at least relative to prior quarters, just like a little bit more insight on the rationale behind the only flat to up 1% guidance for this upcoming year.

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

Yes, let's -- I'll talk a little bit about what's happened in Q4 with regard to how our comp played out. We made some changes in our promotional mix and made some changes in terms of how we invest and what products we invested in. And that's clearly, we weren't sure exactly how that would play out. Why it happened in the past is that the excessive investment in promotions wasn't driving the top line, was actually deflating the sales rather than creating positive sales. And as we've evolved the promotional plans in terms of the products we're putting in our promotions and the pricing we're putting behind them and using different products, the outcome has been what the outcome has been. It hasn't significantly changed traffic trends, but it significantly changed the underlying comp sales that we've had from that from the volume that we're putting through.

Going forward, there's a lot of volatility in the year-on-year comparisons. And as we look at the -- certainly in Q1, Q2 and Q3, you've got a very significant volatility in what we did last year. And as we measure that, I think it's prudent to be where we are at the moment in terms of our forecasts going forward on comp sales.

Paul Trussell - *Deutsche Bank AG, Research Division - Research Analyst*

That's helpful. Just in terms of follow-up, pretty meaningful expansion on the gross margin line this past quarter, how much of that is directly attributable to the pullback on promos versus other drivers impacting that number?

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

Paul, it's Chip. The majority of that is coming from -- I don't want to say the pullback on promotions but promoting differently. So we're promoting products that we can actually make money on it. We're going to the marketplace with the vendors with the deals we're making, finding unique products and then we're promoting those. And then we're -- to some degree, we're not promoting everything to everyone, so we're not trying to chase every competitor to the bottom, and we're being more selective about what those promos are. And quite honestly, that's driving the vast majority of the margin expansion year-over-year. Last year, we had some benefit year-over-year, which we anticipated going into the quarter, but the performance of the strategy, if you will, in the quarter actually overperformed what we expected.

Operator

Our next question comes from Ken Goldman of JPMorgan.

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

As a Brooklyn resident, I do have to thank you for the shout out for Van Leeuwen ice cream. It is a good local brand so it's good to see it expanding out west. And I just wanted to ask a little bit about -- I know you're not ready to talk about all your strategic changes, but the last one where -- or the second to last part of the 5 elements you talked about with a more effective and efficient supply chain network. Can you give us just a little bit of insight into what you think that requires from a CapEx standpoint even if the numbers aren't exactly there yet? It would be helpful to know if you're thinking about a meaningful step-up, something a little bit more modest or maybe nothing at all. Just curious for your insights there if you can.

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

Yes. Regarding -- oh, sorry.

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

Ken, it's going to be really modest because expanding our DC network and expanding, even the DCs are pretty small and relatively small from a CapEx perspective. So anything that's going to materially change our CapEx profile going forward would be more stores, not DCs.

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

And the crux of the supply chain initiatives going forward will be to increase -- we've talked about this in the past. As we've built some of our stores, the network has been stretched in terms of the distribution miles that we're traveling from our distribution centers to our stores. And that causes obviously increased cost but also challenges somewhat the freshness in terms of how do we present the product that we wanted to be presented. So we'll be investing in making sure that the distance that we travel and the opportunities for us to source more locally and more effectively will improve the -- not only the cost of the supply chain, but the quality of the product we're putting in front of the customer as well.

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

Okay. And then just to confirm you talked about that adjustment period potentially coming on traffic. Just to confirm, I assume that your guidance already factors that adjustment period with maybe traffic worsening a little bit as some consumers are a little slower to react to some of the pricing changes you're making. Is that a fair assumption?

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

Yes, I think generally, it's fair. It's a long year and with slightly negative traffic, and we're going to start to comp that negative traffic as we go through the year. We hope that -- we're hopeful that we're going to start to get positive. Hope is not a strategy, of course, but it would be -- it would not be prudent for us to expect a big swing in traffic going into this kind of year.

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

But in time, really -- sorry, Ken, in time we're expecting profitable customers to come. That's the objective of our traffic ambitions going forward, not chase unprofitable customers.

Operator

Your next question comes from Scott Mushkin of R5 Capital.

Scott Andrew Mushkin - *R5 Capital Ltd - Founder & CEO*

I kind of really want to follow up a little bit on a couple of the questions and the answers to them around the gross profit, big move we saw in the margin rate and the expectations as we get into next year. So it sounds like it worked pretty well. It sounds like traffic really didn't deteriorate. You were able to really tack. I guess my question is that it would suggest that why deviate and why is the guidance where it is? So I guess that's my first question.

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

Scott, it's Chip. As it relates to the guidance, so one, we are expecting margin expansion in the year. Two, as I said in the call, it will be predominantly in the first 3 quarters. I think the fourth quarter, given our most recent performance, it's pretty much a push right now. It's the way we -- at least that far out, the way we're thinking about it. And so we will get gross profit increase over the year. But at the same time, we're still putting in 20 stores. And so that's going to put it a little down on the bottom as it relates to SG&A, but on the gross profit side, on a 0 to 1 comp, that's the guidance on EPS. It's really driven by the comp.

Scott Andrew Mushkin - *R5 Capital Ltd - Founder & CEO*

Okay, terrific. And as you guys think about markets that maybe you want to go into, I know you said you want to concentrate the stores. I think you said, Georgia performed better during the quarter. Is -- but I think you only have 4 stores there, is the Southeast, a place where you still are fairly committed to outside of Florida?

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

Parts of the Southeast, most definitely. So Georgia, for sure, Florida, for sure. As we continue to do our work on our customers and understand where we have the greatest opportunity, there will -- of the other parts of the southeast. There's opportunities in the Mid-Atlantic, which we've already started. And there's continued to be opportunities in the markets where we are today like Texas and the Southwest.

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

Yes. So, when you look at the individual markets, we've got 16 stores in Georgia at the moment and we've got 15 in Florida. Both of those markets represent significant opportunities going forward to us. And we also see opportunities in Southern California and in some of our base market, where there's a whole host of our new targeted customers, which we'll be talking to you about in the future. We see that market as a significant area of opportunity for us as well going forward. I was highlighting some of the operational improvements I've been pleased with in Georgia and Florida in our remarks.

Scott Andrew Mushkin - *R5 Capital Ltd - Founder & CEO*

Do I get one more or do I need to go back in the queue?

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

You can have one more.

Scott Andrew Mushkin - *R5 Capital Ltd - Founder & CEO*

Okay. So then my final one is just kind of a quick on the gross profit. Was there -- were there any timing differences, and I know you put rent through the -- for the gross profit that also helped with that big move of 120 bps, and then I'll yield?

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

No, there was nothing -- there were no timing elements of significance, and that was predominantly all driven by margin.

Operator

Our next question comes from Karen Short of Barclays.

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

A couple of housekeeping and then a couple of bigger picture. The first thing is new store productivity was fairly low this quarter. I don't know if there's anything to talk to you on timing or anything? And then second, on housekeeping is a color on inflation in the quarter and what your expectations are for 2020. And then I have some bigger picture questions.

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

Yes, as it relates to new store productivity, it's predominantly timing. And then the other item. We're not -- it's a benign inflation deflation area, and that's the way what we're assuming going forward. And it's an area that, quite honestly, when it comes to inflation, deflation is -- this has been kind of -- in the past, the company has really used that as sort of -- I don't want to say, a sort of a driver when the reality of -- it's our responsibility, whether it's inflation, deflation, go drive sales and do that at a stable plus margin, and that's what we're going to do going forward.

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

Okay. And then just, I guess, bigger picture, I guess, Jack, you made some comments on how you'd restructure the store bonus program. So I was wondering if you could give a little color on that. And then you also commented on having a deeper understanding of the customer. So I guess, I'm wondering if you can elaborate on that a little bit. And then the last thing I'd just ask is, you have talked in the past about specs and changing specs on some of the SKUs that you have, and now especially in produce, so wondering if you could give an update on that.

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

Yes. Okay, let's take what I was saying, store bonus, what we've done in the store bonus, particularly. And in Q4, we ended up paying more bonuses to more stores than we had in the previous few quarters, which is encouraging, but it was based on making -- asking the stores to take accountability for exactly the things they are accountable for, top line sales shrink, operating cost and non -- goods not for resale, the operating of what they can buy more -- how they can manage the inventory in the back of the stores more effectively rather than holding them accountable for things like rent and things like issues that are out of their control. And that's certainly helped, I think, get some real focus and energy behind the stores and achieving the bonuses, and it's something we're encouraging them to develop even further going forward.

The second question was about customer issues. We spent quite a lot of time trying to dig into exactly how the food market in the United States is split up, and we split that up into 6 different groups, and we've seen some of those groups are far more relevant to our future strategy than others. And we'll talk a lot more about this on our next call. Effectively, there's such a huge opportunity for us if we focus in on those customers who already like us, and there's a lot more customers like that out in the marketplace. So how we communicate with those customers and how we

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manage those customers going forward is going to be a core part of our strategy both in terms of our category work and our store work going forward.

And the third question, Karen, was all about product specs. I think one of the things that I've been encouraged with as we've changed the structure of the produce team, in particular, is how you can be appropriate to the specifications by both the geographies that people are operating within and the time of the -- the timing in terms of what's available and what's not available. And being, in my view, specifications are part of the equation of getting really high-quality fresh produce in front of customers, the biggest challenge and the biggest thing that can work is on -- quality is about the freshness of the product itself. And sometimes, we get a little bit to focus on exact size and shape and color as opposed to exactly how the customer would be interested in buying the product. And we've seen a lot of progress on that in different categories where we, if you like, let the specification loose at certain times in certain places. And that's allowed us to put the right products in front of the right customer at the right time. And there'll be a lot more of that going forward, Karen.

Operator

Our next question comes from John Heinbockel of Guggenheim Securities.

John Edward Heinbockel - *Guggenheim Securities, LLC, Research Division - Analyst*

So Jack, maybe 2 related big picture thoughts. Number one, as you've done your segmentation work, where do you think your share of wallet is with your core customer. Do you want to -- I don't know, think about upper decile or quartile or however, you want to define it?

And then secondly, when you think about the existing market storing opportunity, right, with a smaller box, what do you think the residual storing opportunity is in those existing markets? Is it another 100 stores, 200? Have you gotten your arms around those 2 topics yet?

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

Well, certainly, we've got a very good handle in terms of how -- what the opportunity is with regard to the customer base going forward in terms of segmentation. And think about it, it's a fairly -- I can't give you a share of wallet by number because I don't have that number to hand over, right. I don't actually have that number. But what I do have and clearly in my mind is we've got a fairly tiny share of this market that we're going to be targeting. And we're a $5 billion business, and there's plenty of people out there who will -- the health enthusiast, the innovation seeker, the kind of people that we're going to be targeting. We have got a tiny share of that marketplace as it exists today, not only in the geographies that we're not, but in the geographies that we are. So it really is a matter of prioritizing going forward, given the resources that we have. And it may be -- I'll pass you on to Chip to talk specifically about where we are in terms of store growth in the smaller store growth to tackle that market opportunity.

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

John, it's a little premature to talk about the runway. I think that we'll talk to that specifically on the next call in 2 months. But as it relates to opportunity, I can say that we do believe there's a lot of white space. When you look at Sprouts like customers and you look at across the U.S., there are many, many, many, places today where there are Sprouts like customers that we don't serve today, number one.

Number two, though, what's most critical is that we can go after those customers and do it in a profitable way with an operating box that makes sense and creates the right kinds of returns that create shareholder value. And that's the part that we're working on. And that's a part that we're refining, and we're making sure that we're going to get it right before we go after those customers. And that's the work that you'll hear more about next quarter.

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

We do believe there's plenty of opportunity, John, going forward, that's for sure.

Operator

Our next question comes from Chuck Cerankosky of North Coast Research.

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

Quick thing on the balance sheet, you finished with the cash balance, up significantly. Any particular reason for that? Was that timing? And could you have been more aggressive on buying back stock? And I have a follow-up.

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

Well, as it stands right now, Chuck, our intention of buying back stock, we bought back a big chunk earlier in the year. We then made sure we were buying back any sort of dilution for the next year or this coming year that we're in today. But as it relates to the -- we want to get through the strategy work first before we continue to buy back stock. We don't have a new authorization. Our authorization, I believe, expired at the end of the year. So we don't have a new authorization right now. Any cash proceeds, we're going to use to pay down on our revolver. And once we really refined our strategy to determine how much our capital needs are going to be each and every year, we'll revisit what's left over and what we do with it.

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

Got it. And look at the comp guidance for 2020. Anything in the economy that influences you? It does look conservative or are you just concerned about some of the traffic issues you're facing?

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

There's nothing on the economy front. We're a domestic U.S., we're not impacted by the things that are impacting the global economy, which then have residual impacts locally. But as it relates to the comp guidance, yes, we are being prudent, we believe, as it relates to the potential volatility that we're going to have ongoing through the year for traffic as it relates specifically to how we promote and where we promote.

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

So you're talking about a little bit of experimenting perhaps, realized some things might not work before people catch on to the treasure hunt aspects of it.

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

Absolutely. We've been doing experimenting ever since Jack arrived. We've done a lot of experiments. A lot have worked, some have not. And we'll continue to be experimenting through this fiscal year. But we don't think we're going to be doing anything that's going to dramatically impact us negatively or positively at this stage.

Operator

Our next question comes from Judah Frommer of Crédit Suisse.

Judah C. Frommer - *Crédit Suisse AG, Research Division - Senior Analyst*

So first question is regarding the language about the 2020 outlook. I think it says something along the lines of the outlook doesn't contemplate strategic changes. It sounds like the strategy is contemplating changes in pricing and promotion. So what else could change within the strategy that may throw the outlook off course?

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

Well, as it relates to strategic changes, we're still working through the strategy. It is -- as it relates to the promotional side of the house, that work we're doing already. That's not -- that's tactical work that we're working on every day to continue to make the business a better business while working on any sort of longer term, what I would call, impactful things like the store growth, like the size of the box, like the desired pace at which we grow, shifting of categories a little bit. So we're going to have more complete information on that at the next quarter. But bear in mind, the direction we're going or leaning is -- in our opinion, is going to improve the runway of this company and the performance of this company along the way. And there may be some short term wins or losses as well, but we haven't articulated that to date.

Judah C. Frommer - *Crédit Suisse AG, Research Division - Senior Analyst*

Okay. That's helpful. And then maybe more broadly on the competitive environment. Clearly, you've seen I think some concepts that people would consider somewhat similar to Sprouts go bankrupt recently. Obviously, very different leverage profiles there, but kind of similar fresh-led concepts. And you see kind of the bigger grocers in the country continue to focus on fresh. So how do you think about your position? Do you think about price gaps or promotion within fresh and produce differently than center store than maybe you did previously?

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

We certainly spend a lot of time looking at our own business as opposed to looking at our competitors' business. I think the reality of our operation, and this is the thing that I think I've learned most in the last 6 months is we're pretty -- if we do it right, we get good results irrespective of what our competitors do. I've been very encouraged when I go around the country. And depending on who we're sitting next to, we are very much a complementary retailer as opposed to a directly competitive retailer. Our fresh produce operation is better than most and will stay better than most. Our bulk operation is pretty unique. Our vitamin operation is pretty unique and our grocery -- when we have -- the categories are doing really well for us. Or when I can't do any price comparisons because the products that we're selling are totally different to what products I can find in conventional or mass market competitors. So in that sense, we are watching and aware of what's going on, in particular, in the produce pricing marketplace. But we're creating a lot of differentiation by the type of products that we're putting in and the way we're buying it and the way we're focusing behind it.

And I think you identified pretty well the fact that, well, this is a strong cash-generative business with a strong balance sheet, which I think contrast that a little bit with where we've been with some of the more direct competitors in this space. And they don't really have the scale. I don't think to be very meaningful in the sense of hurting us or not hurting us.

With regard to what we have been doing with our stores, I think some things we probably have learned from 1 or 2 of those competitors is if you spend too much money and too much capital and invest too much in labor in certain categories and particularly in deli and prepared foods, you can put yourself in a place where the cost base is it makes it very difficult to make the returns that you'd want to make, and that's something that we will be reversing in our -- as we went down that road over the course of the last few months.

Operator

Next question comes from Edward Kelly of Wells Fargo.

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

I wanted to ask about the promotional strategy and the changes that you're making there. And maybe if you could just provide a bit more specific color on some of the adjustments and whether you're striking the right balance. I think the concern maybe is that if you pulled back on -- from an opening, pulled back a store [online] or if you adjust on promotions, those promotions were probably driving some traffic at a minimum, I guess, right? And is that why we could see continued softness of traffic in '20? And just general thoughts around how you balance all that for the long term.

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

And that's certainly very much part of what the experimentation phase over the last 6, 9 months -- over the last 6 months have been and will be over the next few months. We still got to refine every aspect of it. But the reality of it is, we've turned off unprofitable customers by not going so commodity focused on the products that we put in our promotional and the promotional vehicles that we use both in terms of what we put in the store and what we put in our flyer distribution. So we've tried to take away a lot of the commodity type promotions. They do drive traffic but tend to be very promiscuous customers who will go to wherever the lowest price of chicken breast is as opposed to who is going to go and buy those products that are going to differentiate and make us different and better in the marketplace. We've tried to shape the promotions towards those things that are different and better. And the outcome of that, potentially is you lose some unprofitable customers. But in the long run, it builds us a kind of profitable traffic growth that we're going to be aspiring to over the course of the next few years.

That makes sense?

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

Yes. Okay. And then just...

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

And it's Chip. And I want to -- I just want to point out, too, is there was a period of time in the first half of the year that the company was negative on traffic as well and was continuing to heat up promotions. So there were promotions being piled on top of promotions on top of promotions that weren't doing anything from a traffic perspective. But they were burning down margin.

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

Right. Okay. And just a question on the store format going forward. Any color you can provide on the changes that you plan to make, how you might see the return metrics penciling out? And then just talk about your decision to accelerate growth. I think most of us look at food retail as a pretty saturated industry, but you're obviously confident that you can take share profitably. So just some thoughts there?

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

Yes, I'm very confident that there's more and more people interested in healthy options in terms of buying for themselves and their family. I don't -- I think that trend is pretty clear and is going to accelerate at all income levels and all age levels. I think there's a real opportunity for us to be the leader in that space, and that space is getting bigger. Within an overall food market, there's got some issues, as you're describing it. We're trying to -- we're not really thinking about the overall business. We're thinking specifically around those customers and those trends in the marketplace.

And as we work that one through, we can supply that need in our unique farmer, low profile great presentation of fresh foods, the combination of how bulk can help that as well. It gives us a uniqueness in it. And I'm -- I was in a -- we opened a new store yesterday, it's not far away. And the passion and energy of the customers coming into that store -- it was in Arizona. But the passion and energy of the customers coming into that store for the proposition that we've put in front of them is something that makes me really excited and positive about the opportunities going forward.

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

And add real quick. I just want to point out, I mean, the simplest at its highest level, the stuff we've articulated. The store is -- it is going to be smaller than the 30. That's for sure. It is going to be less expensive to not only build but less expensive to operate. And we believe, and we have a strong belief based on the looking at our customers, looking where the customers are, looking at our merchandise, looking at what's productive merchandise, what's not, we have a strong belief we can still present our value proposition on the corner of Main and Main in a box that's less expensive than the 30 that we're doing today and less costly to operate and really not lose any sales.

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

If anything, we can recreate the farmer's market better, that's the really exciting thing -- part of it. Thanks.

Operator

Our next question comes from Chuck Grom of Gordon Haskett.

Unidentified Analyst

This is actually [Derek Green] right on for Chuck. Just regarding your -- the tweaks made into your supply chain, do you anticipate any store closures regarding that going forward? Or right now, just openings?

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

Derek, well, right now, we're focused on the openings. We are going to evaluate all of our stores. We'll continue to evaluate all of our stores and see how that fits in our strategy, and then we'll sort through that. But right now, we're still working on that work.

Unidentified Analyst

All right, great. And then just in terms of Instacart, any color you can give on the benefit you're still seeing from that?

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

Well, I mean, it's a great business. I mean we're up 150% for the year on home delivery. We're doing almost $11,000 on a per box basis. We've got it at all 340 of our stores on the home delivery side. The pickup side of the house is not really that exciting. And we've got it in 55 of our stores today, it's running at about 1/4 of what the home delivery is. It's not something our customers seem to be that excited about. But as it relates to the delivery, we're excited about that. We have a great relationship with Instacart. And we're going to continue down that path.

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

And we got some stores doing a lot of money, and that's dependent on the market, a big area, in particular, thinking through has been performing well for us in this space. And Instacart doing a good job for us.

Operator

Our next question comes from Robby Ohmes of Bank of America.

Robert Frederick Ohmes - *BofA Merrill Lynch, Research Division - MD*

Jack, just I guess 2 follow-ups. Just on the fourth quarter with the less promotions and everything. Any impact at all from the 6 less shopping days or anything in your seasonal that impacted the quarter negatively, any way to look at it and say that your traffic maybe would have been positive in the quarter, given anything that happened?

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

I've read that from some of the other retailers that have released. And I'm not -- we are not seeing that. I think that impact has been more in the toys and nonfood side of things, and it's been an impact in terms of our food business, so I don't think that's a factor. And we've certainly not identified that as such.

Robert Frederick Ohmes - *BofA Merrill Lynch, Research Division - MD*

That's helpful. And then just a follow-up on the smaller stores and maybe home delivery penetration. How are you thinking about home delivery penetration going forward and pickup? And is that factored into smaller stores matter? Does it help or hurt home delivery penetration or pickup? I'm just curious how you're thinking about the role of delivery and pickup in sort of the new store formats.

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

Yes. I think in terms of the broader strategic challenge of this or thinking through of this one is pickup doesn't seem to be something that's really a big part of how our customers want to interface with our brand. In terms of delivery, smaller stores or bigger stores, we can -- we've got both those types of stores in our network at the moment, both of them fulfill the need for home delivery for our customers pretty effectively when we do it. So going forward, we'll certainly pay attention to in terms of the formats we put in place and make sure it can be executed efficiently, but it's not something we're seeing as a huge challenge. And going forward, we want to be a business where customers come to the store for the reason that they seek. There's a reason to be there because there's something that they weren't expecting or something new or something fresh. I always use with the team internally is farmers market is probably the fastest-growing retail in the United States at the moment. If we can just capture some of that growth in farmers markets, we'll be pretty well placed, and that requires experiential retailing, it requires people to really want to be there. And that's what our aspiration would be in terms of what we create in these small stores. And we've certainly got it in some of our stores today, that's for sure.

Operator

Our next question comes from Kelly Bania of BMO Capital.

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

I think this has been asked, but I'm going to try again. It seems to be there's a little bit of a disconnect between your more cautious comp outlook for 2020 relative to the success you've seen with this tactical change in the promotional strategy, maybe just over the last couple of quarters. So I guess, I'm just curious, is the concern maybe about -- is there any concern about the longer-term impact of this as consumers get more accustomed to what you're promoting and how you're promoting. And maybe can you help us understand if your with -- your comp guidance is within -- if your comps are within your guidance for the first quarter so far?

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

Well, Kelly, this is Chip. First off, as it relates to long term, no, we don't think that there's going to be -- this is a short-term belief as we start to change the way we go to market on the promotional side that we are going to lose some traffic. We continue to lose some traffic. That started before we ever even started to shift. So that part of it, we're working through. We expect that, that will continue through this coming year.

There are -- it is volatile. We'll see the volatility from week to week from promotion to promotion. So it would be, like I said earlier, it would be not -- it would not be prudent for us to just sit here and throw out a higher comp when that's not the work that we're doing.

As it relates to -- what was the second part, I apologize. What?

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

Q1.

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

Oh, Q1. Q1, we're more than halfway through Q1, and we gave a guidance of 0 to 1. So that's what we believe is where we'll be for the quarter.

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

Okay. And I guess, just another follow-up in my understanding of Sprouts, its historical strategy was to kind of lure new consumers in with aggressively priced produce and transition them over time to some of the higher-margin parts of the store. And just curious how you feel about that and if you're seeing that progression and how that plays into your outlook. And what kind of strategy you're -- it sounds like you're still developing?

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

Certainly, going forward, Kelly, the strategy will be -- will have a foundation of very strong value produce in terms of both pricing, quality product. And that will be a fundamental part. It was a fundamental part of the origins of the Sprouts Farmers Market business, and it will be a fundamental part of this business going forward.

In terms of what you then do with that traffic when it's there, which is what this business. And it -- that's not going to change either those elements across the mix of the business that will come together to create the business model that we need going forward. So in some ways, it will be more of the same or going back to the future in terms of how we think that went through because that's what's kind of worked and made this business great in the first place. And there's no reason why that thing can't work just as efficiently going forward.

Operator

Next question comes from Bob Summers of Buckingham.

Robert William Summers - *The Buckingham Research Group Incorporated - Research Analyst*

So just to beat this to death a little bit. So as you're rebalancing the promotional posture, I'm curious as to what type of consumer work you're doing on price or value perception and whether you're breaking that down between loyal customers, cherry pickers or whatever segments you might have because I guess as we think about this with traffic negative, the basket is up. And then, is that driven by the baskets per item, product rate, mix? Just trying to get a feel for how close on price perception you are with the customer because I think that's really with what you're doing could get away from you?

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

Yes. The work with -- again, the traffic hasn't changed significantly since we've changed. It stayed at kind of negative level over the course of that time as we've been changing around and doing experiments on our promotional strategies. I think the issue that we've done in terms of resets going forward has highlighted those pricing areas in certain categories that we need to look at. And we'll talk about that a little bit in our strategy. As we focus different investments in different categories, we'll see there will be some elements of the customers that we're trying to target who are looking for more aggressive pricing in certain places. And that will be part of our strategy going forward as we prioritize certain categories or other categories, and we'll manage that within our mix.

And in terms of how the customers are viewing this, value is an important part of our proposition. And we're not seeing -- we're certainly not seeing anything in the short term that's doing anything other than losing some highly promotional unprofitable customers that will be promiscuous no matter what we do. So getting away from that, those type of customers and targeting what are we going to do to build long-term profitable customers is the key to the whole strategy going forward. And that's why there's some volatility in the numbers because you'll lose the immediate promiscuous customers faster than you'll gain the other customers coming through. And that's what we're trying to evaluate when we're putting together everything that we've been talking about over the last little while.

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

Bob, I would -- one other thing I'd make -- add to that is the work that we've done and the customer research that we've done at the end of the day, we're getting very little credit historically for being a value provider to begin with.

Robert William Summers - *The Buckingham Research Group Incorporated - Research Analyst*

Okay. Okay. That makes sense. And then just on any strategic changes, I think a lot of us will view that as really will equate to investment spending. Clearly still early for you. But just as a way to think about guardrails, and I guess, what I mean is, conceptually, what do you think is the organization's ability to absorb investment, define the rates somehow. I don't know dollars, pressure on earnings, what have you. Do you have any view on what the right way to think about that would be?

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

Well, one, I would think about it as from a capital perspective, capital may go up. But from a P&L perspective, I don't see, from an ongoing operating of the business P&L., I don't see any major investments in the ongoing business that's going to dilute the P&L. If anything, it's going to be positive.

Operator

Thank you. At this time, I'd like to turn the call back over to CEO, Jack Sinclair for closing remarks. Sir?

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

Well, thanks, everybody, for taking time to listen to our call today. We're very pleased with the progress we've made in Q4, and we're very excited about sharing with you the future of the business, starting with our next call in April time. So thanks a lot for your attention.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.
