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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 2017 Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded.

I would now like to hand the floor over to Susannah Livingston. Please go ahead, ma'am.

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 2017 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 2017 results, our 10-Q and the webcast of this call can be accessed through the Investor Relations section of our website at sprouts.com. During this call, management may make certain forward-looking statements, including statements regarding our future performance and growth, product expansion, new store openings and 2017 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 filings with the Securities and Exchange Commission, 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.

For the third quarter ended October 1, 2017, diluted earnings per share of $0.23 increased 44% from diluted earnings per share of $0.16 in the same period in 2016.

With that, let me hand it over to Amin.

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

Thank you, Susannah. Good morning, everyone, and thanks for joining our call today. We're extremely pleased to report the continued momentum at Sprouts for the third quarter. I'm very proud of our store, regional distribution center and support office teams helping us drive health and value to our customers every single day.

The strategies we have shared during our previous calls are driving our performance. Given the third quarter performance and continued strength in the business, we are increasing our full year guidance for 2017, bringing Sprouts back to high single-digit EBITDA growth and EPS in the teens.

For the third quarter, sales rose to $1.2 billion or a 16% increase over the prior year, driven by comp sales growth of 4.6% and strong new store productivity in the low 80s. Our business momentum is strong, evidenced by the sequential improvement of our 2-year stack comp of 5.9%, which accelerated throughout the quarter. Sales were strong across all departments, while inflation was needed and ended flat for the third quarter.

The momentum in our nonperishable departments continued and our produce department benefited from a very strong growing season this year. Traffic was positive and cannibalization is now back to our historical range of 125 to 150 basis points.

We remain focused on our 4 strategic priorities that continue to drive results and provide tailwinds to our business. These include an innovative product offering, investments in our team members, connecting with customers inside and outside the store, and investments in infrastructure and technology to drive greater efficiency and lower cost.

Let me briefly detail advancements in each of these areas. First, we continue -- we remain focused on delighting our customers through the more than 17,000 products with the foundation of health, value, taste and differentiation. Our private label program, with penetration at nearly 12% of revenue, continues to grow well above the company average, driving larger baskets, repeat trips and deeper loyalty to the Sprouts brand.

The upcoming holidays allows us to be a better destination for many exclusive and unique seasonal offerings in private label. These offerings range from affordable-price staples such as organic broth, to unique specialty items focused on taste likes Sprouts brand gingerbread almond butter and gluten-free fudge brownies. These unique items and our complete holiday offering strengthens Sprouts' position as a holiday destination and continues to strengthen our overall business in the fourth quarter.

In addition, our enhanced deli program is now in 130 stores. Most new stores opened with an expanded deli offering and we continue to retrofit existing stores. We remain very pleased with the success, particularly in new stores where our sales mix and deli is meaningfully higher, driven by our new offerings.

These enhancements continue to boost our new store productivity and are resonating well with our customers across the country. The second area is a continued focus on our more than 27,000 team members who are at the forefront of driving exceptional customer experience every day in our stores.

Our knowledgeable customer service is just one differentiator that continues to win over customers. The foundational investment in our team members evolves around leadership, product knowledge and professional development. We are seeing the benefits of investment in our team members through better customer service scores, improvements in our team member retention and a greater number of team members ready for promotion, which is an important element given our new store growth.

Third, Sprouts continues to connect with our customers in meaningful ways. We have seen strong momentum in our customer engagement on our digital and social platforms over the past 6 months. We are very excited about our early 2018 launch of a fresh, new platform for a connected web mobile and app that will enhance the customer experience and deliver even more personalization and relevance for each customer.

I'm very pleased about the progress around the in-store and digital convergence our team is the building, but leveraging our unique and differentiated Sprouts model and the Sprouts brand.

Lastly, Sprouts' investments in technology infrastructure is driving productivity in the stores, enabling us to further manage our cost. Our labor management tool, already in place for the nonproduction departments, will be implemented in the production departments in 2018. This system will further improve both store productivity and customer experience.

Our business intelligence team is providing greater insights allowing emergence to refine and improve our promotional effectiveness, and we will deepen our marketing analytic as is we move into 2018.

Next year, we'll also launch of our new fresh item management tool, which will improve ordering, better in-stock positions to drive sales and reduce shrink. We believe we are very well positioned to harness these cost efficiencies in 2018, and these initiatives will provide Sprouts the flexibility to responsibly invest and price as necessary.

Shifting to new store growth. In the third quarter, we opened 8 new stores and 3 additional stores opened in the fourth quarter, and we will end 2017 with 285 stores in 15 states. Our pipeline remains strong, with 53 approved sites and 44 signed leases for the coming years.

We recently announced our store openings for the beginning of 2018, including our entrance into the Mid-Atlantic with our first store in Maryland. In addition, our expanding footprint will also bring our healthy brand to 3 additional states in 2018 -- Washington, South Carolina and Pennsylvania, for a total of 19 states by the end of 2018.

In summary, our product, customer engagement, team member and infrastructure strategies are working and continuing to position Sprouts to be one of the best-performing grocery retail operators in the country. We strive to remain dynamic in our approach with the customer at the forefront.

Before I hand it over to Brad, I want to touch on the unfortunate natural disasters in Texas, Florida and California, which have led to unimaginable destruction. Sprouts, our team members and our customers actively engaged to support relief efforts in all 3 states.

I'm extremely proud of the many team members who went above and beyond to serve, from providing a ride home for a stranded customer to donating vacation hours to fellow team members who are impacted, to hand-delivering supplies to fire departments and police stations. These small acts of kindness and community engagement represent the Sprouts culture and values for which we stand.

With that, let me turn the call over to Brad to speak about our financial results and 2017 guidance.

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO, Principal Accounting Officer and Treasurer*

Thank you, Amin. I'll begin by discussing some of the business drivers for the third quarter and then review our updated guidance for 2017.

As Amin mentioned, for the third quarter, sales were up 16%, with comp sales growth of 4.6%, our strongest comp since the first quarter of 2016, driven by accelerating traffic and basket. This, coupled with improved merchandise margins, strong labor management and sales leverage across the P&L resulted in EBITDA of $78 million, a 24% increase for the third quarter; and a margin of 6.5% of sales, a 40 basis points improvement.

Let me discuss a few of the driving factors around the solid performance. For the third quarter, gross profit increased by 19% to $346 million, and our gross margin rate increased 60 basis points to 28.7% compared to the same period in 2016. The majority of this increase was due to cycling the heightened promotional environment in the third quarter of last year in addition to sales leverage on other fixed cost.

For the third quarter, direct store expense increased 15% to $250 million, an improvement of 20 basis points to 20.7% of sales compared to the same period last year. Our operating discipline drove productivity in the stores and continued to benefit Sprouts in the third quarter. Leverage on our fixed costs from improved comps, coupled with a focus on operating efficiencies, helped to offset higher benefit costs.

SG&A increased 35% to $40 million for the quarter, an increase of 40 basis points to 3.3% of sales compared to the same period last year. This reflects higher bonus compensation expenses due to improved performance versus the prior year and a slight increase in other corporate cost. We expect some of this deleverage to reverse next quarter, relating to the timing of the bonus compensation expense in the prior year.

As well, during the third quarter, 14 of our stores were affected by hurricanes in 3 states. The net financial cost was $700,000 primarily related to inventory loss and other incremental expenses. These expenses are included in the store closure and other costs line in the income statement for the quarter.

Net income for the third quarter was $31 million, an increase of 32% from the same period in 2016. Diluted earnings per share was $0.23 for the quarter, an increase of $0.07 or 44% from the same period last year.

Now shifting to the balance sheet and liquidity. We continue to generate solid operating cash flows from operations, up 32% year-to-date to $259 million. We also invested $151 million in CapEx, net of landlord reimbursement, primarily for new stores.

During the quarter, we repurchased approximately 3.2 million shares for $72 million. We ended the quarter with $19 million in cash and cash equivalents, $349 million borrowed on our $450 million revolving credit facility and $138 million available under our current share repurchase authorization.

Year-to-date through October 31, we have repurchased 9.1 million shares of common stock, returning $192 million of capital to shareholders. We ended the quarter at 1.5x net-debt-to-EBITDA and plan to remain in the 1.2 to 1.5x range for the near term, allowing us to self-fund our unit growth through cash flow generation and enhance shareholder returns through our ongoing share repurchase program.

Now, let me turn to the 2017 guidance. Net sales growth is expected to increase 14.5% to 15% attributed to ongoing positive trends in the quarter. As well, we are increasing our full year comp sales growth range to 2.5% to 3%, which reflects the continued momentum we are seeing in the business, and we expect to land roughly at the midpoint of this range.

We are increasing our diluted earnings per share to the range of $0.98 to $0.99, resulting in EPS growth of 17% to 19% for the full year. This includes a lower estimated effective tax rate of approximately 32.5% for the year. The lower effective tax rate is primarily due to the change in accounting standard related to the recognition of the excess tax benefits for stock-based compensation, reflected in the income tax provision for the year.

Lastly, our CapEx will be approximately $170 million net of landlord reimbursements. And consistent with our previous guidance back in August, we have opened 32 new stores during the year, completing our new store openings for this year.

A few additional items to note on the 2017 guidance. We expect deflation to be flat to slightly negative for the full year, similar to our expectations last quarter. As it relates to margins, we will continue to make price investments as necessary to drive traffic and to maintain our strong competitive position. As Amin pointed out earlier, many of our strategic initiatives continue to enhance margins and provide us with the flexibility to invest when and where needed.

As a result of our Q3 performance, we now expect full year gross margins to be approximately 30 basis points below 2016, attributed to the competitive promotional environment for the first half of the year and continued deleverage in occupancy due to an overall increase in average square footage growth from building more prototypical new stores. This margin range represents an improvement from our previous guidance of margins being down 40 to 50 basis points for the year.

On the direct store expense line, similar to our previous guidance, we expect DSEs to delever by 10 to 20 basis points for the full year. And on the SG&A line, we continue to expect to be relatively flat to slight deleveraged as a percentage of sales, which implies leverage in the SG&A line in the fourth quarter. Below the EBIT line, we expect interest expense to be approximately $21 million, including interest related to financing and capital leases.

In conclusion, we are very pleased with our solid financial performance. We remain confident competing in this dynamic industry and in our strong competitive position that allows us to deliver solid free cash flow generation, healthy new store productivity 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 the line of Mark Carden with UBS.

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

Can you talk a bit more about any recent changes you've seen in the promotional environment? So you mentioned that you're planning on implementing targeted price investments in the fourth quarter. Are competitors acting any more aggressively on price on the back of [poor trends] and inflation? Or has it been more less in line with what you've seen historically in this kind of environment?

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

Mark, this is Jim Nielsen. As far as the promotional activity in Q3, on a year-over-year basis, last year was a little bit more aggressive. But sequentially, up against Q2, it was in line. And as we've mentioned in the Q2 call, we project the promotional environment to be steady relative to Q3 and Q4. As far as the shelf pricing goes, I just -- it's a quick fall-off as far as shelf pricing goes. We are seeing people now start to pass through some cost base inflation in some key areas, which is obviously benefiting margin as well.

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

That's really helpful. And then second, wage pressure continues to be a theme across retail, especially if cities and states continue to pass legislation that calls for boosting minimum wages in various locales. Given your store footprint of -- perhaps a bit more heavily than some of the aggressive states, are you expecting this get sustained headwinds in the few years? Or are you guys comfortable with where you're at?

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

Mark, we are right now in the best operational readiness position that we've been in over 2 years. So our open position rate is at the lowest we've seen in 2 years. And as far as wages, we made those investments as we called out, in last year's calls, and wages to put ourselves in a very competitive position. And I think today where -- 92% of our team members are above minimum wage. So we feel like we're in a great position as we look forward to 2018.

Operator

And our next question comes from the line of Ken Goldman with JPMorgan.

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

I'm sure you don't want to talk in detail about 2018 yet, but as we think about modeling the year out, are there any particular tailwinds and headwinds, obviously, other than the comparisons we can all see in a quarter-by-quarter basis that we should be aware of? Just trying to get a sense of, if there's anything unusual you're seeing going into next year that we should be thinking about.

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

Ken, thanks for the question. I think the -- overall, I don't think there's any significant unusual items that were -- I would call out. The thing that I would say that is -- we think will strengthen our position going into next year is our innovation and our product pipeline in private label. Deli food as well as meat and seafood is continuing to resonate very well. Private label, as you know, has had tailwinds for the last few years. It's continuing to provide strong tailwinds today. And we're starting to see some good stuff changes in deli food and some of the things we're seeing on seafood side. And so we feel really good about that. I think the second I would just say is tailwinds of customer connection with our new -- launch of our new platform, that will be the first quarter, sometime in the first quarter, we feel good about that. And then, I think, most important I would call out that would be different is we've been working on a number of initiatives such as our labor management system, a fresh audit management project and our business intelligence project. And those projects are all in-flight, and some are -- have now started to launch and some are going to launch into Q1 and Q2. And we're pretty excited about driving both effectiveness, efficiency as well as customer experience, better customer experience out of those. And we think that those savings either will add to margin or provide us the necessary room to invest in price if and as necessary. So those are the 3 things I would call out.

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

And then my follow-up is, I know you're always also hesitant to talk about particular regions and how they're doing, but I'll take a stab at it anyway. Obviously, one of your biggest competitors had a very highly publicized price decrease last -- during your quarter. Do you think that affected you in any way? Were any of your stores that were in particular proximity to that competitor affected? Or was it really more steady as she goes?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO, Principal Accounting Officer and Treasurer*

Ken, it's Brad. What I would say is clearly based on the strength of our comp sales performance and our updated guidance, and our sequential increase throughout the quarter and our 2-year comp. I think it's safe to say that we saw very strong performance across all markets in all regions throughout the quarter.

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

And we're seeing -- the only thing I would add is that in addition to good performance across regions, we're seeing good performance across all departments. So in many ways, we feel like we're hitting on all cylinders in departments and regions, so we feel really good about how we're positioned today.

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

And Ken, I hate to be adding on 3 times, because we always tell ourselves, we don't want do this 3 times. But I think it's critical to remember that our price -- we price check against the market share leaders. Traditionally -- that's the traditional grocer in that particular geography, which has always been our primary competitor, and that's given us a significant pricing advantage over all specialty retailers within those geographies.

Operator

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

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

Brad, on the implied guidance for Q4, it looks like the comps' probably going to come in the range of 3% to 5% comp. And based on your commentary around momentum through Q3, I'm just trying to square the actual -- the guide itself and how we could potentially see a deceleration on a sequential basis. And then maybe more importantly, I'm thinking about the margin profile, compares are really quite similar for Q4 versus Q3 of this year. So can you just speak a little bit more so around why we should actually be looking for gross margins to potentially be down on the quarter as well as just EBIT or EBITDA margins?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO, Principal Accounting Officer and Treasurer*

Okay. So there's a lot of questions there, I'll try to address them. First of all, what I'd like to point out is in the third quarter, we did have a benefit from a very strong produce growing season that we would not anticipate in the ordinary course to exist in the fourth quarter, which is traditionally a seasonally less-robust produce period. Also, we had the benefit in the third quarter, some pretty strong remodels and [relows] that we have now lapped coming into the beginning of the fourth quarter. I think I pointed out in my remarks, with regards to the overall comp guidance for the year, the fact that we anticipate landing in the midpoint of the range effectively suggests that we would be expecting to come in around 4% comp for the quarter in the fourth, which, after adjusting for those 2 positives that we experienced in the third quarter, more or less put us in line Q3 to Q4. Also, our updated guidance improvement in gross margin for the year implies that we'll be relatively flat on merch margins for the fourth quarter. We'll continue to see some deleverage relative to the occupancy costs, as I pointed out, with regards to the more prototypical stores that we're opening throughout the year.

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

Okay. And then, just last one from me. In Q3 itself, seeing how you did manage to expand your gross margin 50 basis points, is there any ability to parse out what the offset was there with price investments? And lastly, how did you actually progress sequentially versus the flat performance in Q2?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO, Principal Accounting Officer and Treasurer*

Yes. I think, again, we point out that if you look at the third quarter of last year, that was the most promotionally intense period of time, and much of the 60 basis points improvement relates to the fact that we were lapping that very deep promotional environment. Things did start to improve for us in the fourth quarter of last year and so that we will be looking for, more or less, a flat performance on merch margins for the quarter.

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

And with regard to tonnage, we did see a positive increase in Q4 and it was driven -- we had a nice balance in all departments on that tonnage contribution -- or Q3, sorry.

Operator

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(Operator Instructions) Our next question comes from the line of Rupesh Parikh with Oppenheimer.

Erica A Eiler - *Oppenheimer & Co. Inc., Research Division - Equity Research Associate*

This is actually Erica Eiler on for Rupesh. So I was hoping you could remind us of how you are thinking about the customer overlap with the Whole Foods customer historically, based on some of your studies.

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

I think that -- and historically, what we've seen is where we're positioned is we're generally from a demographic perspective, less regional is one thing I would say. The second thing I would say is that we're probably more in the broader demographic, more towards the median income, median age, median education level. So all of our demographics, as we think about it, is -- would lean to, I would say, 30% of median demographic of an area to 70%, 80%. So we tend to be more middle class or a broader demographic. It would be how we're positioned to them.

Operator

And our next question comes from the line Chuck Cerankosky from Northcoast Research.

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

If we look at the sales mix in the quarter, you talked a little bit about private label, and that's increasing. I'd like you to talk a little bit about private label fresh products. And the fresh categories, overall, how much bigger they were in the mix of sales including prepared foods?

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

So chuck, this is Jim Nielsen. With regards to private label, again, another fantastic quarter for us, top line closed to 30 and comps in double-digit range. So great performance. Speaking to the specific fresh departments and the success, we're getting fantastic marks back from our customers around better [few] ingredients, freshness and the eating experience, which just came back from some of our consumer insight studies. But overall, it's been a great balance from the nonperishable side to the fresh side with regards to private label, and we're seeing more baskets. And the most fascinating and positive thing that we can see from a private label perspective is the basket size for a customer who has a private label item in it is 50% higher than the reported basket size for enterprise.

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

You said 50, 5-0, percent?

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

Yes.

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

That's impressive. Then in prepared foods, how much of that is specifically branded, whether it's the packaging or the signage that's branded around the Sprouts banner?

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

Yes. We're continuing to expand that. So under the Sprouts banner, we now have Sprouts' Market Corner Delis, The Fish Market at Sprouts, The Butcher Shop at Sprouts. And in the market corner deli, we're continuing to evolve our HMR case to better-for-you ingredients as Jim just talked about. I think our merchandising and our packaging is more consistent today across the platform, and it's starting to resonate really well. And we just introduced a number of new lines of sandwiches, paninis, wraps, salads, as well as home meal replacement and -- our HMR case and then our wall deli, as well as we continue to evolve our 8-foot deli case, which has proteins and sides in it, which was resonating really well. And in my prepared remarks, I talked about how much this is, especially in new stores, impacting -- positively impacting trite as well as making Sprouts more relevant for 12 o'clock, 5 o'clock, and we're really pretty excited about that. And certainly, some of our new store productivity is attributed to that.

Operator

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

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

Just wanted to ask about -- you mentioned about the enhanced digital platform kind of coming on board in 2018. Can you just give us a sense for kind of where you are in the process, maybe some of the enhancements that will be there and how we should think about the roll out. And then maybe just a quick follow-up to that, can you just give us a quick update where you guys are with the Amazon partnership?

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

Yes. I think on the first piece, on the platform -- on enhancing our platform, we really stepped back and looked to see how we can take our brand strength as well as our uniqueness in the space and health, as well as actively driven work and how we can create better content, more personalized content offers for the customer and allow them to see the breadth of offering at Sprouts. So we've completely -- we're going with a new provider and are completely changing our mobile web platform to start bringing in much more customer knowledge and more interaction with respect to how the customer can shop when they're coming in the store. So we're going to go on waves. The first wave is going to really focus on product, product content and then we're going to continue to add functionality to that to make the shopping experience easier when the customer is in the store. So I kind of paused at that. And in terms of the Amazon partnership, we know that our customers love the convenience and speed of home delivery from Sprouts. We continue to offer home delivery in 8 cities, and we look for more opportunities in the home delivery space to give customers option to shop for fresh, natural and organic products from Sprouts. And from a partnership perspective, I can't comment on the details of the partnership. But we know we want to continue to expand to more cities and states in the coming year.

Operator

Our next question comes from the line of Karen Short from Barclays.

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

I had one clarification and then a question. So just to clarify, in terms of the comp overall, was there a storm benefit? And then the second clarification point is, on traffic within the comp, can you give us the exact split? And then can you just give some color on how traffic trended in the third quarter and how it's trending into the fourth?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO, Principal Accounting Officer and Treasurer*

Karen, with regards to the hurricane, as we have previously indicated, there was only 14 stores that were impacted and there was 0 positive or negative impact with regards to the sales. The only impact we had was a hit of $700,000 to EBITDA in the quarter related to inventory losses. With regards to the performance in Q3, as Jim said, we're very pleased with the mix of growth and customer transaction count and basket. We're not going to provide specific numbers. But sequentially, improved nicely from a customer account perspective. And we're seeing a continuation of the third quarter strong performance into the fourth quarter to date.

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

Okay. So my bigger-picture question is just there were some retailers in the last several weeks, I guess, have given some color on what spend -- a customer spend does when they go from being an in-store customer to being an online customer as well. And just wondering, I know it's still early stages for you, but any way you could give some frame of reference on what the spend -- what happens on that particular customer spend when they become more of an omni-channel customer.

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

Yes, Karen, good question. I think that customers, as a practical matter, when they see that they're having to pay for home delivery, they tend to consolidate their trips. So what we see in the data is we do see bigger baskets. And from the early data, it suggests to us is there's some level of consolidation of trips. So I don't believe there's a lot of reports out there that home delivery is 30%, 40%, 50% higher baskets, that's true. But in an -- when everybody's doing home delivery, America's not eating 30%, 40% more food. So I think there's consolidation going on. What's key though for Sprouts is, is that compared to the conventionals, what we've seen is our trade area extends nicely. We don't -- we see -- we don't see a lot of cannibalization in our stores because we're seeing a lot of shopping from extended trade areas and for a specialty retailers like Sprouts or a Costco, we think that's an added benefit because it's extending the trade area for people who may not make that frequent trip otherwise to the store. So we see it as a great business opportunity going forward.

Operator

Our next question comes from the line of Kelly Bania with BMO Capital Markets.

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

Just wanted to clarify the message on expectation for the fourth quarter gross margin to be kind of flattish. Because you're still cycling some big declines from 4Q last year and through the first half of next year. So was it really just a good produce quarter that drove some of the upside here relative to your expectation? Or is there some cushion in the fourth quarter to make some incremental price investments?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO, Principal Accounting Officer and Treasurer*

Yes. As I said in the third quarter, we definitely had a nice benefit from a comp perspective relative to produce and the benefit of the very strong remodel in the comp. But as it relates to the margin, again, we were cycling a very, very deep promotional environment that drove the 60 basis points year-over-year improvement. With regards to the fourth quarter, again, we did see sequentially last year, a nice improvement in merch margin rate. So I think we would be looking to match that and be equal to last year in the fourth quarter on merch margin.

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

Kelly, I know this is -- I mean, let me add here. It seems like this question has come up a couple of times. If I put it in context, gross margin was down 80 basis points third quarter last year and plus 60 this year. So if you combine the 2, it's a negative 20 for the 2 years combined. And if you look at fourth quarter last year, it was a negative 50 and we had some benefits of some adjustments in the quarter that were worth about 30 basis points last year. So when we look at it on a combined basis, they look relatively -- on a 2-year basis, if you will, they look relatively consistent. So we're not seeing any -- at this point, any additional price investments, if you will. As always, we will hold some dollars for price investments just to be prudent, but we don't see this as a backwards quarter from -- going from Q3 to Q4.

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

Great. This is very helpful. And then just, also, wanted to ask about click and collect. You have Walmart and Kroger and others investing pretty heavily in that, and just wondering if that's something that Sprouts is considering and why or why not.

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

Yes, and that's a great question. We always put all of our priorities and opportunities on the board and we focus. And what we've learned from a lot of data, from consumer insight, from data from other combined retailer data, is for somebody like Sprouts, home delivery extends the trade area. And we've seen positive benefit of that. So our goal is to focus on that and execute that very well, and get the in-stock conditions and the high SLAs into the customers' home, execute it well. We believe from a click and collect standpoint, Sprouts -- when somebody comes up to the Sprouts parking lot, they can get in and out of Sprouts fairly quickly. But we know that there will certainly be some percentage of customers that might still find it beneficial. So we'll test it, but we're prioritizing. And what we found as a company and still having 20 priorities, picking 5 or 7 really robust ones and executing them well has served us well and, frankly, separated us from others. So we're likely to test it. I won't comment as to the timing, but we know we'll test it at some point and look for the customer signal.

Operator

And our next question comes from the line of Ben Bienvenu from Stephens.

Daniel Robert Imbro - *Stephens Inc., Research Division - Research Associate*

This is Daniel Imbro on for Ben. So you guys have been opportunistic with acquisitions in the past. Given the headwinds facing the industry, are you seeing more acquisition opportunities popping up which potentially augment unit growth over the coming quarters and kind of into 2018?

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

We won't speak specific to M&A at this point in time. But what we are starting to see is -- I think M&A has been happening in this industry for the past 3 to 5 years. However, what we're starting to see is some retailers, regional retailers who are struggling are not getting bought out. We're seeing an increased number of bankruptcies or split of assets, with some assets going away. So that's a trend, which we do think that that's going to bring more dollars back to the market, which we think that's going to benefit the industry and Sprouts as well. In terms of Sprouts, we're always looking. But nothing to -- particularly interesting or announced at this point.

Operator

Our next question comes from the line of Renato Basanta with Susquehanna.

Renato Basanta - *Susquehanna Financial Group, LLLP, Research Division - Associate*

I guess my first question, could you just give us a little bit more color in terms of what you're seeing in inflation by department? And then maybe give us a better sense of how that's translating into pricing again by department?

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

Yes, Renato, this is Jim Nielsen. Just a quick step back in Q3 and try to call this out on the call. Q3 was flat, which was in line with my projections that we had in Q2 and on the Q2 call, and it was primarily driven by produce being deflationary, some specifics broad areas. We didn't get to too many specific details, but I did call out cherries in the Q3 quarter. So cherries, berries and some tropical items drove down deflation within the quarter. And then dairy on the light side is in bulk and meat has slightly offset the deflation, so going back to flat. Looking forward, we would still expect Q4 to be flat with the data we have in front of us today and not getting the year to flat to slightly negative. Not to get too specific, I would only tell you that, from a broad perspective, that produce and meat we would anticipate being flat on a year-over-year basis.

Renato Basanta - *Susquehanna Financial Group, LLLP, Research Division - Associate*

All right. And then just a follow-up, Amin, can you just talk a little bit about how you view storage density particularly in the context of e-commerce growth? You've sort of been the suburban model, so how does that play -- how does that suburban model play in an environment where the retail store can increase into both denser and more sparsely populated areas vis-à-vis home delivery? And I guess related to that, just the incrementality of e-commerce today, what type of competitor do you think you're gaining share from? Is it specialty, conventional? Is it a mix?

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

I think from a market share standpoint, it's hard to pinpoint, except to say that I think the market share primarily comes from weaker operators. We see this particularly when we go into new markets. And we walk the stores before our opening and after, and we tend to see more impact on weaker competitors in the marketplace or in the trade area. With respect to store placement, actually -- I actually think that Sprouts sets up really well for home delivery networks because we're not located every 2, 3 -- 2 miles apart. We have less cannibalization on home delivery. And as it stands -- as it sits from a suburban versus urban model, what's interesting is the drive times tend to be similar, except in suburban environments. You can go longer distance in the same amount of time. So the delivery patch works really well. And I think Sprouts today is, with our increase in deli and some of our fresh and prepared and to-go programs, we also have more and more stores and a lot of our cities and what I call semi-urban spots. And as you work towards the center of town, and we're opening 2, 3, 4 stores on, call it, the 4 edges as you work to the middle. And as we opened those stores, it actually allows us to home deliver to the center of town and cover a lot of ground in urban centers, without paying the higher rents and putting stores in urban areas, which we've historically not done. So I think we're -- we feel like we're -- that's going to benefit us over time.

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

The only thing that I would add is the home delivery from the grocery space is giving us a good competitive advantage over fast casual, just because the retail price points are better than you would see in fast casual restaurants. So you can anticipate the industry potentially growing as the fast casual side of the business starts to erode.

Operator

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

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

Just a couple of quick ones. On the enhanced deli offering in 130 stores, ultimately, where do you think you could grow that to? And what's been the comp lift thus far? And then on stores, new store productivity was once again very strong. Can you just remind us on what you see as the long-term store opportunity? And then also, how the performance is in the Southeast, particularly in Florida.

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

A number of questions, let me start with the new store productivity, and then we'll take the others. So I think on the new store productivity, I think there's multiple factors. As we've gotten larger in our overall pool of stores, 285 stores, our data is getting better and better. So our site-selection process is better. Our construction team has done a great job of delivering a quality store. And certainly, our operations and training program upfront ahead of the store is better than ever. And lastly, in new markets, we've really seen a step-change especially when we entered Florida in our grassroots marketing and our community engagement to where the customers really know Sprouts even before we open the store. So it's a combination of site selection, operations, being in the community, all of those things are helping new store productivity. And the last comment on new store productivity is the deli shift that we're seeing. The -- from the data we can tell that when you have a new store opening with a deli, a customer walks in the first time, they see all these options and they know Sprouts for those options Day 1. When you don't have those Day 1, it takes longer to get the customer oriented and to attract new customers into the store for the 12 o'clock, 5 o'clock. So we're going to continue to roll out. We'll talk about it on the year-end call how many we'll do next year, but we'll continue to roll out on a methodical basis in our portfolio backwards till we see sort of returns flattening. When I say flattening, not being as productive, so we'll continue to go. And as far as new stores, most of the new stores are going to have this offering in it. So long answer, but I just wanted to cover -- I think I covered all 3 pieces. I'll let Jim add.

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

Chuck, the only part on the deli, in terms 130 is -- was called out on the script. So it's 45% of our -- roughly 45% of the stores, we projected that over the next 3 years would be roughly -- closer to 65% of our total population stores would have the deli elements in it. Again, there's some potential upside to that number just based on performance.

Operator

And our next question comes from the line of Alvin Concepcion with Citi.

Alvin C Concepcion - *Citigroup Inc, Research Division - VP and Senior Analyst*

You guys talked about many tools for next year like labor management, the business intelligence, programs to reduce shrink. Should we see margins expand next year? Or are there some investment costs offsetting some of the benefits from those initiatives? Should it be incremental is what I'm asking really.

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO, Principal Accounting Officer and Treasurer*

Thanks, Alvin, it's Brad. Yes, we're very excited about the opportunities that are before us that we're engaged in as we speak with regards to enhancing performance at store, improving shrink, driving incremental sales through these new automation tools. I think our perspective on it is that will absolutely create a margin opportunity for us and we'll be diligent in the determination of how much, when and where we believe it is necessary to reinvest any portion of those benefits to ensure that we maintain a very strong competitive value proposition in the market.

Operator

And our next question comes from the line of Shane Higgins from Deutsche Bank.

Shane Paul Higgins - *Deutsche Bank AG, Research Division - Research Analyst*

Just on the labor scheduling. I know as you guys continue to roll that out and gain other efficiencies, do you guys see an opportunity to bring your comp lever point down a little bit, maybe to 3%? I believe you guys have said historically somewhere closer to 3.5% to 4%.

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO, Principal Accounting Officer and Treasurer*

Yes. I think, we definitely see an opportunity to reduce the point at which we lever. We'll be implementing these systems throughout 2018, so we'll have some benefit in '18. But a real full year benefit as we get into 2019.

Shane Paul Higgins - *Deutsche Bank AG, Research Division - Research Analyst*

And Brad, do you see that as the biggest opportunity in terms of driving efficiencies and improving on that comp lever point?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO, Principal Accounting Officer and Treasurer*

We do. But we're also very excited about the connected customer program in terms of the updated mobile and web applications that we'll be rolling out in terms of driving incrementality, stronger loyalty, larger total share of wallet for the company.

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

The only other thing I would mention is on our fresh item management program is the opportunities in improved in-stock position for better sales, and as well as better shrink management through proper tools, and yet having all the products on the shelves especially in the fresh department throughout the day where the customers are seeing low, out of stocks, I think is super important when we think about customer experience. So I think that the fresh item management tool -- fresh item management program is going to help on both sales and margins.

Shane Paul Higgins - *Deutsche Bank AG, Research Division - Research Analyst*

Okay. And actually, as a follow-up, Amin, to that, I did notice your inventory per store levels have been coming down pretty nicely. Can you just talk about what some of the initiatives that you have in place that are kind of driving that? And how that is helping shrink? And do you expect those trends and improvements to continue?

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

Yes. I think that the -- some of the processes that we need to develop for the fresh item management tool and the fresh item management system, I'll call it, some of those learnings early on and inspecting those systems. We're starting to deploy this processes in the store, so that when the FIM tool is put in place, the stores can adopt to it quickly. And so as we've been implementing some of these processes into the store, that's having -- that certainly having benefits on in-stock position and ordering, better ordering and better in-stock. I do think of the company, overall, we have pretty significant opportunities in shrink over the next couple of years as we really get into our fresh item management system to allow our team members to order better in the -- in a more automated way in the fresh departments.

Operator

Our next question comes from the line of Scott Mushkin with Wolfe Research.

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

So again, a housekeeping question and then a question-question. So my housekeeping question is the CapEx spending. I know you guided up for the year, and I'm just wondering what was driving that. And then my question-question, is just on the competitive environment. I think the fear and obviously the equity performance has kind of lagged with the turnaround you guys have seen this year. And I think what we hear from people is just competition. You guys are going to start bumping into the other farmers' markets soon, like Lucky's and Fresh Thyme and of course, [literally] you're going to be bumping into them. And then you have Amazon, Whole Foods, obviously. And the Amazon team made comments about bringing now Fresh and Whole Foods together, but also ramping up their store growth. So just wondering, like if you see the competitive environment -- I know, I mean, you made some comments about some closures. Obviously, there's been a few, but it always takes -- it usually takes forever to get some of these assets closed. So there's a lot of fear around the competitive environment, so I wanted you to address that. So those are my 2 questions.

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO, Principal Accounting Officer and Treasurer*

Sure, Scott. I'll just clear out the housekeeping question. First of all, the slight increase in CapEx is related to some timing of store construction relative to timing of new stores opening in 2018 early, as well as just some additional upfront work with regards to our strategic projects that we spoke about on the call.

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

Yes, particularly some of the systems that are on the fresh item management and BI and labor management systems and the (inaudible) management system that we have alluded to. And on your question around competition, we actually monitor competitive intrusions and intrusion reports very, very closely. We have an intrusion report, early intrusion reports -- early report. And we've actually seen intrusion impact to Sprouts continue to come down, which has been good, continuing to come down over the past 12 months. And going into 2018, looking at the number of openings, we see that relatively flat year-over-year. So we didn't -- we don't believe that in 2018. '19 is kind of early to call because the visibility gets better 12 months out. So I don't -- we don't see intrusion and competition, looking from the visibility we have today, getting any worse. I think also having a balanced approach wherein 15 states today, we'll be in 18 states next year. And having a very balanced and openings in a lot of different regions allows us to flex where we see the greatest opportunities in any given 2, 3, 4 years cycle. So for the next 2, 3 years of visibility, we feel pretty good about our pipeline and direction of growth and flexibility of growth. And there's not a lot of bumping today. I can't speak to the Whole Foods comment you made. Don't know the plans -- their plans there. But on the other competitors you spoke about, there's not a lot of bumping there today. I think we know how well they operate. They know how well Sprouts operates. So we feel pretty good about the situation there.

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

Scott, just a quick add-on. In terms of new store growth, well, obviously, we're very responsible for the new store growth and looking at the competitors market and how we're positioned. So we're mindful of that as we grow. But as it relates to intrusion, what we've also done, as Amin said, the number of units is going to be relatively flat. But the team here has done a nice job of putting together some really strong competitive intrusion plans for those competitors that get within a certain distance and drive time. And the early indications are it's definitely proving our competitive position as we see those retailers come into our competitive marketplace.

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

So it's safe to say maybe the fears are, at least in the last -- next couple of years, that you don't see them materializing. And then, after that, we'll have to see what happens. Is that a -- maybe a good summary?

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

Yes. I mean, I think the fears are people feel that one or multiple people are going to bring prices down pretty significantly in the industry. And I think from what we're seeing is people have been fairly responsible in managing the business. And we're also, sort of as deflation is dissipating, we're seeing more -- a lot more discipline from the retailers who are doing well around pricing. Certainly, when somebody gets upside down and starts running negative traffic or deep negative traffic, they may be irresponsible for some period of time. But that tends to be short-lived and doesn't work. And that's been proven in '16, as we know, through the summer. Those retailers aren't doing that well today.

Operator

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

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

Maybe just a quick follow-up on that. You guys did mention earlier, I think, about seeing some cost pass-through. Can you give us a little more color on, is it -- you're seeing at the discounters or the independents or deep discounters or large conventionals? Maybe just a little more for us on what you are seeing.

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

And just a reminder, as we said, the promotional environment continues to be very aggressive. But at the shelf, we're just looking -- I'm going to only speak to the market share leader within each geography we have and you could triangulate that, and it's very stable. And as prices have started to come up, costs have started to come up. We've just seen people acting a little bit more fiscally responsible in late 2017 as opposed to 2016.

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

And maybe just one follow-up. Just egg prices, any color on what you're seeing most recently there?

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

Yes, that's a little bit different. Obviously, we've seen the cost go up on the PPI side. And that's PPI side, there's definitely a bit of a short squeeze there. But that's relative to conventional eggs. That's not the breadth and depth of what we sell. So as it relates to specialty eggs, it's been fairly neutral and the outlook is fairly flat to neutral on the cost basis.

Operator

And that concludes our question-and-answer session for today. I'd like to turn the floor back over to Amin for any closing comments.

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

I want to thank everybody for joining the call today. And hopefully we talked about clearly the strategies we talked about early in the year tend to be -- they are working, and we're looking forward to continuing the momentum into 2018. We'll see you -- speak to many of you soon. Thank you.

Operator

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