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SFM.OQ - Q2 2020 Sprouts Farmers Market Inc Earnings Call

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OVERVIEW:

Co. reported 2Q20 net sales of $1.6b and diluted EPS of $0.57.

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Sprouts Farmers Market Second Quarter 2020 Earnings Conference 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 speaker today, Ms. Susannah Livingston. Thank you. Please go ahead, ma'am.

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 second quarter 2020 earnings call. Jack Sinclair, Chief Executive Officer; and Denise Paulonis, Chief Financial Officer, are with me today. The earnings release announcing our second quarter 2020 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. 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. 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 Jack.

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

Thank you, Susannah, and good afternoon, everyone. Thank you for joining our call today. A lot continues to happen in our world and at Sprouts. Before I speak to the results, I want to express my thanks to our team members who have worked so hard during challenging circumstances. What I've seen from the team is a true demonstration of our Sprouts culture, rooted in respect, inclusion and caring for one another. This culture shines through in everything our team members do for our customers and for each other. In true Sprouts form, our team members have adapted to a new way of operating and remain everyday heroes as they provide our communities and customers healthy food for their families. I long for the day when this pandemic is over, but for now, we are steadfast in doing what we must to keep our team members and customers safe, wearing protective gear, keeping a social distance and maintaining a sanitized and stocked store. Our results are in large part due to our team members on the front line. As such, I am focused on supporting them with enhanced compensation and a safe work environment.

I remain committed to continually reviewing these topics through these trying times. In fact, in July, we once again paid enhanced compensation and continue to encourage and pay for team members to stay home if they're not feeling well. As for our results, our sales for the second quarter peaked in the middle of the quarter and started to settle in June. Some of the consumer trends we experienced in the first quarter related to the pandemic remained in the second quarter. Customers consolidated trips to avoid social contact, which resulted in a reduction in traffic, but with increased basket size. Our customers' desire to remain healthy, correlated to an increase in immune building categories we're known for, such as vitamins and healthier products like organic and plant-based foods. The percent of organic produce sold trended up into the high 20% range of total produce sales, and sales growth of organic chicken is up 3x since pre-COVID days.

As the country continues to practice social distancing, our e-commerce sales have remained elevated, up more than 500% from last year in the second quarter. Our roll-up of pickup service to all our stores was successfully implemented by early May, giving our customers another option for shopping with Sprouts. The pickup service grew rapidly throughout the quarter. And as expected, home delivery remained a preferred service by our customers at 6x the size of pickup.

During the second quarter, we also increased our marketing spend for our owned channel, delivery.sprouts.com. This website is also powered by Instacart, but when customers order through this owned channel, we capture customer data, providing insights for future marketing. The increased marketing dollars resulted in our owned channel sales growing more than 2x that of all e-commerce sales.

The supply chain for our distribution for produce distribution centers finished strong in the second quarter, rebounding from the high volumes in March and early second quarter. Importantly, for our fresh distribution, our on-time delivery to stores is nearly back to historical norms. From a nonperishable standpoint, service levels have dramatically improved since the low levels in March, and the stores are doing well, keeping the stocks -- shelf stocked with available products. Our pinch point mainly remains with the vendor community in assortment availability, but imports are flowing through again, resulting in improved levels of private label products. And importantly, our innovation pipeline is robust. We continue to launch new items like the Snow Monkey vegan paleo ice cream and frozen vegetables from Stahlbush Island Farms who was the first farm to build a biogas plant using agricultural byproduct and become certified as sustainable. I'd now like to provide an update on a few pillars of our strategy. Starting with some additional color on our target customer segments. Last quarter, we highlighted 2 consumer segments that Sprouts resonates with, the health enthusiast and innovation or experience seeker. These 2 consumer segments combined cover a wide range of income in age demographics from Gen Z to baby boomers, where they live in the country aligns nicely with our stores and our store expansion plant. Healthier foods and a pleasant store experience highlighted by friendly customer service, 2 defining characteristics of Sprouts, drive their shopping habits.

Both consumer segments also over-indexed depressed produce, a foundational category of Sprouts and part of our DNA. Our produce lineage traces a long way back in history, and the bountiful fresh produce selection at great prices will always be the centerpiece of our stores. Having said this, we have significant headroom within these target groups to capture new customers by doubling down our efforts.

Today, we're only capturing a small percentage of the more than $200 billion market that makes up these 2 segments. Starting in June, we began to significantly adapt our marketing spend to focus on more digital, social, radio and for the first time, TV towards these 2 customer segments. In the past, our heavy reliance on a print ad kept us from optimizing our connection to the customers that our brand and experience resonate with the most.

To bring this point home, in June 2019, we sent out 110 million print flyers of our weekly ad. Without having full visibility into how many were seen by customers. In comparison in June of 2020, we had 125 million measured digital impressions of our weekly ad. And we're able to achieve a significant 1,800% year-over-year increase in digital impressions of brand and promotional content by reallocating the saving from eliminating print.

Another key insight is that we know from the data that customers who read the printed flyers frequently only read the front page, while the digital flyers have high readership across all pages. We're reaching more customers and importantly, customers that align most to our offering, and this new media strategy will continue to evolve. Our messaging and promotions are evolving as well. Gone are the days when all our marketing dollars are spent talking about price. Our promotions are starting to become more around storytelling. The products we carry are unique like Daring's frozen plant-based chicken alternatives, and our marketing stories will bring them to life. This in no way means we are eliminating promotions. Even during this COVID pandemic, we are still promoting, but we're being smarter, we're buying better and targeting our promotions to our core customers. Our investments are focused on items that are elastic and drive volume. We stopped the deep promotions in price that did not change the customer's decision or drive additional traffic and only resulted in deflated sales.

Moving forward, we are promoting what we are known for, healthy differentiated products and multiple varieties of produce. A portion of the promotional dollars left are being reinvested back into a competitive everyday price. We started this promotional change in the back of the third quarter of 2019. In the fourth quarter of last year and the pre-COVID days of 2020, this strategy was taking hold as seen in those results, and it still is today.

Outside of March and part of April, most all grocers are back with their full distribution of print promotions, and we continue to see the benefits from our strategy, as evidenced from today's results. Being we're such a young company, our operating margin improvement opportunities are beyond promotion and price. We've already begun to experience shrink improvements from the implementation of fresh item management. For example, for the first time, the meat department has a clear line of sight of how to reduce overproduction and what products really are their best sellers from an overall cost perspective, reducing the complexity of our stores, merchandising appropriately with the right number of SKUs and minor fixture changes will result in further savings in shrink in the years to come. A smaller, less complex box with our new format will also contribute to better labor standards, helping to offset future increases in labor costs and. A continuation of the rollout of self-checkout stations in our stores, can create additional labor efficiencies to help to offset additional labor needed for future e-commerce growth. Our future at Sprouts remains bright, and I look forward to the continued improvement in the business as we scale and grow. Now let me hand it off to Denise to speak to the financials for the quarter and provide some additional color on our start to the third quarter.

Denise A. Paulonis - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

Thanks, Jack, and good afternoon, everyone. First, I hope all of you and your families are staying healthy and safe. The COVID-19 pandemic continued to positively impact our business in the second quarter. Net sales grew 16% to $1.6 billion and comparable store sales were up 9.1% compared to the same period last year. Our comp sales peaked in May at 13%, led by the grocery, meat and frozen categories. As state reopenings became more widespread in June, comps came in at 8%. E-commerce sales continued to remain strong. For the quarter, e-commerce was 12% of sales up more than 500% compared to last year. It's hard to delineate a precise amount of sales that were driven by the COVID-19 environment. But needless to say, the comp trends are substantially above the prior guidance we gave back in February of this year. For the second quarter, gross profit increased by 32% to $613 million, and our gross margin was 37.3%, a positive increase of 450 basis points compared to the same period last year. Two main buckets drove this margin expansion. First, were the positive strategic changes we made that were in-flight prior to COVID. This includes utilizing more thoughtful promotions that are focused on more unique, differentiated products instead of just price and eliminating inefficient promotions in addition to the benefit of ongoing shrink initiatives. The promotional changes were an outsized benefit in the second quarter as we cycled very deep promotions from last year. The second bucket included COVID-enabled benefits and accounted for approximately 250 basis points of the improvement. We were able to accelerate our planned shift from print to digital for our weekly ad resulting in a reduced number of items on ad and more sales at everyday retail prices. As well, our produce team was able to procure excess product in the marketplace at great prices, and we benefited from shrink due to sales leverage and lower sales on high shrink items like deli. While some of the COVID benefits will not repeat post pandemic, others like the mix shift between promo and reg price sales may carry forward depending on customer sentiment.

Offsetting some of the gross margin leverage, SG&A increased $106 million to $489 million or 29.8% of sales, a deleverage of 270 basis points compared to the same period last year.

SG&A included a pretax special charge of $3.4 million related to our ongoing strategic initiative. As we discussed in our last call, we took significant steps to adjust to the impact of COVID-19. Most importantly, we made investments in bonus pay and benefits to recognize our team members' commitment to serving our customers during these unprecedented times. Sick pay and ongoing safety measures in the store added to these costs. In total, we estimate the additional costs associated with COVID-19 was approximately $47 million for the quarter. Additionally, with increased e-commerce sales, we realized increased e-commerce fees, which were partially offset by lower marketing expense as we shifted from a print circular to more digital spend.

Moving down the rest of the income statement. Our depreciation and amortization costs for the second quarter were $31 million or 1.9% of sales, a decrease of 20 basis points compared to the same period last year.

For the quarter, our adjusted earnings before interest and taxes were $96 million, an increase of 87% when compared to the same period last year. Our interest expense was $4 million, and our effective tax rate was 25%. Second quarter diluted earnings per share was $0.57, and adjusted diluted earnings per share was $0.59 compared to diluted and adjusted diluted EPS of $0.30 in the same period last year.

Our cash position remained strong. Year-to-date, we have generated cash flow from operations of $393 million, up 58% for the year. We ended the quarter with $328 million in cash and cash equivalents. Reflective of our strong balance sheet, we ended the quarter with a net debt-to-adjusted-EBITDA ratio of 0.3x. As well, subsequent to the end of the quarter, we paid down $76 million on our revolving credit facility. We continue to prioritize our strong cash generation organic growth opportunities consistent with our strategic growth plans.

Lastly, we invested $48 million during the second quarter in capital expenditures, net of landlord reimbursement, primarily for new stores. For the second quarter, we opened 6 new stores ending the quarter with 350 stores in 23 states. We remain on track to open approximately 20 new stores this year.

To date, only a few stores have been delayed for a short period of time due to COVID-19 pandemic. As for current trends, elevated levels of grocery spend have continued into July. Our comps have reaccelerated in July, and we estimate them to increase approximately 9% compared to the same period last year. Similarly, e-commerce trends remain elevated, and we estimate that we'll finish the month at approximately 11% of sales for July. The trajectory of the COVID-19 situation remains uncertain, clouding the impact to the food retail industry over the coming quarters. While our sales continue at elevated levels, so do additional costs associated with operating our business. Additionally, at the end of the third quarter, we'll begin to lap the first phase of our promotional efficiency efforts that drove merchandise margin improvements starting in the fourth quarter of 2019. That said, at this time, we expect increased gross margins in the second half of the year. Predicting specific outcomes remains difficult. And accordingly, we are not stating a new outlook range. We remain confident in the financial strength of our business and our strong balance sheet and our new long-term growth strategy presented last quarter, which we believe will strengthen the Sprouts brand and set us up for long-term success. At this, we can open up the call for questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Chuck Grom with Gordon Haskett.

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

Congrats. Jack, curious when you've dissected your customer base here in the second quarter, if you've done any work on new versus existing shoppers? And if any of the new ones have started to repeat? And then as a follow-up, looking ahead, what steps you're taking to solidify those relationships with those new customers going forward?

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

Thanks Chuck. Because of the trend -- the traffic and transaction trends in the second quarter, it's difficult to break it all down because the whole industry, as you know, is seeing such dramatic reductions in transactions. And then such dramatic increase in baskets. Anecdotally, our stores are seeing a lot of new people that look like the people we've been targeting. And that's quite encouraging. We're going to do a lot more work to get to the bottom of exactly who's coming and who's not coming, and there's a lot of backup work being done on customer analytics to see if it's following through on the targeting that we talked about in our last earnings call. So in some ways, that's a little bit big, Chuck, but we're seeing a lot of new customers in our stores, seeing less transactions. But we're seeing customers that we think are very much in line with the new customers that we're targeting.

Sorry, what was the second part of the question, Chuck? Because I -- sorry.

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

Just in terms of productivity opportunities looking ahead and how you can continue to engage with those customers going forward?

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

Yes. Well, very much, we've got a very dramatic change to our marketing positioning going forward in terms of how we're going to engage that customer. We've got a massive brand piece of work. We've got a new marketing head in the organization who's changing not only the fact that we're moving in the media, but very much the messaging, and we're going to be telling a lot of stories behind the reality of the products that we have in our stores in terms of differentiation, in terms of our fresh produce offer, in terms of our bulk offer, in terms of our vitamins and -- vitamins offer and a lot of the exciting things we've got in our grocery business that are different. There'll be -- the team will be telling the story of that in very different ways and -- starting actually at the back end of Q3 and going into Q4. And I'm excited about that, and I think it'll be very clear that it's targeting the kind of customers that we know will respond to our offer when we put that clearly in front of them.

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

That's great. And then just as a follow-up would be performance thus far in July, I think you said 9%. Curious how the performance has been in some of the markets where you've seen a surge in COVID cases such as your backyard, Arizona, Florida, California?

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

Well, I -- we see -- basically, you're -- we've got places where the COVID cases are high. So California, Arizona, Florida, have been performing pretty well. But the rest of the country has been performing very well as well. You see little peaks and troughs based on when local ordinance has come out. And we watch that pretty closely. When a place shuts down and changes a little bit when it opens up, it changes a little bit, and we see that within our categories. But by and large, we're seeing a pretty consistent pattern across all states and all counties, really.

Operator

Our next question comes from Ken Goldman with JPMorgan.

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

I wanted to ask, first, one of your larger competitors recently talked about promoting more in June than in April and May. Obviously, you gave us all your numbers. But I'm just curious, did you experience any impact from any of your major competitors shifting a little bit of their priorities in terms of promotions in June? So that's my first question.

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

Yes. Well, Ken, I think we talked about -- we talked long before the COVID thing about how we were changing our promotion emphasis, and that we're going to promote things that are very -- not quite so deep cut, which was creating a huge margin problem, not driving traffic and probably deflating some sales as well in some of those categories. So what -- we realigned our promotion focus starting with produce, then meat and then across the store in Q3, Q4 last year. And that's what we continue to do. When the pandemic kicked in March, we clearly pulled out our flyer and went to -- promotions had to come out anyway partly because of availability, but partly because of sending paper into people's homes wasn't what we wanted to do. So that went away and then everybody came back and put the flyers back in. We didn't. We made it all digital and pushed hard on digital promotions. We saw no impact from the changes in June from everybody else flying back into the flyer. Flyers are back in the rest of the industry about where they were before pre COVID. We're now in a position where we're spending 0 on it. And it doesn't seem to have affected us at all, Ken.

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

Okay. And then my follow-up, Denise, you talked about funding some of your debt pay down subsequent to the quarter. You don't have necessarily a high interest rate on your revolver. And you have a lot of potential projects you can spend on. There's CapEx on new stores and DCs, there's remodels and Jack, you talked today about having some more work to do in understanding your customers. So I guess I'm still a little curious why maybe some more growth-oriented projects are not getting a little bit more of a higher priority from your cash flow at this time, if that's a fair question. Not -- obviously, paying down debt is a very valuable thing, too. I'm just trying to get a better sense of, as cash flows in and where your priorities might be ahead.

Denise A. Paulonis - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

Yes. Ken, let me separate out the 2 different pieces about what our priorities are over the long-term versus what we just did as we finished the quarter here. So it's very real term as we finished the quarter, we are sitting on excess cash. We believe that it's been prudent through the pandemic to always have a little bit of excess cash, but just because we had more than we needed, we did just want to take some of that off the revolver and get the revolver balance down a bit. That said, first and foremost, if you think about our long-term capital allocation plans right now, we are very focused in investing behind the business. I don't think that there -- you'd be able to say that there's a shortage of our investment that we have done this year. But much of our investment is going to be to come as we cycle out of 2020 into 2021, both in IT projects, in our new stores and putting our 2 new DCs in place. So I would tell you, we are 100% behind investing on what has returns to drive the business go forward, and that'll be the first priority. And then after that, excess cash that's out there, we'll continue to come back and reevaluate where we feel like we are with the revolver versus some other return of capital options. But for now, I'd actually just reemphasize that we are focused on investing in the business. It just happens to be some of those investments are a little bit further out than this particular quarter.

Operator

Our next question comes from Chris Mandeville with Jefferies.

Christopher Mandeville - *Jefferies LLC, Research Division - Equity Analyst*

Yes. I guess, I was curious if we could maybe dig into your online business a little bit further, specifically, I'm kind of interested in understanding how the margin profile looked given presumably some greater basket size as well as maybe some of the mix shift in delivery versus pickup and anything else that might have influenced channel profitability? Also, I suppose, with e-commerce penetration actually slowing a little bit, now that it's about 11% of sales in July versus 13% in April, how did that play out on the margin for you? And maybe in light of the fact that you've now rolled out pickup nationally, I guess I'm curious if this reduced penetration might have actually surprised you? And if you can provide any color with results -- with respect to the result of pickup.

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

Yes, Chris, let me take the kind of what's happening in our e-commerce business, and I'll let Denise go through the margin profile and the impact of that. In terms of our business, when this all started, we were running at 4% and it got back up, as you said, to over 13%. And it had tipped down a little bit and it's tipped back up a little bit. It just kind of goes up and down, but it's very significantly different than where it was. Our strategy remains the same on this. We want to provide the option for the customer -- particularly within the context of the coronavirus, we want to give them the option to either pick up, have it delivered or use the store. And that way we expanded -- as we talked the last time, we expanded dramatically the pickup capability in our business, and the team did a really nice job of making that happen. We've seen the customers respond to that partly in a different way at different times depending on -- this is one that's very dependent on local jurisdictions and how people are feeling comfortable with it. And it's also actually helped us deal with the mask issue enable -- to enable people to say, look, you don't have to come into the store. If you don't want to wear a mask, you can use a delivery or the pickup, which has actually helped us a lot in the dialogue on that thorny issue. So I'll let Denise talk about specifically on the margin side of it.

Denise A. Paulonis - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

Sure. Just to pick up on that, a couple of things just about what we're seeing in the overall trends of the basket and how they evolve. Our e-commerce basket is a notably bigger basket than an (inaudible) basket, as you can think about the idea of people consolidating purchases, it's a bigger basket to start. And generally, the mix of the products in the basket is a little bit more margin favorable to us. Our business actually is very strong on a profit perspective in areas like grocery and vitamins. Things that are nonperishables for us generally hold a little bit higher margin, and those are mixing a little higher into the basket. So that's a bit of a benefit when we think about the margin and an e-commerce basket that we have, from a mix perspective. And then secondarily, the other piece is with us having balanced our business to have both delivery and pickup. While pickup still remains a very small part of the business, our margin on that pickup business, we have the ability to leverage a bit more by the use of our own team members in-store to do the picking and the delivery out to the vehicles from a pickup perspective. So there's also a little bit of an arbitrage there as people mix out and have a bit of their business being pickup. So overall, we're playing e-commerce for margin dollars. Our e-commerce business is profitable. And so we really want to serve the customers where they want to be served. But the notion of that bigger basket and a little bit of positive mix benefit in terms of the product choices is a benefit to us.

Christopher Mandeville - *Jefferies LLC, Research Division - Equity Analyst*

Okay. That's very helpful. And then my follow-up, well, I believe you only really have a handful of stores that are exposed to 4 new ALDI locations that will be opening in the state of Arizona later this year. Can you just give us a quick reminder with regards to what initial impact you might have saw or what you did see for that matter from that banner when it came to California a few years back and how quickly you were able to recover?

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

Yes. Funnily enough it -- I don't say it in any many -- in any way arrogantly. When ALDI come next to us, it doesn't make a lot of difference to our business. If anything, it drives a little bit of traffic to us. And it's such a different proposition. That the customer seems to be pretty comfortable using us as a complementary shop in that environment. I've competed with ALDI all my career and all sorts of different guises. And they're a very clear competitor in very many places. For us here at Sprouts, I see them less as a competitor. And in some ways, the driving of traffic that comes from it might even help us a little bit. You might be surprised to hear me say that, but that's certainly how we view it.

Operator

Our next question comes from Kelly Bania with BMO Capital.

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

I had 2 that I really wanted to ask about, first, just on gross margin, obviously, a really big increase there, I think, may be probably bigger than you were planning, but help -- I was wondering if you could help us understand and unpack just the shrink, the promotional impact? And what categories are you pulling back on promotions? And just help us think about that kind of gross margin expansion.

Denise A. Paulonis - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

Sure. Kelly, I'll start and then Jack can jump in as he sees fit. First, you mentioned the idea of did it come in a bit stronger than we might have anticipated earlier in the quarter. I would say it actually did come in a bit stronger, 2 drivers to it coming in stronger. One was, shrink improvement was better than we originally expected. Part of that is sales velocity remained high. We were not necessarily betting. It would remain as high as it did, which helped shrink. But we also saw good traction on some of our own operating initiatives in-store to be driving that shrink improvement. So that was one item. And then the second, as we came into the quarter, I think we were cautiously optimistic that our ability to pull back and stick with digital ads versus print ads would be able to continue, but when we were able to continue that through the whole quarter, we saw a little bit more outsized benefit in being able to do that than we originally anticipated coming into the quarter. But then more broadly, kind of unpacking the items that are there. From a promotion perspective, Jack has talked about this quite a bit. We're really leveraging a couple of different tools and approaches. One is really understanding what's an elastic promotion and what is an efficient promotion, sticking with those and pulling back in places where those don't make sense. I think the second is really the shift between a print ad to a digital ad and being able to become much more targeted as to what we're promoting each week. And the third tide to that is what we're able to do to marry up the way we think about, in particular, our produce buying and then what we promote. And having moved to a digital ad, we're actually able to leverage much closer in what our produce buying team is able to do and getting good deals on short notice and being able to take advantage of getting those to the customer in the marketplace. And so we're really able to work through those levers in a bit of a different way than we would have been if we were only doing a print ad. And then on shrink, as I mentioned, one portion of this is we just have great sales velocity. And with things like deli and salad bars being closed down during COVID, some high shrink areas, by default, have lower sales and in turn, a bit lower shrink coming through. The second part, though, is all the operational efficiencies we're doing. So whether that's part of our fresh item management program and being better about what produced items are coming out in what quantities and managing that. Or just being disciplined of team members watching turns of product in the store and appropriately kind of reordering and setting order sizes and managing through that, we're starting to see the goodness of that shrink program come in as well. And then the third part, I would just add, is to realize that last year in the second quarter, we were very deep in our promotional intensity. So not just the number of items promoted, but how deep we are going. So we also happen to be lapping in a quarter, just a very deep cycle from last year.

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

Yes. And I think the key probably is the whole produce change in the way -- the approach to produce has been. Last year, we were doing a lot of very aggressive commodities at very low prices, below anyone in the marketplace. And they were being planned 3, 4 weeks out to support a flyer. What we're doing now has been much more thoughtful about what we put. Produce is still promoting fairly aggressively, but we're being much more thoughtful about the items we're putting in it and being much more in taking advantage of a fairly volatile supply situation because we're doing a digital ad, and it's happening, you can make changes right up till the last day almost in terms of planning this. And because our distribution centers are there, we can flow it through very quickly. So I think the flexibility in being kind of nimble and the team who have put some new people and some really good people have joined the produce department, we're very encouraged by the progress they're making. And that's probably why it got a little bit better than we thought it would be within Q2. And that will moderate in Q3 and Q4.

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

Okay. That's very helpful. I guess, Jack, just one other big picture question. Obviously, when you laid out your strategy in the early stages when COVID kind of hit, so I guess, just curious, as you dissect the results and look at the business, what metrics are you using discern how much is COVID versus the core underlying strategy and sustainable? And obviously, hard to maybe separate those, but what gives you comfort that you're on the right track with this strategy?

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

Well, first of all, clearly, it's difficult. We've tried to break it down in the numbers that we've gone through and tried to say this is COVID and this is non-COVID. And I think we made a pretty good fist of getting as close as we can to that. And maybe, Denise, you can kind of outline how we've done that. But the piece that gives me some confidence in the strategy is actually, the question that was just asked about everyone else going on aggressively promoting. So the context, when we introduced the strategy pre COVID was we're going to target a very specific group of customers, and we're going to communicate with them in an effective way. And we're going to turn on our head how we're doing our promotions and how we're doing our marketing so that we can target those -- that group. And I suppose in our business, for us as we work this one through, it was how effective was that going to be. The fact that everybody else has raised into promotions and our numbers have stayed pretty strong has given me a lot of confidence on that. And as we do more customer research and more customer analytics, we're getting clearer and clearer about the exact people that we're targeting. And when I've done that -- we've been doing the work on real estate and looking back over the stores that we had, we can tell the stores that are working really well, that are targeted. And we can actually see 1 or 2 stores that maybe haven't quite got all the customers that we'll have in the stores going forward. So a couple of data points. Other guys promoting are performing really well. And the data point as we're looking at our real estate portfolio, but it looks like it's very much in line with the target when we dig into the catchment areas.

Operator

Our next question comes from Paul Trussell with Deutsche Bank.

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

I wanted to ask about new stores. You obviously don't -- haven't opened up as many as usual. But just curious in terms of the performance that you are seeing. And as we look forward, if you can talk about the pipeline of locations to open and how that site selection process is going? In addition, the supply chain, maybe just given up (inaudible) of goods that you're seeing and the progress you guys are making on the overall fresh supply chain plan that you outlined as part of the strategy?

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

Thanks [Paul]. I'd like to talk about the new stores first, and I'll let you get into more detail, Denise, on this one. But specifically, we consciously -- we said this long before COVID, we consciously said we would slow down the new store program because they were too big. And we wanted them to be more in line with the stores, going back to the basics. And that's the program that we're working on now, and we'll have 1 or 2 stores opening next year that are in line with our new format. In the meantime, there's a pipeline that's in place that some of which we could get out of and some of which we couldn't. I've been very encouraged by the stores that have been opened in 2020. I've visited a number of them. And I've been really encouraged by the customer reaction to them. And I think if we make them a bit smaller, they'll work even -- they'll provide the kind of returns that we want from them, and we're very much in the middle of that work that's creating that new format store, more like what we used to do rather than what we did in the last 2 or 3 years supply chain. We've announced the creation of the distribution center at Colorado and Florida, and those are up and running. They will be up and running in the early part of the May time -- between March and May next year, we'll get them up and running. And that will significantly improve the freshness for a number of stores as we get this store portfolio within 250 miles of a distribution center. There's further work we're doing on that strategically going forward as to what other categories should we be carrying in those DCs, and there's a lot of work going on in to build that for next year. But we can anticipate as we go into 2021, significantly lower transportation costs and significantly better fresh quality in a number of stores that have been -- had too far to transport the product to. Denise?

Denise A. Paulonis - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

Yes. I think the only thing I'd add to that, Paul, is that regarding the stores this year, I think the stores we've opened so far, which is 10 stores year-to-date, generally performing in line with expectations. And in some cases, where they're in areas where we might be less well-known in the market. I think the benefit of opening during COVID, where people are looking for additional alternatives, has been a nice way to get new customers into those stores. So all in all, the cohort is performing well to date. As we look to 2021, when we laid out our strategy, we talked about getting 10-plus percent growth each year, right? We're starting to build a pipeline. I will tell you, we're not yet at that 10%, right? As we think about restarting our pipeline from having taken a pause while we worked through the strategy. That restart takes a little bit of time. So we certainly aspire to get back to that number in 2021, but it's going to be kind of touch and go as opportunities present themselves or maybe there'll be a pocket of boxes that might be able to come all at once. But the flip side of that, realizing that some developers who might be doing ground up builds might just be more challenged to get financing when they might not have as many tenants signing up for new boxes at this point in time. So overall, still very much working that pipeline, still very much aspiring to hit those numbers, but just starting a little bit later than might be ideal to know that we're going to get there.

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

And then just a quick follow-up -- is just on the SG&A. Maybe a little bit more color on the breakdown of the growth in expenses this quarter. And how we should think about those higher operational costs and bonuses going forward?

Denise A. Paulonis - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

Sure, sure. So when you think about the SG&A front overall, as we mentioned, we incurred about $47 million of costs that we would say are directly attributed to COVID. Additionally, we saw a little bit of increased cost pressure from the higher penetration of e-com, but that was really close to fully offset by some marketing efficiencies as we moved from print to digital. So net-net, the story really for the quarter was about the COVID cost. If you think about the breakdown of those costs, the vast majority is tied to labor, whether that's through bonuses that we've paid out, earned bonuses tied to higher sales performance or sick time, and that would have come through then the remainder of the costs are really more about PPE and safety-related measures in the stores. When we think about those going forward, we spend a good amount of time talking about how many will -- how much of that will persist, how much of it won't. I think in general, if the operating environment remains like it does today, a reasonable amount of those costs will persist. We believe that safety matters, and our team members are facing a lot of challenges as they're working in the stores, and we want to continue to reward them. But I think the piece I'd also leave you with is some of those costs are variable. So if sales are not at the levels they are now or they start to moderate at all, some of those costs are really tied with a particular level of sales outperformance that will come down in line with sales trending. So we'll closely monitor things. But I think the good news for us is as we think about it, there'll be some things we just don't compromise on. We won't compromise on safety of our team members, we will not compromise on PPE and doing the right thing with sick time for those that need it. But some of the costs are variable tied to sales, and that's an option of what we can manage over time.

Operator

Our next question comes from Karen Short with Barclays.

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

A couple -- actually, since we were just talking about SG&A broadly. When you back out COVID and obviously the strategic expenses, SG&A was still up 14%. So I guess, is -- I know you commented that e-com costs were offset by the shift in digital -- or in media to digital. But is 14% the right way to think about SG&A growth going forward ex COVID? Because that just seems like a high number.

Denise A. Paulonis - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

Yes. Karen, I really think about the incremental SG&A that we will have going forward will be tied with new stores coming online and the cost of operating those stores for the -- all of our costs of operating the stores hit within our SG&A. And we also would see some SG&A costs as we're investing in the business behind some things like IT. And the comment of the 14%, in specific, I'm not really going to give a prediction on that specific number. But overall, we're watching SG&A very closely. And in total, would not consider it to end up being an outsized area of growth beyond what's happening with new stores and some basic inflation.

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

Okay. And then I wanted to just ask about gross margin kind of more broadly. So obviously, Jack, before you arrived, there was conversation at Sprouts where the focus was on the fact that merchandise margins had remained remarkably stable over time, and that was generally true because we can all look at the model. But when you arrived at the conversation kind of shifted a little bit to the fact that produce merchandise margins had obviously been coming down and had been a big headwind for a while. So I guess my question is, how -- can you help us -- and again, it's hard with COVID, but can you help us think about what gross margins could look like more sustainably longer term if we kind of get back to a more normalized environment?

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

Yes. And you're right, Karen, it's very difficult because of COVID to be very explicit about this. But let's take it back to the pre-COVID world. What we were facing -- and this is my -- the first one I came in on was Q2 last year. So I -- that was the first conversation. I had literally been here a few days. And when you look at the business, it was seeing a very significant margin investment to get a very low comp sales and a negative traffic and declining profitability. And a business that's so depend -- and one of our great heritage is our produce business and the DNA of produce in our organization is second to none. How do you effectively maintain that DNA while managing those kind of dynamics that we -- that I inherited. So very specifically, it's about being smarter. And I think that's what -- and that's sustainable going forward. Positioning our business where we bring differentiation in terms of both product and kind of what we're promoting. We talk about if a company does one thing, we want to do the other, and we were getting caught into this pattern of trying to beat every promotion from every competitor. And as I said earlier, I'm comforted by the fact that our margins will have some sustainable growth when I see what the other guys are doing right now in terms of throwing a lot of flyers at it, trying to build for Fourth of July and Memorial Day and all the things that people have talked about. I think we've got a sustainable long-term margin enhancement that's coming about from what we're doing. And I'm getting more confident at -- rather and less confident as time goes on. What that exact number is, Karen, it's so difficult to highlight because of where we are with COVID.

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

Okay. And sorry, just to ask one more question because I really would like your view on this. So you mentioned on the last call that the 2019 cohort of stores outperformed, I think, during COVID, and granted, it was only a couple of weeks that you would have been able to measure that. But I guess that was in the format that -- so that in 2019 cohort would have had more bells and whistles. And you did comment that, that cohort outperformed. So I guess how do you weigh the risk again and simplifying the format by going forward when it looked like that was the store base that actually performed better in COVID?

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

Well, again, let me take you back to pre-COVID dates. When I went to visit all the San Diego stores and the Colorado stores and the stores in California that were smaller, they're performing really, really well. When I went to visit the new stores, the 200 -- 2019 cohorts, I thought the stores were lovely. But when I looked to the numbers, they didn't add up, all the economics didn't add up. So I think what happened in the -- when COVID came along was there's -- and it didn't just apply to our 2019 stores, I think it applied to all our stores. There's a kind of tailwind to what we do. And there's a tailwind to organic. There's a tailwind to produce. There's a tailwind to vitamins, enhance their whole supplements business that we've got to benefit from. And I think if you like a shiny new store that customers haven't been exposed to before. Because of the pandemic actually encouraged -- and that's certainly what people were seeing when they were coming into the stores. And our marketing being so -- in the past, our marketing being so dependent on price and promotions wasn't really targeting the target customers that we were targeting at the time. And what we're seeing at the moment, I think, is a tailwind driving people into all the stores and a new store creating kind of good feel in the communities that we're in.

Denise A. Paulonis - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

Yes. And I really think about it as these stores just matured a bit faster and earlier than other stores would have matured. They actually started off perhaps a little lackluster, and what they did is they just caught up because of the COVID environment, to Jack's point.

Operator

Our next question comes from Rupesh Parikh with Oppenheimer.

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

So I guess I just wanted to dive a little deeper into market share for the quarter. So the level of comp growth appears to have trailed some of your larger conventional peers. So just wondering, if you can provide any more color or thoughts in terms of maybe what's contributing to the difference?

Denise A. Paulonis - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

Yes. So I'll start there. I think about it, as we talked about on the last call, we do sell a different assortment of product in our store than the conventional sell. So where the conventionals have a fair amount of paper [products], consumables, cleaning supplies, all things that people are continuing to buy in higher quantity. Those just are items that aren't in our store. So I think when you start to narrow it more as a comparable mix, we're pretty much in line with what we think the market is performing on a comparable mix basis. Certainly, there are some places where folks are having really great results. But when we really stare it down, it's a bit of that mix effect playing out more than anything.

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

Okay. Great. And then my one follow-up question. So I -- on inflation, what type of benefit did you get from food inflation in the quarter? And then just any thoughts on the outlook going forward?

Denise A. Paulonis - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

Yes. So in the quarter itself, food inflation was not a material part of our story. I think we all saw a little bit of elevated costs in meat, where all the production sites were having a little bit of challenge, but it wasn't really an outsized effort for us. When you look forward, I'd say the 2 places where we watch it the most closely would be in our produce and our meat spaces. It feels as though meat has kind of leveled off. Production facilities have figured out their new operating procedures, managing through, and it seems like that supply-demand equation is pretty good. I'd say on the produce side, we anticipate there could be some inflation coming forward as just -- there's just a lot of demand out there and growers, from what we can tell, are being appropriately cautious about what they're planting and the quantities of what they're planting, not knowing exactly what the future holds for them. But overall, I don't think we'd look at it and say there's anything tied to inflation or deflation that wouldn't let us continue to manage the business the way we've been doing it.

Operator

Our next question comes from Robbie Ohmes with Bank of America.

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

I actually wanted to follow-up on Karen's question. I know you and most others are not giving any guidance, but your gross margin's going up a lot right now, and you're telling us to expect it to be up in the back half. And we do have to think about next year, and we have to think about the cost of you guys shifting more into e-commerce, et cetera. When you look to next year, I mean, should -- is Sprouts going to a significantly higher gross margin place in a normalized environment? And do you think some of the things you're doing already are things you were going to do pre COVID that are getting you there and you see a way to keep a much higher gross margin than historically? And then do we need to think differently about the SG&A as you're doing more pickup? I mean, can you give us any kind of thoughts on could gross margin stay at this level? Or should we think it's going to be somewhere between what you're doing now and what you used to do? Any thoughts on structural changes to the longer term here?

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

There's a number of things longer term that should -- I'll let you talk to the SG&A, Denise. But in terms of specifically around the margin, there's 3 different key dynamics that potentially will make a big difference to next year's margin. One, we've talked about, which is the promotional investment and the changing in promotional investment should enable us to have a more consistent pattern of our product gross margin. Our shrink improvements, there's a lot of very fundamental things. It's a very immature business, Sprouts, in terms of its processes in store. Denise talked a little bit about some of the stuff that we're doing in the meat departments and the deli departments and just getting some system investment and operating our stores a little bit more -- in a little bit more of a streamlined way, I think will give us some sustainable shrink improvement going forward. And we're pretty convinced that, that's there and there to be had through the next couple of years. And the other side of this is the transportation costs. When you drive -- when we -- built stores too far away from our distribution centers, which was putting a lot of pressure on transportation costs. For these 2 new distribution centers and then potentially another one somewhere else, could significantly -- should significantly reduce our transportation costs going forward. So those are things that are right in front of us. And I -- so if you take product margin, you take shrink and you take transportation costs, those are all real things going forward that will come through irrespective of the COVID environment. I think the COVID environment probably allowed us to accelerate this change from paper flyers to digital flyers. And that speed at which we were able to do that surprised us, and it was because of COVID, but I believe it'll also be sustainable going forward.

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

And then, Jack, on the SG&A side, if you get back to a place where your transactions are more, but your e-commerce penetration is still high. Should we be thinking about a much higher store SG&A rate to support that?

Denise A. Paulonis - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

Yes. I think the way that I'd suggesting thinking about is there are puts and takes here in terms of tailwinds and headwinds, right? On one hand, while e-commerce penetration comes with a little less margin than our core store business. Offsetting that, we still have, as Jack referenced, we're a relatively young company, and things that we can do on other labor productivity fronts can be a help and an offset to that. So we're testing some self-checkout in some of our stores. I know most people might think we already have it in all of our stores, but we actually don't, we're testing through that process. We're also thinking a lot about how to better leverage our stores and be more efficient in the e-commerce work that we do. Of course, there'll be some of the standard SG&A pressures, which will just be around labor rates, which will be around health care benefits. But there's a fair amount of puts and takes for us to be able to manage both sides of that equation. And I guess to sum it up, I know we aren't giving guidance for next year, but I think that as Jack mentioned, I think we feel good about being able to continue to manage in the margin environment that we're operating in today.

Operator

Our final question comes from Edward Kelly with Wells Fargo.

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

Can I just -- I wanted to ask really just one question. And that's how -- when you're looking at the business today and given that we're in an environment with COVID, how difficult is it to say definitively that the strategy is working? And I ask that because your comps aren't up as much as peers'. And I know there's reasons for that. But the gross margin's up a ton. I'm wondering, if ex COVID we'd be looking at a flat comp with gross margins up a lot or if they would be better than that. I know it's hard for us to draw definitive conclusions from what we're seeing. And I'm just kind of curious how you're doing that. And what you would say to us to support the fact that things are moving in the right direction. And I really mean from a top line perspective, and I mean from getting this business going again.

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

Well, traffic's very difficult to read because of COVID. It's -- and your questions are very good one. It's difficult to know. I wouldn't have expected by -- let's assume COVID hadn't happened. I wouldn't have been expected to sit here looking at the Q2 numbers to have seen a meaningful impact from the strategy that we've put in place. I wouldn't have expected a meaningful. I would have expected us to dilute to change the margin profile because of the change in the promotion emphasis that we talked about pre COVID. So I would have expected to see some margin enhancement, not by as much as we had, but we'd have seen some margin enhancement. And we would have been articulating the new marketing campaign, articulating the new customer segmentation and chasing after it. So the answer to your question is, we've probably been able to accelerate some of this promotional stuff that we wouldn't have been able to do otherwise. And that seems to be working. The other parts of the strategy will evolve and will come forward. We're not in a position -- one of the reasons partly is we're not in a position because of COVID, but partly, we've not gone far enough down this route. We've not got a new marketing campaign out there. We've not really established. We've not put a new format in place. So there's a number of things we've still got to prove in this strategy going forward. And COVID's confused, everything, to be honest with -- and the key thing for us has been, I think we were trying very hard, and we talked about this pre COVID is that the customer base would change, we would create a situation where the promotionally conscious customers who are coming in for very deep cut promotions only on the occasions when we had the deep cut promotions, we would lose some of them and that we would gain the new customer base that we were talking about, which is -- again, we've talked about this. It's a very significant $200 billion market. And we just need a small slither of that to make this thing grow dramatically. And that would have been coming through -- that wouldn't have been coming through today in this conversation, whether we had -- if we hadn't had COVID or we do have COVID if that helps, Ed?

Operator

Ladies and gentlemen, this concludes our question-and-answer session. I would now like to turn the call back over to Jack Sinclair, Chief Executive Officer, for any closing remarks.

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

Thank you ever so much for taking the time to listen to us and show interest in our company. We're very excited about the prospects. And I really appreciate you all, and I hope you all stay safe and look after yourselves. Thanks ever so much.

Operator

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