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SFM - Q1 2019 Sprouts Farmers Market Inc Earnings Call

EVENT DATE/TIME: MAY 02, 2019 / 2:00PM GMT

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Sprouts Farmers Market First Quarter 2019 Earnings Conference Call. (Operator Instructions) And as a reminder, today's conference call is being recorded.

I'd now like to turn the conference over to Susannah Livingston. Please go ahead.

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 first quarter 2019 earnings call. Brad Lukow, interim co-CEO and Chief Financial Officer is also on the call with me today. The earnings release announcing our first quarter 2019 results, our 10-Q and the webcast of this call can be accessed through the Investor Relations section of our website at investors.sprouts.com.

During this call, management may make certain forward-looking statements, including statements regarding our 2019 expectations and guidance. These statements involve a number of risks and uncertainties that could cause actual results to differ materially from those described in the forward-looking statements. For more information, please refer to the risk factors discussed in our SEC filings along with a commentary on forward-looking statements at the end of our earnings release issued today.

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

With that, now let me hand it over to Brad to review the first quarter highlights as well as provide an update on our strategic initiatives and full year guidance.

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

Thank you, Susannah. Good morning, everyone, and thanks for joining our call today. Before I begin, I'd like to note that Jim Nielsen, our interim co-CEO, President and Chief Operating Officer, will not be joining me on the call today. Jim is taking a temporary medical leave of absence. We wish Jim a speedy recovery and we look forward to his return.

Now turning to the first quarter results. Net sales were $1.4 billion, up 10% compared to the same period last year. Comparable store sales increased 1.4%, driven by strong results in deli, grocery, frozen and meat, offsetting some produce availability challenges that we had during the quarter and cycling the strong cough and cold season from the prior year.

For the quarter, we experienced cost inflation predominantly driven by adverse weather conditions causing periods of significant spikes in the cost of certain produce items that we were not able to fully pass through in retail pricing.

On the nonperishable side of the business, we started to see some pass-through of the cost increases that we experienced in late Q4 and into the first half of Q1. While produce remains an important traffic driver, increasingly, our customers are viewing Sprouts as a full shop healthy grocery store.

During the first quarter, we opened 8 new stores, bringing our total to 321 stores in 19 states. We continue to look forward to bringing our unique model of Healthy Living for Less to 2 new states, New Jersey and Louisiana, this June. Our recent store vintages continue to open very strongly in both new and existing markets, resulting in a new store productivity in the low 80s, a reflection of our growing brand strength that is resonating across the country.

As we outlined back in February, our 2019 strategic priorities reinforce a strong foundation in people, process and technology with a focus of building upon our points of differentiation and enhancing our in-store and out-of-store customer experience. Let me briefly touch on the progress of a few of these key initiatives.

We continue to build upon our momentum of providing consumers with healthy products and meal solutions that are on trend, convenient, fresh and at great prices. This is particularly evident in our new prototype stores, which are performing very strongly driven by enhanced customer experience in deli and meat and seafood. During the second quarter, 3 new stores will be opened in this new prototype format.

We continue to expand our selection of Sprouts brand private label products that taste great, are made with quality ingredients and at a great price. Private label now accounts for nearly 14% of our revenue today and continues to significantly outpace our overall company net sales and comp growth. We will continue to introduce new stable, trending and unique products this year along with increased in-store, digital and social media messaging to drive further trial, engagement and loyalty among our customers.

On the customer engagement front, one of our key goals is to continue to enhance and further differentiate our guest experience. We are gaining deeper customer insights that will allow us to personalize our guest experiences with relevant messaging, content and offers. Our focus is to seamlessly integrate a mutually supportive digital and in-store experience that will lead to greater loyalty, advocacy and share of spend. In addition, we are expanding our digital channels and increasing our reach in customer impact.

To further meet the needs of our guests, we now offer delivery in every market where we have a store presence. Home delivery continues to grow, up over 60% in the first quarter as consumers look to Sprouts as a trusted, reliable partner for added convenience in their busy lives. We have expanded our testing of click and collect and are now offering this service in a number of stores in 6 markets. We will continue to test and learn to ensure we are seamlessly engaging with our customers regardless of how they choose to shop.

On the technology side, we have continued with the rollout of fresh item management and are on track to complete the implementation of production planning by the end of the third quarter this year. The system is allowing us to optimize production of the right items at the right time, resulting in better in-store position and driving incremental sales. Also, we recently implemented Workday Financials, which will streamline our finance process, integrate with our operational systems and provide timely, actionable financial information throughout the store network.

I also want to acknowledge our dedicated team members, both in the store and at the support office, who are the brand advocates that continue to drive customer engagement, sales and authority in the natural and organic space. We remain focused on serving our guests and helping them on their healthy living journey.

As you may have seen, we recently published our annual Sustainability Report. We are pleased with the progress we have made over the past few years. In 2018, we deepened our commitment to the environment with programs that fight hunger and reduce waste. We donated 27 million pounds of food to local food banks, the equivalent of 23 million meals. We diverted 35 million pounds of food to animal feed and compost facilities and recycled 91 million pounds of cardboard.

We are focused on procuring innovative, healthy products that are grown and sourced responsibly. In 2018, we made great advancements in sourcing sustainable seafood with now almost 100% of Sprouts' fresh and frozen seafood sourced from responsibly managed fisheries.

Our goal of bringing positive change to our nation's health goes beyond the food we sell. Since 2015, the Sprouts Healthy Communities Foundation has contributed $7 million to local nonprofit partners that create school nutrition education and farming programs, and deliver lifesaving prenatal nutrition to at-risk mothers amongst others.

Last year, we supported more than 130 nonprofit partners that provided critical funding to health and wellness programs that empower children to live healthier lives. We look forward to building upon these sustainability initiatives and improving the health and wellness programs in the communities we serve.

Now I'd like to review some details of our first quarter results and then review our guidance for 2019. For the first quarter, gross profit increased by 9% to $484 million, and our gross margin range decreased by 30 basis points to 34.3% compared to the same period last year. This deleverage was primarily due to cost inflation in certain items that were not fully reflected in retail prices due to the competitive environment in addition to changes in product mix.

SG&A increased 11% to $375 million or 26.5% of sales compared to 26.3% in the same period last year. Excluding the 35 basis points impact from the adoption of the new lease accounting standard, SG&A leveraged 15 basis points. This leverage reflects lower unemployment tax for California team members compared to last year and lower stock and bonus compensation expenses predominantly related to the open CEO position. In addition, due to some delayed store openings that we discussed on our last call, we received rent credits which also reduced our SG&A spend for the quarter. These were partially offset by higher spend related to our wage investments.

For the first quarter, our depreciation and amortization costs increased 13% to $29 million or 2.1% of sales, an increase of 10 basis points compared to the same period last year. Adjusted EBITDA increased 3% in the first quarter to $110 million, and adjusted EBITDA margin decreased 50 basis points, including the noncash impact from the new lease accounting standard adopted for fiscal 2019. For comparability, if the first quarter of 2018 results reflected the same lease accounting impact, EBITDA would have increased 8% and EBITDA margin would have decreased by 15 basis points.

Net income for the first quarter was $56 million and diluted earnings per share was $0.46 compared to $0.50 in the same period last year. The EPS decrease of $0.04 is primarily driven by cycling a lower effective tax rate in 2018 and the adoption of the new lease accounting standard, partially offset by higher sales and fewer shares outstanding due to our share repurchase program.

As you may recall, the first quarter of 2018 benefited from the exercise of expiring pre-IPO options, which substantially reduced our effective tax rate to 9.8%, a benefit of $0.08 per share as compared to 24.4% tax rate during the first quarter of 2019. And as a reminder, the lease accounting standard change will result in a net incremental expense of $0.04 per share for fiscal 2019 or $0.01 a quarter.

Shifting to the balance sheet and liquidity. We continue to utilize our strong operating cash flow from operations, $113 million in the first quarter, to support our unit growth and sales initiatives. We invested $24 million in capital expenditures net of landlord reimbursement primarily for new stores. We ended the quarter with $20 million in cash and cash equivalents, $500 million borrowed on our $700 million revolving credit facility, $106 million available under our current share repurchase authorizations and a net debt-to-EBITDA ratio of 1.5x.

Consistent with our capital allocation strategy, we continued returning capital to shareholders in the first quarter, repurchasing 4.9 million shares for a total investment of $112 million. Quarter to date through April 29, we have repurchased an additional 2.4 million shares of common stock for a total year-to-date investment of $163 million.

Now let me turn to 2019 guidance. We are increasing the bottom end of our earnings per share range to $0.18 from $0.16 to reflect the stronger first quarter results. The top end of our EPS range of $1.24 per share remains the same.

We expect net sales growth to be between 9% and 10.5% driven by strong new store growth and full year comp sales growth in the range of 1.5% to 3%. Reflecting first quarter results, we now expect full year comps to be towards the lower end of the comp sales range.

We are on target to open approximately 28 new stores. We expect a normalized tax rate of approximately 26% or slightly lower. And we continue to expect our CapEx spend to be in the range of $170 million to $175 million, net of landlord reimbursement.

A few additional items to note on the full year 2019 guidance. As a reminder, our store pipeline for 2019 will be more back-end loaded than 2018. We plan to open 8 stores in Q2 with the majority of the remaining stores to be opened in the third quarter.

We expect gross margins to be slightly down year-over-year, reflecting first quarter results and the competitive environment as well as higher transportation costs associated with more new stores in new markets, partially offset by improvements in promotion and pricing optimization.

We expect SG&A to deleverage by 55 to 60 basis points for the full year, which includes the 35 basis points impact related to the adoption of the new lease accounting standards.

Our capital allocation priorities remain unchanged. First, unit growth; second, investments in the business; and third, returning capital to our shareholders. As for share repurchases, we continue to expect our net debt-to-EBITDA ratio to be in the range of approximately 1.2 to 1.5x, which excludes operating leases consistent with past practices.

In closing, we are pleased with our financial performance and are confident that the investments we are making this year will continue to strengthen our business. Our strong free cash flow and healthy new store productivity position us well for continued growth and long-term shareholder value creation.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Rupesh Parikh of Oppenheimer.

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

So Brad, to start out, you just mentioned that comps you expect to be at the lower end of the full year -- for the full year. So just curious what's driving comps to the lower end.

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

Yes, Rupesh. Reflecting on the first quarter, we had some availability issues we talked to on the February call with regards to produce because of the heavy rains that we saw in California. We saw some pretty significant, what I'd call, hyperinflation in a number of products in the produce categories that really restricted our ability to get our quantities at reasonable cost. And that also reduced our ability to promote, and therefore we had a little bit lower sales that we would've expected in produce as a result. So it's really just reflective of the Q1 produce situation. As well, into the early parts of Q2, we've seen some continued weather from a rains perspective in California and some cold weather out of Mexico which has had some negative impact on availability in a number of produce items.

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

Okay. Great. And on the competitive front, it sounds like your gross margin guidance before was flat, now you're expecting it to be down slightly. So just curious what you're seeing right now from a competitive standpoint.

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

Yes. Competition remains pretty much in line with the last quarter. It's a competitive environment. What we saw on the nonperishable side of the business starting in late Q4 of last year and into the first half of Q1 is a lot of the pent-up cost increases started flowing through from suppliers driven by freight increases. Obviously, there's a short squeeze. Typically, when those cost increases come through relative to when they get passed through on the shelf, we are starting to see a lot of those cost increases now flow through to the shelf. But because of the short squeeze, you take a bit of a margin hit in the short term. So that would be really our modest change from expecting to be approximately flat on gross margin, which we said in February, to now just being slightly deleveraged for the full year as our current expectation.

Operator

And our next question comes from Judah Frommer of Crédit Suisse.

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

Maybe just a follow-up on the drivers of gross margin there and the competition you mentioned. Is the retail pricing from the competitive landscape impact, is that largely focused on produce? Are you seeing that in non-produce as well? And would you say that the produce competition is fully tied to availability? Or is there more going on there as lower-cost providers look to compete in that category?

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

Yes. I think typically on produce items when there's changes in cost, you see that retail prices get reflected fairly shortly thereafter, particularly with commodity type items. I would say that just from an overall competitive landscape point of view, the front page ad remains competitive and certain markets are more competitive than others. But again, offsetting that on the nonperishable side of the business, we're starting to see a lot of pass-through on the cost increases that came through thru the end of the first half of the quarter.

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

Okay. Great. And then maybe just going to the comp and kind of the gap to total sales. You missed the consensus comp by a little bit, but the total sales number looks fine, which like you've been telegraphing is due to new stores being more productive than they have been historically. Can you help us with the balance of comps and new store productivity going forward? And any color you can give us on maybe comps by vintage or historical banners, maybe you can help us there.

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

Sure. You're correct. As we've been talking about for the last number of quarters, we continue to see terrific new store openings, in particular in the new markets that we're expanding into, which is important from our perspective because this year is a real meaningful change in terms of the percentage of stores opening up in new markets. Historically, 2/3 of our stores in any given year opened up in our existing markets, sort of Texas West. This year, 55% of our new stores, the 28 stores that will open, are opening up in new markets. Some of our largest grand opening week and the openings in new markets this year are the top in company history. So we're very excited about what's happening for the consumer adoption of the Sprouts Farmers Market brand across the U.S.

Operator

And our next question comes from Vincent Sinisi of Morgan Stanley.

Michael Efram Kessler - *Morgan Stanley, Research Division - Research Associate*

This is actually Michael Kessler on for Vinnie here. So just wanted to ask more actually on the expenses side. So it looks like you guys had pretty solid expense control this quarter given investments you have been making. So just wondering if you can maybe walk us through where you're at, at this point as far as what you've already done, how much is left to be accomplished and maybe what the cadence of those investments are going to look like as we move through the year.

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

Yes. As we pointed out in our guidance update, there's no change to the SG&A expectation for the year. As we pointed out in our release and our remarks, we did have some benefit in the first quarter as a result of the California food reduction of the expense from that point of view. Also, we had a benefit of stock-based compensation in the first quarter that would continue into the second quarter but reverse later in the back half of the year. As well, one of the offsets in the first quarter, as everyone should be aware, we lapped the $10 million incremental wage investment that we started at the beginning of the second quarter last year. So that actually was a headwind of 25 basis points in the first quarter, we now lap that at the beginning of the second quarter.

From a strategic investment point of view, as we pointed out in February, we're on track to deliver on our fresh item management, roll it out across all the fresh departments. That'll happen by the end of the third quarter, so you've got more of those rollout cost and SaaS cost coming through in Q2 and Q3. As well as we mentioned today, we just launched our Workday Financials system that's up and live. And we have -- Q2 to Q4, we'll have ongoing strategic investments in connection with our marketing and connected customer and digital loyalty project. So we still expect to be -- and again, if you park the noncash impact of the lease accounting change, which is 35 basis points hit to the P&L, we still expect to be 20 to 25 basis points deleveraged primarily related to the strategic investments as well as lapping that last year increase in wages.

Michael Efram Kessler - *Morgan Stanley, Research Division - Research Associate*

Great. Awesome. That's very helpful. And then just as a quick follow-up on the e-commerce side, you mentioned delivery up 60% in 1Q. I guess where -- given now that we're moving a little more into getting kind of across the entire markets that you guys operate in with delivery, any kind of updates on what you're seeing with the results? Any new learnings from the rollout as we kind of move into a little more maturity here?

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

Sure. We've had tremendous success rolling out home delivery now across all of our markets. And it was really only in this last quarter, late in the last quarter, that we rolled out into Southeast. We're seeing pretty significant customer adoption. I think from our perspective and based on our years of history with home delivery, what really matters most in terms of how consumers make decisions around who to buy from is the quality of the product, the consistency of making sure what the order is what gets delivered, and ultimately, it's the brand. And the Sprouts brand, which is all about fresh, is really resonating with customers.

So we see a continued increase in average weekly sales on home delivery. By the end of this year, it's going to be 1.75% to 2% of our total sales. Basket size is 2.5x that of the store. And so our real focus is around -- there's going to be this continued shift of our consumer purchasing from both in the store and out of the store, and we're up over 60% year-over-year on home delivery sales in the first quarter. That will just continue. Our entire focus is really no longer just a focus around what happens in the store, it's how to be engaged with that consumer, where and how they want to engage with us, in the store, out of the store, digitally. And we're focused entirely on maximizing share of wallet.

As we pointed out before, the home delivery basket not only significantly larger but the margin mix to us is much stronger relative to the mix of products that are being ordered online. And even though we have the same prices online as we do in the store and some of our competitors do not, the ad penetration on the home delivery orders is meaningfully below that of the store because it's really about the convenience factor from a consumer standpoint. So overall, I think kudos to the team that are leading the home delivery operation within Sprouts. And certainly the operators and the team members in our store are making it happen, resulting in Sprouts continuing to have the highest customer service rating on the Instacart platform.

Operator

And our next question comes from Chuck Grom of Gordon Haskett.

John Christopher Parke - *Gordon Haskett Research Advisors - Research Associate of Retail*

This is actually John Parke on for Chuck. I mean, I guess we obviously don't know what your internal expectation was here for the quarter, but you seem to have beaten the Street by $0.05 and then all the share repurchase that you guys have done seem to add another $0.04 to $0.05 of earnings this year, but yet you only kind of raised the low end of your EPS guidance by $0.01. So kind of what else is kind of changed here for more of that not to flow through?

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

Yes. Well, I'll just clarify that we've increased the bottom end of our guidance range by $0.02. The previous bottom of the range was $1.16. It's now to $1.18. And I think if you do the math on the amount of shares that we've bought back, the annualized impact is an incremental $0.02.

Operator

And our next question comes from Scott Mushkin of Wolfe Research.

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

Before I get there, just our thoughts and prayers are with Jim and hope he's okay. Second thing I would ask is -- I know we talked about it a little bit, Brad, but if we could look at those SG&A, better SG&As, can we quantify some of those as onetime or look at them as some of those as onetime? And if we could, what would you put that number at?

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

Yes. So first of all, Jim would have liked to have been here today. He's had some health issues that he's taking care of at this time. And he is, of course, anxiously looking forward to his return. And so everyone in the company is certainly just focused on making sure he deals with his health and executing on our priorities for the year without any interruption.

As we pointed out, Scott, in our earnings release and in our remarks, the California food was a benefit because last year in the first quarter, we were still paying that payroll tax and stock-based comp was also a winner year-over-year. Those 2 items are roughly 20 basis points, about 10 bps each, that benefited the first quarter. The California food would be, if you think about Q2, Q3, would be nominal, and then it would reverse in Q4 because we took the benefit in the fourth quarter when the -- when California got out of their deficit position with the Fed.

So part of that is definitely timing in the first quarter. The occupancy benefit that we had in the first quarter for some rent credits was expected in our full year, but it came in a little bit earlier than we anticipated. So all told, those benefits were about 30 basis points. Now recall because we didn't lap the incremental wage investment until the beginning of Q2, that was a headwind embedded in our numbers in Q1 of 25 basis points. That goes away in Q2 because we lapped that.

Operator

And our next question comes from Paul Trussell of Deutsche Bank.

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

Just maybe taking a step back, you had a few timing issues as you've mentioned. Maybe just help us better understand the impact in 1Q from cycling a strong cold-flu season a year ago, how we should think about Easter shift, maybe impact to comps and margins from the produce availability issues. And just any kind of updated thoughts on inflation for the year.

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

Sure. Cough-cold flu from 2018 was probably the strongest season in recent memory if not ever. So that had a pretty meaningful effect because, of course, the whole vitamins area of the business is typically strongest at the beginning of the year where people want to live healthier after the holiday season. So that was a pretty big headwind in the first quarter. And certainly, the produce availability challenges because of the weather had a meaningful impact on our ability to, a, get quality product; and b, promote because the -- some of the veg items cost inflation were in the 40-plus range in terms of cost increase. And it's always a challenging one to be able to promote when you can't get the good quality. And if the cost is a lot higher, you got to pass some of that along. So definitely headwinds in Q1.

From an inflation standpoint, we were overall inflationary on cost in the first quarter. That was really driven by produce and meat. We were seeing inflation from beef where exports are pretty significant. So supply is tight, herds are tight and we anticipate that continuing through the second quarter. So our line of sight at this point in time, we'd expect the full year on a cost basis to be maybe 1% inflationary.

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

Got it. And then a big topic of conversation last quarter, whether -- were headwinds that come from all the initiatives and investments being made, whether it is in the rollout of the fresh item management or some of your technology and delivery initiatives. And you kind of spoke about -- at least your current line of sight was a return to the double-digit algorithm as we approach that kind of second half of 2020. Just given we've got 1 more quarter in the books, any change to that thought process?

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

No, there's no change at all. We sat back as a management team as we do every year last summer and really looked at what did we need to do to continue to drive our point of differentiation with our customer and how do we implement core infrastructure systems that are going to allow us to grow in scale efficiently. And we certainly are pleased with what we've executed to date and our plans remain intact to deliver on all these strategic initiatives this year. We're extremely happy with the team that's rolling out the fresh item management that's critical for us. We're starting to see some early wins.

And really, it's about the customer and the work that we're going to do for the balance of the year, building out our digital platform and strategy and loyalty. I think that really positions us well to take it to the next level from a customer engagement point of view. And so given the dollars that we're spending and obviously a significant increase this year when we think about 2020 and beyond, obviously, projects this year roll off and some new ones roll on. And that's why we're still feeling confident that we return to that double-digit EPS growth.

Operator

And our next question comes from Ken Goldman of JPMorgan.

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

I hate to ask this when Jim's on medical leave and please pass along our well wishes. But I just wanted a little more of a complete update if we could on the board's process in identifying a permanent head because it's been over 5 months since Amin resigned. It's a pretty long time for any company to operate without a fixed leader. And Brad, you're not doing the job that 3 people used to, right? CEO, CFO and COO. And I know that Jim is just on temporary leave, but how much bandwidth do you personally have to keep this going as is? You're running a pretty large company, I'm sure this is taking up a lot of your time.

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

Thanks for the questions, Ken. First of all, just with regards to the CEO, permanent CEO search, as you know, these searches can typically take 6 to 9 months. As you point out, we're 5 months in. The board is highly engaged. The search committee in moving through to the conclusion of this search, they're deep into it. And we'll hopefully have something to share in the not-too-distant future. Look, Jim and I have worked together for 3 years and we have a very close relationship, great working relationship. And we haven't missed a beat since the end of last November. We got a deep management team that are executing on our strategic initiatives. And yes, well, in this interim short period while Jim's away, his direct reports are now reporting into me.

But if we think about the merch side of the business, Dave McGlinchey, who is absolutely solid with over 20 years of experience in grocery -- and I've been working actually closely with him for the last year, he's been with us for 2 years, he and the team are executing and running the business. Dan Sanders, who heads up our operations, has decades of experience at senior levels running operations and has been with us for almost 4 years. And as we pointed out, I think over the last couple of calls, Dan has been really successful in bringing in some very seasoned SVPs of operations who have been running now for about the last year operations in the East and the West. And as you know, I took over real estate responsibilities as part of the planned development back in August, September of last year, and I've run real estate in my past life for 5, 6 years.

So it's not about one person. It never is. The company has been focused over the last 24-plus months of building the bench and bringing in great talent. And the fact is that we're now approaching a $6 billion company, that has been pretty important and enabling us to attract top talent to the company. So we're feeling very solid as a management team that we're continuing to execute. Yes, we're busy, but we wouldn't have it any other way.

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

All right. That is very helpful. I just wanted to sort of state, though, I have been -- like many people on this call, I've been doing this a long time. I cannot recall when it's taken 9 months for a company to find a permanent CEO. I just don't understand why the board wouldn't have a backup plan in place, a sort of "what happens if the CEO gets hit by a bus" plan as they like to say. So it's not really a question as much of a statement, but it just feels like a very long time to me for a big company. So I'll let it go.

Operator

And our next question comes from Robby Ohmes of Bank of America Merrill Lynch.

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

Brad, at the beginning of the call, I think you mentioned something about becoming more of a full grocery shop and kind of referencing it around produce historically being a good traffic driver for you. I know it wasn't as helpful this quarter because of the lack of availability. But could you maybe go a little deeper into that, how the -- how Sprouts is changing from its strategy which used to be probably a lot more heavily dependent on being the cheapest place in town to get produce. And how you're going to keep -- how does that conversion work as you become more of a full grocery shop? Are you -- I understand adding the delis and everything. Are you changing items a lot? Are you adding more household supplies? Maybe a little more detail on that. And then semi but not totally related to this, with the new store, the new markets that you're going into and the comp coming in a little bit lighter at the low end for the year, can you remind us how new stores coming into the comp base are contributing to the comps right now versus history?

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

Sure. Thanks, Robby. I would say that over the last 2.5 years as we've really focused on aligning our offering with what consumer trends are moving towards has been very helpful. With regards to the deli area of the business, we've introduced a lot of newer items that are on trend and healthy. And that's a real point of differentiation for us. You can go to any supermarket and get something that you can pick up and eat that's convenient, but there's a huge difference between what many other retailers offer and what Sprouts offers. And we're all about natural, organic, healthy ingredients at very good prices.

And that's exactly what our consumer research is telling us. Particularly in the deli area, recent consumer research has come back and saying the customer certainly enjoys our fresh offering in the deli area, and in particular, the fact that they can trust the ingredients that are contained within the product. We brought on a fantastic chef in our business now, probably 2.5 years ago, who had deep global experience in creating fantastic items that are on trend with protein and different salads that are clean ingredients, that merchandise beautifully and can execute that at store level. And that's absolutely resonating with our customers and we're seeing continued sales growth. And in fact, our sales growth, one of the top categories in the first quarter, continue to be our deli.

I would say on the private label side, the team has been built out over the last couple of years and expanded significantly because we see the size of the opportunity. And for us, we're now at 14% penetration. We've been growing out 150 basis points of penetration a year. We now are at about 21% penetration in grocery. Frozen and dairy is approaching 20%. And our go-to-market strategy is still significantly different. It's all about taste. It's all about clean ingredient set, non-GMO, organic, better-for-you ingredients, fantastic taste and packaging.

And not only is our growth in the 20-plus range and comping double digits in private label consistently. It's not about just introducing SKUs and that's driving the sales growth. It's really more so the consumer adoption and more items in the basket. And we continue to see baskets with private label and in it that are 50% larger than our overall basket size. So that -- we see a lot of tailwinds there. We're at 14% there now. We see that going to 16% to 18%, which obviously comes at a slightly better margin as well.

And I would just add that the new prototype store that we've introduced, we have 5 stores, now 6 stores in place, there'll be 8 total incremental new format stores this year. And then beyond 2019, every new store that we open is in this new prototype, which is all about the customer experience, particularly around deli and meat and seafood. It's more of a theater with all the service from within a rectangular island within the store and production has been moved back of house.

The consumer feedback that we received on this new proto has been fantastic. And the incremental sales that we're seeing in meat and seafood deli and, in fact, bakery have been very promising and positive, in fact exceeding our expectations. So I know it's a bit of a long answer, but there's a number of factors that are giving us a lot of confidence around we're not just the specialty grocer, this is really about a natural organic fresh full grocery shop.

Operator

Our next question comes from Edward Kelly of Wells Fargo.

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

So I wanted to start just on comps in Q2. Have you seen any improvement in trend so far in Q2? I mean the tone on the call doesn't sound like it, but we are cycling out of the flu issue, we had the Easter shifts into April. Just any color you can help us with there?

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

Yes, Ed. As we pointed out in our -- earlier on the call, we are still seeing some challenges on the produce supply availability because of the combination of cold weather out of Mexico and continued rains in California have hurt our availability. Now offsetting that in terms of our view for later in the quarter and into the summer, fruit is setting up to be a very solid season as compared to last year. In particular, cherries look to be a much better crop this year, so that will be more helpful to the summer months.

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

So to that point, and this is kind of like my other question here, is that if we think about guidance for comp for the full year now being at the lower end of the range, I mean in order to get there, I mean it kind of seem like we have to take down the back half, too. And I don't have you at this point comping by more than, I don't know, 2% or so now in the back half despite assuming sort of like a normal produce environment. I guess, is that fair? How should we think about that? I mean to me, it's kind of a low number for you at this point, so I'm just kind of -- especially now if we're talking 1% inflation for year.

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

Yes. So a couple of things. Number one, our original guidance, we gave a broad range at the beginning of the year just from the context of it's so difficult to project what happens with inflation/deflation in the produce given an average 6-week growing season. So we specifically called out that out in February, and we're aiming towards the midpoint of the range of about 2.2%, 2.3% at the beginning of the year. And then we had obviously had a challenge in the first quarter with availability which impacted our ability to promote and drive traffic into the store and that resulted in the lower comp in the first quarter and with some slight continuation, well, in produce availability in the second quarter. When we look out for the full year, we're going to be below the midpoint of our previous range. So somewhere in between the low end of the range and slightly higher.

As it relates to inflation and our specific comments, it's not that all the cost inflation can be immediately passed through, and so that obviously has some compression on top line as well as margin. And so we're just looking at how that's going to play out over the next quarter or 2. As I did point out on the nonperishable side, we are now starting to see most people pass through the lion's share of those cost increases. But that was more a headwind in the first quarter and slightly into the second quarter, but that's starting to come through in shelf pricing.

Operator

And our next question comes from Mark Carden of UBS.

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

So building on some of the earlier competition questions, there've been a lot of headlines about one of your larger natural organic competitors getting more aggressive on price. I know you guys have historically said that your core customer's a bit different, but have you faced any more pressure this time around? And if it's not Whole Foods, then where is the competition coming from?

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

Sure. Thanks, Mark. Yes, while we don't specifically comment on any one given competitor, I would say though we -- our pricing from an overall basket standpoint regardless of department is still meaningfully lower. And our core customer is Middle America. And it's a different demographic and we have not seen any changes in trends when we look back over previous price moves and current price moves. And also, we locate our stores much closer to where our core customers reside as opposed to High Street destination center. So for those 2 reasons, we're really -- we're in a different space and not seeing any changes regardless of what competitors are out there doing.

There's no question, fresh is an area of focus for everyone in the industry. I mean, that's -- the good news is that natural and organic is still projected to grow 6-plus percent top line over the next couple of years. And with 50% of what we sell being anchored on fresh and natural, we're in the sweet space and we see more and more of our customers, as I pointed out on a previous question, really being focused on expanding their shop with us across all the categories in the store as we're very much on trend in terms of where the customers are going.

So look, it is competitive market. We have seen not across the board, but typically you see some increased heat on front page ads in various markets and they tend to cycle market to market. But that's being offset and balanced by the fact that on the nonperishable side of the business, cost increases related to freight are starting to get passed through on shelf, so it's a bit of a balance.

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

Great. And then on the perishable side of the business, how do the tightness in produce compare to last year's first quarter? Was this impactful in aggregate? And is this something we should just consider to be simply normal in the first quarter due to weather?

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

Yes. It was more impactful in the first quarter of this year. And as we've pointed out in the past, the shoulder seasons, if you will, from sort of November through February are the most challenging to be able to predict because that time of the year, a much more significant component of produce items are being sourced from offshore outside of the U.S. And you can have a number of challenges, including tie-ups at borders. So it's more a difficult period of time to try and predict in that time of the year. But as we think through the summer months here, as I pointed out, looking like a better growing season certainly on the fruit side of the business in produce.

Operator

And our next question comes from Chris Mandeville of Jefferies.

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

Just one question from me. Brad, in the markets where fresh item management has already been rolled out, how are the associates taking today's system? And I think you had mentioned a little bit earlier in the call that you're seeing some early wins. Is there anything you can quantify there in terms of improvement in shrink or out-of-stocks?

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

Yes. Thanks, Chris. We're actually implementing the system. We're rolling it out not by geography but really by department and we're now in bakery and meat and parts of deli. And I think the most fundamental learning is that in sort of late last year, we identified that we needed to augment our training program in terms of making the new system and how to use it stick better. And we're seeing much greater success rolling that out this year. With this system, I think the greatest challenge was to convince long-standing team members that you need to trust the system. To be honest with you, that was the biggest challenge because everyone is in the habit of how to order and how to determine production quantities. But the biggest learning and aha is, well, when I rely on the system, it actually works.

And so there's 2 ways you can go at fresh item management in terms of sequencing, how you're rolling it out. One is to optimize sales. The second is to optimize shrink. And we've taken, I think, the right approaches to optimize sales first and getting the production quantities set at the right levels so that were not leaving sales on the table. And then once you optimize sales, you can go back and look at SKU productivity and identify items where you can pull back on to enhance and improve the shrink situation.

So overall, we're seeing nice wins as it relates to increasing sales in our stores. And we have implemented computer-assisted ordering for certain areas of the store, like the back wall of produce, we're seeing much better in-stock positions. Some of the items in the deli, the hanging meats and cheese, is now on computer-assisted ordering. And we've got production planning now in the rotisserie chicken area of the deli, which we've seen some probably the most meaningful step-up in sales and productivity. So it's going according to plan and we're very pleased with how we've retooled the rollout and the training and it's sticking.

Operator

Our next question comes from Karen Short of Barclays.

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

Just a couple of clarifications from me. So you've obviously given cost inflation at the 1% level. But can you maybe just clarify what you think retail inflation will be looking like for the full year? And I mean I ask that in the context of your comp guidance because, obviously, comp guidance has not been increased. And you've given us an explanation as to why, but inflation guidance have increased.

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

Yes. Certainly, we've seen a competitive marketplace with increased focus on fresh in produce. And the situation in the first quarter of availability challenges, anytime you have significant inflation to the extent that we saw on a number of commodity important items, you can't pass that through. So you see a pretty significant difference between cost and retail inflation on those items. And because that has continued into the first part of the second quarter, that's really driven our view on comp sales for the full year.

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

Okay. And then I guess maybe just on the competitive landscape in general, I'm still not totally clear. Are you saying that it remains competitive but it hasn't gotten worse? Because it kind of does sound like you're trying to indicate maybe it has gotten a little bit more aggressive. Can you just clarify that?

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

Yes. I think in certain markets, it has gotten more aggressive on front page ad. But it's being offset to some extent by less aggressiveness as everyone seems to now be more than willing to pass through cost increases that, quite frankly, everyone's absorbed from late Q4 right through the first half of Q1 before any meaningful pass-throughs. So it's a bit of a bifurcation between on-shelf versus on-ad.

Operator

And our next question comes from John Heinbockel of Guggenheim Securities.

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

So Brad, if you think about mature stores, is it fair to think that they're probably comping 0% to 1%? Not just this quarter, I'm thinking kind of look out last 1.5 years and maybe going forward, 0% to 1%. And then is that fair? And then when you think about home delivery and fresh item management, is it possible to move the dial on that maybe 100 bps that much? And then the third part would be, if not, right, as you think about your -- the level at which you need to leverage expenses, if we're really looking 0% to 1%, can you get the expense trajectory down to where you can leverage at 1% or a bit below?

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

Sure. Thanks, John. Look, the identical stores that are the strongest performing in terms of store EBITDA, they are also the stores that are taking the lion's share of the cannibalization. So we always look at the health of the business on an ex cannibalization basis. And when you add back the cannibalization, they're performing stronger than you suggested. And so that's point number 1. And as it relates to home delivery, really, our entire approach with regards to e-comm is more holistic in terms of wanting to engage with the customer however and wherever they want to engage. And that's how we're building out our digital strategy and loyalty strategy.

From a leverage standpoint, how we leverage on the total company basis, we do need a comp of around 3%. But the identical stores, which is the lion's share of the stores leverage at a significantly lower level of sales growth than that. Really again, if we think about the entire full year 2019, our guidance has not changed with regards to roughly 20 to 25 basis points of deleverage all coming from the SG&A line. It's really related to lapping through the first quarter the incremental wage investment as well as the strategic initiatives that we're executing on this year and only slightly leverage on the gross margin line.

Operator

And that concludes our question-and-answer session for today. I'd like to turn the conference back over to Brad Lukow for closing comments.

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

We just like to thank everyone for joining us on the call today, and we look forward to speaking to you seeing with a number of you in the weeks to come. Thank you.

Operator

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