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SFM - Q3 2018 Sprouts Farmers Market Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and thank you for standing by. Welcome to the Sprouts Farmers Market Third Quarter 2018 Earnings Conference Call. (Operator Instructions) As a reminder, this conference call may be recorded for replay purposes. It is now my pleasure to turn the conference over to Susannah Livingston. Ma'am, you may begin.

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

Thank you and good morning, everyone. We are pleased you have taken the time to join Sprouts on our Third Quarter 2018 Earnings Call. Amin Maredia, Chief Executive Officer; Jim Nielsen, President and Chief Operating Officer; and Brad Lukow, Chief Financial Officer, are also on the call with me today.

The earnings release announcing our third quarter 2018 results, our 10-Q and the webcast of this call can be accessed through the Investor Relations section of our website at about.sprouts.com. During this call, management may make certain forward-looking statements, including statements regarding our 2018 expectations and guidance. These statements involve a number of risks and uncertainties and 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.



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With that, let me hand it over to Amin.

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

Thank you, Susannah. Good morning, everyone, and thanks for joining our call today. Last month, we rang the bell on NASDAQ to celebrate our 5th year as a public company. While much has changed in this industry during these 5 years, looking back, I'm extremely proud of what our team has accomplished.

Since our IPO, we have nearly doubled our store count from 160 to 315 today, entered 11 new states, accelerated innovation across the store with emphasis in deli and private label, continued to build technology and talent in our stores and support office for scale, and many other accomplishments, all resulting in more than doubling of revenue and EBITDA over the past 5 years and enhancing our business model, which will continue to increase our return on invested capital, which is stronger today than it was 5 years ago. This is a testament to the strength of our business model of making healthy eating easy, understandable and most importantly, affordable.

All of this is supported by an extremely talented team that keeps us on trend and moving forward. Today, I remain excited as we continue to build a brand that our customers love as we remain laser-focused on building long-term shareholder value.

Turning to the third quarter. Sales rose 10% to \$1.3 billion. These results were driven by a comp of 1.5%, with continued positive traffic and tonnage trends as well as strong new store productivity. We had strong openings in our new states of Pennsylvania and Washington. As Sprouts expands, our unique model is bringing healthy and relevant offerings in cities and states across the country. Solid operations, product innovation and the evolution of our store merchandising continues to drive strong new store productivity.

During the third quarter, we opened 12 new stores. And with the addition of 2 new states, we are now in 19 states coast-to-coast. Since the end of the quarter, we have opened 2 additional stores, bringing our total store openings to 30 for the year, and our new store pipeline remained strong for the coming years.

The promotional environment has remained fairly consistent this year. While it remains competitive, we continue to maintain our proven pricing strategies across our different regions and within our various departments. At the same time, we continue to face an overall deflationary environment, driven primarily by produce. Despite this headwind, Sprouts drove a positive comp and a strong 2-year stack of 6.1% in the third quarter.

Now I'd like to discuss our 2018 strategic priorities focused on product innovation, customer experience, team members and technology. Sprouts has always embraced a small format which creates meaningful engagement between our team members and customers. Every year, we build on these customer relationships to further enhance the connection and shopping experience at Sprouts. This year, a few of our new stores are incorporating a fresh, innovative design to reflect the latest customer trends. In our market corner deli area, these enhancements improve the customer service and allows customers' clear sight across our healthy deli offering. Importantly, our consumers continue to want fresh and healthy food and our expanded offering of ready-to-eat, heat or cooked meal solutions are resonating very well with our customers. With our expanded deli offering now in more than half of our stores, our customers can choose meal types that best fit their lifestyle in the convenience of a full-service, healthy grocery store.

In private label, our quality, unique and great tasting product offering at an exceptional value are increasingly resonating with existing and new customers. Sprouts has been an authority in natural and organic foods for more than a decade and we apply this experience and knowledge to stay ahead of trends in the products we double up for customers. Today, more than half of our private label products are non-GMO or organic and it's this quality that continues to drive traffic to our stores. Private label remains a high growth category at Sprouts and at only 13% penetration today, we believe we have many more years of growth in private label for new product introductions and increased customer engagement and messaging. Private label products continue to help drive our top line and with higher gross margins, will provide added flexibility when it comes to further investments as necessary in the business.

On the home delivery front, our partnership with Instacart has continued to grow. And today, we are in more than 200 stores, covering most of our major markets with the remaining markets to come online in early 2019. Though home delivery remains a small percentage of grocery shopping



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in the U.S. today. Our early involvement and experience in this space combined with strong brand, trust, loyalty and execution continues to allow us to think about new and exciting ways to serve the customer outside the store.

Second, as we called out last quarter, tax reform was a catalyst to allow us to invest an additional \$10 million this year in our key members. Sprouts continues to differentiate in leadership development through pay and benefits and fostering a culture of customer and team member engagement. One of my favorite events for our leadership's growth is SproutsFest, which recently occurred in the third quarter. This year, we invited more than 600 of our grocery and vitamin managers, our largest event ever. The purpose is to ensure our store team members learn about the strategic direction of the company, continue to build on their leadership skills to inspire our people-led, purpose-driven culture and most importantly, understand the vendor's unique product attributes and brand heritage firsthand. This training allows each manager to return to their individual store, more knowledgeable of the company and the products they sell.

Lastly, on technology, we continue to learn from the implementation of fresh item management, a companywide initiative that will further improve shrink and in stock positions. The early results in bakery are encouraging as we're seeing future cost efficiencies. We would like to ensure this system is rolled out at the right speed, that change management is accepted at every level in the store and will allow learnings to be adapted to all other department rollouts. Overall, we remain very pleased with the early results, expect future savings in the back half of -- starting in the back half of 2019 and are building a smart technology for our scale.

In summary, while the environment from 5 years ago has changed, our unique small format farmers market model focused on health, value, selection and service is resonating more than ever with greater adoption in existing and new markets with our customers, giving us confidence in the future growth of Sprouts.

With that, let me turn the call over to Brad to cover our financial results and 2018 guidance.

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

Thank you, Amin, and good morning, everyone. So I'll begin by discussing some of the business drivers for the third quarter and then review our guidance for 2018.

For the third quarter, sales were \$1.3 billion, up 10% over the prior year, driven by comp sales growth of 1.5%, consistent traffic year-to-date, positive tonnage and solid new store productivity in the low 80s. Overall, a lack of inflation continued in the third quarter, almost entirely produce-related. Offsetting this pressure was continued strong growth in private label, our nonperishable departments and our deli enhancements that continue to resonate with our customers. Our new store productivity remained strong, a testament to our model being well received in both new and existing markets. These trends provide us confidence in raising the bottom end of the EPS and net sales guidance and tightening our comp range for the full year.

For the third quarter, gross profit increased by 10% to \$382 million and our gross margin rate increased by 5 basis points to 28.8% compared to the same period last year. This leverage was primarily due to improved merchandise margins in certain categories, partially offset by higher occupancy costs. Direct store expense increased 12% to \$281 million, an increase of approximately 40 basis points to 21.2% of sales compared to the same period last year. This deleverage was consistent with our plan and was primarily driven by planned investments in our team members' wages and benefits as well as higher depreciation expense. In addition, we continue to see our customers shifting to use more credit cards, leading to pressure on this line item from higher interchange expenses.

SG&A increased 10% to \$44 million or 3.3% of sales for the quarter, flat to the same period last year. This primarily reflects increased strategic investments and advertising costs that were offset by a lower bonus expense compared to last year. As well for the third quarter, our preopening costs were higher than last year by 10 basis points due to nearly doubling our store openings this quarter as compared to the same period last year.

EBITDA for the third quarter increased 4% to \$81 million, a decrease of 40 basis points to 6.1% of sales when compared to the same period last year. The decrease in margin was mainly driven by increased operating costs from our strategic wage investments previously discussed.

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Net income for the third quarter was \$38 million and diluted earnings per share was \$0.29. During the third quarter, we recorded a \$3 million dollar benefit due to an adopted tax calculation method change in conjunction with the adoption of the Tax Cuts and Jobs Act. Excluding this benefit, net income was \$35 million and diluted earnings per share was \$0.27, an increase of \$0.04 or 17% over the same period last year. The improvement in reported earnings per share is primarily due to higher sales, a lower effective tax rate and fewer shares outstanding due to our share repurchase program.

Shifting to the balance sheet and liquidity. We continue to self fund our unit growth and strategic initiatives with solid operating cash flows of \$235 million year-to-date. We invested \$129 million in capital expenditures net of landlord reimbursement primarily for new stores. During the third quarter, we've repurchased approximately 700,000 shares for \$15 million. We ended the quarter with \$17 million in cash and cash equivalents and \$283 million available under our current share repurchase authorization. Our borrowings on our \$700 million revolving credit facility decreased to \$435 million, bringing our net debt-to-EBITDA down to 1.6x. Return on invested capital was 16.2% aided by a lower effective tax rate compared to 13.6% last year. Year-to-date through October 29, we have repurchased 8.4 million shares of common stock, returning \$193 million of capital to shareholders.

Now let me turn to 2018 guidance. Due to the continued solid earnings performance for the year, we are raising the bottom end of our net sales range to 11% to 11.5% for the full year and EPS guidance by \$0.02 to a range of \$1.28 to \$1.30, including the \$0.02 benefit in the third quarter for the tax calculation method change. As well, we have tightened our full year comp sales growth to 1.7% to 2%. Due to the adopted tax calculation method change this quarter, we expect our effective tax rate to be approximately 18% for the year, returning to a more normalized range of 25% to 26% in the fourth quarter and into 2019 under the new tax reform structure.

We also lowered our CapEx spend slightly to a range of \$160 million to \$165 million, net of landlord reimbursement due to timing of projects. And lastly, consistent with our prior guidance, we will open 30 new stores in 2018, which are all open at this time.

A few additional items to note on the full year of 2018 guidance. We now expect inflation to be negative for the full year. And as it relates to margins, we expect gross margins to be near flat year-over-year. We expect DSE to deleverage by approximately 35 basis points for the full year, primarily related to additional wage investments from the tax reform savings. We continue to expect some deleverage in SG&A for the full year, consistent to what we have seen on a year-to-date basis through the third quarter. Below the EBIT line, we expect interest expense to be approximately \$28 million, including approximately \$11 million related to interest for financing and capital leases.

We would also like to take this opportunity to discuss the more significant changes in connection with pending lease accounting standard, which we will adopt on a prospective basis at the beginning of our 2019 fiscal year. As you know, we leased all of our store properties and the vast majority are currently accounted for as operating leases with rent expense charged on a straight line basis. Under the new lease accounting standard, these leases will continue to be classified as operating and we will record an asset and a related obligation on the balance sheet and expect these amounts to be material. Rents expense for these operating leases will continue to be calculated and recorded on a basis consistent with the current standard. In addition, we have approximately 45 store leases that are currently accounted for as financing leases. For these leases, the buildings and related improvements are reflected as assets on our balance sheet and we record a depreciation charge and interest expense related to the asset and lease obligation, respectively. Under the new lease accounting standard, we believe that these leases will be transitioned to operating leases. This reclassification will result in an increase to our rent expense, which is included in EBITDA, and a decrease in interest expense going forward. In addition, this rent expense will be recorded on a straight-line basis. This change in expense recognition to a straight-line model as compared to financing lease accounting under the current standard will result in a net incremental expense for the year. Importantly, none of these accounting changes will have any impact on the future cash flows or liquidity of the company.

While we are still working through the adoption process, we wanted to provide you with our current analysis of the lease accounting impacts for 2019.

In closing, we remain confident that our strategic investments are establishing a strong foundation for ongoing success and we remain encouraged by the solid free cash flow generation and healthy new store productivity that we continue to experience as we expand across the country.

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



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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question will come from the line of Chuck Grom with Gordon Haskett.

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

Just on the top line, it looks like you tweaked down your guidance a little bit. Just wondering if you could dissect the reasons for that change in your view.

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

Yes, we adjusted our guidance based on what we're seeing primarily on the lower deflation or deflation side of the business. We continue to see some level of deflation. But the overall business continues to hold strong in terms of tonnage and traffic. And so that's what the guidance reflects.

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

Okay. And then just my follow-up is, I wonder if you guys could give an update on your fresh item management strategy? And where you think the benefits could be throughout the P&L over the next couple of years?

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

Yes, it's Brad. As we've talked on recent calls, we have a pretty robust implementation program to roll fresh item management across all the fresh departments between now and into the third quarter of next year. We're very pleased with our progress to date. We're very cognizant around the change management program which is critically important in these types of initiatives to get right. So we're on track. And as Amin mentioned in his earlier remarks, we expect to start to see the benefits in terms of bettering stock positions include shrink and that will come in the beginning -- or the third quarter of next year, basically the back half of next year. So we're on track.

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

And I think I just want to reiterate that the program is intended to ensure that we again have the right level of inventory to both maximize sales and have the right level to also assist on shrink. So it's an exercise of both sales and better in-stock and sales as well as lower shrink.

Operator

And our next question will come from the line of Mark Carden with UBS.

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

I wanted to dig in a bit on the merch margin. Can you talk about how you've been able to manage through industry cost pressures? And presumably mix has helped, but if you've been able to fully pass through higher cost scenarios like freight, or have you been seeing any increased headwinds on that front?

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

Mark, it's Jim Nielsen. As it relates to the gross margin yes, we did have a little bit of benefit on the mix side. But that's not -- it's really 4 key things that we can do to focus on, it's people, product, process and partners. From a people perspective, we have hundreds of years of experience here in natural foods and a very passionate team in the field that -- who wants our guests to eat healthy and help them live a better life. The product side, we're always on the leading edge of innovation in terms of attributes and then of course, the private label in deli helped us mix out on that side. In the process side, it's the investments we've had in the technology that's really helping us be more strategic in our investments, that, coupled with some of the human capital we've added recently, is really helping us support the price optimization. And then the great partners we have out in the marketplace today have also been extremely supportive. And as it relates to your last question around freight, the team here internally on the freight side has done an excellent job of looking at our contracts, redoing the contracts to offset some of those increases that were in the market from the ELD mandate as well as fuel cost. And as I've talked about in prior calls, we are starting to see some cost increases on the nonperishable side. But we're -- we've been able to pass most of those through at retail today.

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

Great. And as a follow-up, you've previously noted that Sprouts have attracted most of its new customers from conventional competitors. Are you still seeing similar patterns taking place today? And in markets where your conventional competitors have been undertaking some interest or renovation projects, have you been seeing any outside share gains?

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

Yes. I think broadly across the board, our model continues to resonate really well. And as we continue to, Jim just spoke to this, differentiate our business in fresh, health and convenience. So at Sprouts, if you step back and look at what our store looks, feel, the products we carry, the merchandising today versus 3 to 5 years ago, it's quite drastically different and that's a kudos to our team to continue to evolve with the customer, and it's really across the store. It's quality in produce and quality in meat and seafood, it's made-in-house, ready-to-eat, heat and cook items, a wider selection and unique products in grocery and frozen, and service-led VMS and HBA departments. So at Sprouts, we feel that we're positioned better than we've ever been in this marketplace, particularly when it comes to authentic health and as well as fresh, prepared and convenient. So our core stores without cannibalization continue to drive very strong traffic and we really feel good. And Brad talked about our new store productivity. So overall, we're continuing to move and focus on what we're great at and our customers are certainly responding well to it.

Operator

And our next question will come from the line of Edward Kelly with Wells Fargo.

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

I wanted to circle back on the comps. Could you just give us a little bit more color on the cadence of the comps throughout the quarter, both in total and from a traffic standpoint? And then what was Q3 inflation overall and what are you expecting for Q4?

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

Yes, as far as cadence of the comps, Q3 and Q4 last year were similar at 4.6%. And you heard us this morning, our 2-year stack was 6.1% for Q3. In terms of -- we expect fairly good consistency in Q3 and Q4 where we're sitting today. And in terms of deflation, we expect still consistent deflation from Q3 to Q4. And then we'll see what the plantings look like early in the year and we'll have more guidance for 2019 on our year-end call. But -- and it's primarily in produce. So it's limited to one part of the store. So again, we really focus on the controllables, which are tonnage and traffic, and we're seeing good momentum there.



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

Just to clarify. I think last quarter, you said overall cost deflation was just over 1%. How did Q3 look relative to that?

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

The third quarter was more deflationary than it was in the second quarter. Again, the cadence, it's largely produce and just a little bit in the poultry area.

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

Are you expecting that to worsen in Q4?

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

Not to worsen. We're seeing pretty consistent cost deflation levels currently in the fourth quarter relative to Q3.

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

Okay. And then just a quick follow-up. As you think about -- I know it's early, right, so you don't -- probably won't talk too much about next year. But with the consensus number for next year has a reacceleration in the top line and I was just curious if you could help us out maybe qualitatively on the items that you think can drive better momentum for you next year?

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

Yes, I mean, I think the overall momentum in the business remains quite strong particularly on the fresh side and then the nonperishables also particularly in certain areas of the nonperishable. So I think we will wait until the year-end call to give full guidance for the year. But on a 2-year stack basis, certainly we'll be positioned better going into next year. And certainly, it's been a deflationary year this year, so to the extent that, that settles down, that perhaps provides a little bit of upside. And the last comment I would make is the one that's a little bit more known as cannibalization. We expect cannibalization to be relatively neutral to potentially down a bit for next year. So those are some puts and takes. But, really, I think we'll wait until our year-end call to provide broader color of what we expect to see for next year.

Operator

And our next question will come from the line of Karen Short with Barclays.

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

Just on the comps. So looking at the guidance for the full year on comps, the implied range for 4Q is fairly wide. So wondering if you could talk a little bit about -- I mean, I'm kind of getting 40 basis points on the low end to 1.9 on the high end. Can you talk a little bit about where you're thinking in terms of how we should think about that?



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

Yes, Karen, it's Brad. As we've indicated, we were seeing pretty consistent behavior in the marketplace in terms of the competitive standpoint. Also, from an inflation/deflation perspective, quite consistent relative to the third quarter. And so everything that we're seeing today lines up to what our expectations are for the fourth year -- sorry, the fourth quarter. I mean, it's a very tight range. If you look at the implied midpoint, if you will, for our full-year guidance.

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

Okay. And then in terms of merchandise margins. Jim, the things that you kind of pointed to, all of those things, in terms of the drivers of stronger-than-expected merchandise margins, seem pretty sustainable. Is that a fair comment? I mean, because that's obviously something that was the upside surprise this quarter?

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

Yes, yes. So as I look at, assuming the competitive landscape stays just as it is today, we continue to improve, as we talked about on the product side, the people side, and then the technology that we're onboarding here and with the right human capital behind it. We are confident around keeping margins stable. The only thing that I can't look forward and tell you about this what's the competitive landscape going to look like in 2019. But assuming it's in line with 2018, we should have -- we'll have stability in gross margin.

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

Okay. And then sorry, just last question. Brad, in terms of that comment on the net incremental expense, so rent is obviously going up more than interest is going down, further change in accounting. Do you have a dollar amount that you could give us for '19?

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

We're still working through the mechanics right now as we speak, so it's a little bit premature for us to come out with a range. But I would just put -- try to put it in a little bit of context for you today in terms of the interest and depreciation charge in connection with those roughly 45 leases. It's -- \$11 million is the expected number for this year and depreciation's around \$4 million. So we know that \$15 million today is largely going to go above the line. The only mechanics that we're working through is obviously, there's a difference in the expense timing recognition under a straight line model, straight line rent expense, which will -- those leases will convert to is our expectation versus under a current treatment, which is more of a debt model. And so that's basically where we are at this point in time and we'd be able to additionally give you precise numbers when we're back in touch with you in the new year.

Operator

And our next question will come from the line of Chris Mandeville with Jefferies.

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

Amin, just a point of clarity based on one of your comments you just reference around being better positioned in 2019 on the 2-year stack. What's that based off of? Is that a fixed one that you reported in Q3? Or was the midpoint of implied guidance for Q4 suggesting...



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

Yes, let me clarify. I was speaking to specifically the 1 year, not the 2 year. And then also just the comments around deflation. A little early to call yet, but it's been quite deflationary this year. And so we'll see where our next share line's up, and then cannibalization, we expect to be slightly lower next year. So really speaking to the 1 year, not the 2 year.

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

Okay. And then again, I realize you're not providing official 2019 guidance today. But I think we're all generally looking at it at this point. So given your comments that the lease accounting change is going to be a net expense increase and then considering how fresh item management won't really benefit things until the back half of the year, I was hoping you could maybe help us understand or think about overall expense leverage? With what investments you made in 2016 and really -- or taking 2017 and this year? If comps do see some improvements on the 1 year, can we expect leverage on DSE and SG&A?

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

Here's what I would say, Chris. First of all, I would just like to reemphasize the fact that all of this noise around lease accounting has 0 impact on future cash flows. It's an accounting exercise. So if you park that for a second. We've talked about how we've made investments funded out of our tax reform savings this year that will amount to \$10 million of investment spend this year, allowing us to get ahead of future minimum wage rate increases that would've otherwise hit us in '19 and '20. We need to lap that through the first quarter, so we don't lap that at the beginning of the second quarter. And as we've stated previously, that's about 25 basis points for the full year this year. So it's about 6 bps of headwind in the first quarter. As well, the lion's share of the heavy lifting and OpEx expense largely related to training initiative to get the FIM in happens in the first half and into the third quarter of 2019, with benefits expected thereafter. Hopefully, that helps.

Operator

And our next question will come from the line of Ken Goldman with JP Morgan.

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

I'll change the subject from 2019 even though I want to ask more about it and ask about even the longer-term, which is, you guys have talked about 30 new stores annually and there's so much expected growth in delivery. And we have different companies talking about dark stores and so forth. I'm just curious if you still think 30 is the right number. It really hasn't changed a whole lot for you. And if delivery continues to do extremely well, would you consider pushing that number down a little bit? Or is it too early to think about that?

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

Ken, that's a good question. So if you step back and think about where Sprouts is today, we're in 19 states, but only about half of those states that were fairly strongly penetrated in. So as a company, we've got a long runway to open stores in many, many new markets and some of our recent markets that we've added stores like Florida, Maryland, State of Washington -- sorry, the Mid-Atlantic, State of Washington, we've just got started in. So one of the benefits that we have is we actually can take the world of e-commerce and home delivery, et cetera, into account in where we're placing stores and in our new store strategy to maximize the potential of in-store and e-commerce sales which are relatively low today. But to the extent they continue to grow, we think that Sprouts will be better positioned to play stores and leverage without having duplicative cost of either shutting down stores or changing the business model compared to many other conventionals.



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

Okay. And then I wanted to ask another sort of broad question which is every quarter, you guys, I think, rightfully talk up the potential for private label. The goal is still 15% of sales. You're reasonably close to that goal already. I know that you'll never get sort of as high as some of your more traditional supermarket players just given your product mix. But 15% still strikes me as a bit low. So why shouldn't this number be higher in the long run given how constructive you are on these store brands?

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

Hey, Ken, it's a good comment. And at the last call, I actually elevated that a little bit. But...

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

I'm sorry?

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

Yes, just to step back really quickly. I mean, we're well-positioned there. We continue to be a bit conservative in talking about it around not only taste but attributes and the quality of the product and value, which is again, as Amin mentioned and Brad mentioned in the call, over 13% penetration, top line at right around 20%. And where we get more confident in that 16% to 18%, more like 2021 hitting, maybe 2020 on the 16%, it's just the SKU productivity that we're seeing. So it's not an item count growth. It's a SKU productivity growth which is about 60-40, bring more items in the basket and 40% of that is driven by new baskets. So the brand's resonating, the eating experience has been fantastic and that's propelling the productivity. And Amin mentioned on the call as well is, we're going to continue to work harder on doing the content development around how we're differentiated whether it's the sourcing, the attributes of the product or how it's crafted. And I'm very, very confident on that 16 and tail end of 2020 or early 2021.

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

Ken, this is Amin. I just wanted to add one more comment is, compared to -- again, if we're comparing to conventionals, remember that 60% of our business is fresh. So when we think about this 13% penetration, you almost have to start removing some of the items that these sales in produce and bulk and some of the other fresh departments where you don't have as much private label concentration. And so the private label concentration tends to be more in the nonperishables and certainly, some of our perishable brands where we have packaged products, but more in the nonperishable. So a number of our nonperishable departments were either around or slightly north of 20% today. And we'll continue to grow that mix. But what's important to Sprouts when you compare our model to others is we're laser-focused on giving the best, fresh health and unique product to the customer. And we recognized that the best can come from private label, it can come from big manufacturers or it can come from emerging brands. So our goal is to have the best product for the customer at the end of the day. So I think this balance is a good balance and we continue to grow the private label brand at the appropriate pace.

Operator

And our next question will come from the line of Ben Bienvenu with Stephens Inc.

Benjamin Shelton Bienvenu - *Stephens Inc., Research Division - Research Analyst*

I wanted to ask about Instacart. I think the prior expectation is that this partnership was going to be neutral in 4Q. I think there may have been prior commentary that it was a potential negative impact to comps or EBITDA on 3Q. Could you just clarify what the impact might have been in 3Q and then your expectation for when that might be additive going forward?



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

Hi, Ben, it's Brad. As we did indicate on our second quarter call, given the transitioning into Instacart into more markets, coming off the Amazon platform, we did experience a headwind from a comp standpoint in both Q2 and Q3 and we're starting to now exceed -- or basically at and starting to exceed the levels at which we were previously. I know you compare it to last year. So I would expect that it's fairly neutral overall from a total fourth quarter perspective, and our expectation based on what we are seeing today is that we'll continue to ramp up as -- into 2019 as the customer adoption has been very solid. And Sprouts is really a leader from a perspective of the customer, service scores on home delivery. And we're very proud of that. And we expect that, that will continue going forward.

Benjamin Shelton Bienvenu - *Stephens Inc., Research Division - Research Analyst*

Okay, great. And then I have a follow-up question on gross margin as it relates to merchandise margins. Just to clarify, did merchandise margins improved exclusive of mix or does it improve mix, drive up merchandise margins? And then just thinking going forward about improved merchandise margins as it relates to mix. You talked about private label, some of the deli programs, could you just talk about your expectations for how mix could positively impact gross margins going forward?

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

Yes, I'll start and then Jim can add on. Certainly, with the gross margin -- merch margin improvement in the third quarter, it was a combination of the fact that we continue to see very strong growth in our nonperishable departments. We see continued very strong growth in private label, which obviously comes out a little bit of a higher margin rate. And importantly, we continue to really push on the deli initiative that's resonating strongly with customers as we see that in increased traffic. So we would say, mix of those 3 that drove an increase from a year-over-year point of view in the third quarter.

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

Yes, I wouldn't add much to that other than the fact that we talked about the mix as we look forward. The whole idea of enhancing and do what we do in terms of private label and deli is being more relative to consumer. And it's just that the balance over time -- I know that we need to enhance that overall gross margin, anticipating that we will have some competitive investments that we will have to make over time. So we're anticipating flat gross margin as we look forward into 2019.

Operator

Our next question will come from the line of Paul Trussell with Deutsche Bank.

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

Just to circle back to the expense conversation from before. Just curious, as you head into 2019, is your view that the wage investments that you've made is enough from a competitive standpoint? And that as we move towards second quarter and beyond of '19, your view is that incremental wage investments won't be necessary at this time? And then also just wanted to get maybe a little bit more additional color on some of the other puts and takes within expenses as we think about advertising spend if you move into new markets, health care, which has been a topic over the past year or 2 as well and just some of the other puts and takes around DSE will be helpful.



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

Yes, thank you. You asked some pretty broad questions. I think that the broad way Brad spoke to some of the natural compression on the first quarter related to the \$10 million investments. In terms of the P&L overall, our goals are to, as Jim said, is be relatively neutral on gross margin and then try to have some of these technology and initiatives that we are putting in place, is to use those technology initiatives to help offset any -- offset many of the pressures that you just spoke to, broadly. There is some timing, Brad spoke to the timing of those investments rollout and the change management required and the cost required to roll them out. But overall, broadly speaking, over the next 1, 2, 3 years, we feel fairly well-positioned to overall try to get to a place where our goal would be to get closer to a more neutral state in EBITDA margin, that's certainly our goals. I think what Jim spoke to is this: we'll always lay the competitive environment sort of to the side. And to the extent that, that brings incremental headwind, we'll have to work through those as necessary. But that's really how I would answer, broadly speaking. I'll let Brad add any specificity if it's helpful here.

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

No, I would just say, Paul, that certainly, because we will be lapping that wage -- the incremental wage investment through the first quarter of next year together with the timing of the rollout of fresh item management, which is largely an OpEx investment, will pressure the first half, but expectation is that we will start seeing those benefits in the back half. And I'd also add that the team's done a great job on the goods not for resale procurement piece where we still see a nice runway ahead of us to continue to offset the pressures that you mentioned, certainly health care. And as well, we're looking to take greater advantage of the opportunity to push on the digital space and advertising with the customer. And again, some of these operational savings that we get, including labor productivity that we're experiencing today, will continue to drive through 2019 our offsets for these investments that we're making. Our view is over the longer-term, 3 to 5 years, because we've got the tailwinds of all of these systems initiatives and as well as the merchandising initiatives to have stable EBIT margins as we look out over the next several years.

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

Paul, this is Jim. And I hate to do this because we don't generally fall 3 times but we always talk about wage. I think we want to look at the entire benefit plan. And the team's been, one, very strategic about the investments we make made in wages, not only by geographies but job classes. So strategic in that capacity but also enhancing the overall benefits. So today, now all team members in our store are subject to incentives. Now we have clerk bonuses, service store bonuses, so it's really pay for performance on top of that getting an everyday discount of 15% on all the goods that we do sell, promotional or regular priced. And then that whole culture that we've created, that people power, purpose-driven culture is really helping us retain talent and acquire talent as we move into new marketplaces which is ultimately driving that productivity measure which Brad just mentioned.

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

I appreciate the color. Just a follow-up also on Instacart. You mentioned healthy adoption rates. Just curious of any other learnings, incremental learnings over the past few months? If you could speak to maybe the percent of the customer base utilizing Instacart that was not a known Sprouts shopper before, basket size or penetration of sales and some of the early stores that rolled it out. Any additional color will be helpful.

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

Yes, I think just broadly, the growth is going well. Brad talked about that our brand and the trust and health is resonating very well online and it's converting into the high scores. In terms of overall model of home delivery, one of the benefits for Sprouts compared to other conventionals is because our stores are more spread out, we tend to see more incrementality, which is key to be able to offset the additional cost of delivery for it to be value add to overall profitability to the company. So we like that component of Instacart quite well. And certainly, as you would expect and what many other retailers see is our baskets are significantly higher online than they are in the store. And one of the other thing that's quite unique is we're seeing very strong private label penetration online compared to in-store. And so the way to market and message private label online is it certainly becomes easier than sometimes in-store experience around private label. So overall, we're very -- we feel really good about the health of



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out of store channel, and going into 2019 are starting to explore other ways to add value to the customer. And really resonating, looking at it from a customer perspective and looking to test maybe a couple other channels and see how it resonates with the customer.

Operator

(Operator Instructions) And our next question will come from the line of Vincent Sinisi of Morgan Stanley.

Vincent J. Sinisi - Morgan Stanley, Research Division - VP

Wanted to go to -- Amin, you mentioned early on in the call that a few of your new stores are having a new design. It sounds, from what you said, it's more kind of further expansion in the deli, ready-to-eat areas. I guess for all of us on the phone who haven't been into -- have or many might be in this format, did the stores look materially different? Is there any kind of notable reallocation of spaces inside? That would be helpful for us. And then I guess from what you maybe seeing, I don't know how long these might be out there at this point. But are you looking at these new designs as maybe the kind of the prototype for '19 growth?

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

Yes. So I'll -- overall, what we are really focused on is how can we enhance -- as I talked about earlier on the call, that our products and our allocation of product and our focus on private label and deli and fresh meat and seafood and health cut meat have continued to evolve over time. So we wanted to take a look at how can we improve the customer experience and what can we do better? Overall, the allocation of space in the store to departments is not materially different. But what the customer is telling us is it's resonating significantly better with the broader customer base, particularly the millennials. So we really like that. And we wanted to sort of separate also some of the customer service elements to the production elements in the store. So we were very thoughtful with a laser focus on experience. Early -- we've put 5 of these stores out there to test and we'll continue to tweak it. But early indications is it's resonating very well with the customer. And what we are looking to do today is just continue to tweak it a little and it will be our new sort of prototype, if you will, going forward. But it's just continued merchandising enhancements, something that the company has always done. And so maybe 1/3 of our stores in '19 will be on that platform and then there will be a new sort of prototype going forward. And we're pretty excited to see the impact that it's having on deli, fresh meat and seafood, at the case, in -- be our line in fresh bakery. So very positive overall to the store and I think it will help our new store productivity going forward.

Vincent J. Sinisi - Morgan Stanley, Research Division - VP

Okay, that's helpful. And then maybe just a question on Instacart. I think early, early, early on with some of the online initiatives, I think you guys had mentioned that the large majority of the orders that were coming in were outside of your typical 5- to 7-minute drive time. Could you give us an update if that is still the case? And if you are maybe, either currently or in the future, going to test, as you continue to build your stores, how -- kind of the distance between one versus another?

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

Yes. So I think generally, broadly, we're still seeing good incrementality to your point around it helps solve the convenience point where if you're 10, 12 minutes from a Sprouts, if you're trying to get something quickly, you just might go to another retailer 2 minutes away. But the point here is online solves that equation. So positive from that perspective. And I think the way we think about this is, it really is a valuable input to our new store selection process and our new store development program as we go to more cities and how we think about spacing between stores as e-commerce continues to grow at a pace -- at the pace, the natural pace that it's been growing at. And so we think it's a net-net positive. We're looking currently at couple of other channels to see if it can add value to the customer and we'll, like I said earlier, likely test 1 or 2 of those in 2019.



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Operator

Our next question will come from line of Judah Frommer with Crédit Suisse.

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

Maybe, first, just a follow-up on what Vinnie was asking. Can you help us with the new store return model and if anything has changed there? I mean, clearly the stores are more expensive to open today because they have more service departments than they used to. The new store productivity remains very good. Do you still have the kind of the natural comp waterfall that you kind of came public with? Or has the return trajectory changed given that the store has changed as well?

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

Hey, Judah, it's Brad. I would say the new store financial return model has only improved over the last few years because what we are seeing in the more relevance in the departments and the meat and seafood and the merchandising mix and the improved go to market strategy and advertising in advance of opening up stores, particularly in new markets, has resulted in much stronger average weekly sales over the gates. So clearly, that provides you with a better IRR model. What it does to you though is it mutes the year 2 comp growth rate but we'll take that all day long from a relevance perspective with the consumer and a financial returns model. But it does meet the year 2 comp rate.

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

That makes sense. And maybe just one quick one on the core customer, if that core customer has changed at all given that more and more traffic is being driven by prepared food meal solutions, deli, things like that. Is there still kind of this natural ramp in basket build throughout the store over time? Or do you find that more customers are buying specifically for those departments? And any more color on the expanded use of credit card will be interesting.

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

So I think that several of the departments historically have taken longer to ramp. We continue to see those departments ramp over time. To your question around mix is, might -- we have absolutely sort of one department that takes a little bit longer time for ramping, we continue to see that. In terms of how customers are using the store, this is, again, where we feel really good about, how Sprouts is positioned, where a customer uses the store for many different occasions and reasons. And so where our focus has been to have a program which is meeting the needs of the customers, whether they just want to come in for lunch and grab a sandwich, chips and drink or come and pick up something ready to cook or ready to heat for dinner tonight or come into the store and do a full expansive grocery shop. And overall, what we're seeing is greater traffic to the store because of what we've been doing to the program. What we've been -- how we've been enhancing the program that customers are using us in a broader way for more occasions across the store. It speaks to what Brad just talked about in our enhanced prototype is we're seeing greater deli mix as customers are coming in for 12:00, 5:00 traffic. But that's just adding to the overall foot traffic in the store as well as the overall basket in other departments as well. So all very positive news to the overall business.

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

The only other concept around the new concept store is it's getting us more relative to the working millennials. So as you think of urban environments and different things that we have historically done, we're just resonating a lot better with the millennials with that content.



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

You also had a question around credit card expenses. This is something that the industry has been facing increasingly over the last 2 years in particular as more and more card issuers are issuing premium cards, which carry with it a higher interchange rate, and notwithstanding the fact that we've been able to shield some of those otherwise larger increases with better negotiated rates, it does remain a pressure on the overall industry as cash as a tender continues to approach 0 over time. And that puts pressure on the overall interchange expenses.

Operator

And our next question will come from the line of Robbie Ohmes with Bank of America Merrill Lynch.

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

Just two real quick ones. Could you guys clarify just on the produce deflation, how much of it is just cost driven versus competitive driven price deflation? And then the other question I had is with Kroger and Walmart rolling out their pickup locations, any color you can give on kind of what happens to one of your stores in a market where a pickup is rolled out, say, across the street from a Sprouts, at a Kroger, something like that?

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

Robbie, on the deflation side and the produce, it's all cost base driven. So do you want to answer the second half?

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

Yes, as far as from a competitive standpoint, we obviously don't talk about any one competitor action. But to date, in our numbers, we are not seeing any impact of any particular activity of any one particular competitor at any meaningful way. So to the extent that there is any impact, it's not discernible. It's really within the system is how I'll would describe it.

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

Yes. I'd also add, Robbie, that we've seen really solid adoption of the delivery model that we are executing, and that's really resonating with customers because we have a footprint where there's much greater distance between stores as compared to our conventional competitors. Naturally, it is significantly more accretive than a click and collect model, which would be largely cannibalizing if you have a very tight footprint of your store network. So we're very pleased with the approach that we've taken.

Operator

Ladies and gentlemen, this all the time we have for questions today. I would now like to hand the conference back over to Mr. Amin Maredia, Chief Executive Officer, for any closing comments or remarks.

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

Yes, thank you. I just wanted to end by saying is, what we started at the beginning of the call, what this is, that given all the things we talked about on the call today, we really feel that Sprouts is better positioned in the marketplace today than it ever has before. Our cash-on-cash return model has continued to go up over the last several years with the enhancements we're making to the business and how they're resonating to the customer. And so as a company, Jim, Brad and I are really excited about the future and where this business model is going and how it will add shareholder value over time. And we thank you for the time and look forward to seeing you on the road. Thanks.

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Operator

Ladies and gentlemen, thank you for your participation on today's conference. This does conclude our program, and we may all disconnect. Everybody, have a wonderful day.

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